Chapter 2: Ethics

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Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

Enforcement is one means the IRS uses to reduce the tax gap. This not only includes enforcing the Internal Revenue Code related to income and expenses, it also includes scrutinizing the preparation of returns by tax preparers. The IRS released several notices in the past year pertaining to tax preparation. This chapter reviews some of these notices. In addition, there is a discussion at the end of the chapter about the tax professional's responsibility to protect client information in order to prevent identity fraud.

The IRS published proposed regulations on tax return preparer penalties on June 17, 2008. Final regulations are expected prior to December 31, 2008. The proposed regulations answer many of the questions regarding the way the IRS will interpret the IRC §6694 penalties. The new regulations are summarized on pages 56–59.

The IRS will assess §6694 penalties in appropriate cases. However, the IRS intends to modify its internal guidance so that a referral by revenue agents to the Office of Professional Responsibility (OPR) will not be mandatory when a §6694 penalty is assessed against a preparer who is a practitioner within the meaning of Circular 230.

In matters involving nonwillful conduct, the IRS will generally look for a pattern of failing to meet the required penalty standards under §6694(a) before making a referral to the OPR. A preparer may be referred to the OPR in the case of egregious conduct resulting in a penalty.

The IRS estimates the proposed rules will affect 38,566 tax return preparation firms and 260,338 self-employed tax return preparers that qualify as small entities.

PREPARER PENALTIES

Note. Although the majority of preparers do not intentionally prepare fraudulent returns, it is important for all preparers to understand the consequence of understating tax due, whether it is done intentionally or not. It is also important for preparers to understand how to support positions that could be construed as understatement of tax in order to avoid being liable for preparer penalties.

Congress passed the Small Business and Work Opportunity Tax Act of 2007 (SBWOTA) on May 25, 2007. This Act expanded the scope of tax preparer penalties to include all types of returns.[1] The phrase "income tax return preparer" was replaced by "tax return preparer."

1. IRC §7701(a)(36)

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For understatement of tax liability, the Act increased the amount of the return-preparer penalty from $250 to the **greater of** $1,000 or 50% of the income expected or received by the preparer for the return or refund claim. Further, the standard of conduct that must be met to avoid imposition of the penalty was amended in two ways:

1. The **realistic possibility** standard for undisclosed positions was replaced by an **unreasonable position** standard.[2]
2. For disclosed positions, the Act replaces the **nonfrivolous** standard with the requirement that there will be a **reasonable basis** for tax treatment of the position.

UNDERSTATEMENT DUE TO UNREASONABLE POSITIONS (NEW LAW)

Under the **unreasonable position** standard, the penalty is imposed if:

- The preparer knew, or reasonably should have known, of the position;
- There was not a reasonable belief that the tax treatment of the position would **more likely than not** be the proper treatment; and
- The position was not disclosed or there was not a reasonable basis for the position.

Under both the prior and current law, disclosure is adequate if made using:

- Form 8275, *Disclosure Statement;*
- Form 8275-R, *Regulation Disclosure Statement;* or
- IRS revenue procedures.

Under new law, the penalties apply unless there is a reasonable basis for the tax treatment. Unfortunately, the IRS has yet to define reasonable basis for these penalties. However, for accuracy-related penalties,[3] basing a position on one or more recognized authorities meets the reasonable basis standard. To meet this standard, the preparer must also take into account the relevance and persuasiveness of the authorities, as well as subsequent developments.

A **reasonable cause exception** applies if it is shown that there was reasonable cause for the understatement and the preparer acted in good faith.[4]

Prior to the amendment, a $250 penalty could be assessed if a tax preparer took a position that the IRS later ruled unrealistic. There must have been a realistic possibility that the position would be sustained on its merits. This pertained to an issue in which the preparer should have known or knew there was little chance it would be sustained. The penalty could also be assessed if it was a frivolous position. One possible way to avoid the penalty was to disclose the position on the original tax return.

The following examples help define the **unreasonable position** issue.

Example 1. Preparer Willis prepared Charlie Client's returns for many years. One position on Charlie's return was questionable, but there were no specific statutes regarding the deduction. In 2007, the IRS published a statute which specifically prohibited the deduction. If Willis fails to abide by the new statute on Charlie's current year return, he is considered to have known or should have known of the position, and there was no reasonable belief that the position would more likely than not be sustained on its merits (clearly, in view of the new statute). He could be subject to a penalty.

Note. Willis needs to tell Charlie that the prior year's return should be amended to reflect the new statute.

2. IRC §6694(a)(2)
3. Treas. Reg. §1.6662-3(b)(3)
4. Treas. Reg. §1.6664-4

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Example 2. Use the same facts as **Example 1.** Willis reads the committee report and finds that Congress did not intend this statute to apply to a business such as Charlie's. However, this is not stated in the statute. Following either the committee report or the statute is considered a realistic position. However, disclosure is required when following a committee report that constitutes a disregard of a rule or regulation.

REALISTIC POSSIBILITY STANDARD (OLD LAW)

A position meets the realistic possibility standard if a reasonable and well-informed analysis by a person with income tax law knowledge would conclude that the position has at least a **one-in-three or greater chance** of being sustained. However, the opinions found in legal periodicals or the opinions of other tax professionals do not constitute legal authority. The possibility the return will not be audited cannot be taken into account.

When making the one-in-three determination, the tax practitioner must understand what the IRS views as **substantial authority.**[5]

Only the following are considered substantial authority for purposes of determining the tax treatment of an item:

- Applicable provisions of the Internal Revenue Code and other statutory provisions;
- Proposed, temporary, and final regulations construing such statutes;
- Revenue rulings and revenue procedures;
- Tax treaties and regulations, and Treasury Department and other official explanations of such treaties;
- Court cases;
- Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- Private letter rulings and technical advice memoranda issued after October 31, 1976;
- Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
- Internal Revenue Service information or press releases; and
- Notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.

Practitioners should be cautious when using a Field Service Advice (FSA) as substantial authority. In a recent case, the court ruled that the taxpayer was liable for $473 million in tax and interest when it based a transaction on an FSA.[6] The IRS pointed out that an FSA is different than a private letter ruling. The IRS is bound by a private letter ruling, because it is based on exact facts presented by the taxpayer, and the taxpayer is entitled to a conference to discuss the ruling. An FSA is the opinion of an attorney in the Office of Chief Counsel based upon general facts and is provided at the request of field personnel. The taxpayer is not notified of the FSA and has no right to a conference with the IRS. The court agreed with the IRS.

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5. Treas. Reg. §1.6662-4(d)(3)(iii)

6. *Schering-Plough Corporation v. U.S.*, No. 2:05-cv-02575 (D.N.J. Dec. 3, 2007)

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Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not considered authority. However, the authorities underlying such expressions of opinion when applicable to the facts of a particular case may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. For example, in the case of court decisions, a District Court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for that district. However, a Tax Court opinion is not considered overruled or modified by a Court of Appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the Court of Appeals. Similarly, a private letter ruling is not authority if revoked or if it is inconsistent with a subsequent proposed regulation, revenue ruling, or other administrative pronouncement published in the Internal Revenue Bulletin.

Written Determinations

There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a(n):

- Ruling or a determination letter issued to the taxpayer,
- Technical advice memorandum in which the taxpayer is named, or
- Affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations").

However, the preceding authorities do not apply if:

1. There was a misstatement or omission of material facts that when subsequently developed are materially different from the facts on which the written determination was based, or
2. The written determination was modified or revoked after the date of issuance by:
    a. A notice to the taxpayer to whom the written determination was issued,
    b. The enactment of legislation or ratification of a tax treaty,
    c. A decision of the United States Supreme Court,
    d. The issuance of temporary or final regulations, or
    e. The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.

A written determination that is modified or revoked ceases to be authority on the date, and to the extent, that it is modified or revoked.

Taxpayer's Jurisdiction

The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

When Substantial Authority Is Determined

There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

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Transitional Relief (2007)

Originally, the new penalty structure applied to returns prepared after May 25, 2007. However, Notice 2007-54 provided transitional relief if the tax preparer made adequate disclosure of the questionable issue.[7] Disclosure was considered adequate if Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, was attached to the return.

The notice also provided that for all other returns, amended returns, and claims for refund, the reasonable basis standard, without regard to the disclosure requirements, is applied in determining whether the IRS will impose a penalty.

The notice applied to all returns due on or before December 31, 2007, and to 2007 employment and excise tax returns due on or before January 31, 2008. The notice also provided that transitional relief was not appropriate for tax return preparers who exhibited willful or reckless conduct, regardless of the type of return prepared.

Transitional Relief (2008)

The IRS released a second transitional relief statement in January 2008.[8] This notice acknowledged that Notice 2007-54 did not address a due date for amended returns and claims for refund. Notice 2008-11 clarified that Notice 2007-54 applies to timely amended returns or claims for refund (other than 2007 employment and excise tax returns) filed on or before December 31, 2007, and to timely amended employment and excise tax returns or claims for refund filed on or before January 31, 2008.

Notice 2008-11 applies to original returns, other than 2007 employment and excise tax returns filed on or before December 31, 2007, and to original employment and excise tax returns filed on or before January 31, 2008.

The notice also clarifies that Notice 2007-54 applies to advice given by nonsigning preparers for advice given on or before December 31, 2007.

NOTICE 2008-12 PREPARER SIGNATURE REQUIREMENTS

SBWOTA amended IRC §6695(b) to impose a penalty on a tax return preparer who fails to sign a return when required by regulations unless the failure is due to reasonable cause and not to willful neglect. The penalty is $50 for each failure to sign, with a maximum of $25,000 per person imposed for each calendar year.

If the tax return preparer is unavailable to sign the return, another tax return preparer may review the entire preparation of the return and then sign the return.

If more than one tax return preparer is involved in the preparation of a return, the preparer who has the primary responsibility for the overall substantive accuracy of the preparation is considered the return preparer.

Notice 2008-12 lists the returns and claims for refund that must be signed by the tax return preparer. The list may change when the IRS issues final regulations. The notice increases the list of 34 returns under the current regulations to 41 returns under SBWOTA.

IRC §6694(a) PENALTIES

Until Congress passed SBWOTA, the regulatory provisions governing tax return preparer penalties had remained substantially unchanged since the late 1970s. The IRS has issued proposed regulations governing tax return preparer penalties.

Prior to implementation of SBWOTA, an income tax return preparer was defined as any person who prepared an income tax return or a substantial portion of an income tax return for compensation. A tax return preparer is now defined as any person who prepares a tax return or a substantial portion of a tax return **for compensation** and is no longer limited exclusively to preparers of **income** tax returns.

7. IRS Notice 2007-54, IRB 2007-27

8. IRS Notice 2008-11, IRB 2008-3

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Currently, a tax return preparer includes any person who completes all or a substantial portion of a tax return or claim for refund for compensation. The amended law also subjects persons who perform a wide range of activities to the penalties if they do not sign the tax returns or claims for refund. These persons may have no knowledge of how their work is ultimately reported on the tax return or knowledge of the size or complexity of the schedule, entry, or other portion of the return relative to the entire tax return.

The current regulations broadly define the term "substantial portion" using a facts and circumstances test. The test compares the relative length, complexity, and tax liability of a particular schedule, entry, or other portion of the tax return to the length, complexity, and tax liability or the tax refund as a whole. Caselaw supports the current regulations. These deem the preparer of a Schedule K-1 for a partnership to be a preparer of a partner's income tax return on which the partnership items were reported if the Schedule K-1 constitutes a substantial portion of the partner's tax return.[9] It is possible that the preparer of an information return could be considered a tax return preparer if the amount reported on the information return constitutes a substantial portion of the income tax return. A person who prepares documents, such as depreciation schedules or cost, expense, or income allocation studies for compensation, could also be considered a preparer. Even though these documents do not report tax liability, they affect entries on a tax return, which thus affects tax liability.

SBWOTA also raises the standards of conduct for tax return preparers. For "undisclosed positions," it replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position will more likely than not be sustained on its merits. For "disclosed positions," it replaces the nonfrivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

More-Likely-Than-Not Standard

A preparer must reasonably conclude in good faith that there is **greater than 50% likelihood** that the tax treatment of the item will be upheld if challenged by the IRS.

Until regulations are issued, a tax return preparer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper tax treatment if she analyzes the pertinent facts and authorities in the manner described in Treas. Reg. §1.6662-4(d)(3)(ii). The weight accorded an authority depends on its relevant facts and persuasiveness, and the type of document providing the authority.

For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority for which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue.

An older private letter ruling, technical advice memorandum, general counsel memorandum, or action on decision generally must be accorded less weight than a more recent one. Any of these documents that is more than 10 years old is generally accorded very little weight. However, persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document.

There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.[10]

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9. *Goulding v. U.S.*, 717 F.Supp 545 (ND Ill 1989), *aff'd*, 957 F.2d 1420 (7th Cir. 1992)

10. Treas. Reg. §1.6662-4(d)(3)(ii)

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If a tax return preparer has a reasonable belief that the position would more likely than not be sustained on its merits, she may rely in good faith, without verification, upon information furnished by the taxpayer. She may also rely in good faith, without verification, upon information furnished by another advisor, tax return preparer, or third party. The tax return preparer is not required to independently verify or review the items reported on tax returns, schedules, or other third-party documents to determine if the items meet the standard requiring a reasonable belief that the position would more likely than not be sustained on its merits. However, the preparer may not ignore the implications of information furnished or actually known by the preparer. The preparer is required to make reasonable inquiries if the information furnished by another tax return preparer or a third-party appears to be incorrect or incomplete.

Example 3. Aaron prepares a Form 8886, *Reportable Transaction Disclosure Statement.* Aaron does not prepare the tax return or advise the taxpayer regarding the tax return reporting position of the transaction to which the Form 8886 relates. The preparation of the Form 8886 is not directly relevant to the determination of the existence, characterization, or the amount of an entry on a tax return or claim for refund. Rather, the Form 8886 is prepared by Aaron to disclose a reportable transaction. Aaron has not prepared a substantial portion of the tax return and is not considered a tax return preparer under §6694.

Example 4. Brenda prepares a partnership's Form 1065 (including Schedules K-1) allocating the partnership's losses among its partners in proportion to their original investment. Brenda is neither an employee of the partnership nor an employee of the general partner. Brenda knows that the loss deduction she calculated and claimed by one of the partners on that partner's tax return, if disallowed, is the most significant portion of the liability on that partner's tax return. Brenda has prepared a substantial portion of the partner's tax return and is considered a tax return preparer under §6694.

Example 5. Ernesto specializes in tax planning at a law firm and develops Strategy Y, a plan with a significant purpose of tax avoidance. Ernesto provides Strategy Y advice to 50 taxpayers. The 50 taxpayers implement Strategy Y in a manner that significantly reduces the federal tax liability that would otherwise be reported on their tax returns. After Strategy Y is entered into, Ernesto advises each of the 50 taxpayers on the reporting of specific amounts he knows will be placed on the tax return for each of the 50 taxpayers.

Ernesto knows that the tax liability involved in this entry, if disallowed, is a significant portion of the tax liability for each of the tax returns. Neither Ernesto nor any other person associated with Ernesto's firm signs the taxpayer's tax returns as a tax return preparer. The advice relating to Strategy Y constitutes preparation of a substantial portion of each of the 50 taxpayers' tax returns. Thus, Ernesto is a tax return preparer under §6694.

Example 6. During an interview conducted by Preparer Hal, a taxpayer stated that he had made a charitable contribution of real estate in the amount of $50,000 during the tax year. In reality, the taxpayer did not make this charitable contribution. Hal did not inquire about the existence of a qualified appraisal or complete a Form 8283, *Noncash Charitable Contributions,* in accordance with the reporting and substantiation requirements. Hal reported the deduction on the tax return for the charitable contribution. This resulted in an understatement of tax liability. Hal is subject to a penalty under §6694.

Example 7. A corporate taxpayer hires Accountant Jill to prepare its tax return. Jill encountered an issue regarding various small asset expenditures. She researches the issue and concludes that there is a reasonable basis for a particular treatment of the issue. However, Jill cannot reach a reasonable belief about whether the position would more likely than not be sustained on its merits, because it was impossible to make a precise quantification. The position is not disclosed on the tax return. Jill signs the tax return as the tax preparer. The IRS later disagrees with this position taken on the return. Jill is **not** subject to a penalty under §6694.

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Example 8. Attorney Linda advises a large corporate taxpayer in writing concerning the proper treatment of complex entries on the corporate taxpayer's tax return. Linda knows that the tax liability involved in these entries, if disallowed, is a significant portion of the tax liability for the tax return. When providing the advice, Linda concludes that one position does not meet the reasonable belief standard that the position would more likely than not be sustained on its merits. It also does not have substantial authority, although the position meets the reasonable basis standard. Linda, in good faith, advises the corporate taxpayer in writing that the position lacks substantial authority, and the taxpayer will be subject to an accuracy-related penalty under §6662 unless the position is disclosed in a statement included in the return. Linda also documents the fact that this advice was contemporaneously provided to the corporate taxpayer in writing at the time the advice was provided. The corporate taxpayer decides not to include a disclosure statement in the return. Neither Linda nor any other attorney associated with Linda's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by Linda constitutes preparation of a substantial portion of the tax return. Thus, Linda is a tax return preparer for purposes of §6694. Fortunately, Linda is not subject to a penalty under §6694.

NOTICE 2008-14[11]

In an attempt to reduce the number of frivolous tax returns, Congress increased the penalty for frivolous returns from $500 to $5,000 in 2006.[12] The penalty is imposed on any person who submits a **specified frivolous submission.** A submission is classified as frivolous if any portion of the submission is based on a position the IRS has identified as frivolous or reflects a desire to delay or impede administration of the federal tax laws.

Following enactment of the Tax Relief and Health Care Act, the IRS released a list of 39 positions classified as specified frivolous submissions.[13] Notice 2008-14 adds four more positions the IRS deems frivolous. They are:

1. The Ninth Amendment exempts those with religious or other objections to military spending from paying taxes to the extent the taxes will be used for military spending.
2. Only fiduciaries are taxpayers, or only persons with a fiduciary relationship to the United States are obligated to pay taxes, and the United States or the IRS must prove the fiduciary status or relationship.
3. A taxpayer who is employed on board a ship that provides meals at no cost to the taxpayer as part of the employment may claim a so-called "Mariners Tax Deduction" allowing the taxpayer to deduct from gross income the cost of the meals as an employee business expense.
4. A taxpayer may claim the fuels tax credit, which is limited to gasoline used in an off-highway business use, even though the taxpayer did not purchase and use gasoline during the taxable period for which the credit is claimed for an off-highway business use. In addition, the taxpayer claims an amount of refund that is so disproportionately excessive to any (including zero) business income reported on the taxpayer's income tax return as to be patently unallowable. For example, a credit that is 150% of business income reported on Form 1040 or facially reflects an impossible quantity of gasoline given the business use, if any, as reported by the taxpayer.

WHEN DISCLOSURE IS ADEQUATE FOR REDUCING THE PENALTY

IRC §6662 applies a 20% penalty to any portion of an underpayment of tax required to be shown on a return. The penalty rate is 40% in the case of gross valuation misstatements. An understatement of income tax is considered substantial if the amount of the understatement exceeds the greater of 10% of the amount of tax required to be shown on the return for the year or $5,000.

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11. IRS Notice 2008-14, IRB 2008-4
12. Tax Relief and Health Care Act of 2006, Pub. L. 109-432
13. IRS Notice 2007-30, IRB 2007-14

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IRC §6694(a) imposes a penalty on a tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position of which of the preparer knew or should have known. This applies if the preparer did not have a reasonable belief that the position would more likely than not be sustained on its merits and the position was not disclosed. This penalty is equal to the greater of $1,000 or 50% of the income derived by the preparer for the return or claim.

Rev. Proc. 2008-14 identifies circumstances under which disclosure on a taxpayer's return is adequate for the purpose of reducing the understatement of income tax under IRC §6662(d) and for the purpose of avoiding the preparer penalty under §6694(a).[14]

To comply with Rev. Proc. 2008-14:

1. Additional disclosure of facts or positions taken is not required as long as the forms and attachments are completed in a clear manner and in accordance with their instructions.
2. The monetary amounts entered on the form must be verifiable. A number is considered verifiable if the taxpayer can demonstrate the origin of the number, even if that number is not ultimately accepted by the IRS. The taxpayer must also show good faith in entering that number on the applicable form.
3. The disclosure of an amount is not adequate if the understatement arises from a transaction between related parties. If an entry may present a legal issue or controversy because of related-party transactions, that transaction and the relationship must be disclosed on Form 8275, *Disclosure Statement,* or Form 8275-R, *Regulation Disclosure Statement.*
4. When the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category), the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt. If space limitations on the form do not allow for an adequate description, the description must be continued on an attachment.
5. Although a taxpayer may literally meet the disclosure requirements of this revenue procedure, the disclosure will not prevent a §6662 accuracy-related penalty if the item or position on the return:
   a. Does not have a reasonable basis,
   b. Is attributable to a tax shelter item, or
   c. Is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position.

Rev. Proc. 2008-14 lists all of the items necessary to meet the adequate disclosure provisions when:

- Completing Form 1040, Schedule A, *Itemized Deductions,*
- Reporting certain trade or business expenses,
- Reporting differences in book and income tax reporting,
- Completing Schedule M-1 and all Schedules M-3,
- Reporting foreign tax items, and
- Reporting other items.

14. Rev. Proc. 2008-14, IRB 2008-7

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FORM 8275

Many tax practitioners have not been in a position where they were required to attach Form 8275, *Disclosure Statement*, to a tax return. However, the increased penalties may cause more practitioners to consider filing this form.

Some preparers are filing the form to disclose situations such as the following:

Example 9. Jared, a farmer in Illinois, rented 240 acres of farmland to a family partnership which included Jared and his two children. He owned a 33% interest in the partnership. The partnership agreement specified each partner had an equal vote and was required to work full time in the operation. The lease was on a 30% crop-share basis and the partnership paid the crop expenses. In 2007, Jared's accountant considered the arrangement as a nonmaterial participation lease and did not reflect the rental amounts as SE income. The accountant was relying on the ruling rendered in the *Mizell* case.

In order to avoid penalties, Jared's accountant filed the Form 8275 shown on the following page.

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For Example 9

Form **8275**
(Rev. May 2001)
Department of the Treasury
Internal Revenue Service

Disclosure Statement

Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement.
See separate instructions.
► Attach to your tax return.

OMB No. 1545-0889
Attachment Sequence No. **92**

Name(s) shown on return: **Jared**
Identifying number shown on return:

Part I **General Information** (see instructions)

(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1 Mizell v Comm'r TC Memo 1995-571; 70 TCM 1469	Rent	Lease payments from partnership to partner	E	-	44,000
2					
3					

Part II **Detailed Explanation** (see instructions)

1 The taxpayer is located in the 7th Circuit. The Mizell case was decided in the 8th Circuit. The taxpayer is aware of the difference in opinions of the 7th and 8th Circuits. However, he feels his involvement as lessor and lessee does not rise to the level of material participation needed to warrant self-employment income treatment for the rental income. The decision reached in the 8th Circuit was the same decision in the Bot, Hennen and McNamara cases decided in the 8th Circuit.

2

3

Part III **Information About Pass-Through Entity.** To be completed by partners, shareholders, beneficiaries, or residual interest holders.

Complete this part only if you are making adequate disclosure for a pass-through item.

Note: *A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).*

1 Name, address, and ZIP code of pass-through entity	2 Identifying number of pass-through entity
	3 Tax year of pass-through entity / / to / /
	4 Internal Revenue Service Center where the pass-through entity filed its return

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61935M Form **8275** (Rev. 5-2001)

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SUMMARY OF POSSIBLE TAX PREPARER PENALTIES

With the increased emphasis on tax preparer penalties, it is important to review the Code sections under which preparer penalties can be assessed.

The American Jobs Creation Act (AJCA) of 2004 created a major enforcement tool for the IRS. It extended the assessment of penalties to the company level. In the past, the IRS could only assess monetary penalties against the tax preparer. The assessed penalty was also limited to a fixed dollar amount. With AJCA enactment, the IRS is permitted to assess penalties against the tax preparer's employer. The amount of the penalty is only limited by 50% of the fees collected for the infraction.

Below are some of the preparer penalties that can be assessed by the IRS.[15]

Violation	Amount	Employee	Employer	IRC Section
Understatement of taxpayer's liability due to unrealistic positions	Greater of $1,000 or 50% of income derived	Y	Y	6694(a)
Willful attempt to understate liability or reckless or intentional disregard of rules	Greater of $5,000 or 50% of income derived	Y	Y	6694(b)
Failure to furnish copy of return to taxpayer	$50 per failure	Y	N	6695(a)
Failure of preparer to sign return	$50 per failure	Y	Y	6695(b)
Failure to furnish identifying numbers	$50 per failure	Y	N	6695(c)
Failure to maintain copies of the returns prepared or maintain a listing of clients	$50 per failure	Y	N	6695(d)
Failure to file information returns required by IRC §6060	$50 per failure	Y	N	6695(e)(1)
Failure to provide all information required under IRC §6060	$50 per item	Y	N	6695(e)(2)
Endorsing or negotiating a tax refund check	$500 per check	Y	Y	6695(f)
Failure to comply with due diligence for EIC	$100 per failure	Y	Y	6695(g)
Promoting abusive tax shelters	$1,000 per activity or, if less, 100% of income derived	Y	Y	6700
Aiding and abetting understatements	$1,000 per return ($10,000 per corporate return) per preparer	Y	Y	6701
Improper disclosure or use of information	$250 per disclosure	Y	Y	6713
Fraud and false statements	$100,000 fine ($500,000 in the case of a corporation) and/or 3 years imprisonment	Y	Y	7206
Willful delivery or disclosure of fraudulent documents or information to the IRS	$10,000 fine ($50,000 in the case of a corporation) and/or 1 year imprisonment	Y	Y	7207
Unauthorized disclosure of taxpayer information	$1,000 fine and/or 1 year imprisonment and prosecution costs	Y	Y	7216

15. *2005 University of Illinois Federal Tax Workbook*, page 117, updated to reflect new law.

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PENALTY ASSESSMENT PROCESS

The Internal Revenue Manual was revised on February 8, 2008, to reflect the new penalty guidelines. An examiner is not allowed to discuss the possibility of assessing a preparer penalty in front of the taxpayer.[16] Most preparer penalties must be assessed within three years from the time the return is filed. However, the penalty for willful understatement of liability may be assessed at any time. This penalty has no statute of limitations.

Prior to assessing a preparer penalty for statement of liability, the IRS sends a report of the examination to the preparer. They also send a 30-day letter notifying the preparer of the proposed penalties, and a demand for payment is made. The preparer must make a 15% payment and then file a claim for refund. Within 30 days after the claim is denied, the preparer may bring suit. The suit can be filed within 30 days after the expiration of the 6-month period beginning on the date the claim for refund was filed. The IRS cannot begin collection proceedings on the penalty until the court makes its final decision.

In order to have a penalty abated, the preparer must prove at least one of the following:

- The position taken was adequately disclosed.
- The preparer did not know or could not have known that the questioned position was taken on the return.
- There was reasonable cause and good faith concerning the position.

If it is determined that the tax liability was not understated, the penalty is abated.

USE OF RETURN INFORMATION

In January 2008, the IRS updated the regulations concerning the disclosure and use of tax return information by tax preparers with Treas. Dec. 9375.[17] They also finalized the regulations regarding the taxpayer's consent to use this information. The updated regulations strengthen the taxpayers' ability to control their tax return information by requiring that tax return preparers give the taxpayers specific information, including who will receive the tax return information and the particular items of tax return information that will be disclosed or used. This allows taxpayers to make informed and voluntary decisions about the disclosure or use of their tax information by their tax preparer.

The regulations are a part of IRC §7216. They impose criminal penalties on tax preparers who knowingly or recklessly make unauthorized disclosure or uses of information furnished to them in connection with the preparation of an income tax return. Preparers are also subject to civil penalties under §6713 unless there is an exception under the rules of §7216(b).

The regulations provide that a tax return preparer may only disclose or use tax return information to prepare a tax return. Use for other than the specific purpose of preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of any tax return of the taxpayer is a misdemeanor. The violator may be fined up to $1,000, imprisoned not more than one year, or both, and is responsible for the costs of prosecution. This applies to more than the person who actually meets with the client and signs the tax return.

16. IRM 20.1.6.1.3

17. TD 9375, January 4, 2008, corrected February 12, 2008

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TAX RETURN PREPARER

The term "tax return preparer" means:[18]

1. Any person engaged in the business of preparing tax returns;
2. Any person engaged in the business of providing auxiliary services in connection with the preparation of tax returns;
3. Any person paid for preparing or assisting in preparing a tax return for any other person, including friends, relatives, or acquaintances, even when the return is not prepared in the course of a business;[19] or
4. Any person performing services in support of those listed above who assists in the preparation of, or assists in providing auxiliary services in connection with, a tax return.

Example 10. Acme State Bank provides a tax preparation service. One of their employees solicits the necessary tax return information for the preparation of a tax return. Another employee prepares the return based on the information that is furnished. Under these circumstances, both employees are tax return preparers. In addition, if a secretary is used to type, input data, or otherwise work on returns prepared by the tax return preparer, the secretary is considered a tax return preparer.

The regulations also apply to a person engaged in the business of preparing tax returns. The regulations apply if, in the course of his business, he holds himself out to taxpayers as a person who prepares tax returns, whether or not tax return preparation is his sole business activity, and whether or not he charges a fee for the services.[20]

A person providing auxiliary services in connection with the preparation of a tax return is considered a preparer if he holds himself out to tax return preparers or to taxpayers as a person who performs such services, whether or not these services are his sole business activity and whether or not he charges a fee for these services.[21]

Example 11. Angelo provides a computerized tax return processing service based on tax return information furnished by another person. Angelo is considered a tax return preparer.

Example 12. Sheila is in the business of selling insurance. A friend tells Sheila he is having a problem filing his income tax return. Sheila offers to help him complete the return. In appreciation of her help, he pays her $10. Sheila falls under these regulations as a tax return preparer.

A person is not a tax return preparer merely because the person leases office space to a tax return preparer, furnishes credit to a taxpayer whose tax return is prepared by a tax return preparer, or otherwise performs some service which only incidentally relates to the preparation of tax returns.

Example 13. Hometown Department Store leases space to a tax return preparer. They advertise that taxpayers who use the tax return preparation service may charge the cost of having their tax return prepared to their charge account with the department store. The department store is not a tax return preparer.

TAX RETURN INFORMATION

The term **tax return information** applies to any information which is furnished in any form or manner by a taxpayer in connection with the preparation of the tax return. Examples include, but are not limited to, name, address, or identifying numbers. Tax return information includes information furnished by the taxpayer or by any person on behalf of the taxpayer.[22]

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18. Treas. Reg. §301.7216-1(a)(2)
19. Treas. Reg. §301.7216-1(b)(2)(iv)
20. Treas. Reg. §301.7216-1(b)(2)(ii)
21. Treas. Reg. §301.7216-1(b)(2)(iii)
22. Treas. Reg. §301.7216-1(b)(2)(v)

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Information is considered "in connection with tax return preparation" if the taxpayer would not furnish the information except when intending to use or using the services of a tax return preparer to prepare a tax return.[23]

Example 14. Taxpayer Ashley purchases computer software designed to assist in the preparation and filing of her income tax return. When Ashley installs the software on her computer, it prompts her to register her purchase. In this situation, the software provider is a tax return preparer. The information Ashley provides to register her purchase is **tax return information** because she is providing it in connection with the preparation of a tax return.

Example 15. Acme Brokerage is a brokerage firm that maintains a website through which its clients may access their accounts, trade stocks, and generally conduct a variety of financial activities. Through its website, Acme offers its clients free access to its own tax preparation software.

Taxpayer Bart is a client of Acme. He furnished Acme with his name, address, and other information when he registered to use Acme's website for brokerage services. Acme has a record of Bart's brokerage account activity, including sales of stock, dividends paid, and IRA contributions made. Bart uses Acme's tax preparation software to prepare his tax return. The software populates some fields of Bart's return on the basis of information Acme already maintains in its databases.

Acme is a tax return preparer, because it has prepared and provided software for use in preparing tax returns. The information in Acme's databases that the software accesses to populate Bart's return — the registration information and brokerage account activity — is not considered tax return information because Acme did not receive that information in connection with the preparation of a tax return.

Once Acme uses the information to populate the return, it is now considered information associated with the return and becomes tax return information. If Acme retains the information in a format in which Acme can identify that the information was used in connection with the preparation of a tax return, the information in that format is considered tax return information. However, if Acme retains the information in a database in which Acme cannot identify whether the information was used in connection with the preparation of Bart's return, then that information is not considered tax return information.

Tax return information includes statistical compilations of tax return information, even in a format that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. A tax preparer is permitted to use the statistical information in the internal management or support of his tax preparation business. However, he may not disclose or use the information in connection with, or in support of, businesses other than the tax return preparation. He may not disclose a compilation to any other person unless disclosure is made in order to comply with financial accounting or regulatory reporting requirements. He may use the statistical information in conjunction with the sale or other disposition of his tax return preparation business.[24]

Tax return information may be disclosed for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The review may be conducted only by attorneys, certified public accountants, enrolled agents, and enrolled actuaries who are eligible to practice before the IRS. No return information identifying a taxpayer may be disclosed in any evaluative reports or recommendations that may be accessible to any person other than the reviewer or the tax return preparer being reviewed. The return preparer must maintain a record of the review, including the information reviewed and the identity of the persons conducting the review. After completing the review, no documents containing information that identifies any taxpayer by name or identification number may be retained by the reviewer or his administration or support personnel. Any person, including administrative and support personnel, receiving tax return information in connection with a quality or peer review is considered a tax return preparer.

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23. Treas. Reg. §301.7216-1(b)(3)

24. Treas. Reg. §301.7216-1(b)(3)(B)

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USE OF TAX RETURN INFORMATION

Use of tax return information includes any circumstance in which a tax return preparer refers to or relies upon tax return information as the basis to take or permit an action.

> **Example 16.** Gina is a tax return preparer. She also sells securities. When preparing a tax return, Gina determines that a taxpayer is eligible to make a contribution to an IRA. She asks whether the taxpayer desires to make a contribution. Gina does not ask about IRAs in cases in which the taxpayer is not eligible to make a contribution. She is using tax return information to determine what action to take. When Gina asks about IRA contributions based upon knowledge gained from information that the taxpayer furnished in connection with the preparation of the taxpayer's return, she is in violation of §7216.

Occasionally, a return preparer discloses one taxpayer's return information when preparing the tax return of a second taxpayer. The preparer may disclose information from the first taxpayer's return if:[25]

- The second taxpayer is related to the first taxpayer as described below,
- The first taxpayer's tax interest in the information is not adverse to the second taxpayer's interest in the information, and
- The first taxpayer does not expressly prohibit such disclosure or use.

The first taxpayer must be related to the second taxpayer in any one of the following relationships:[26]

- Husband and wife,
- Child and parent,
- Grandchild and grandparent,
- Partner and partnership,
- Trust or estate and beneficiary,
- Trust or estate and fiduciary,
- Corporation and shareholders, or
- Members of a controlled group of corporations.

If a taxpayer furnishes tax return information to a preparer located within the United States, including any territory or possession of the United States, the tax information may be disclosed to another employee of the same firm. This is permitted for the purpose of performing services that assist in the preparation of, or assist in providing auxiliary services in connection with, the taxpayer's return. However, if the other member of the tax preparation firm is located outside of the United States or any territory or possession of the United States, the taxpayer's consent is required prior to any disclosure.[27]

> **Example 17.** Thomas is a client of ABC Tax Preparers. Edward is an employee at ABC's Illinois office. He receives the tax information from Thomas. In order to complete the return, Edward discloses the information to Paul, who is an employee of ABC's Indiana office. ABC is not required to acquire Thomas's consent prior to the disclosure of the return information because it is disclosed to an employee of the same tax return preparer located within the United States.

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25. Treas. Reg. §301.7216-2(b)(1)
26. Treas. Reg. §301.7216-2(b)(2)
27. Treas. Reg. §§301.7216-2(c)(2) and (3)

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Example 18. Use the same facts as **Example 17,** except Paul is located in ABC's Nepal office. In this situation, ABC must obtain Thomas' consent prior to transferring the information to Paul.

Even if Thomas agrees to allow the information to be disclosed to the Nepal office, Thomas' social security number must be redacted from all disclosed information.[28]

WRITTEN CONSENT FROM TAXPAYER

If a tax return preparer obtains consent from the taxpayer, the preparer may use tax return information to solicit additional current business in matters not related to the IRS for services which he provides and offers to the public. The consent request must be made no later than the time the taxpayer receives his completed tax return. If the request is not granted, the preparer cannot make a follow-up request. Even if the taxpayer consents to the use of the tax information to solicit other services, the consent only applies to the tax preparer. For example, it does not allow the tax preparer to give a nonmember of the firm the taxpayer's name in order to solicit other services.[29]

A separate signed written consent must be obtained for each separate use or disclosure. The consent must contain:[30]

- The name of the tax return preparer,
- The name of the taxpayer,
- The purpose for the consent,
- The date on which the consent is signed,
- A statement that the tax return information may not be disclosed or used by the tax return preparer for any purpose other than that stated in the consent, and
- A statement by the taxpayer that he consents to the disclosure or use of the information for the purposes described.

Example 19. In order to increase the number of loans it makes, First Bank advertises that it also prepares tax returns. Marshall goes to First Bank to have his tax return prepared. After the return is completed, the tax preparer who obtained the tax return information from Marshall explains that he owes an additional $400 in taxes, and the bank loan department may be able to offer Marshall a loan to pay the tax due. If Marshall decides to accept the opportunity offered to apply for a loan, First Bank must obtain written consent to use any of the tax return information which was used to determine whether to make the loan.

Example 20. Linda sells life insurance and mutual fund shares. She also is in the business of preparing tax returns. Patty hired Linda to prepare her tax return. At the time Patty picks up her completed return, she is asked to consent to Linda using her tax information to prepare a quote for a life insurance policy and to suggest a purchase of mutual fund shares. Before Linda may use the return information, Patty must execute **separate** written consents; one authorizing the use of the information as a basis for soliciting the sale of mutual fund shares, and a second authorizing the use of the information as a basis for soliciting the sale of life insurance.

A taxpayer must provide written consent before a return preparer discloses or uses the taxpayer's tax return information. A preparer may not request consent to disclose or use tax information for purposes of solicitation of business unrelated to the tax return preparation after the preparer provides a completed tax return for the taxpayer to sign. If the taxpayer declines a request for consent to disclose or use the tax information for purposes of solicitation of business unrelated to the tax return preparation, the preparer may not solicit another consent for a purpose substantially similar to the rejected requests.

The tax preparer must provide a copy of the executed consent to the taxpayer at the time of execution.

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28. Treas. Reg. §301-7216-3(b)(4)
29. Treas. Reg. §301.7216-3(a)(1)(i)
30. Treas. Reg. §301.7216-3(b)

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EFFECTIVE DATE

The new regulations, as amended by TD 9375, apply to disclosures and uses of tax return information occurring on or after January 1, 2009.

CONTINGENT FEES

In an attempt to clarify Section 10.27(b)(2) of Circular 230, the IRS released Notice 2008-43 on March 26, 2008. This notice will become part of the final regulations. It allows a tax practitioner to charge a contingent fee for services rendered in connection with the IRS examination or challenge of:

- An original tax return,
- An amended return or a claim for a refund or credit filed before the taxpayer received a written notice of examination of or a written challenge to the original return, or
- An amended return or a claim for a refund or credit filed no later than 120 days after the receipt of a written notice or written challenge. The 120 days is computed from the earlier of a written notice of the examination, if any, or a written challenge to the original return.

The tax practitioner may also charge a contingent fee for services rendered in connection with:

- A claim for refund or credit filed solely in connection with the determination of statutory interest or penalties assessed by the IRS,
- A claim under the whistleblower provisions of IRC §7623, and
- Any judicial proceeding arising under the Internal Revenue Code.

The new rules are applicable to fee arrangements entered into after March 26, 2008.

PROPOSED REGULATIONS

FURNISHING COPY OF THE TAX RETURN

Tax preparers are required to furnish the taxpayer with a copy of the prepared return.[31] The proposed regulations amend this provision for electronically filed Forms 1040EZ and 1040A for tax years 2009, 2010, and 2011. The amendment allows the preparer to provide a replica of Form 1040.

DATE RETURN IS PREPARED

The date a return is prepared is considered the date it was signed by the return preparer. If the return is not signed, the preparation date is deemed the date the return is filed. The relevant date for a nonsigning return preparer is the date the person provided the advice on the position that resulted in the underpayment.[32]

DEFINING THE PREPARER WITHIN A FIRM

The current regulations provide a "one preparer per firm" rule. If a signing preparer is associated with a firm, that individual, and no other individual in the firm, is treated as the return preparer with respect to a §6694 penalty.[33]

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31. Treas. Reg. §1.6107-1(a)
32. Prop. Treas. Reg. §1.6694-1(a)(2)
33. Prop. Treas. Reg. §1.6694-1(b)(1)

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The proposed regulations use a position-by-position basis and focus on the position(s) creating the understatement. Only one preparer is considered primarily responsible for each position and is assessed the penalty.[34] If multiple positions create the understatement, more than one preparer can be subject to the §6694 penalty.

The individual that signs the return is generally considered the person primarily responsible for all positions on the return. If the signing preparer provides relevant information that another person within the same firm was primarily responsible for the position which resulted in the underpayment, the non-signing individual will be liable for a penalty.[35] A similar rule applies when there are one or more nonsigning preparers at the same firm.[36] The proposed regulations make it possible for a nonsigning preparer to be liable for the penalty rather than the signing preparer.

RELIANCE ON INFORMATION PROVIDED

Currently, a preparer may rely in good faith and without verification on information furnished by the taxpayer. The proposed regulations provide similar reliance with one exception. The preparer may not rely on information provided by the taxpayer with respect to legal conclusions on federal tax issues.[37]

The preparer may rely in good faith and without verification on information furnished by another adviser or return preparer even when that individual is within the same firm. The preparer may also rely upon a tax return that was previously prepared by the taxpayer or another return preparer and filed with the IRS. However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer and must make reasonable inquiries if the information appears to be incorrect or incomplete.

INCOME DERIVED DETERMINATION IN COMPUTING PENALTY AMOUNT

The definition of "income derived (or to be derived)" with respect to a return includes all compensation the preparer receives or expects to receive for the engagement.[38] This includes research and consultation related to the position(s) taken on the return that gives rise to the understatement. If the preparer was not compensated directly by the taxpayer, but was paid by a firm that employs him, "income derived" means all compensation received from the firm that can reasonably be allocated to the engagement related to the position taken that created the understatement.

The proposed regulations clarify that only compensation for time spent regarding the tax advice which resulted in the position(s) creating the understatement are used to calculate the §6694 penalty. Based upon information received from the preparer, it may be concluded that the number of hours spent on the erroneous position(s) is less than the total time spent on the engagement. If so, the penalty is based only on the compensation pertaining to the erroneous position(s). The penalty will not exceed 50% of the compensation determined above.

FIRM LIABILITY

The firm is also liable for a §6694 penalty if it is determined the review procedures were disregarded by the firm through willfulness, recklessness, or gross indifference in the formulation of the advice, or the preparation of the return.[39]

REASONABLE BELIEF OF "MORE-LIKELY-THAN-NOT STANDARD"

The "reasonable belief that the position would more likely than not be sustained on its merits" standard is satisfied if the preparer analyzes the pertinent facts and authorities. In reliance upon that analysis, the preparer must reasonably conclude that the position has a greater than 50% likelihood of being sustained on its merits. In determining whether the preparer meets this standard, the IRS looks at all facts and circumstances including the preparer's due diligence. The IRS looks at the preparer's experience in the area of the tax law in question, familiarity with the taxpayer's affairs, and the complexity of the issues and facts in the case.

34. Prop. Treas. Reg. §1.6694-1(b)(1)
35. Prop. Treas. Reg. §1.6694-1(b)(2)
36. Prop. Treas. Reg. §1.6694-1(b)(3)
37. Prop. Treas. Reg. §1.6694-1(e)
38. Prop. Treas. Reg. §1.6694-1(f)
39. Prop. Treas. Reg. §§1.6694-2(a)(2) and 3(a)(2)

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The proposed regulations also provide that a preparer may meet the "reasonable belief" standard if the position is supported by a well-reasoned construction of the applicable statute despite the absence of other types of authority. The preparer also meets the standard if he relies on information or advice furnished by third parties.[40] However, the preparer may not rely on unreasonable assumptions.[41]

REASONABLE BASIS

The proposed regulations do not change the "reasonable basis" standards found in the old regulations. However, the proposed regulations add that the preparer could rely in good faith and without verification on information furnished by a third party even if that party is within the preparer's same firm.[42]

ADEQUATE DISCLOSURE

The proposed regulations build on the current regulations and the interim guidance provided in Notice 2008-13.[43] This allows for disclosure of a position for which there is a "reasonable basis" but when the preparer does not believe the position will be sustained on its own merits and meet the more-likely-than-not standard.[44]

The proposed regulations list five ways to disclose a position:

1. File Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, as appropriate and include it with the taxpayer's return.
2. For income tax returns, if the position does **not** meet the substantial-authority standard, disclosure is adequate if the preparer provides the taxpayer with a prepared tax return that includes the appropriate disclosure.
3. For income tax returns, if the position meets the substantial-authority standard, disclosure is adequate if the preparer advises the taxpayer of all the penalty standards applicable under §6662.
4. For income tax returns, if the position may be described as a tax shelter, disclosure of the position is adequate if the preparer advises the taxpayer that there needs to be a minimum "substantial authority" for the position. The taxpayer must possess a "reasonable belief that the tax treatment was more likely than not" the proper treatment. The disclosure does not protect the taxpayer from the accuracy-related penalty.
5. For returns or refund claims subject to penalties other than the accuracy-related penalty for substantial understatements, the preparer must advise the taxpayer of the penalty standard under §6662.

For a nonsigning tax return preparer, the position may be disclosed in one of three ways:

- The position may be disclosed on Forms 8275 or 8275-R.
- The nonsigning preparer may advise the taxpayer of all opportunities to avoid penalties that could apply to the position and advise the taxpayer of the standards for disclosure.
- The nonsigning preparer may advise the return preparer that disclosure may be required.

> **Caution.** No form of a general boilerplate disclaimer satisfies the above standards.

The preparer of a pass-through entity return need only make disclosure to the entity. He does not need to make disclosure to each Schedule K-1 recipient.[45]

40. Prop. Treas. Reg. §1.6694-2(b)(1)
41. Prop. Treas. Reg. §1.6694-2(B)(2)
42. Prop. Treas. Reg. §§1.6694-2(c)(1) and (2)
43. Prop. Treas. Reg. §1.6694-2(c)(3)
44. Prop. Treas. Reg. §1.6694-2(c)(3)
45. Prop. Treas. Reg. §1.6692-4(f)(5)

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REASONABLE CAUSE

The reasonable-cause rules of the current regulations are unchanged except for a proposed revision. This revision provides that whether a position is supported by a generally-accepted administrative or industry practice is an additional factor to consider in determining whether the return preparer acted with reasonable cause in good faith.[46]

ELECTRONICALLY-SIGNED RETURNS

In the case of an electronically-signed tax return, a preparer does not need to sign the return prior to presenting a completed copy of the return to the taxpayer. The preparer must furnish all the information to the taxpayer contemporaneously by furnishing Form 8879, *IRS e-file Signature Authorization*, or a similar IRS e-file signature form.[47]

DUE DILIGENCE FOR EARNED INCOME CREDIT

The proposed regulations establish a reasonableness standard for the "signing tax return preparers" due-diligence requirements with respect to determining eligibility for the earned income credit. Examples are also added.[48]

> **Note.** See Chapter 8, "IRS Update," for more detailed information on the due diligence requirements.

CLAIMS FOR REFUND OR CREDIT BY TAX RETURN PREPARERS OR APPRAISERS

The proposed regulations also discuss procedures for filing claims for credit or refund of assessed penalties.[49]

DEFINITION OF TAX RETURN PREPARER

A signing tax return preparer is any tax return preparer who signs or is required to sign a return or claim for refund as a tax return preparer pursuant to Treas. Reg. §1.6695-1(b). A nonsigning tax return preparer is any preparer who prepares all or a substantial portion of a return with respect to events that have occurred at the time the advice is rendered.[50]

In determining whether an individual is a nonsigning preparer, the proposed regulations provide that any time spent on advice that is given for events that have occurred, which is less than 5% of the aggregate time incurred by that person for the position(s) giving rise to the understatement, is not taken into account. Whether a schedule, entry, or other portion of a return is a substantial portion is determined based upon all facts and circumstances. For example, a single tax entry may constitute a substantial portion of the tax required to be shown on a return.[51]

There is a de minimis exception in determining a substantial portion of a return for nonsigning preparers. Under the proposed regulations, the de minimis exception applies if the item creating the understatement is less than $10,000, or less than $400,000 if the item is also less than 20% of the taxpayer's gross income.[52] This de minimis rule does not apply for signing preparers.

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46. Prop. Treas. Reg. §1.6694-2(d)
47. Prop. Treas. Reg. §1.6694-1(b)(2)
48. Prop. Treas. Reg. §1.6694-2(b)(3)
49. Prop. Treas. Reg. §1.6696-1
50. Prop. Treas. Reg. §301.7701-15(b)(2) and (3)
51. Prop. Treas. Reg. §301.7701-15(b)(3)(i)
52. Prop. Treas. Reg. §301.7701-15(b)(3)(ii)

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PROTECTIVE CLAIMS

Generally, taxpayers must file any claim for refund within three years of the time the return was filed. If the return was filed before its due date, a taxpayer has three years from the **due date** to file a claim. The claim must be filed within two years from the time the tax was paid if that is a later date. If no return was filed, the claim must be filed within two years from the time the tax was paid.

Example 21. Tosha filed her 2004 tax return on April 1, 2005. Any refund claim must be filed by April 15, 2008 because the due date for the return was April 15, 2005.

Example 22. Kyle did not file his 2004 return nor pay the tax due until January 5, 2006. If Kyle files a claim for refund, it must be filed by January 5, 2008.

Situations occur in which there is pending legislation or a pending court case which affects many taxpayers' income tax liability. These may not be settled until after the statute of limitations for filing a refund claim has passed. These taxpayers must file a **protective refund claim** to allow them to receive a refund if the legislation or court case is successful.

Protective refund claims are generally filed when a taxpayer's right to a refund is contingent on future events that will not be resolved until after the statute of limitations expires. In order to preserve the taxpayer's right to obtain a refund, a timely and proper protective refund claim must be filed.

The refund claim must satisfy all the following requirements:

- It must be written.
- It must be signed under oath or penalties of perjury.
- Separate claims must be filed for each tax year.
- Any tax in question must be paid.
- The grounds upon which the claim is based must be stated in detail.
- Sufficient facts must be stated to explain the basis of the claim to the IRS.
- The amount of the claim must be stated.
- Any applicable supporting evidence must be filed with the claim.

A timely-filed claim that meets the above requirements cannot be rejected on formal grounds. However, it may be rejected on its merits.

One method used to file a protective claim is to complete an amended tax return. The words "**PROTECTIVE CLAIM — DO NOT PROCESS**" should be written on the top of the return in bold letters.

Many taxpayers receive checks when their insurance companies demutualize. The IRS's position is that the taxpayer's stock has no basis and consequently resulted in 100% gain when it was sold. This position was challenged in court. The court ruled in favor of the taxpayer on August 6, 2008, and consequently, allows basis for the stock.[53] The IRS has not indicated whether it will appeal the court's decision. Therefore, taxpayers who paid tax and followed the IRS's original advice may be entitled to a refund if the IRS does not win on appeal. If no protective refund claim was filed and the tax was paid on a 2003 tax return, no refund is available because the statute of limitations expired. If tax was paid on a 2004 return, a protective claim had to be filed by April 15, 2008.

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53. *Eugene A. Fisher, Trustee, Seymour P. Nagan Irrevocable Trust v. U.S.*, No. 04-1726T (Fed.Cl. Aug. 6, 2008)

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PRIVACY AND INFORMATION SECURITY REQUIREMENTS FOR TAX PRACTITIONERS

WHY PROTECT PERSONAL INFORMATION?

The ability to collect and use personal information has grown exponentially over the past few years, while the complexity and risks of managing that information has grown at an even greater pace. Over 127 million records from 446 breaches[54] were reported lost or stolen in 2007, triple the amount reported in the prior year.

Personal information is vulnerable to a variety of risks, including loss, misuse, unauthorized access, and disclosure. Individuals expect their privacy to be respected and their personal information to be protected. With almost daily reports of identity theft, they are no longer willing to overlook a company's failure to protect their privacy.

Tax preparers must understand and effectively address privacy and information security as a risk management issue. Noncompliance or the failure to properly respond to a data breach of a client's information may result in:

- Damage to the company's reputation, brand, or business relationships;
- Legal liability and industry or regulatory sanctions;
- Charges of deceptive business practices; or
- Customer or employee distrust.

GENERAL REGULATIONS AND REQUIREMENTS

Tax preparers that collect, use, disclose and retain individual customer information should be aware of specific laws and regulations that apply to their business. There are a number of state and federal laws that require tax preparers to implement "reasonable" privacy and information security practices. Depending on the scope of services provided, these laws or regulations may apply. They include the following:

Federal Trade Commission (FTC) Act

The FTC Act prohibits deceptive or unfair trade practices. Under the FTC Act, businesses must handle information in a way that is consistent with promises to their customers, as in their privacy statements. They must also avoid data security practices that create an unreasonable risk of harm to a customer's personal information.

The FTC is the primary agency charged with consumer protection in the United States. It aggressively enforces company-made privacy promises and enforces obligations imposed on companies by privacy and security laws. The FTC also brings actions against companies for failure to comply with federal privacy laws, including those listed below.

The FTC developed guidelines around Fair Information Practices, which include:

1. **Notice and Awareness.** Consumers need notice to make an informed choice about whether to provide their information. This notice should include:
    - Who is collecting their information,
    - The uses of their information,
    - Who will receive their information,
    - The nature of their information and the means by which it is collected (if not obvious), and
    - The steps taken to preserve the confidentiality, integrity, and quality of their information.

54. *Identity Theft Resource Center.* www.idtheftcenter.org/artman2/publish/lib_survey/ITRC_2008_Breach_List.shtml

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2. **Choice and Consent. Choice** means giving consumers options as to how any personal information collected from them will be used. Choice may apply to secondary uses of information — uses beyond the original reasons for which the data was provided. Choices generally allow the consumer to opt in or opt out.
   - **Opt In.** An individual's data won't be shared unless he specifically approves the sharing of his information (provides **consent).**
   - **Opt Out.** A business can share an individual's data unless he tells them not to share the information.
   - Companies should make the opt-in/opt-out process simple and easily accessible.
3. **Access and Participation. Access** refers to an individual's ability to access his data (in its entirety) and correct any inaccuracies.
   - Access must encompass timely and inexpensive access to data.
   - Organizations must provide simple means for contesting inaccurate or incomplete data.
   - Organizations must provide the means by which corrections and/or consumer objections can be added to the data file and sent to all data recipients.
4. **Integrity and Security.** Data must be accurate and secure. Security involves both managerial and technical measures to protect data against the unauthorized access, destruction, use, or disclosure of data.
   - Businesses must take reasonable steps to ensure the integrity and security of data.
   - Internal procedures should limit access to data and ensure that it is not utilized for unauthorized purposes.
   - Technical measures should be implemented to prevent unauthorized access, including encryption, use of passwords, and proper data storage.
5. **Enforcement and Redress.** Privacy principles can be enforced in a number of ways, including:
   - Industry self-regulation (e.g., consumer reporting and marketing associations);
   - Fines and sanctions by the FTC if a company breaks promises made in its privacy policies (Section 5 of the FTC Act); and
   - Additional enforcement for specific types of data (e.g., medical, financial, etc.) through federal agencies, or state attorneys general.

WIRED, *June 22, 2005 (paraphrased)*

CardSystems' Data Left Unsecured

In what the FTC called the largest known financial data security breach to date, CardSystems Solutions' failure to safeguard customer data resulted in exposing 40 million credit and debit cards to information leaks and millions of dollars in illegal purchases.

The FTC complaint alleged that CardSystems Solutions failed to employ reasonable and appropriate security to protect the personal information on its computer network and this failure caused or is likely to cause substantial injury to consumers. The FTC classified this conduct as unfair under Section 5(a) of the FTC Act.

CardSystems made no promises to its customers concerning its privacy and security practices. Its lack of privacy and security standards were characterized as unfair rather than deceptive. Even with a promise, companies must meet minimum security standards to protect sensitive personal data.

As part of the settlement, CardSystems must have an independent audit every other year for the next 20 years, as well as adopt tighter security measures.

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Gramm-Leach-Bliley Act (GLBA)

The GLBA was created to protect the privacy of consumers' and customers' personal financial information that businesses obtain. GLBA defines a financial institution as any company that is **significantly engaged** in financial activities, including:

- Tax preparers,
- Insurance providers,
- Securities firms,
- Landlords, and
- Mortgage lenders.

GLBA's basic requirements for financial institutions are to:

1. Securely store personal financial information,
2. Give notice of their policies regarding the sharing of personal financial information, and
3. Give consumers the alternative to opt out of some of the sharing of personal financial information.

Under GLBA, these types of business are required to protect the privacy **of nonpublic personal information** (NPI) collected from consumers or customers. GLBA requires a financial institution to give notice of their policies regarding how NPI will be used (the Financial Privacy Rule) and to protect a customer's personal information (the Safeguards Rule). These rules are enforced by the FTC and financial industry regulators as well as state attorneys general.

CUSTOMERS AND CONSUMERS

The Financial Privacy Rule discusses the differences between consumers and customers. While all customers are consumers, not all consumers are customers. **Customers** are individuals who obtain financial products or services for personal, family, or household purposes. **Consumers** evaluate information that a business submits and determine whether they wish to become customers. Customers are one type of consumer. They have ongoing relationships with tax preparers who provide them with specified financial products or services.

However, there is an exception to the financial privacy rules. Consumers or customers that are businesses or wish to obtain information for business purposes are not covered by the Privacy Rule. Tax preparers who prepare business returns for entities such as corporations, partnerships, and trusts do not have to comply with the Privacy Rule for these particular clients. However, tax preparers who prepare a business Schedule C for sole proprietors who file Form 1040 are covered by the Privacy Rule.

The Privacy Rule notices differ for consumers and customers. The differences are:

- All customers must be given initial privacy notices;
- Initial notices (or short-form notices) must be given to consumers who are not customers only if the practitioner intends to disclose NPI about the consumer to nonaffiliated third parties;
- Practitioners must give annual privacy notices to individuals as long as they remain customers, unless they opt out after initial notice; and
- Practitioners are not required to send annual notices to consumers who are not their customers.

> **Note.** All consumers are entitled to the same protections from disclosures of their NPI regardless of whether they become customers. The transition from consumer to customer generally occurs when there is some form of contractual agreement.

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Example 23. Robert meets with David, a tax practitioner, and discusses the possibility of hiring him to prepare his tax return. During the meeting, he gives David personal information about his income and net worth. In this instance, Robert is a consumer. If he later makes a decision to retain David to prepare his return, his status will change to that of customer.

COMPLIANCE PROVISIONS

Customer Notification

FTC regulations require practitioners to provide their customers with information about how NPI will be used. Such notices must provide customers with the following types of information:

- Types of NPI that are being collected,
- NPI that could be disclosed,
- Parties to whom the NPI could be disclosed,
- Client's right to opt out of the privacy notification,
- Policies regarding the sharing of information of former clients,
- Practices of the tax professional that protect the confidentiality and security of clients' NPI, and
- Procedures for customers to submit inquiries and address issues.

Notices must be easily understood. The regulations state that the information should utilize concise sentences, paragraphs, and sections, short explanatory sentences, and bullet lists whenever possible. In addition, the notices should use everyday words, active voice, and avoid legal or highly technical business terminology. There are additional requirements. The FTC regulations go into considerable detail on this subject.

> **Note.** It is important that notices call attention to their nature and significance by using large type size, boldface, or other forms of highlighting to distinguish this type of information. Practitioners should provide annual notices to individuals as long as they remain in a customer relationship. Customers may elect to opt out of receiving annual notices. The initial notice can provide customers with information on how they may opt out. Annual notices must be provided on a consistent basis and at least once in each period of 12 consecutive months.

If a tax professional does not furnish the NPI of her customers to any nonaffiliated third parties, the professional can use a simplified notice. Such simplified notices are sufficient if they:

- Describe the categories of NPI the professional collects,
- State that the professional does not share NPI except as authorized by law, and
- Describe the policy and practice the professional uses to protect the confidentiality and security of the NPI.

The form of notice used by the tax professional must be such that she can reasonably expect the notice to reach her consumers or customers. Oral notice is not sufficient. Customers may agree to receive their notices in electronic form, but a hard copy in written form must be available to customers who desire this. Since the following formats do not have a reasonable expectation of delivery, they should not be used as the sole form of notification:

- Posting signs in offices,
- Placement of advertisements, or
- Sending notices electronically to consumers who do not obtain their products or services electronically.

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Notices should include the tax practitioner's policies and procedures that protect the confidentiality and the security of clients' NPI. For example, the practitioner could state that she will only retain the information that is needed to provide her professional services. The practitioner may also wish to include comments about any electronic safeguards that are being used to protect privacy.

A sample privacy notice that could be utilized by tax practitioners follows.

Privacy Notice

WHIZ TAX SERVICE, INC.

Tax practitioners are held to financial privacy standards just like other providers of personal financial services. Whiz Tax Service, Inc. is now required by law to inform clients about the importance of privacy for their personal information. We are held to high standards of confidentiality and respect your right to privacy.

NONPUBLIC PERSONAL INFORMATION WE COLLECT

When necessary, Whiz Tax Service, Inc. collects nonpublic personal information about you that you provide to us or our firm obtains from third parties with your authorization. We do not secure more information than is necessary to complete our duties on your behalf.

PARTIES TO WHOM WE DISCLOSE INFORMATION

We do not disclose any nonpublic personal information that we have gathered from current or former clients except that which is required or permitted by law. Specific types of information could be provided to our employees and, in very limited situations, to unrelated third parties who need the information in order to assist us in providing our services to you. We stress the confidential nature of all information that you share.

SAFEGUARD SYSTEM

We only retain records relating to services that we provide so that we are better able to assist you with your needs. We may also need to retain some information in order to comply with our professional guidelines. We maintain physical, electronic, and procedural safeguards that comply with those professional standards.

ANNUAL NOTICE

This notice will be provided annually unless you elect to opt out and not receive future notices. If you wish to opt out, please contact Whiz Tax Service, Inc. by telephone at 317-555-5555 or by email at optout@taxwhiz.com.

Please contact us if you have any questions. Your privacy is very important to us.

Opt-Out Notice

I request to opt out of future financial privacy notices from Whiz Tax Service, Inc.

_____ _____

Signature Date

Note. GLBA was updated in October 2007 to exempt CPAs from the annual privacy notification requirement because CPAs are certified or licensed by state boards of accountancy and are already subject to state laws and regulations that prohibit disclosure of NPI without the expressed consent of the client. This exemption applies **only** to CPAs and does not apply to other tax preparers.

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GLBA Safeguards Rule

All financial institutions, including tax preparers, must comply with the GLBA Safeguards Rule. This rule was established to:

1. Ensure the security and confidentiality of customer records and information,
2. Protect against any anticipated threats or hazards to the security or integrity of such records, and
3. Protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer.

Any organization required to comply with the Safeguards Rule must implement an information security program. As a part of the program, the organization must:

- Designate an employee or employees to coordinate the program;
- Identify reasonably foreseeable internal and external risks to the security, confidentiality, and integrity of customer information and assess the sufficiency of any safeguards in place to control the risks;
- Design and implement safeguards to address the risks and monitor the effectiveness of these safeguards;
- Select and retain service providers that are capable of maintaining appropriate safeguards for information and require them, by contract, to implement and maintain such safeguards; and
- Adjust the information security program in light of developments that may materially affect the program.

An information security program is defined as the administrative, technical, and physical safeguards used to access, collect, distribute, process, protect, store, use, transmit, dispose of, or otherwise handle customer information.

The security programs of individual tax preparers may vary in scope, but they must meet these requirements. Practitioners should tailor their programs to the sensitivity of their customer information and design programs that are appropriate to the size and complexity of their individual businesses.

Federal Trade Commission News Release, *September 28, 2005*

Mortgage Company Settles Information Security Charges

Superior Mortgage Corporation is a direct lender, specializing in residential mortgage loans. During the mortgage application process, Superior Mortgage collects personal information, including social security numbers, credit histories, and bank and credit card numbers through its branch offices and websites.

The FTC complaint alleged that Superior Mortgage failed to implement reasonable security policies and procedures as required by the Gramm-Leach-Bliley Safeguards Rule. Superior Mortgage Corporation allegedly failed to:

- *Conduct timely risk assessments of its customer information;*
- *Control access to customers' personal information through the use of password policies;*
- *Encrypt the personal information of its customers that was emailed using outside computer networks; and,*
- *Oversee its service providers to ensure that appropriate security was being used to protect its customers' information.*

In addition, through its website, Superior Mortgage made false and misleading representations to consumers regarding the privacy and security of the personal information collected by stating that "All information submitted is handled by SSL encryption — see the yellow padlock at the bottom of the browser," when in fact, the information was not encrypted.

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Fair Credit Reporting Act (FCRA)

The FCRA is designed to primarily protect the privacy of what it calls "consumer report" information. If a tax preparation business includes financial advisory services, maintains reports on employees from background checks or uses reports to look into a client's credit history, the FCRA may apply.

The FTC issued the Disposal Rule in June 2005. This rule requires businesses who maintain information covered by the FCRA to take reasonable measures to dispose of the information. The rule applies to any business that uses consumer reports, not merely to financial institutions.

Federal Trade Commission News Release, *December 18, 2007*

Company Will Pay $50,000 Penalty for Tossing Consumers' Credit Report Information in Unsecured Dumpster

CHICAGO, IL — A mortgage company that left loan documents with consumers' sensitive personal and financial information in and around an unsecured dumpster has agreed to settle Federal Trade Commission charges that it violated federal regulations.

The FTC's complaint alleges that Northbrook, Illinois–based American United Mortgage Company violated the Disposal, Safeguards, and Privacy rules by failing to properly dispose of credit reports or information taken from credit reports, failing to develop or implement reasonable safeguards to protect customer information, and not providing customers with privacy notices.

"Every business, whether large or small, must take reasonable and appropriate measures to protect sensitive consumer information, from acquisition to disposal," FTC Chairman Deborah Platt Majoras said. "This agency will continue to prosecute companies that fail to fulfill their legal responsibility to protect consumers' personal information."

SECURITY BREACH NOTIFICATION LAWS

The state of California enacted the first security breach notification law in the United States with SB 1386 in 2003. Since that time, approximately 40 states have enacted legislation requiring organizations that possess sensitive personal information to notify state regulatory agencies and warn individuals of security breaches. Tax preparers with clients in multiple states should be aware of the notification laws that can affect them and their clients.

Security breach notification violations are generally enforced by a state's attorney general's office. Companies can also face FTC actions if it is determined that the company engaged in unfair or deceptive trade practices.

North Country Gazette, *April 26, 2007 (paraphrased)*

CS Stars Settles for Loss of Consumer Data

The State of New York reached the first settlement on record involving its state data breach notification law, with a $60,000 fine against a Chicago company.

CS Stars, a claims management company, noticed in May 2006 that a computer containing personnel records of a New York firm involving 540,000 consumers was missing, but waited more than six weeks to notify anyone.

The firm also agreed to implement precautionary procedures and comply with the data breach notification law in the future.

The stolen computer was later recovered from an employee of a cleaning contractor, and the sensitive files had apparently not been accessed.

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INTERNATIONAL DATA LAWS

Any tax preparer that provides services to a multinational client must be aware of the privacy and data transfer laws of each country or region. The European Union, Canada, Australia, Asia-Pacific and several South American countries all have laws and principles relating to the handling and transfer of personal information. Information exchange includes offshore outsourcing of information processes, information relating to U.S. expatriates, foreign employees, and so on.

WEBSITE PRIVACY NOTICE

Tax preparers who maintain websites must be very careful in constructing privacy notices and other consumer-facing statements. The FTC has taken the position that misrepresenting the reason information is being collected from consumers or how the information will be used constitutes a deceptive practice. These enforcement actions will continue to grow as new legislation is passed.

INFORMATION SECURITY

HOW TO PROTECT CLIENT INFORMATION

Background

According to the GLBA Safeguards Rule, all firms must have a written information security plan that describes the program to protect client information. The plan must be appropriate to the firm's size and complexity, scope and nature of the services, and sensitivity of the client information.

Tax preparers collect and store extremely sensitive information about their customers and employees. If this information falls into the wrong hands, it could put these individuals at risk for identity theft and the preparer at risk of regulatory or financial penalties.

Rarely a day goes by without a data breach being reported by a business, an educational institution, or a state or federal government agency. The majority of breaches are not hackers breaking into a computer system — in fact, recent statistics estimate that over 60% of data breaches occur through theft, mishandling of information, or improper privacy processes and policies.

Wisconsin Office of Privacy Protection, *February 21, 2008*

Wisconsin *— The office of Kurt Bischoff Tax & Accounting, Inc., was burglarized on February 21, 2008, and had a desktop computer stolen. The computer had personally identifiable information on it, such as names, addresses, birthdates, social security numbers, and bank account numbers for 600 individuals.*

An effective privacy and information security program should comply with federal and state privacy laws, but should also educate employees and ensure that protecting information becomes part of the company's core values and culture. Sensitive information that a tax preparer should protect includes:

- Employee information, including social security number, bank account, medical and benefit information;
- Client tax and financial information;
- Credit bureau reports;
- Bank statements, credit card statements, and insurance;
- Emails and fax documents; and
- Historical information (e.g., previous years' returns, past client records, etc.).

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Basic Information Security

Information security doesn't have to be complicated. As a tax preparer who works with sensitive information, the tax preparer is required to understand the privacy and security regulations that applies to her business and follow some basic security guidelines, including:

1. Identifying the personal information collected and who has access to that information;
2. Understanding how personal information is collected and how it is used, stored, and disposed;
3. Protecting sensitive information by implementing an information security program;
4. Implementing an employee training and awareness program; and
5. Planning for the worst — developing and practicing a plan for responding to security incidents.

The following sections can be used to help assess the practitioner's current security environment, identify potential risks, and assist with compliance of federal and state information security requirements. These are general guidelines and the level of detail is dependent on the size and type of the business.

Security Guidelines

One of the most basic privacy principles is to understand the information that is flowing into your practice. You need to understand the personal information you collect as well as who has access to that information and why. Tax preparers should complete the following checklist to evaluate their client data security.

1. Do you collect personal information (data)? If so, what type:

   ☐ Client data ☐ Consumer reports

   ☐ Employee data ☐ Other _____

2. What is the purpose for each type of personal data you collect, and do you actually need to collect the data?

   ☐ Client data ☐ Other _____

   ☐ Employee data

3. Who provides you with data?

   ☐ Clients ☐ Credit card companies

   ☐ Financial institutions ☐ Government agencies

   ☐ Credit bureaus ☐ Other _____

4. How do you classify the data you receive?

   ☐ Confidential ☐ Public

   ☐ Private

5. Which of the following groups have access to sensitive data in your practice? Do you have policies stating this?

   ☐ Individual employees ☐ Outsourcing firms

   ☐ Departments ☐ Other _____

   ☐ Contractors

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6. For what type of information have you developed processes and controls which restrict access to sensitive information?

☐ Administrative ☐ Physical

☐ Technical

7. Which privacy policies accurately reflect how you collect and use personal data?

☐ Privacy policy (customer notification) ☐ Web-based privacy policy

8. With which of the following third parties do you share personal information?

☐ Contractors/consultants ☐ Affiliates

☐ Service bureaus ☐ Other _____

☐ Outsourcing firms

9. Which of your vendors have privacy and security policies that meet or exceed your policies?

☐ Contractors/consultants ☐ Affiliates

☐ Third parties ☐ Other _____

☐ Outsourcing firms

The next step is to understand how personal information is used, stored, and destroyed. All firms should establish a policy related to how long to retain client information, and whether the information is either returned to the client or destroyed at the end of the retention period.

1. For each of the following, how is personal information used in your organization?

☐ Client services ☐ IT support

☐ Employee hiring ☐ Sales or marketing

☐ Employee benefits ☐ Other _____

2. For each of the following, how does sensitive information flow into, through, and from your business?

☐ Individual employees ☐ Storage

☐ Departments ☐ Destruction

☐ Third parties

3. For each of the following, where is your information stored?

☐ Hard-copy media

- Filing cabinets
- Desks
- Storage rooms
- Open areas

☐ Electronic media

- Servers
- Desktop computers
- Laptop computers
- Flash drives or other portable media devices (e.g., iPod, MP3 players, etc.)
- Handheld devices (e.g., PDA, Blackberry, cell phones)
- Tape media

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☐ Off-site storage

- Employee home computers
- Disaster recovery companies
- Storage facilities
- Back-up facilities

4. For each of the third parties that you use, where do they store your information?

☐ Servers
☐ Desktop computers
☐ Laptop computers
☐ Storage facilities
☐ Disaster recovery facilities
☐ Flash drives or other portable media devices (e.g., iPod, MP3 players, etc.)
☐ Handheld devices (e.g., PDA, Blackberry, cell phones)
☐ Tape media
☐ Other _____

5. Which of the following do you use to dispose of your information?

☐ Electronic destruction
☐ Hard-copy destruction
☐ Return to client or third party

Protect your sensitive information by implementing an information security program.

The FTC has stated that a security program must be appropriate to the firm's size and complexity, scope and nature of the services, and sensitivity of the client information.

The following items apply to the security requirements of the Safeguards Rule and provide general guidelines to ensure that "reasonable steps" have been taken to protect client information and comply with privacy laws.

Administrative Security

The firm must designate at least one employee to coordinate the safeguards program. The responsibilities include:

1. Identifying risks:
   - Understand applicable privacy and security laws and regulations;
   - Identify reasonably foreseeable internal and external risks; and
   - Ensure that security safeguards are established, adequate, and current.
2. Establishing access controls:
   - Understand the roles of employees and restrict access to information that is not necessary to perform their job;
   - Ensure employees who leave the company no longer have access to sensitive client information; and
   - Ensure the firm has implemented security controls and processes and these policies are continuously monitored and updated as required.
3. Coordinating security training and ongoing awareness programs for:
   - New hires,
   - Temporary help, and
   - Third parties.

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4. Providing vendor controls and oversight:
    - Define specific needs for vendor access to sensitive information,
    - Ensure that vendors understand and contractually agree to follow security controls and processes, and
    - Confirm that vendors have privacy and security policies that meet or exceed the firm's standards.

San Francisco Chronicle, *February 10, 2006 (paraphrased)*

Security Breach Fallout Reaches 200,000 Debit Card Holders

Letters went to an undisclosed number of employees whose personal information was contained in a computer and a hard disk stolen from the trunk of a locked vehicle belonging to an employee of an accounting firm retained by Wells Fargo.

"We require all vendors and service providers to take strict measures and follow specific guidelines for protecting sensitive data," a Wells Fargo spokesman said. "In this case, they did not adhere to the specified policies."

Wells Fargo previously settled a $9.6 million class action suit relating to wrongly disclosed consumer information to third parties.

Technical Security

Special attention should be paid to areas that present significant risks to information security. Areas to address include:

1. Computer system security:
    - Ensure virus, spyware, and other security software is installed and up to date;
    - Restrict downloads or unauthorized software installations (e.g., restrict employees from installing personal software or games); and
    - Restrict information that is stored on individual computers or laptops.
2. Network and applications security:
    - Implement firewalls and other network security measures;
    - Change factory-provided default passwords on computers, servers, and network equipment; and
    - Maintain log files of security-related information to monitor network activity.
3. Access controls:
    - Implement role-based access to information;
    - Use and regularly change strong passwords; and
    - Ensure employees do not share passwords.
4. Encryption:
    - Encrypt sensitive electronic data transfers or transmissions (e.g., emails, sensitive documents, back-up tapes, or other media);
    - Encrypt all laptop data; and
    - Encrypt all data that is physically sent to third-party providers.

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Great Falls Tribune, *January 29, 2008 (paraphrased)*

Davidson Co.'s Security Breach Reminds That Personal Data Isn't as Safe as We'd Like

A computer hacker broke into a Davidson Companies database *and obtained the names and social security numbers of virtually all of the Great Falls financial services company's clients.*

The database included information such as account numbers and balances, said Jacquie Burchard, spokeswoman for Davidson Companies. However, the hacker didn't get access to the accounts. The computer hacker accessed information on 226,000 current and former clients, Burchard said.

Physical Security

A significant number of data breaches occur due to burglaries or improperly stored information. Considerations for physical security include:

1. Facilities controls (physical access and security):
   - Ensure work facilities are properly secured,
   - Restrict access to unauthorized personnel, and
   - Lock all filing cabinets and remove information from desktops when not present.
2. Storage or disposal:
   - Do not store current or back-up data in an unsecured area,
   - Review and audit security measures and policies of third-party vendors, and
   - Ensure that information is not retained longer than necessary and that there is proper disposal of unneeded information.

KOMOTV.COM, *January 25, 2008 (paraphrased)*

Sensitive Documents Found in Dumpster

Seattle *— One man went dumpster-diving and discovered a company he trusted trashed his personal information in a public dumpster where anyone could have snatched them up.*

Steve Gillett of Seattle said Visa Services Northwest threw out the sensitive documents instead of shredding them. The documents, which ended up in a downtown alley, included papers with Gillett's name, social security number, credit card information, and even a copy of his signature.

In a letter, state officials warned Visa Services Northwest that it is required to destroy customers' personal information it does not plan to retain. Anything short of that is a violation of state law.

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Employee Training and Awareness Program

Proper hiring processes and employee training is essential to protecting sensitive information and developing a culture of security awareness. Training and preventive considerations should include:

- Checking references and/or conducting background checks before hiring employees who will have access to sensitive information;
- Requiring every new employee to sign an agreement to follow the company's confidentiality and security standards for handling sensitive data;
- Taking time to explain privacy and security rules to the staff and training them to spot suspicious activities and vulnerabilities;
- Implementing a regular schedule of employee training that includes remote employees, temporary help, and contractors;
- Developing ongoing privacy and security awareness by posting reminders about where information is stored or used;
- Training employees to be aware of social engineering risks, including:
  - Phone phishing,
  - Fraudulent representations by service or delivery people, and
  - Job applicants that intend to steal client information;
- Ensuring all employees understand the risks and responsibilities associated with privacy laws and regulations; and
- Developing procedures for customer inquiries regarding privacy policies and ensuring that employees are trained on how to address customer concerns.

Plan for the Worst

Although the firm may have identified the information to collect, understand how it is used, and implemented an information security and training program, it may still determine that a breach of client information has occurred.

- A firm should develop a plan for how to handle a breach to ensure all clients are notified.
- A firm should also ensure it is compliant with applicable laws.

Not all information compromises result in identity theft. The type of personal information can significantly affect the degree of potential damage. The FTC provides information and suggestions to help firms determine how to evaluate and respond to a data breach, and many states provide guidelines on how to be compliant with state breach notification laws. Ideas and suggestions can be found at **www.tinyurl.com/6l62y8.**

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SUMMARY

Maintaining clients' privacy is a good business practice and is necessary to protect the business and maintain customer trust. There is an extremely strong likelihood that a firm will experience some type of security breach or incident. How it prepares for a breach may determine the future of the company.

USA Today, *April 8, 2008 (paraphrased)*

Taxpayer Data May Be Vulnerable to Theft

Washington *— A Treasury Inspector General for Tax Administration (TIGTA) audit reported weak controls over the main IRS computer system, leaving sensitive taxpayer data vulnerable to attack. There are 374 accounts able to access the system's routers and switches. Nearly 40% lack proper authorization. TIGTA reported no evidence to indicate any of the 55 employee or contractor accounts had ever been authorized. While no evidence of foul play was reported, TIGTA said "A disgruntled employee, contractor, or hacker could reconfigure routers and switches... and steal taxpayer information."*

Note. Taxpayers should check their credit reports on an annual basis. The report can be downloaded free at **www.annualcreditreport.com.** If they find any discrepancies, they should contact the credit reporting agency.

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