Chapter 12: Ethics

Corrections were made to this material through January of 2012. No subsequent modifications were made.

INTRODUCTION

There are several reasons for the "tax gap" — the difference between the amount of tax that taxpayers should pay under the tax laws and the amount actually paid. While taxpayer and tax preparer abuses are not the only reasons for the tax gap, they are certainly contributing factors. Most taxpayers and tax professionals are honest and ethical. However, the Treasury Department has made recent changes to increase tax preparer regulation and education. The goal of these changes is to regulate those tax preparers who may be contributing to the tax gap because of their lack of knowledge and accuracy and to expose unsavory and dishonest practices.

TD 9527, announced on May 31, 2011, revises Circular 230 in a major step toward accomplishing this goal. The effective date of these changes is August 2, 2011. The new version of Circular 230 was released on August 2, 2011, with an official publication date of June 3, 2011.

These changes encompass the following areas.

- A new registration system for tax preparers
- A new classification for tax return preparers
- A new competency exam to ensure a minimum level of knowledge and expertise for tax preparers
- New continuing education requirements for some preparers
- Additional regulation of preparers
- Changes to penalties applicable to preparers for understatement of tax liability
- Effective early enforcement of these new initiatives

This chapter addresses changes made in 2011 for Circular 230. It is imperative for every tax practitioner to familiarize themselves with these changes, particularly in light of the anticipated increase in IRS rules enforcement.

PRACTICING BEFORE THE IRS

PRACTICE BEFORE THE IRS

Circular 230, §10.2(a)(4), defines what constitutes practice before the IRS. This includes any presentation to the IRS involving taxpayer rights, privileges, or liabilities under federal tax laws. Practice before the IRS includes the following activities.

- Filing documents
- Corresponding and communicating with the IRS
- Rendering written advice for a taxpayer, transaction, or plan
- Representing a client at conferences, hearings, and meetings[1]

TD 9527 clarifies that practice before the IRS also includes **preparing** a document and **filing** a document with the IRS.

PRACTITIONERS

Circular 230 identifies who is able to practice before the IRS. These individuals are practitioners who have not been disbarred or suspended from IRS practice and are either:

- Attorneys,
- CPAs,
- Enrolled agents (EAs),
- Enrolled actuaries, or
- Enrolled retirement plan agents.

In addition to the above five classes of practitioner, the recent changes effective August 2, 2011, create a new classification of practitioner. These new practitioners are referred to as "**registered tax return preparers**" (RTRPs). This new classification of tax preparer is fully discussed in the next section.

Note. All "practitioners" under Circular 230 are individuals, not firms or organizations.

Practitioners Becoming Client Representatives

In addition to meeting the various requirements imposed by the IRS for becoming a qualified practitioner (discussed later in this chapter), practice before the IRS requires appointment by a client. This is typically accomplished by using one or more forms designed for this purpose. The scope and nature of representation is determined by the particular form. The attorney, CPA, EA, enrolled actuary, or enrolled retirement plan agent uses the following forms to verify that a client has appointed them as the practitioner to represent the client before the IRS.

Form	Scope of Qualified Practitioner Authority
Form 2848, *Power of Attorney and Declaration of Representative*	Full representational authority
Form 8821, *Tax Information Authorization*	Receive and inspect written or oral tax information
Form 706, *U.S. Estate Tax Return*	Full representation of estate [a]

[a] Enrolled actuaries and enrolled retirement plan agents cannot use this form due to limitations on their IRS practice as discussed in the next section. These practitioners cannot represent an estate.

1. Cir. 230, §10.2(a)(4).

Once qualified, new RTRPs will also use the above forms to initiate practice before the IRS. These forms are also used by unenrolled preparers to provide them with the limited level of representation as discussed below.

Note. Checking the Third Party Designee box on Form 1040 series returns and signing the return as preparer provides the preparer with limited authority to communicate with the IRS in the processing of the return.[2]

IRS Pub. 4019, *Third Party Authorization,* provides full details on the required forms and related procedures to verify appointment by a client as representative. Information in the publication includes what forms a client uses to appoint representatives who are **not** attorneys, CPAs, EAs, or other qualified practitioners. Such persons are currently referred to as "unenrolled," and the scope of their representation is limited. Unenrolled practitioners cannot legally perform any of the following.

- Represent a taxpayer in any IRS appeals matter
- Execute closing agreements
- Extend any statutory period to collect tax
- Execute refund claims or waivers
- Receive refund checks

Note. Further details on the limitations for "unenrolled" parties can be found in IRS Pub. 470, *Limited Practice Without Enrollment.*

Example 1. Amy is bookkeeper for St. Joe Speedy Software Solutions, LLC. Amy is not an attorney, CPA, EA, enrolled actuary, or enrolled retirement plan agent. The manager of the LLC executes a Form 2848 appointing Amy as power of attorney for the LLC. The Form 2848 is sent to the appropriate IRS office for processing. Amy is the LLC's representative. However, she cannot represent the LLC in an IRS appeal or with a collections office, or execute closing agreements, refund claims, waivers, or extend any collections period. She cannot personally receive any LLC refund checks. Because she is unenrolled, her practice before the IRS as representative of the LLC is limited. However, her representational role permits her to obtain tax information for the LLC and represent the LLC before IRS customer service representatives, revenue agents, and examination officers if Amy prepared and signed the LLC's return being examined.[3]

Revocation or Withdrawal as Representative

A client can **revoke** the decision to appoint a particular practitioner as representative. The client that used Form 2848 or Form 8821 to assign representation can accomplish the revocation by forwarding a copy of the original Form 2848 or Form 8821 with the word "revoke" written across the top of the form. In addition, underneath the original signature, the effective date of revocation must be indicated along with a current signature. The practitioner can also use this method to **withdraw** as representative if a Form 2848 or 8821[4] was used for the original appointment and they no longer wish to represent a particular client.

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2. Jonathan Blattmachr, Mitchell Gans, & Damien Rios, *The Circular 230 Deskbook* (Practicing Law Institute, 2010), pp. 4–14.

3. See Form 2848 instructions.

4. See Form 2848 and Form 8821 instructions.

If the client wishes to revoke and has no copy of the Form 2848 or did not use this form, it is sufficient to send the IRS a written statement that includes the following details.

- An indication that the power of attorney is revoked
- An indication that the revocation is removed for all years or periods or a specific list of particular matters, years, or periods for which selective revocation is made
- The name and address of each representative being revoked
- A signature and date[5]

The withdrawing practitioner can also withdraw using a similar statement. The name, taxpayer identification number, and address (if known) of the client must be indicated.

Executing a new Form 2848 is another revocation method that a client can use. Submitting a new Form 2848 automatically supersedes a previous one and serves to appoint a new representative. If the client wishes to appoint a new representative and retain an existing one, a new Form 2848 is executed to appoint a new representative and name the retained representative. The existing representative's Form 2848 must be attached to the new Form 2848.[6]

> **Note.** All original representative appointments and revocations must be sent to the appropriate IRS offices. There are several regional addresses and these are indicated in the instructions for the particular form being revoked or used to appoint a representative.

Practitioner Retiring or Closing a Practice. If a practitioner plans to retire or close a tax practice, it is essential that they withdraw from representation for each client. If the practitioner remains on record as the representative for clients, the various duties, obligations, and responsibilities to clients outlined in Circular 230 continue to be owed to those clients. Withdrawing from representation keeps the IRS informed that the practitioner is no longer responsible for various duties and obligations to the taxpayer. Withdrawal from client representation does not mean revocation of qualified practitioner status under Circular 230.

Example 2. Carol, a CPA, has had a tax practice for 35 years. She is retiring and the closing date on the sale of her entire practice is about six months away. She is selling her practice to FGH Accounting Services, LLC. Carol should begin the process of withdrawing as representative for each of her clients. She could simply withdraw by sending in a copy of the original Forms 2848 or 8821, writing "revoked" across the top, indicating the withdrawal is for all tax years, and date and sign each form as required. Alternatively, she could have each client execute a new form that appoints the **relevant individual** at FGH Accounting Services, LLC (only individuals can be appointed as a power of attorney).[7] This would appoint the new FGH person as representative and also automatically terminate Carol's status as representative. The new form appointing the new FGH person automatically supersedes the original form signed by the client to appoint Carol. There is no provision for appointing FGH Accounting Services, LLC, (an entity) as the new representative on Form 2848. An individual, corporation, firm, organization, or partnership can be appointed on a Form 8821 to receive or inspect tax information.[8]

> **Note.** Under the Freedom of Information Act, practitioners are able to obtain a list of clients for whom powers of attorney are still in effect for that practitioner.[9]

5. See Form 2848 instructions.
6. Form 2848, *Power of Attorney and Declaration of Representative.*
7. See Form 2848 instructions, line 2.
8. See Form 8821 instructions.
9. [www.irs.gov/foia/article/0,,id=211443,00.html#CAF] Accessed on Sep. 7, 2011.

Limitations on Some Practitioners

Enrolled actuaries' practice before the IRS is limited to certain enumerated Code sections that specifically relate to employee plans, annuities, pension plans, and deferred compensation arrangements.[10] There is also a provision for temporary recognition to practice before the IRS[11] and for self-representation by the taxpayer**. Enrolled retirement plan agents** also have limited representational capacity.[12]

REGISTERED TAX RETURN PREPARER

The new **registered tax return preparer** (RTRP) designation became effective August 2, 2011. The RTRP refers to a distinct new classification of practitioners. To become an RTRP, the candidate must be age 18 or older and meet several requirements, as follows.

Tax Compliance and Suitability Tests

New RTRPs must pass a tax compliance test and a suitability test as part of the RTRP qualification process.

The **tax compliance test** is a check to ensure that the candidate has filed all of their own required personal or business returns. In addition, the candidate must have either paid all outstanding taxes in full or have made appropriate payment arrangements.

The **suitability test** ensures that the candidate has not engaged in any conduct that would cause suspension or disbarment of a practitioner. This includes disreputable conduct under Circular 230, §10.51. Section 10.51 enumerates several items that constitute disreputable conduct. Among other forms of conduct, these items include the following.

- Criminal convictions under federal tax law
- Criminal convictions involving a crime of dishonesty or breach of trust
- Federal or state felony convictions involving conduct that renders the practitioner unfit to practice before the IRS
- Providing false or misleading information to the Department of the Treasury or any tribunal that addresses federal tax matters
- Use of solicitation methods that either violate §10.30 (discussed later in this chapter) or are false or misleading with the intent to deceive clients or prospects
- Willfully failing to file a federal tax return, or in any way evading an assessment or payment of tax
- Willfully assisting, counseling, or encouraging a client or prospect to violate a federal tax law or suggesting that they do so
- Knowingly counseling a client or prospect to participate in an illegal plan of tax evasion or suggesting such a plan to them
- Misappropriating client funds intended to be used to pay federal tax or other federal obligations
- Use of threats, false accusations, duress, coercion, or making an inappropriate inducement or gift to an IRS employee or officer in an attempt to influence them
- Disbarment or suspension from practice of an attorney, CPA, public accountant, or actuary by any state, U.S. territory or possession, the District of Columbia, or by any federal court, agency, body, or board

10. Cir. 230, §10.3(d)(2).
11. Cir. 230, §10.5(d).
12. Cir. 230, §10.3(e)(2).

- Knowingly assisting another person with practicing before the IRS during a period of disbarment, suspension, or ineligibility of the other person
- Contemptuous conduct in connection with IRS practice, including use of abusive language, making accusations known to be false, or publishing or circulating malicious or libelous matter
- Willfully failing to sign a tax return prepared by the practitioner when a practitioner signature is required unless the failure is due to reasonable cause and not due to willful neglect
- Willfully failing to file on magnetic or other electronic media a tax return prepared by a practitioner when the practitioner is required to do so by federal tax law unless the failure is due to reasonable cause and not due to willful neglect
- Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number
- Willfully representing a taxpayer before an officer or employee of the IRS unless the practitioner is authorized to do so

Note. There are several other items mentioned in §10.51 that constitute incompetence or disreputable conduct. Reference should be made to §10.51 for further details. The items mentioned do not constitute an exhaustive list. Other forms of conduct not specifically mentioned in §10.51 might also constitute incompetence or disreputable conduct.

AICPA Code of Professional Conduct. The AICPA Code of Professional Conduct, Rule 501-7, "Failure to File Tax Return or Pay Tax Liability," imposes a similar prohibition on CPAs as that found in Circular 230. Under this rule, a CPA who fails to comply with federal, state, or local laws or regulations regarding the timely filing of personal tax returns may be considered to have committed an act discreditable to the profession.[13]

Competency Exam

The IRS indicated the competency exam will focus on material relevant to the preparation of a wage earner's nonbusiness Form 1040 and related schedules. The IRS has shared the following information about the exam.

- It will be an open-book exam but no tax software will be available for calculations.

Note. The IRS will furnish the resource material. Preparers will not be allowed to bring their own materials into the examination room.

- The anticipated availability date is during the fall of 2011.
- RTRP candidates will have until December 31, 2013, to pass the exam.
- Test-taker identities and fingerprints will be verified at the exam site.
- The exam may be taken an unlimited number of times.
- There may be a minimum waiting period imposed between the times the exam is taken for those taking the exam more than once.
- The exam will be administered at Prometric, Inc., test sites.
- The IRS will not provide any sample test questions but will provide a general guide on what the exam will cover.

13. AICPA Code of Professional Conduct, Rule 501-7.

Attorneys, CPAs, and EAs are not required to take the competency exam. Once the competency exam, tax compliance, and suitability tests are met and the RTRP designation is obtained, the IRS will issue a registration card or certificate.[14]

Note. The competency exam, the suitability test, and the tax compliance test must **all** be passed before the IRS will award the RTRP designation to the candidate. An applicant that is denied status as an RTRP will receive a letter from the IRS indicating the specific reasons for the denial.[15]

Preparer Tax Identification Number (PTIN)

IRS Notice 2011-6[16] provides guidance on acquisition of PTINs. The new RTRPs and all other practitioners must obtain and then annually renew a PTIN in order to prepare returns for compensation. This rule became effective January 1, 2011. Tax preparers that meet all the other requirements must apply either online through the IRS website or by filing Form W-12, *IRS Paid Preparer Tax Identification Number (PTIN) Application.* The PTIN is renewable annually. The initial PTIN fee was $64.25 for the first PTINs issued in 2010–2011. This annual fee may change in the future. The first PTIN registration year commenced September 30, 2010, for 2011 PTINs. The renewal period for 2012 PTINs is expected to commence in October 2011.

Observation. In order to electronically file tax returns, the preparer must obtain an electronic filing identification number (EFIN). The application process for the EFIN and PTIN involve similar features and have similar requirements, including a suitability test. The IRS acknowledges that there may be redundancy in the use of the two different numbers. An IRS initiative is presently underway to investigate some options to eliminate this redundancy. This is a long-term project and any changes are not expected until about 2015.

If the tax preparer has primary responsibility for the overall substantive accuracy of the return or refund claim, the preparer must sign the return and furnish their respective PTIN. When a tax preparer is employed by a firm, the employer's EIN must be furnished as well. Failure to include the appropriate identifying information as preparer may result in penalties.

Note. Volunteers for programs such as VITA, as well as other unpaid tax preparers, are **not** subject to the PTIN requirements.

As a general rule, after December 31, 2011, attorneys, CPAs, and EAs qualify (without testing) for the PTIN that is necessary to be a paid tax preparer. IRS Notice 2011-6 specifies **two additional groups** of preparers who are not attorneys, CPAs, EAs, or RTRPs but who can qualify for the PTIN.

- Tax preparers who are appropriately **supervised** by an attorney, CPA, EA, or RTRP
- Tax preparers who prepare returns **other than Form 1040** tax returns and therefore are not subject to the competency exam requirements[17]

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14. TD 9527 (May 31, 2011).
15. Ibid.
16. IRS Notice 2011-6 (Dec. 30, 2010).
17. IRS Notice 2011-6 (Dec. 30, 2010); IRS Notice 2011-45 (Jun. 20, 2011).

Supervised Tax Preparers. The IRS allows certain **supervised tax preparers** who are not attorneys, CPAs, EAs or RTRPs to qualify for and obtain a PTIN. A supervised tax preparer may obtain a PTIN if the individual:

- Is at least age 18;
- Is supervised by an attorney, CPA, EA, enrolled retirement plan agent, or enrolled actuary that is authorized to practice before the IRS;
- Is employed at the law firm, CPA firm, or other **recognized** firm;
- Is not the individual signing the return or refund claim, but rather, the supervisor is the signor; and
- Passes the tax compliance and suitability tests.[18]

> **Note.** A **recognized** firm is a partnership, professional corporation, sole proprietorship, or any other association, other than a law firm or CPA firm, that has one or more employees lawfully engaged in practice before the IRS and that is 80% or a greater percent owned by one or more attorneys, CPAs, EAs, enrolled actuaries, or enrolled retirement plan agents authorized to practice before the IRS under sections 10.3(a) through (e) of Circular 230.

These individuals must **certify** on the PTIN application that they work under the required supervisor who will sign the returns prepared. The supervisor's PTIN must be furnished on the application. Individuals obtaining a PTIN under this provision are not required to pass the competency exam. Preparers obtaining their PTIN under the **"supervisory exception"** are restricted in the following ways.

- Cannot sign returns or other IRS documents
- Cannot represent clients in any capacity before the IRS
- Cannot refer to themselves as RTRPs
- Are not considered practitioners under Circular 230

If the individual no longer has the required supervision, the IRS must be notified by the individual and the individual will not be permitted to engage in the preparation of tax returns.[19]

Non-Form 1040 Preparers. The new competency exam will focus on Form 1040 tax returns. As noted earlier, some tax preparers do not prepare Form 1040 series tax returns.

Non-1040 tax preparers will be able to obtain their PTINs under the "**non-Form 1040 exception**" without first passing the competency exam. To do so, they must be over age 18 and **certify** to the IRS that they do not complete Form 1040 series returns or refund claims. They must pass the tax compliance and suitability tests.[20] They can represent clients before revenue agents, customer service representatives and similar employees, or officers of the IRS in connection with the non-1040 tax returns that they sign. These non-1040 tax preparers cannot represent themselves to clients or the public as RTRPs.

There are procedures for foreign persons and U.S. citizens without social security numbers (due to conscientious religious objection, for example) to follow to obtain PTINs.[21] Temporary relief is also provided during the 2011 filing season for those experiencing delay in obtaining the required PTIN.[22]

The supervisory exception and non-Form 1040 exception may create problems as **Example 3** shows. This is particularly true since there is nothing about the PTIN number that identifies it as one that falls under one of these exceptions.

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18. Ibid.
19. IRS Notice 2011-6 (Dec. 31, 2010).
20. Ibid.
21. Rev. Proc. 2010-41, 2010-48 IRB 781.
22. Ibid.

Example 3. Diana obtains employment with the law firm Chilver, Peters & Graham, LLC, as a seasonal tax preparer for the 2011 filing season. She applies for her PTIN under the "supervisory exception" because Mr. Peters, a tax practitioner with his own PTIN, directly supervises her. She works for the law firm for the first half of the 2011 calendar year, which included the busy tax preparation season.

After the filing season, she found a job at Cornerstone Financial Planners, LLP. This firm has no tax practitioners yet on staff. Diana was hired because she has a PTIN that would allow the firm to make a strategic move into the lucrative tax return preparation area. Diana begins preparing and signing tax returns for Cornerstone's clients.

Question 3A. Does Diana's PTIN allow her to do the type of work she is doing at Cornerstone?

Question 3B. What should Diana have done upon leaving the law firm?

Question 3C. What are the ramifications to Diana and to Cornerstone?

Question 3D. How will the IRS track this sort of problem in order to prevent it?

Answers to the questions for **Example 3,** along with discussion, can be found at the end of the chapter.

Pre-Competency Exam Interim Rule. A special interim rule allows individuals who are not attorneys, CPAs, or EAs to obtain a provisional PTIN before the date that the first competency exam is offered. These provisional PTINs can be obtained through the IRS website or by filing Form W-12*, IRS Paid Preparer Tax Identification Number (PTIN) Application.* **After the competency exams begin, it will not be possible to obtain a new provisional PTIN.** PTINs already issued before the first competency exam can be renewed until December 31, 2013. After December 31, 2013, only attorneys, CPAs, EAs, and those passing the competency exam and meeting the other necessary requirements for the new RTRP designation will be eligible to obtain a PTIN.[23]

The Office of Professional Responsibility

The IRS Office of Professional Responsibility (OPR) was established in January 2003. The OPR is the successor to the former Director of Practice office. The mission of the OPR is to "foster excellence in tax professional services by setting, communicating, and enforcing standards of competence, integrity, and conduct."[24] The OPR administers and enforces the regulations regarding practice before the IRS that are found in Circular 230.

On October 26, 2010, IRS Commissioner Douglas H. Shulman announced the creation of the new **Return Preparer Office** (RPO).[25] This is a separate department within the IRS and it reports directly to the Deputy Commissioner for Services and Enforcement.

The OPR continues to administer all disciplinary proceedings under Circular 230 in connection with all tax practitioners. The RPO handles the following areas of responsibility.

- Administration of the new competency exam
- Oversight of continuing education and testing of all practitioners
- Management of the registration system for all tax practitioners[26]

Note. Based upon Commissioner Shulman's comments, it appears that at least part of the reason for establishing the new RPO is to relieve the OPR of the administrative aspects of the upcoming return preparer initiatives. This will allow the OPR to increase its focus on enforcement and disciplinary issues for practitioners.[27]

23. IRS Notice 2011-6 (Dec. 30, 2010).
24. [www.irs.gov/taxpros] Accessed on Jul. 26, 2011.
25. Commissioner Douglas H. Shulman's keynote speech before the AICPA Fall Tax Meeting, Oct. 26, 2010.
26. Ibid.
27. Ibid.

Early IRS Enforcement Measures. On July 12, 2011, the IRS announced that it sent approximately 100,000 letters to various tax return preparers. These tax preparers prepared returns in 2011 but did not adhere to the new requirements, such as obtaining a PTIN. Many of these tax preparers continued to use either outdated PTINs or their own social security numbers as identifying numbers instead of the new PTIN as required. The letters explain the new program to oversee tax preparers as well as the requirement for a new PTIN.[28]

Since the IRS initiated its PTIN registration program in the fall of 2010, approximately 712,000 preparers have obtained PTINs.

The IRS anticipates a problem with "ghost preparers" without PTINs who will continue to prepare returns without signing those returns. The IRS plans to identify many of these noncompliant preparers. This will be accomplished by sending letters directly to taxpayers who filed unsigned returns that appear to have been completed by a preparer who did not sign or provide a PTIN. The letter will inform the taxpayer how to choose a legitimate preparer and how to file a complaint against nonsigning preparers.[29]

Accordingly, the IRS has made enforcement an integral part of the new tax preparer oversight program.

IRS Disciplinary Actions. The OPR receives referrals from IRS personnel and employees about practitioner conduct that may be in violation of Circular 230. In addition, taxpayers can personally direct complaints to the OPR.

Once sufficient referrals about a practitioner are received to warrant further investigation, or once a taxpayer complaint is received, the case is assigned to an OPR attorney who investigates the allegations. If the evidence implies behavior that would be a Circular 230 violation, a letter is sent to the practitioner. The letter informs the practitioner of the charges. The letter provides the practitioner with the opportunity to respond in writing and request a conference with the OPR.

Depending upon the nature of the case and the responsiveness of the practitioner, varying degrees of communication can take place between the practitioner and the IRS on the matter. In many cases, the OPR determines the preparer is not in violation of Circular 230 and all issues are dismissed. However, if a violation is identified, the OPR may seek to settle the matter with the practitioner by obtaining agreement to censure, disbar, suspend, or reprimand the practitioners. The OPR may also initiate disciplinary proceedings against the practitioner. A hearing occurs in front of an administrative law judge (ALJ) that determines the outcome of the case. The practitioner may appeal.

The following is a sample of disciplinary decisions made under Circular 230.

- Mr. Tim Kaskey, CPA, engaged in disreputable conduct under Circular 230, §10.51. His disreputable conduct involved failure to file his own personal individual income tax returns for five consecutive years. In addition, the OPR alleged his failure to exercise due diligence in determining the correctness of the written representations made to the IRS in connection with a client's corporate tax return for two tax years. The OPR stated that this violated Circular 230, §10.22. Further, the OPR alleged a §10.34 violation because Mr. Kaskey failed to disclose and avoid penalties likely to apply to the tax positions he took on corporate and individual returns. Mr. Kaskey failed to appear for the disciplinary hearing. The ALJ ruled in a default decision on September 9, 2009, that Mr. Kaskey engaged in disreputable conduct under §10.51 and should be **disbarred** from practice before the IRS. The ruling was upheld on appeal on May 28, 2010.
- Mr. Milton Friedman worked with collections matters for clients. Mr. Friedman entered into a 3-year Consent of Public Censure Agreement with the IRS in December 2003. He agreed to modify his behavior and cease using statements that were offensive, threatening, or insulting. During the 3-year term of the agreement, he issued a letter to an IRS employee. The letter demanded the withdrawal of Notices of Levy issued by the employee and threatened to sue the employee personally for damages incurred by his client. This letter was determined to violate the Public Censure Agreement and Mr. Friedman received a 1-year **suspension**. The decision was affirmed on appeal in April 2008.

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28. IRS News Release, IR-2011-74 (Jul. 12, 2011).

29. Ibid.

- Mr. Donald Petrillo was an attorney. It was determined that he willfully failed to file his personal federal tax returns for 2001 through 2006, and failed to pay his taxes for the same years. The OPR alleged that this constituted disreputable conduct under Circular 230, §10.51. Mr. Petrillo was **disbarred** from practicing before the IRS.
- The OPR initiated disciplinary action against Mr. Lawrence Legel, CPA, for assisting a taxpayer in not paying income taxes. Legel created Sun Blest Design, LLC, which was used to conceal Mr. Wolfe's (a draftsman) income. Legel had sole control of the LLC. Wolfe was not a member of the LLC. Wolfe's clients were instructed to make checks payable to Sun Blest Design, LLC. Wolfe cashed these client checks at a check cashing store. Legel opened a bank account in the name of Sun Blest Design to further aid in concealing Wolfe's income. Amounts from this account were used to pay for expenses in connection with Wolfe's house. Wolfe's money was also subsequently placed in other accounts in Legel's name. It was determined that Legel had extensive experience and knew, or should have known, that his actions would allow Wolfe to conceal his income for the year and evade taxes. After a conviction in Florida federal court regarding this matter, it was determined that Mr. Legel's guilty plea in federal court established that he engaged in disreputable conduct under Circular 230, §10.51. Mr. Legel received a 3-year **suspension** from practice before the IRS.

> **Observation.** Most disciplinary proceedings initiated by the OPR are directed against practitioners who have failed to file all required personal tax returns. The typical outcome is disbarment or suspension.

AICPA Code of Professional Conduct. CPAs are not subject to the IRS competency exam. However, CPAs are subject to the competency requirement of AICPA Rule 201.01. Under this rule, an agreement to perform professional services implies that the CPA has the required competence and will apply knowledge and skill with reasonable care and diligence. However, the CPA is not expected to be infallible. Competence relates to knowledge of CPA professional standards, techniques, and the technical subject matter involved. It also encompasses the ability to exercise sound judgment in applying knowledge in the course of performing professional services. Additional research or consultation with others might be necessary during the course of completing work. This is ordinarily viewed as part of the performance of professional services. It is not normally indicative of incompetence.[30]

Continuing Education Requirements

New RTRPs must certify the completion of a minimum of 15 hours of continuing education credit to maintain active enrollment as a practitioner before the IRS. Each year, the 15 hours of credit must consist of:

- Two hours of ethics or professional conduct credits,
- Three hours of federal tax law update course credits, and
- Ten hours of federal tax law topics.[31]

A special interim rule exempts holders of provisional PTINs from the continuing education requirements during the first registration year that commenced September 30, 2010. RTRPs must keep records that verify completion of the continuing education requirements and these must be maintained for four years.[32]

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> **Note**. There is no continuing education requirement for 2011. This requirement begins in 2012. RTRP candidates and provisional PTIN holders have until December 31, 2013, to pass the initial competency exam. However, these candidates and provisional PTIN holders still must obtain the required 15 hours of continuing education in 2012 even prior to passing the competency exam.[33]

30. AICPA Code of Professional Conduct, Rule 201.01.
31. IRS *Return Preparer Review,* Dec. 2009; NPRM REG-138637-07 (Aug. 20, 2010) as adopted by TD 9527 (May 31, 2011).
32. TD 9527 (May 31, 2011).
33. *Frequently Asked Questions: Education Requirements.* [www.irs.gov/taxpros] Accessed on Jul. 27, 2011.

Continuing Education Course Providers

Because the requirement for continuing education has been postponed until 2012, there are currently no IRS-approved course providers for RTRP continuing education courses. However, under the current rules, there are four categories of providers.

- Accredited educational institutions
- Continuing education providers recognized by the licensing body of any state, territory, or U.S. possession
- Organizations that are recognized and approved by a qualifying organization providing continuing education for EAs or enrolled retirement plan agents
- Providers that are recognized by the IRS as a professional organization, society, or business whose programs include programs for EAs and enrolled retirement plan agents[34]

By late 2011, the IRS anticipates it will have additional details on the requirements for continuing education course providers. It appears that providers of continuing education courses will be required to obtain a qualified continuing education provider number.[35] This number will make them eligible to offer continuing education courses. While it is likely that individual courses will not need to be approved by the IRS, the provider must obtain a continuing education program number for each course.

Note. After careful consideration, the IRS decided against requiring IRS approval of every course. However, the IRS made it clear that this may become a requirement in the future. Currently, only a number is required for each course.

Only courses offered by IRS-approved providers satisfy the IRS continuing educational requirements. Some individuals may practice in states that already have continuing educational requirements. The IRS has indicated that these state-required courses can also be used to fulfill the IRS continuing education requirement. This is acceptable to the IRS as long as the provider is IRS-approved and the state has no restrictions or objections on the course being used to meet both the state requirement and the IRS requirement simultaneously.[36]

Limitations on RTRP Practice

There are some limitations on IRS practice activity for the new RTRP classification of practitioner.

- RTRPs are limited to preparing tax returns, refund claims, and other documents for IRS submission.
- RTRPs may represent taxpayers before IRS agents, customer service representatives, Taxpayer Advocate Service, and other similar employees for returns that they prepared.
- RTRPs cannot represent taxpayers before IRS appeals offices, revenue officers, the IRS Chief Counsel, or similar employees.

Observation. Section 10.3(f)(3) of Circular 230 states the following.

A registered tax return preparer's authorization to practice under this part also does not include the authority to provide tax advice to a client or another person except as necessary to prepare a tax return, claim for refund, or other document intended to be submitted to the Internal Revenue Service.

The IRS plans to issue a registration card or certificate to all RTRPs. This is required, in addition to a valid PTIN for the RTRP to be eligible to practice before the IRS.[37]

34. *Frequently Asked Questions: Education Requirements.* [www.irs.gov/taxpros] Accessed on Jul. 27, 2011.

35. TD 9527 (May 31, 2011).

36. *Frequently Asked Questions: Education Requirements.* [www.irs.gov/taxpros] Accessed on Jul. 27, 2011.

37. TD 9527 (May 31, 2011).

FURNISHING INFORMATION TO THE IRS

Circular 230, §10.20, addresses the practitioner's duty to furnish information to the IRS. This provision has a "production of information" component and a "cooperation with IRS" component.

PRODUCTION OF INFORMATION

When the IRS properly and lawfully requests information, the practitioner:

- Must promptly submit the information to the IRS, and
- Must not interfere with IRS efforts to obtain the information, unless the practitioner has a good faith belief based upon reasonable grounds that the information is privileged.

"Privilege" refers to the **attorney-client privilege.** The nature of the attorney-client privilege is as follows.

- The privilege belongs to the **client** and is exercised by the client, not the attorney.
- The information was communicated by the client to the **attorney or a subordinate** of the attorney.
- The information was furnished in connection with the **provision of legal advice.**
- The client did not communicate the information for the purposes of committing a **crime.**
- The client has not committed any acts that could be construed to have **waived** the privilege.

The purpose of the attorney-client privilege is to protect confidential communications between a client and the client's attorney. It encourages the client to openly and fully communicate with the attorney on legal matters. Full communication is necessary to obtain accurate legal advice and proper, effective legal representation.

Attorney-Client Privilege and Tax Return Preparation

Most case law indicates that communications in connection with the preparation of a tax return are not covered by the attorney-client privilege. The U.S. 9th Circuit Court of Appeals accepted the argument that communication pertinent merely to the preparation of a tax return does not involve giving or receiving legal advice.[38] Therefore, information given to the attorney by the client did not fall under the attorney-client privilege. The U.S. 8th Circuit Court of Appeals held that a tax return itself is not privileged because its purpose is disclosure to a third party (the IRS). Therefore, an expectation of confidentiality cannot exist.[39] There are contrary cases that have held that the attorney-client privilege might apply to a communication about what to claim on a return[40] or that tax return communications should be considered legal advice.[41] However, the overall weight of authority indicates that the attorney-client privilege does not apply in connection with communications regarding tax return preparation.

Accountant-Client Privilege

Like the attorney-client privilege, the accountant-client privilege also involves confidentiality. Many states[42] have laws that provide an accountant-client privilege. In some states, the accountant-client privilege is evidentiary: It can be used to bar the admission of evidence in court just like the attorney-client privilege. In other states, the accountant-client privilege is more limited.

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38. *U.S. v. Gurtner,* 474 F.2d 297 (9th Cir. 1973).

39. *U.S. v. Cote,* 456 F.2d 142 (8th Cir. 1972).

40. *U.S. v. Abrahams,* 905 F.2d 1276, 1283 (9th Cir. 1990).

41. *Colton v. U.S.,* 306 F.2d 633 (2nd Cir. 1962).

42. The Illinois Public Accounting Act provides an accountant-client privilege. It is codified at 225 ILCS 450/27. It is evidentiary but cannot be used in an investigation or hearing pursuant to the Public Accounting Act.

In connection with federal income tax issues, federal law does **not** recognize any accountant-client privilege.[43] Accordingly, this privilege cannot be successfully asserted in matters involving the IRS or federal tax law.

Federally Authorized Tax Practitioner Privilege

The IRS Restructuring and Reform Act of 1998 amended the Code to provide the federally authorized tax practitioner privilege (FATPP).[44] The aim of this amendment is to create a privilege for tax practitioners that is similar to the attorney-client privilege. However, the FATPP has some very significant limitations compared to the attorney-client privilege. The following table compares the attorney-client privilege with the FATPP.

	Attorney-Client Privilege	FATPP
Applicability	• Applicable in federal and state matters • Applicable in civil and criminal matters	• Only applies in civil tax matters before the IRS • Does not apply to criminal or state matters • Substantial limitation on applicability to written communications regarding tax shelters
Effective date	• Effective as of the time of the communication	• Only applicable to communications on or after July 22, 1998 (effective date of the legislation)
Practitioner	• Attorney or subordinate	• Practitioner as defined by Circular 230, §10.3
Nature of advice covered	• Any communication leading to legal advice	• Communications leading to tax advice • General business consultations or personal financial planning communications not covered

Therefore, like the attorney-client privilege, the FATPP will not likely apply to communications involving tax return preparation.

COOPERATION WITH IRS COMPONENT

If the IRS requests information that the practitioner or client does not have, the practitioner must:

- Make reasonable inquiry of the client about who may have the information, and
- Tell the IRS any known information regarding any person who the practitioner believes may have the information.

AICPA Code of Professional Conduct

The AICPA Code of Professional Conduct Rule 301, "Confidential Client Information," indicates that the CPA "shall not disclose any confidential client information without the specific consent of the client." In certain circumstances, the CPA might find a conflict situation between the Circular 230, §10.20 provision of automatic disclosure to the IRS and the AICPA Rule 301, particularly when the client cannot be reached for further inquiry or when the client does not consent to provide information on the location of records to the IRS.

43. *Couch v. U.S.*, 409 U.S. 322 (1973).

44. IRC §7525(a)(1).

Example 4. Bill, a CPA, prepared the 2010 tax return for his client, Rebecca, an interior designer. Rebecca has appointed Bill as power of attorney for tax purposes. Bill receives a copy of a letter to Rebecca from the IRS requesting deposit books, bank statements, and other source information to confirm gross income as reported on Rebecca's Schedule C for 2010. Bill returned Rebecca's source information to Rebecca after completing her return. Bill calls Rebecca's office and speaks with Rebecca's secretary. The secretary states that Rebecca is out of town for three weeks working on a major project. Bill inquires about the 2010 financial records. The secretary tells Bill that she has none of the financial records or information on file at the office. The secretary noted that she was reasonably sure that Rebecca dropped all the information off at a lawyer's office. She believes Rebecca is planning to sue a supplier firm for breach of contract and lost profits. The secretary also indicated she believed that Rebecca might be initiating a lawsuit against the IRS for a refund of taxes paid. The secretary gives Bill the lawyer's telephone number.

Question 4A. Has Bill made an adequate inquiry of the client under Circular 230, §10.20?

Question 4B. Have any confidentiality rules been violated?

Question 4C. What should Bill tell the IRS regarding the location of the records?

Question 4D. Should Bill contact the lawyer to determine if the lawyer has the records?

Answers to the questions for **Example 4,** along with discussion, can be found at the end of the chapter.

Example 5. Dynamic Media, Inc., is in the business of providing marketing services to business clients. Frank is the sole shareholder and works full time for Dynamic Media. Carol, an EA, prepares Dynamic Media's corporate return each year. Frank appointed her as power of attorney for tax purposes. In January 2010, Dynamic Media, Inc., filed a lawsuit against a supplier for breach of contract and lost profits. Frank furnished the corporate lawyer with all the financial records for 2008 and 2009 in preparation for the filing of the lawsuit. Carol indicated to Frank that she needed this information before completing the 2009 return for the corporation. Frank picked up copies of all these items from the lawyer's office and dropped off the copies to Carol. Carol completed the 2009 return. Frank met with Carol to review the return. Carol retained the copies of the source information in her file.

In August 2010, Carol receives a copy of a letter to Dynamic Media, Inc., from the IRS requesting the "original source document information that will verify corporate gross income for the 2010 taxable year" for Dynamic Media, Inc. The IRS letter also includes a request for specific information on amounts the corporation paid to Frank and a verification of Frank's personal income from the corporation.

Question 5A. Is the corporate financial information privileged?

Question 5B. When Frank furnished copies to Carol, did this constitute a waiver of the privilege?

Question 5C. The IRS letter requests original documentation. Should Carol let the IRS know she has copies?

Question 5D. Is the IRS request for a verification of Frank's personal income appropriate? If not, what should Carol do? Is information regarding Frank's personal income privileged?

Answers to the questions for **Example 5,** along with discussion, can be found at the end of the chapter.

SUBMISSION STANDARDS, WRITTEN ADVICE REQUIREMENTS, AND CLIENT OMISSIONS

The following three sections collectively outline basic practitioner duties in connection with advice to the client, and reliance on information provided by the client and used to prepare IRS returns.

- Section 10.34, Standards with respect to tax returns and documents
- Section 10.21, Knowledge of client omissions
- Section 10.37, Requirements for other written advice

Note. Section 10.34 applies to oral or written advice to clients, whereas §10.37 applies only to written advice.

Standards with Tax Returns and Documents

Circular 230, §10.34, provides guidance on the professional standards required of practitioners in connection with the preparation of a tax return or other documents and related advice to clients. There were recent changes to §10.34.

Tax Return Preparation Standards. IRC §6694(a) imposes a penalty on a tax return preparer when the tax preparer takes a position that is unreasonable and an understatement of tax liability results. IRC §6694(b) imposes a penalty if the tax preparer takes the unreasonable position willfully or recklessly.

TD 9527,[45] effective August 2, 2011, substantially broadens Circular 230, §10.34, by incorporating some of the §6694 concepts.

Section 10.34 now states that a tax preparer may not willfully, recklessly, or through gross incompetence sign a return or advise a client to take a position on a return that:

- Lacks a reasonable basis,
- Is an unreasonable position,
- Is a willful attempt to understate tax liability, or
- Is a reckless disregard for tax rules and regulations.

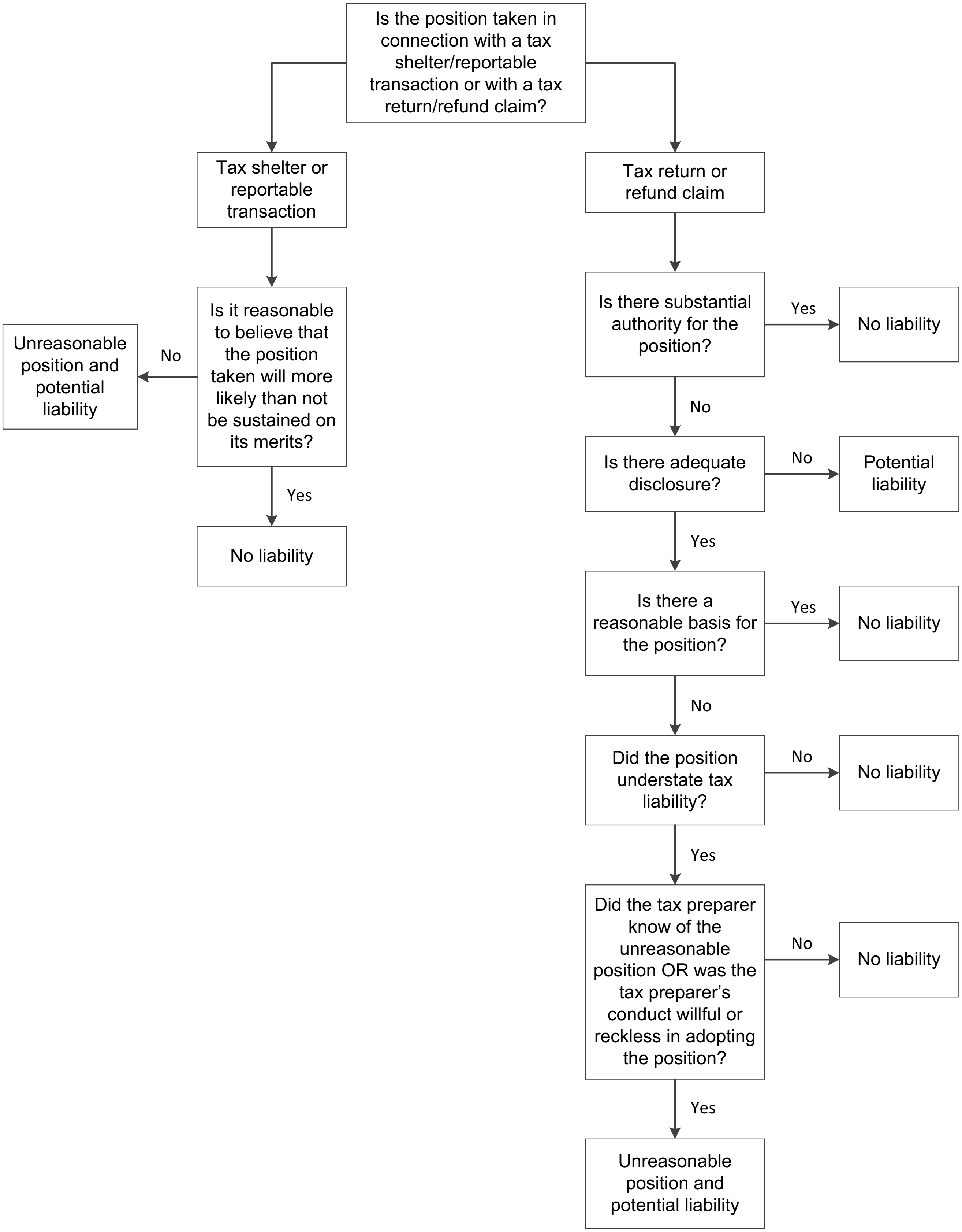
Willful and reckless disregard are legal terms that refer to a particular state of mind that exists when a person acts. The term **willful** refers to acts that are intentional, conscious, and directed toward achieving a purpose. The phrase **reckless disregard** refers to acting with gross negligence because there is a distinct lack of concern for adherence to tax law.

The IRC §6694(a)(2) definition of **unreasonable position** is adopted within Circular 230, §10.34. In addition, the IRC §6694(b)(2) concept of reckless or intentional disregard for tax rules or regulations is similarly incorporated into §10.34. Determining whether a §10.34 violation has occurred therefore requires direct reference to core §6694 concepts and definitions.

The following page provides a flowchart for practitioners which illustrates what constitutes an "unreasonable position" on a tax return or other document.

45. TD 9527 (May 31, 2011).

Unreasonable Position Flowchart



One of the following items must exist to ensure that a position taken on a tax return is not an unreasonable position.

- The position has substantial authority, or
- The position is adequately disclosed and has a reasonable basis.

Therefore, knowledge of these three key concepts from §6694 are necessary. These concepts are part of Circular 230, §10.34, effective August 2, 2011.

Substantial Authority. The phrase **"substantial authority"** is not clearly defined. It is more stringent than the "reasonable basis" standard. Substantial authority requires the position taken to be based on one or more of the many authorities outlined in Treas. Reg. § 1.6662-4(d)(3)(iii) which include the following.

- Internal Revenue Code and other statutory provisions
- Proposed, temporary, and final regulations
- Revenue rulings and revenue procedures
- Tax treaties and tax treaty regulations
- Court cases
- Private letter rulings and technical advice memoranda[46]

Note. For further information on substantial authority, see the "Explanation of Contents" section of Chapter 14, Rulings and Cases.

However, the substantial authority standard is less stringent than the "more likely than not" standard, which requires a position taken to have a greater than 50% chance of being upheld.[47]

Whether there is substantial authority for a position also depends on the "strength" of the sources of the authority. For example, the **relevance and persuasiveness** of the authority are two of the factors considered.[48] A court case provides stronger authority if the facts of the case strongly parallel those of the practitioner's client. The same case may not provide much authority if the facts of the taxpayer in the case are materially different than the facts the practitioner is addressing with a client position.[49]

Adequate Disclosure. **"Adequate disclosure"** of an item or position on a return exists if it is made on a properly completed form attached to the return or qualified amended return.[50]

When the position is not otherwise disclosed on a return,[51] the adequate disclosure requirement is met if Form 8275, *Disclosure Statement,* is used. If the position is contrary to a regulation, Form 8275-R, *Regulation Disclosure Statement,* is used.

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46. Treas. Reg. §1.6662-4(d)(3)(iii) lists several acceptable sources of authority.
47. Treas. Reg. §1.6662-4(d)(2).
48. Treas. Reg. §1.6662-4(d)(3)(ii).
49. Ibid.
50. Treas. Reg. §1.6662-4(f)(1).
51. Instructions for Form 8275, p. 1.

Reasonable Basis. The **"reasonable basis"** standard is not clearly defined. A position that is not frivolous, not patently improper, and merely arguable does not have a reasonable basis. However, if the position is reasonably based on one of the authorities listed in Treas. Reg. §1.6662-4(d)(3)(iii) for substantial authority, and it is relevant and persuasive enough, then it would provide a reasonable basis even if the substantial authority standard is not met.

> **Note.** Before TD 9527 became final and incorporated these IRC §6694 concepts into Circular 230, §10.34, many practitioners were concerned that a §6694 violation would mean that a §10.34 violation occurred simultaneously. This could mean "stacked" violations with "stacked" penalties. However, the IRS indicates that this is not the case. A violation under each of these two provisions requires a separate, unrelated disciplinary proceeding.[52]

The following table provides a list of key terms and definitional sections for future reference.

Term	Reference
Tax shelter	IRC §6662(d)(2)(C)(ii)
Reportable transaction	IRC §6662A
Reasonable basis	Treas. Reg. §1.6662-3(b)(3)
Substantial authority	Treas. Reg. §1.6662-4(d)
Signing or non-signing preparer	Treas. Reg. §1.6694-2(d)(3)
Adequate disclosure	Treas. Reg. §§1.6662-4(e), (f) and 1.6694-2(d)(3)

Reliance on Client Information. The signing or nonsigning tax practitioner can rely on the information furnished by the client. The practitioner is not required to verify the information.[53] However, if the information furnished by the client appears to be incorrect, inconsistent, or incomplete, the practitioner must make further inquiry.[54] The practitioner cannot ignore the implications of the information furnished.

Advising Clients of Penalties. Even when the practitioner is not subject to any penalties in connection with a position taken on a return, §10.34 has a separate requirement to inform the client of penalties.

If the practitioner prepared or signed the client's return or other IRS form or advised the client on a position taken on the return, then the practitioner must inform the client of any applicable penalties in connection with a position taken on a return.[55]

Moreover, the practitioner must also advise the client of an opportunity to avoid penalties through disclosure. This requirement includes advising the client on what is necessary for adequate disclosure.[56]

Advice to Clients on Documents Submitted to IRS. A practitioner cannot advise a client to submit a document or take a position on a document submitted to the IRS that is frivolous. Further, a practitioner cannot advise a client to submit a document whose sole purpose is any of the following.

- Delaying action
- Impeding tax law administration
- Omitting or containing information in a manner that shows an intentional disregard for a rule or regulation (unless the client is also advised to submit a document showing a good faith challenge to the rule or regulation)

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52. TD 9527 (May 31, 2011).
53. Cir. 230, §10.34 (d).
54. Ibid.
55. Cir. 230, §10.34 (c)(1).
56. Cir. 230, §10.34 (c)(2).

Example 6. Marvin, an individual taxpayer, provides his 2010 tax year information to his tax professional, Gwendolyn, an EA. The information includes his spreadsheets showing business income and expenses for 2010. Gwendolyn knows that Marvin is an excellent recordkeeper who is quite knowledgeable about keeping appropriate records in a detailed, organized fashion. After preparing Marvin's Schedule C and the rest of his 2010 tax return, she notices that Marvin's business income is less than half of what it was for the previous year. Many of the expenses, however, remained at about the same level. This is the first year that Marvin will report a business loss on his Schedule C. The return is filed with the lower income amount.

Question 6A. Should Gwendolyn have confirmed the income figure with Marvin before completing the return?

Question 6B. Is she entitled to rely on Marvin's information under Circular 230, §10.34?

Answers to the questions for **Example 6,** along with discussion, can be found at the end of the chapter.

Example 7. It is April 2012. Clark, an EA, is preparing Matilda's tax return for 2011. Matilda's tax information was accompanied by a detailed note in connection with something unusual that occurred during the 2011 taxable year. Matilda invested $70,000 with a real estate developer who apparently developed, established, and maintained certified nursing homes and assisted-living homes in Matilda's state and other states. Matilda's note indicates that the developer's entire business turned out to be a fraud. It was found that the business never actually had the development track record it marketed to investors and was founded by an individual who had several convictions for fraud and related felonies. Matilda's note indicates that this amount should be claimed "as a loss somehow" on her 2011 return. Clark decides to claim the $70,000 as a casualty loss on Matilda's return.

Question 7A. What does Clark need in order to properly take this position on Matilda's tax return under Circular 230, §10.34?

Question 7B. Does Clark have substantial authority for the position taken on the return? What should he do to find it?

Question 7C. Does he have a reasonable basis for the position?

Answers to the questions for **Example 7,** along with discussion, can be found at the end of the chapter.

Example 8. Gregory, a CPA, reviews the 2010 tax information for his client, Roberta. Roberta is head of her own interior design business. During the tax year, Roberta loaned some additional money to her business. Among the tax information that she furnished to Gregory was a brief handwritten letter indicating the amount she loaned the business. After speaking with Roberta on the nature of the loan, Gregory noted that the loan was guaranteed by Roberta's sister. Under the "at risk" rules, the loan will not provide Roberta with loan basis, which she needs in order to claim the year's loss on her return. However, Gregory noticed that the guarantee was structured with several contingencies that made it highly unlikely that Roberta's sister would ever be called upon to pay. Gregory concluded that Roberta was "at risk" with respect to the loan. Gregory took the position that the guarantee was essentially worthless and that the loan would provide Roberta with enough loan basis to claim a business loss of $55,000 for the 2010 taxation year. He provides Roberta with the completed return to sign and file with the IRS.

Question 8A. Can Gregory rely on Roberta's information about the loan under Circular 230, §10.34?

Question 8B. What does Gregory need in order to properly take this position on Roberta's tax return under Circular 230, §10.34?

Question 8C. Does Gregory have substantial authority for the position taken on the return? What should he do to find it?

Question 8D. Does he have a reasonable basis for the position?

Answers to the questions for **Example 8,** along with discussion, can be found at the end of the chapter.

Example 9. Use the same facts as **Example 8,** except Gregory researches the loan basis issue and determines that there is no substantial authority for taking the position that the loan provides basis. He also concludes that there is not likely any reasonable basis for this position. Therefore, Roberta should not claim the loss for the year. Along with her return, Gregory also provides Roberta with a Form 8275, *Disclosure Statement,* that will accompany the return when it is filed. The return claims the loss. However, Roberta reads the Form 8275 and decides not to sign it or mail it with her return for 2010.

Question 9A. If a Form 8275 is filed with the return, would that be sufficient to provide adequate disclosure?

Question 9B. Does providing the Form 8275 to Roberta protect Gregory from disciplinary action for taking an unreasonable position on the return?

Question 9C. For Roberta, what are the ramifications of not filing Form 8275?

Answers to the questions for **Example 9,** along with discussion, can be found at the end of the chapter.

PENALTIES FOR PREPARER AND TAXPAYER

Taking an unreasonable position on a tax return that understates tax liability can trigger penalties for **both** the tax preparer and the taxpayer.

Preparer Penalties

Understatement of tax liability by the tax preparer under IRC §6694(a) related to taking an **unreasonable** position results in a penalty that is the **greater** of:

- $1,000, or
- Half of the compensation the tax preparer receives or expects to receive in connection with preparation of the return, refund claim, or advice to the client for the position taken.[57]

Under IRC §6694(b), when the understatement of tax liability occurs **willfully** or due to the tax preparer's **reckless or intentional disregard** for rules and regulations, the **penalty is increased.** In such cases, the penalty is the **greater of:**

- $5,000, or
- Half of the compensation the tax preparer receives or expects to receive in connection with preparation of the return, refund claim, or advice to the client for the position taken.

Example 10. Karin is an EA retained by Ben to do his tax return for 2010. Ben paid Karin a total of $7,000 for tax work in connection with the 2010 taxation year. Of this amount, $4,000 relates to tax research and consultation involving a business transaction that took place during 2010. Based on Karin's hourly rate, $1,000 is reasonably allocable to advice provided to Ben for items prior to the business transaction. The remaining $2,000 was paid to Karin in connection with the preparation of the 2010 tax return upon which Karin's advised position was taken.

It was later determined that Karin's position **was unreasonable** and violated IRC §6694(a). The unreasonable position resulted in understating tax liability. However, it was also determined that Karin's conduct constituted **neither** a **willful attempt** to understate tax liability **nor** a **reckless or intentional disregard** for tax rules or regulations. The amount of income received by Karin for preparing the return includes the amount for the research and advice about the position taken on the return ($4,000) plus the amount Karin received for the preparation of the return itself ($2,000), for a total of $6,000. The IRC §6694(a) penalty is the **greater** of $1,000 or half of the $6,000 received by Karin. Karin's penalty is $3,000.

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57. IRC §6694(a); TD 9436 (Dec. 15, 2008).

If both penalties apply, the IRC §6694(b) penalty for willfulness or reckless disregard is reduced by the amount of any §6694(a) penalty assessed.[58] This is to prevent the "stacking" of the two penalties.

Example 11. Use the same facts as **Example 10,** except it is determined that Karin's conduct is **willful.** She deliberately advised Ben to take a position on his return for which she had no substantial basis. She advised Ben to take the position on his return in order to reduce tax liability for the year despite tax regulation guidance to the contrary.

Karin is liable for **both** the IRC §6694(a) understatement penalty of $3,000 as calculated in **Example 10** and the IRC §6694(b) penalty in connection with willful disregard for tax rules and regulations. Her penalty liability under §6694(b) is the greater of $5,000 or half of the compensation of $6,000 (which is $3,000) received by Karin in connection with the completion of the return. Karin's §6694(b) penalty is $5,000. The "anti-stacking" rule reduces the §6694(b) penalty by the amount of Karin's §6694(a) penalty.

Accordingly, Karin's §6694(a) penalty is $3,000. Karin's §6694(b) penalty is $2,000 ($5,000 − $3,000). Karin's total penalty is $5,000 ($3,000 + $2,000).

Taxpayer Penalties

Understatement of tax liability by a tax preparer not only creates possible penalties for the preparer but also subjects the taxpayer to potential penalties. IRC §6662 outlines most of the penalties that apply to a tax underpayment. Generally, these §6662 penalties can be avoided if the taxpayer can show "reasonable cause and good faith," which is discussed later in this section. The more common IRC §6662 penalties are as follows.

Negligence or Disregard of Rules or Regulations. IRC §6662(b)(1) provides for a taxpayer penalty of 20% of the portion of any understatement that is attributable to negligence or disregard of tax rules or regulations. **Negligence** involves a failure to make a reasonable attempt to comply with tax laws.[59] **Disregard** exists if the failure to comply with tax laws is intentional, reckless, or due to carelessness.

Substantial Understatement of Income Tax. A substantial understatement of income tax exists if the amount of the **understatement** for the tax year exceeds the greater of:

- 10% of the tax that should have been shown on the return, or
- $5,000[60] (or $10,000 in the case of a corporation other than an S corporation or an IRC §542 personal holding company).[61]

The 20% penalty only applies to the amount of any understatement in tax liability that was not due to an item for which there was substantial authority or for which there was adequate disclosure.[62]

Example 12. Amy's 2010 tax return was examined by the IRS. The information shown on the return and the exam results follow.

	Per Return	As Corrected by IRS Examination
Taxable income	$25,000	$55,000
Tax	4,000	15,700

58. IRC §6694(c).

59. IRC §6662(c).

60. IRC §6662(d)(1)(A).

61. Treas. Reg. §1.6662-4.

62. Ibid.

The IRS made numerous adjustments to Amy's 2010 tax return. Amy had substantial authority for one $10,000 adjustment. That adjustment resulted in increases to her taxable income and tax as follows.

	Per Return	With Substantial Authority
Taxable income	$25,000	$35,000
Tax	4,000	7,000

To determine if there is a substantial understatement, the amount of tax on Amy's return is calculated as if it included the $10,000 adjustment for which she had substantial authority. The amount of Amy's 2010 understatement is $8,700 as shown here.

Corrected total tax per IRS examination	$15,700
Less: corrected tax determined with substantial authority	(7,000)
Amount of substantial understatement	**$8,700**

Ten percent of the tax that should have been shown on the return ($15,700) is $1,570. Because the amount of the substantial understatement ($8,700) exceeds the greater of $1,570 or $5,000, it is a substantial understatement. Amy's substantial understatement penalty is $1,740 as calculated here.

Substantial understatement amount	$8,700
Penalty rate	× 20%
2010 substantial understatement penalty	**$1,740**

Gross Valuation Misstatement. Any portion of understated tax liability attributable to misstatement in the valuation of property may result in a penalty to the taxpayer. Under the tax rules, the misstatement in valuation can either be a "substantial valuation misstatement" or a "gross valuation misstatement."[63]

A substantial valuation misstatement occurs if the value or adjusted basis of any property claimed on a return is 200% or more of the correct amount. A substantial valuation misstatement results in a penalty of 20% of the portion of any understatement of tax liability attributable to the misstatement.[64]

A gross valuation misstatement occurs if the value or adjusted basis of any property claimed on a return is 400% or more of the correct amount. A gross valuation misstatement results in a penalty of 40% of the portion of any understatement of tax liability attributable to the misstatement.[65] The value or adjusted cost basis claimed for property that actually has a value or cost basis of zero is considered to be 400% or more of the correct amount. Therefore, the 40% penalty applies.[66]

Small misstatements may not trigger a penalty. In order to trigger a penalty, the portion of the tax year's underpayment attributable to a substantial or gross understatement must exceed a **minimum threshold** of **$5,000** (or $10,000 in the case of a corporation other than an S corporation or §542 personal holding company).[67]

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The determination of whether there is a substantial or gross valuation misstatement is made on a property-by-property basis.[68]

63. Treas. Reg. §1.6662-5.

64. Treas. Reg. §1.6662-5(a).

65. Ibid.

66. Treas. Reg. §1.6662-5(g).

67. Treas. Reg. §1.6662-5(a).

68. Treas. Reg. §1.6662-5(f)(1).

Example 13. The following table summarizes the various FMV figures for various assets that Henry claimed on his 2010 gift tax return. It also summarizes the correct valuations for each asset after Henry was audited and appropriate appraisals were done.

Property	FMV Reported on Return	Actual FMV from Appraisal
A	$110,000	$60,000
B	100,000	40,000

The valuation misstatement for Property A will constitute a substantial misstatement if the value originally reported on the return is 200% or more of the appraised amount. The reported amount must therefore be at least 200% of the appraised amount of $60,000, or $120,000. However, since the reported amount is only $110,000, there is no substantial misstatement.

Similarly, for Property B, a substantial valuation misstatement exists if the reported value is at least 200% of the $40,000 appraisal amount which is $80,000. The reported value is $100,000, an amount which is greater than the $80,000 required for a substantial valuation misstatement. A 20% penalty would apply to any additional tax attributable to property B.

Even though the aggregate reported values ($210,000) are 200% or more of the appraised values ($100,000), there is only a substantial valuation misstatement in connection with Property B because a property-by-property determination is used instead of an aggregate determination.

Note. Even though a property-by-property determination is made in respect of a substantial or gross valuation misstatement, an aggregate valuation is used to determine whether the **$5,000 minimum threshold** is exceeded.

Transactions Lacking Economic Substance. A penalty is imposed on the taxpayer for an understatement of tax that arises due to any disallowance of tax benefits claimed because of a transaction lacking economic substance.[69] IRC §7701(o)(1) states that a transaction that lacks economic substance is a transaction:

- In which the taxpayer does not have a substantial nontax purpose for entering, and
- That does not change the taxpayer's position in any meaningful way.[70]

The penalty is 20% of the amount of underpayment that is attributable to engaging in a transaction lacking economic substance.

However, if the transaction lacking economic substance is not adequately disclosed in the return or in an attached statement to the return, the penalty is **40% instead of 20%.**[71]

Note. This penalty is a **"strict liability"** penalty. The usual "reasonable cause and good faith" exception **does not** apply to this penalty.[72]

69. IRC §6662(b)(6).

70. IRC §7701(o)(1).

71. IRC §6662(i).

72. IRC §6664(c)(2).

This penalty applies to certain transactions after March 30, 2010, the date that the legislation was passed into law.[73] Substantial guidance on the application of this penalty does not come from IRS materials but rather from the Joint Committee on Taxation's explanation that accompanied the final bill.[74]

It is generally accepted that a taxpayer can arrange their usual business affairs to minimize tax.[75] However, arranging affairs strictly to avoid tax without any primary business or other nontax purpose can be abusive.[76] There is no clear line between these two situations. The courts fashioned the "economic substance doctrine" as a means to draw that line in specific cases. The taxpayer must have a **business purpose** other than tax benefits. In addition, the transaction must result in a **meaningful change** to the taxpayer's economic position.[77]

Important factors about this penalty are as follows.

- IRC §7701(o) does not create or change the court-made economic substance doctrine. It simply **codifies** it.[78]
- This doctrine and the penalty only apply to **trade or business transactions.**[79]
- The penalty can only apply when the economic substance transaction is **relevant** to the transaction.

The Joint Committee explanation provides a **"safe harbor"** of four business decision areas when the economic substance doctrine does not apply.

1. Business decisions involving the choice between debt and equity for financing
2. Decisions involving the choice of either a foreign or domestic corporation to make a foreign investment
3. The choice to undergo a corporate organization or reorganization
4. The decision to use a related-party entity in a transaction that meets IRC §482 standards and other applicable concepts[80]

The courts have been very inconsistent in their decisions to apply the economic substance doctrine. This inconsistency exists across cases that are somewhat parallel in fact patterns as well as within the same cases from trial to appeal.[81] Despite the fact that the IRS has indicated that taxpayers can rely on existing case law as precedent regarding when the doctrine applies, the existing case law is split in this regard. The courts will often find other narrower or technical grounds to arrive at their rulings instead of the economic substance doctrine. This may signal the fact that some courts find this doctrine too ambiguous or contentious to apply in at least some cases.[82]

Note. For further information on the economic substance doctrine, see the discussion in Chapter 8, Small Business Issues.

73. Health Care and Education Reconciliation Act of 2010.

74. Joint Committee on Taxation explanation JCX-18-10 accompanied the bill. JCS-3-09 is also useful in determining how to apply this tax code provision.

75. *ASA Investerings Partnership v. Comm'r,* 85 AFTR 2d 2000-675, 201 F.3d 505, 513 (D.C. Cir. 2000).

76. Ibid.

77. *Pasternak v. Comm'r,* 990 F.2d 893, 898 (6th Cir. 1993).

78. IRC §7701(o)(5)(C).

79. IRC §7701(o)(5)(B).

80. Joint Committee on Taxation explanation JCX-18-10.

81. Jackel, Monte A. When Is the Economic Substance Doctrine Relevant? *State of the Tax Practice, Tax Notes* (Jul. 4, 2011).

82. Ibid.

Undisclosed Foreign Financial Assets. There is a penalty for the understatement of tax liability due to an undisclosed foreign financial asset.[83] This penalty applies to tax years beginning after March 18, 2010, which is the date that this penalty provision became law.[84]

The phrase "undisclosed foreign financial asset" refers to an asset for which disclosure by the taxpayer was required. The following Code sections include the disclosure requirement.

- IRC §6038B, transfer of property to a foreign person or entity
- IRC §6038D, the Foreign Account Tax Compliance Act (FATCA) filing requirement
- IRC §6038, the disclosure requirements with respect to foreign business entities

Note. In addition, each of the above three Code sections have "failure to disclose" penalties included within their respective provisions. The IRC §6662(j) penalty in connection with the resulting understatement of tax liability can be assessed in addition to the failure to disclose penalties. The IRS provided guidance on the ordering and calculation of multiple penalties.[85]

Note. For additional information on disclosure of foreign financial assets, see the discussion of this topic in Chapter 7, Individual Taxpayer Topics.

The penalty for a tax understatement is 40%[86] of that part of any underpayment of tax attributable to the nondisclosure under the three Code sections noted above.

Avoiding Taxpayer Penalties: Reasonable Cause and Good Faith

The understatement penalties under IRC §6662, with the exception of the penalty for transactions lacking economic substance, can be avoided by showing that there is reasonable cause for the understatement of tax liability.

Determination of whether reasonable cause and good faith exist is made on a case-by-case basis.[87] The most important factor is the taxpayer's effort to assess the proper tax liability.[88] An honest misunderstanding of fact or law, reasonable in light of all the facts and circumstances, may indicate the existence of reasonable cause and good faith. Experience, knowledge, and education of the taxpayer are among the facts and circumstances considered.[89]

The following items alone are **insufficient** to establish reasonable cause and good faith.[90]

- Reliance on an information return or professional advice
- Reliance on facts that, unknown to the taxpayer, are incorrect
- The mere existence of an appraisal

The taxpayer must establish further evidence indicating reasonable cause and good faith in these instances.

83. IRC §6662(j).
84. IRC §6662(j) was part of the Hiring Incentives to Restore Employment Act (PL 111-147).
85. Treas. Reg. §1.6664-3.
86. IRC §6662(j)(3).
87. Treas. Reg. §1.6664-4(b).
88. Ibid.
89. Ibid.
90. Ibid.

Example 14. Raphael works as an occasional laborer in an auto parts plant. His hours are very irregular. There are times he heads production projects and receives overtime. There are also weeks when his hours are minimal. Raphael receives his Form W-2. It shows $31,345 of gross income for the year. Due to an audit of the employer's payroll records, it was discovered that the employer's payroll office made an error and neglected to include an additional $1,233 that he earned over a couple of holiday weekends. However, Raphael had no reason to know that the amount of gross income reported on the Form W-2 is incorrect. Under these circumstances, Raphael can establish that he reasonably relied in good faith on the Form W-2 figures and can establish reasonable cause for the underpayment of tax due to the payroll error. Raphael is obligated to file an amended return for the tax year that includes the additional income.

Example 15. Use the same facts as **Example 14,** except Raphael is on a salary and a stable schedule. His salary was outlined to him in an acceptance letter issued at the inception of the job. Raphael therefore knows what his total compensation is for the year. Under these facts, Raphael cannot establish reasonable cause or good faith in order to avoid a penalty for understatement of tax.

Example 16. Maggie is in the process of preparing her 2011 tax return. She works as a food preparation assistant for a catering company. She has a friend, Stephanie, who is an architect. Maggie discusses with Stephanie a number of expenses that she incurred during the tax year. Stephanie indicates to Maggie that she can itemize these expenses. Stephanie indicated that she, too, had similar expenses in 2009 and deducted them without difficulty. Maggie deducts the expenses on her 2011 return. The IRS challenges these deductions and determines that Maggie has understated her tax liability for the year. Maggie will not be able to establish reasonable cause and good faith in relying on Stephanie's advice. Had Maggie made an additional effort to research and determine on her own the correctness of Stephanie's advice she might be able to establish reasonable cause and good faith.

Example 17. Use the same facts as **Example 16,** except Stephanie is an EA who prepares tax returns. Maggie knows Stephanie as a very capable, knowledgeable, and highly professional tax preparer who continually updates herself on tax changes. Stephanie's position is not based on any unreasonable, factual, or legal assumptions. Maggie will likely be able to establish she had reasonable cause and good faith in relying on Stephanie's professional advice.

Whether reliance on tax advice is reasonable depends, in part, on the taxpayer's education, sophistication, and business experience. In this determination, all facts and circumstance must be taken into account including the opinion of the tax advisor.[91] The advice cannot be based on any unreasonable factual or legal assumptions. It cannot rely on unreasonable representations made by the taxpayer or other person.[92] If a taxpayer takes the position that a regulation is invalid in order to establish reasonable cause and good faith, it is necessary to have adequately disclosed the position under Treas. Reg. §1.6662-3(c)(2) in order to succeed.[93]

91. Treas. Reg. §1.6664-4(c)(1).

92. Treas. Reg. §1.6664-4(c)(1)(ii).

93. Treas. Reg. §1.6664-4(c)(1)(iii).

CLIENT OMISSIONS

When the practitioner knows of a client's tax law noncompliance or an error or omission on a submitted IRS document, they must advise the client. In addition, the practitioner is obligated to advise the client of the consequences of the noncompliance, error, or omission under the Code and regulations.[94]

AICPA Code of Professional Conduct. For CPAs, using a known client error or omission in preparing or signing documents, financial records, or statements can result in a knowing misrepresentation of fact. This violates **AICPA Rule 102.02**, "Knowing Misrepresentations in the Preparation of Financial Statement or Records." This rule prohibits making materially false and misleading entries in an entity's financial statements or records. This rule also requires the CPA to correct false and misleading information if the CPA has the authority to do so.[95]

The Due Professional Care standard mandated by AICPA Rule 201.01 may also be implicated when a known client error or omission is ignored, used, or uncorrected.

WRITTEN ADVICE

A practitioner cannot provide written advice to a client unless the practitioner:

- Has reasonable factual and legal assumptions upon which the written advice will be based,
- Has considered all of the facts known or that should be known, and
- Has not unreasonably relied on the information furnished by the client or third party.[96]

Unfortunately, §10.37 provides no indication of what might constitute **an unreasonable legal assumption** by the practitioner. However, a similar concept in Treas. Reg. §1.6664-4(c)(1)(ii) can be looked to for guidance. Under this regulation, a taxpayer can defend against a §6662 penalty based upon a good faith reliance on professional advice. One requirement of a successful defense is to establish that the professional advice was not based upon an unreasonable legal assumption. In *Long Term Capital Holdings v. U.S.,*[97] the court concluded that the law firm's professional advice relied upon by the taxpayer was based on unreasonable legal assumptions. The advice failed to consider pertinent legal precedent and also failed to analyze an instrumental Supreme Court case.

This standard suggests that the practitioner is obligated to make full and accurate assessments of the various legal arguments that are in support of or contrary to the taxpayer's position in order to meet the requirements of §10.37. The practitioner must consider all relevant legal authority relevant to the client's tax issues and apply fair judgment on the probable likelihood that the taxpayer's position will be upheld before providing written advice on the issue.

Section 10.37 also provides no insight on what constitutes **an unreasonable factual assumption.** The discussion of unreasonable factual assumptions in §10.35, which addresses covered opinions, may be looked to for some guidance on this item. Under §10.35, an unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or complete. Specifically, §10.35 states that it is unreasonable for the practitioner to simply accept the client's assertion that a transaction has a business purpose without further inquiry. The practitioner cannot rely on financial information that the practitioner knows or should know is incorrect, incomplete, or has been prepared by someone incompetent or unqualified.[98] This standard suggests that if the practitioner has no knowledge that the client's information is incomplete or inaccurate, the client's representation can be relied upon without any further inquiry and used in the preparation of written advice to the client.

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94. Cir. 230, §10.21.

95. AICPA Code of Professional Conduct, Rule 102.02.

96. Cir. 230, §10.37(a).

97. *Long Term Capital Holdings v. U.S.,* 330 F. Supp. 2nd 122 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2nd Cir. 2005) (unpublished).

98. Cir. 230, §10.35 (c)(1)(ii).

AICPA Code of Professional Conduct. Reliance on unreasonable factual or legal assumptions in the preparation of financial statements or records of an entity or failure to correct materially false or misleading information can implicate Rule 501-4, "Negligence in the Preparation of Financial Statements or Records." Under this rule, a member is considered to have committed an act discreditable to the profession when, by virtue of their negligence, the member:

- Makes, permits, or directs another to make materially false and misleading entries in the financial statements or records of an entity,
- Fails to correct an entity's financial statements that are materially false and misleading when the member has the authority to record an entry, or
- Signs, permits, or directs another to sign a document containing materially false and misleading information.

ACCURACY OF ITEMS SUBMITTED AND COMMUNICATIONS TO THE IRS

Under Circular 230, §10.22, the practitioner must exercise **due diligence** in:

- The preparation, approval, and filing of tax returns and other documents submitted to the IRS,
- Determining the correctness of oral or written communications to the Department of Treasury, and
- Determining the correctness of oral or written communications made by the practitioner to the client.

The term **"due diligence"** is not defined in Circular 230. Case law under the previous §10.22(c) that used the same due diligence standard provides some explanation about what due diligence means. In *Harary v. Blumenthal*,[99] the court indicated that the practitioner had to be honest with the client with all IRS matters and act with loyalty, devotion, care, and prudence. A due diligence "safe harbor" applies under §10.22(b) in connection with the reliance on information prepared by others. The exercise of due diligence is presumed when the practitioner relies on the work of another person if the practitioner uses reasonable care in engaging, supervising, training, and evaluating the person. This suggests that a reasonable care standard may be looked to in determining whether the necessary due diligence standard has been met within §10.22(a).

BEST PRACTICES FOR TAX ADVISORS

Circular 230, §10.33, indicates that the practitioner should adhere to various "best practices" in connection with advising clients and preparing and submitting information to the IRS. Following are best practices outlined in §10.33 of Circular 230 plus other best practices not listed in Circular 230.

COMMUNICATING CLEARLY WITH THE CLIENT

The tax advisor should clearly define the form and scope of the advice to be provided to the client. The advisor should ascertain the client's purpose for and use of the advice sought.

Note. For a sample engagement letter, see pages 28–29 in the 2009 *University of Illinois Federal Tax Workbook*. A list of information to include in engagement letters can be found on pages 72–73 of the 2007 *University of Illinois Federal Tax Workbook*. These can be found on the accompanying CD.

99. *Harary v. Blumenthal,* 555 F.2d 1113 (2nd Cir. 1977).

ARRIVING AT WELL-SUPPORTED CONCLUSIONS

The tax advisor should establish the facts and determine which of those facts are relevant. The reasonableness of any assumptions or representations made should be evaluated. Applicable law, including judicial doctrines, should be applied to the relevant facts of the client's situation to arrive at a conclusion or position supported by the law and facts.

FULLY INFORMING CLIENT

The client should be advised of the ramifications of the conclusions reached, including whether accuracy-related penalties might be avoided if the client relies on the advice provided.

FAIRNESS AND INTEGRITY

The tax advisor should act fairly and with integrity in practice before the IRS.

SUPERVISORY ADVISORS

Advisors with supervisory or oversight responsibilities within their firm should take reasonable steps to ensure that relevant firm procedures are consistent with the use of best practices.

RETURN OF CLIENT RECORDS

Even if there is a dispute with a client over fees, the practitioner must return all records to the client upon the client's request. This includes all records necessary for the client to comply with federal tax law.

> **Note.** If state law provides the tax preparer with a professional lien on client documents in connection with a fee dispute, the practitioner is required to return only those items that must be attached to a return. The practitioner must provide the client with reasonable access to the remaining documents retained for review or from which to make copies. For a more complete discussion regarding return of client records, see pages 104–105 in the 2006 *Univerity of Illinois Federal Tax Workbook*. This can be found online at **www.TaxSchool.illinois.edu/taxbookarchive.**

AICPA Code of Professional Conduct

For CPAs, Rule 501-1 directly addresses the requirement to return certain records to requesting clients. The rule creates four classes of records.

1. Client-provided records
2. Client records prepared by the member
3. Supporting records
4. Working papers

Under this Rule, client-provided records must be returned to the client upon request. Client records prepared by the member should also be returned but may be withheld if preparation is not yet complete or if fees from the client are still due in connection with the preparation of those records. Supporting records should also be provided to the client except in the case of outstanding fees owed. Working papers are the property of the CPA and need not be provided to the client.

RECORDKEEPING

Although not specifically listed in Circular 230, it is good practice to document interactions between anyone in the office and other parties. For example, maintaining a regular telephone log is prudent. The telephone log should indicate the date and time of calls, whether each call is incoming or outgoing, who the discussion was with, and the basic details of the discussion. Other regular records that should be created and maintained on a day-to-day basis include the following.

- A mail log for outgoing mail
- A daily journal of work done by the tax practitioner, indicating the client files worked on, time expended, correspondence completed, and other details of regular daily work in the course of business operations
- Memos for each client file which record contacts and discussions with the client and the nature of any work completed or pending
- A journal for those visiting the office to sign in and out, with name, date, and time

Note. One reason for keeping business records of this nature is the ability to obtain such details in connection with work done for a client or a client's discussions or appointments. Also, in connection with litigation against either the tax practitioner or a client, the **Federal Rules of Evidence,** and similar rules for many states, provide for the admission of "regular business records."[100] This can be important in assisting a client as a witness, or in defending a practitioner malpractice suit.

INTAKE OF CLIENT INFORMATION

Although not listed in Circular 230, taking steps to "standardize" the multitude of tax information that clients furnish for tax preparation is a good step in organizing the information and reducing error. It can also save significant time when preparing returns if the information is in a format that facilitates input into the tax software.

Some steps to accomplish this are as follows.

1. All clients should complete a detailed tax organizer. The organizer should cover all the essential questions for a basic return.

Note. Given that the IRS is preparing to aggressively enforce new laws regarding the disclosure of **offshore accounts and assets,** tax questionnaires for 2011 should include inquiries about the existence of any such accounts. This will facilitate proper completion of Schedule B, Part III, and any other required disclosure indicated by the client's responses.

2. Design and use separate organizers for proprietorships or disregarded entities (Schedule C clients) or rental income (Schedule E clients) and other schedules. (Organizers should be developed so that they can be used in "modular" format, with clients receiving those organizers that are applicable to their own tax situation.)

Note. Many practitioners have found it helpful to use Form 8867, *Paid Preparer's Earned Income Credit Checklist,* which is designed for clients who appear to fit the qualifications for the EIC. This checklist is used to document the information the practitioner receives from the client in connection with this credit.

[100]. Fed. R. Evid. 803(6).

3. Organizers should mirror the actual IRS schedules to facilitate software data input. (Designing the organizers in this fashion ensures all relevant data is obtained from the client. It also provides an excellent archive of information in the client file.)

4. Data should be organized in a highly standardized fashion. (The information should be placed in an order that facilitates efficient input into the particular software being used for tax preparation. This substantially reduces error and provides an effective means to determine if a particular client is missing critical information.)

5. Returns should be tagged with a checklist that requires a special schedule or other type of special disclosure. (This ensures those items are not overlooked.)

6. Utilize a means to "track" all returns from the initial intake of information to the final completion and review. (This ensures tracking of returns that are awaiting additional information from the client and ensures all returns are moving through the preparation process toward completion. It also prevents returns from being overlooked and therefore not finalized before the deadline.)

QUALITY CONTROL

After data entry is complete, the input data should be reviewed for accuracy. Ideally, this is accomplished by someone other than the person who initially input the data.

The completed return should be reviewed for accuracy. If possible, this is also best done by someone other than the person who completed the return. The reviewer should ensure that all areas of the return are complete and that all items appear in the appropriate places on the return. It is also helpful to compare the current return with the return from the previous year for consistency. If the current year's return is notably different from the prior year, those differences should be investigated by the reviewer. This ensures that differences exist because of "one time" occurrences, changes in the client's tax situation, or other reasons that can be explained.

Many software systems have "alerts" or a similar system that flags potential problem areas or places where information appears to be missing or inaccurate. The reviewer should address these areas.

REVIEW WITH CLIENT

All items discussed with the client during the final return review should be documented in some way, such as:

- Outlining the items discussed in connection with the return;
- Outlining the particular documents that were initially furnished and which are being returned;
- Providing an itemized list of attached schedules to be filed with the return; and
- Providing a list of any special attachments that are to be filed with the return, such as Form 8275, Form 8275-R, detailed brokerage statements on securities transactions, and other special disclosures or documentation the preparer expects to be filed with the return.

When the software-generated letter does not provide the above information or does not provide the ability for significant amendment, a separate accompanying letter can be developed.

Note. Documenting the return of information to the client and the particulars of additional disclosures to accompany the return is always prudent. This documentation can prove useful in defending a malpractice suit or responding to a Circular 230 inquiry from the IRS.

SOLICITATION

Circular 230, §10.30(a)(1), indicates that a practitioner cannot convey false, fraudulent, misleading, or deceptive information in public communications or private solicitations in connection with any IRS matter.

In addition, new RTRPs cannot use the term "certified" in referring to their designation. RTRPs cannot imply any employer/employee relationship with the IRS. The changes effective August 2, 2011, indicate that RTRPs can use the following phrase to describe their designation in solicitations: "*designated as a registered tax return preparer by the Internal Revenue Service*" once they successfully pass the competency test.

> **Note.** In the new RTRP solicitation phrase, the original proposed version used the phrase "with the IRS" instead of "by the IRS." Many practitioners expressed concern that this went too far in implying some affiliation with the IRS. Accordingly, the word "with" was replaced with the word "by" to address this concern.

AICPA CODE OF PROFESSIONAL CONDUCT

Rule 502, "Advertising and Other Forms of Solicitation," directly addresses the subject of solicitation for CPAs. False, misleading, or deceptive forms of advertising or solicitation are prohibited. This includes the use of advertising or solicitation that creates false or unjustified expectations of favorable results. Advertising or solicitation that implies the ability to influence a court, regulatory agency, or other body or official is similarly prohibited. Any representation that would cause a reasonable person to misunderstand or be deceived is not permitted. The use of coercion, over-reaching, or harassing conduct violates this rule.

COMPLIANCE PROCEDURES BY SUPERVISOR

Circular 230 provides guidance on expectations of those in supervisory roles within firms that oversee covered opinions advice.[101] Covered opinions involve certain transactions which have tax avoidance or tax evasion purposes.

Recent changes to Circular 230 provide additional guidance for those in supervisory roles within a firm in connection with tax preparation and the preparation of other documents submitted to the IRS. Supervisors who oversee a firm's tax and document preparation activity must take reasonable steps to ensure that the firm has adequate procedures in effect for all employees in order to ensure Circular 230 compliance.[102]

When an employee's conduct is not in compliance with Circular 230, the supervisor is subject to discipline. Discipline occurs when reasonable steps are not taken within the firm to ensure Circular 230 compliance due to the supervisor's willfulness, recklessness, or gross incompetence. Supervisory discipline also occurs if the supervisor is willful, reckless, or grossly incompetent in failing to take appropriate corrective action for the noncompliant behavior of the employee.[103]

As with the other changes to Circular 230 brought about by TD 9527, these changes became effective August 2, 2011.

101. Cir. 230, §10.36 as created by TD 9165 (Dec. 17, 2004).

102. Cir. 230, §10.36; TD 9527 (May 31, 2011).

103. Ibid.

INCOMPETENCE AND DISREPUTABLE CONDUCT

Circular 230, §10.51, enumerates various courses of conduct that constitute incompetence and are considered disreputable. This conduct may subject the practitioner to the sanctions outlined in §10.50.

Legislation passed in November 2009 requires many paid tax return preparers to file federal income tax returns electronically.[104] This new electronic filing requirement is being phased in over two years. Individual income tax returns as well as trust and estate income tax returns are covered under the new requirements. For preparers that file 100 or more returns, electronic filing requirements are effective as of January 1, 2011. For smaller preparers filing 11 or more returns, electronic filing requirements become effective January 1, 2012.

Circular 230 now reflects the IRS position that willful failure to comply with the new electronic filing requirement constitutes disreputable conduct. Accordingly, changes effective August 2, 2011, have added such a failure to the list of items within §10.51 that constitute disreputable conduct.[105]

The IRS points out that it cannot permit tax return preparers to intentionally disregard tax laws and still continue to practice before the IRS.[106] The IRS also notes that there are exclusions from the electronic filing requirements, including waivers for undue hardship and administrative exemptions.[107]

SANCTIONS AND PENALTIES AGAINST PRACTITIONERS

Circular 230 provides the IRS with the authority to censure, suspend, or disbar a practitioner for incompetency or disreputable conduct as described in §10.51.[108] Further, practitioners are subject to monetary penalties.[109] The monetary penalties can be in addition to any censure, suspension, or disbarment.[110]

When it is determined that a practitioner should receive disciplinary action, the IRS can commence an administrative hearing against the practitioner.[111] This is initiated by filing and serving a complaint to which the practitioner must respond.[112]

Recent changes to Circular 230 affirm that the IRS is able to accept or deny a practitioner's consent to a sanction under §10.50 instead of going through an administrative hearing.[113] Previous changes to Circular 230 eliminated the clause providing for the IRS option to accept or deny a practitioner's consent to sanction. The clause is inserted back into §10.50 to eliminate any question that the IRS has authority to do so.[114]

104. The Worker, Homeownership and Business Assistance Act of 2009 (Nov. 6, 2009), Section 6011.
105. Cir. 230, §10.51(a)(16).
106. TD 9527 (May 31, 2011).
107. TD 9518 provides the exclusions and waivers from the electronic filing requirement.
108. Cir. 230, §10.50(a).
109. Cir. 230, §10.50(c).
110. Cir. 230, §10.50(c)(3)(i).
111. Cir. 230, §10.60(a).
112. Cir. 230, §10.62.
113. Cir. 230, §10.50(d).
114. TD 9527 (May 31, 2011).

FEES

A practitioner cannot charge an unconscionable fee for services.[115] In addition, a **contingent fee** is prohibited unless it is permitted under one of four exceptions. A contingent fee can be charged if it is in connection with:

1. The examination of or challenge to an original return;
2. The examination of an amended return or refund claim if that amendment or claim is filed within 120 days of the taxpayer receiving either a written notice, an examination, or challenge;
3. A claim or credit for refund associated with only interest or penalties; or
4. Any judicial proceeding under the tax code.[116]

A contingent fee is a fee based, in whole or in part, on whether:

- A tax return position avoids IRS challenge,
- It is sustained by either the IRS or in court,
- A percentage of a refund or taxes is saved, and
- A specific result or outcome is attained in a matter.[117]

ANSWERS FOR EXAMPLES 3–9

Example 3. Diana obtains employment with the law firm Chilver, Peters & Graham, LLC, as a seasonal tax preparer for the 2011 filing season. She applies for her PTIN under the "supervisory exception" because Mr. Peters, a tax practitioner with his own PTIN, directly supervises her. She works for the law firm for the first half of the 2011 calendar year, which included the busy tax preparation season.

After the filing season, she found a job at Cornerstone Financial Planners, LLP. This firm has no tax practitioners yet on staff. Diana was hired because she has a PTIN that would allow the firm to make a strategic move into the lucrative tax return preparation area. Diana begins preparing and signing tax returns for Cornerstone's clients.

Question 3A. Does Diana's PTIN allow her to do the type of work she is doing at Cornerstone?

Answer 3A. Diana's PTIN was obtained under the "supervisory exception." She is only entitled to prepare returns under the supervision of another preparer who is an attorney, CPA, EA, enrolled actuary, or enrolled retirement plan agent. In the course of obtaining her PTIN under this exception, she certified to the IRS that she worked under a signing supervisor. She is obligated to inform the IRS when she no longer has the required supervision. Her PTIN does not allow her to prepare and sign returns at Cornerstone without the required supervision.

Question 3B. What should Diana have done upon leaving the law firm?

Answer 3B. Notice 2011-6 requires Diana to notify the IRS once she no longer has the required supervision. Her supervision ended when she left the law firm. If her new job provided similar supervision, Diana would not need to inform the IRS because she would continue to have the required supervision.

115. Cir. 230, §10.27(a).

116. Cir. 230, §10.27.

117. Ibid.

Question 3C. What are the ramifications to Diana and to Cornerstone?

Answer 3C. Diana's PTIN, obtained under the supervisory exception, does not make her a practitioner before the IRS. However, she is still subject to Circular 230. Her failure to appropriately inform the IRS and her preparation and signing of returns outside the scope of her special PTIN subjects her to possible disciplinary action under Circular 230. In order to continue preparing returns, she must pass the competency exam, the suitability and compliance tests, and obtain a PTIN as a full practitioner before the IRS. Cornerstone likely hired her without realizing that her PTIN was limited. If Cornerstone wishes to move into the tax preparation business, it must have a tax preparer on staff that is a practitioner before the IRS who can prepare and sign returns. Diana's PTIN does not allow her to do this.

Question 3D. How will the IRS track this sort of problem in order to prevent it?

Answer 3D. Presently, there is no method or system for the IRS to regulate or prevent the type of situation that is found in this problem. There is no unique identifying feature of a PTIN obtained under the supervisory (or non-Form 1040 preparer) exception that distinguishes it from a full practitioner PTIN.

Example 4. Bill, a CPA, prepared the 2010 tax return for his client, Rebecca, an interior designer. Rebecca has appointed Bill as power of attorney for tax purposes. Bill receives a copy of a letter to Rebecca from the IRS requesting deposit books, bank statements, and other source information to confirm gross income as reported on Rebecca's Schedule C for 2010. Bill returned Rebecca's source information to Rebecca after completing her return. Bill calls Rebecca's office and speaks with Rebecca's secretary. The secretary states that Rebecca is out of town for three weeks working on a major project. Bill inquires about the 2010 financial records. The secretary tells Bill that she has none of the financial records or information on file at the office. The secretary noted that she was reasonably sure that Rebecca dropped all the information off at a lawyer's office. She believes Rebecca is planning to sue a supplier firm for breach of contract and lost profits. The secretary also indicated she believed that Rebecca might be initiating a lawsuit against the IRS for a refund of taxes paid. The secretary gives Bill the lawyer's telephone number.

Question 4A. Has Bill made an adequate inquiry of the client under Circular 230, §10.20?

Answer 4A. If Bill has the information, he must furnish it to the IRS unless in good faith and on reasonable grounds, he believes the information is privileged. If Bill does not have the information, he must make reasonable inquiry of his client on the subject of who has the information and then convey this information to the IRS.

Bill did not have the information in this case and therefore has an obligation to make reasonable inquiry of Rebecca in connection with where the information is. He may not have fulfilled the "reasonable inquiry of his client" obligation by only speaking with her secretary instead of speaking directly with Rebecca. The fact that the secretary stated that she was only "reasonably sure" the information was at the lawyer's office because nothing was on file may underscore the need for Bill to speak directly with Rebecca on the matter.

Question 4B. Have any confidentiality rules been violated?

Answer 4B. The secretary indicated that there was a possible lawsuit pending against the IRS as well as a supplier. If Bill indicates to the IRS that the records the IRS is seeking are at the office of Rebecca's lawyer, this could alert the IRS of the possibility of being named in a lawsuit by Rebecca for claim of refund. Providing this information to the IRS at this early stage may put Rebecca and her lawyer at a disadvantage if they do not wish the IRS to know a case is being considered. Circular 230 does not address any confidentiality obligation Bill has to Rebecca, his client. However, Bill is a CPA and must take into account AICPA Rule 301, "Confidential Client Information." There may be other confidentiality rules and state laws of which Bill might need to be aware so that his communication to the IRS on the whereabouts of the records does not violate any confidentiality obligations to his client or jeopardize the efforts of Rebecca's attorney.

Question 4C. What should Bill tell the IRS regarding the location of the records?

Answer 4C. Circular 230, §10.20, requires Bill to tell the IRS "any known information" regarding any person who the practitioner believes may have the information. Bill's dilemma makes him ponder just how far to go in fulfilling this requirement and still preserve confidentiality, if possible, about a pending lawsuit. Arguably, Bill satisfies this requirement by letting the IRS know that the records are with a law firm and then furnishing the IRS with the lawyer's telephone number.

Question 4D. Should Bill contact the lawyer to determine if the lawyer has the records?

Answer 4D. On its face, Circular 230, §10.20, does not obligate Bill to contact Rebecca's attorney. However, the inability to reach her directly and the sensitivity to the confidentiality of her legal course of action arguably requires Bill to contact the attorney before calling the IRS.

Example 5. Dynamic Media, Inc., is in the business of providing marketing services to business clients. Frank is the sole shareholder and works full time for Dynamic Media. Carol, an EA, prepares Dynamic Media's corporate return each year. Frank appointed her as power of attorney for tax purposes. In January 2010, Dynamic Media, Inc., filed a lawsuit against a supplier for breach of contract and lost profits. Frank furnished the corporate lawyer with all the financial records for 2008 and 2009 in preparation for the filing of the lawsuit. Carol indicated to Frank that she needed this information before completing the 2009 return for the corporation. Frank picked up copies of all these items from the lawyer's office and dropped off the copies to Carol. Carol completed the 2009 return. Frank met with Carol to review the return. Carol retained the copies of the source information in her file.

In August 2010, Carol receives a copy of a letter to Dynamic Media, Inc., from the IRS requesting the "original source document information that will verify corporate gross income for the 2010 taxable year" for Dynamic Media, Inc. The IRS letter also includes a request for specific information on amounts the corporation paid to Frank and a verification of Frank's personal income from the corporation.

Question 5A. Is the corporate financial information privileged?

Answer 5A. The information that Frank provided to his attorney is arguably privileged. Frank furnished the information to his attorney in order to obtain legal advice about a possible suit against a supplier. The various factors required for attorney-client privilege appear to have been met.

Question 5B. When Frank furnished copies to Carol, did this constitute a waiver of the privilege?

Answer 5B. The IRS could argue that when Frank picked up copies of that information and furnished them to Carol, this constitutes communication of that same information with a third party that results in a **waiver** of the privilege. If the IRS argues that such a waiver takes place, Frank can argue that he had no choice but to communicate the information because it was necessary in order to fulfill his tax filing obligations each year. Allowing the IRS to prevail might conceivably allow the IRS to successfully establish a waiver in respect of every taxpayer that furnishes information to their tax preparer that is also the subject of a legal privilege.

Scope of the waiver is also relevant. The IRS requested verifying information about the income for Frank's corporation and his own personal income. Frank furnished the income information to his lawyer to secure legal advice on corporate lost profits. While the legal issues and advice will not likely implicate Frank's personal income, it is clear that Frank's personal income comes from the corporation since he works on a full-time, self-employed basis. While the IRS could argue that any portion of the information relating to Frank's personal income is not privileged, Frank's corporate and personal income may be so strongly interconnected for purposes of the lawsuit given his full-time self-employment status that both corporate and personal income information is privileged.

Question 5C. The IRS letter requests original documentation. Should Carol let the IRS know she has copies?

Answer 5C. Unless Carol has a good faith belief based on reasonable grounds that the information is privileged, she arguably should provide copies of the information because it would provide the IRS with the same information that would exist on the original documents. Even if Carol has a good faith belief that a privilege exists for the information, there is no bright-line rule for what constitutes "reasonable grounds" for that belief. Presumably, this means grounds that a reasonable person would understand as being sufficient for the privilege to exist. If she withholds the information from the IRS and is later held accountable for that action, she may have a very difficult time establishing "reasonable grounds" given the lack of guidance on the subject.

Question 5D. Is the IRS request for a verification of Frank's personal income appropriate? If not, what should Carol do? Is information regarding Frank's personal income privileged?

Answer 5D. Typically, an IRS inquiry focuses on either corporate or personal tax information. This inquiry requested both, presumably due to a desire to review the flow of corporate income to Frank, among other items. Although it can be argued that the personal tax information should not be requested in a corporate inquiry, the IRS can still obtain this information through a similar request on a personal inquiry about Frank's personal return. Arguably, if the corporate information is privileged, so is the information about the amount of that income passing to Frank for the year. That information, particularly for a sole owner working full time for the corporation, is directly related to the income earned by the corporation and would very likely be part of the information necessary for the lawyer to have for a lost profits lawsuit. Therefore, if there is a privilege, the information regarding Frank's income from the corporation arguably falls under that privilege.

Example 6. Marvin, an individual taxpayer, provides his 2010 tax year information to his tax professional, Gwendolyn, an EA. The information includes his spreadsheets showing his business income and expenses for 2010. Gwendolyn knows that Marvin is an excellent recordkeeper who is quite knowledgeable about keeping appropriate records in a detailed, organized fashion. After preparing Marvin's Schedule C and the rest of his 2010 tax return, she notices that Marvin's business income is less than half of what it was for the previous year. Many of the expenses, however, remained at about the same level. This is the first year that Marvin will report a business loss on his Schedule C. The return is filed with the lower income amount.

Question 6A. Should Gwendolyn have confirmed the income figure with Marvin before completing the return?

Answer 6A. Circular 230, §10.34, generally permits Gwendolyn to rely on Marvin's information without further verification. However, §10.34 also provides that Gwendolyn must make further inquiry if Marvin's information appears incorrect, inconsistent, or incomplete. Despite the fact that Marvin is known by Gwendolyn to be a good recordkeeper, this is very likely to be a situation that calls for further verification on Gwendolyn's part. This is particularly true because the gross income figure is substantially lower for Marvin than for previous years and this will be the first year the business sustained a loss. The fact that expenses seem in line with previous years despite a gross income figure of less than half of that for prior years is also an indication that the gross income figure might be incorrect or inconsistent. Gwendolyn should contact Marvin to verify the information because it does not appear correct or consistent.

Also, §10.34 places a separate requirement on Gwendolyn to inform Marvin of any penalties as a result of a position taken on his return. Even without any liability for failure to verify the information, Gwendolyn should, at a minimum, advise Marvin that the income figure is substantially lower than for previous years. She should advise Marvin of the 20% penalty for substantial understatement under Treas. Reg. §1.6662-4 which may result from underreporting the income. She should also inform Marvin about the 20% negligence penalty under Treas. Reg. §1.6662-3(a). At least this will bring Marvin's attention to the issue and bring about its possible correction before the return is actually filed.

Question 6B. Is she entitled to rely on Marvin's information under Circular 230, §10.34?

Answer 6B. Under Circular 230, §10.34, Gwendolyn cannot rely on the information because of the inconsistency and apparently incorrect 2010 gross income figure provided by Marvin. Gwendolyn cannot ignore the implications of the information furnished.

Example 7. It is April 2012. Clark, an EA, is preparing Matilda's tax return for 2011. Matilda's tax information was accompanied by a detailed note in connection with something unusual that occurred within the 2011 taxable year. Matilda invested $70,000 with a real estate developer who apparently developed, established, and maintained certified nursing homes and assisted-living homes in Matilda's state and other states. Matilda's note indicates that the developer's entire business turned out to be a fraud. It was found that the business never actually had the development track record it marketed to investors and was founded by an individual who had several convictions for fraud and related felonies. Matilda's note indicates that this amount should be claimed "as a loss somehow" on her 2011 return. Clark decides to claim the $70,000 as a casualty loss on Matilda's return.

Question 7A. What does Clark need in order to properly take this position on Matilda's tax return under Circular 230, §10.34?

Answer 7A. Circular 230, §10.34, permits Clark to rely on Matilda's information without further verification unless the information appears to be incorrect, inconsistent, or incomplete. Matilda's note, with no additional information, arguably constitutes incomplete information. Circular 230, §10.34, incorporates concepts under IRC §6694, including the need to avoid taking an unreasonable position on a tax return. These changes became effective August 2, 2011. Accordingly, Clark must avoid taking an **unreasonable position** on Matilda's tax return in connection with this $70,000 transaction. To ensure any deduction of this amount is not taken unreasonably, Clark must make further inquiries about the transaction. Clark needs to ensure that the following aspects are addressed.

1. Clark needs **substantial authority** to claim the $70,000 item on Matilda's return. Treas. Reg. §1.6662-4(d) indicates that substantial authority is an objective standard involving an analysis of the law and application of the law to relevant facts. Clark must fully research whether this type of transaction might qualify as a casualty loss and whether this would be the best and most accurate manner to report it on Matilda's tax return. This would not only involve researching the rules on casualty losses but also searching for other IRS guidance on the subject, and fully researching case law for a full understanding and assessment of the legal arguments that Matilda can make if this claim is challenged by the IRS. Clark should only claim this item on Matilda's return if there is substantial authority to use it as a deduction. A full assessment of any possible IRS counter-arguments should also be made. Matilda should be fully informed of these research results and the risks inherent in taking any position on her return that claims this $70,000 as a deduction. Any relevant aspects of the transaction that would make it qualify as a deduction should be documented within Clark's file. Section 10.34 prohibits Clark from advising Matilda to take a position on her return that is frivolous. This course of research will ensure that the position taken is not frivolous but rather has substantial legal and factual basis.

2. Clark must ensure that if he claims the $70,000 on Matilda's return, **adequate disclosure** is made. Properly reporting the $70,000 claim on Matilda's return likely serves as adequate disclosure. This would be sufficient to place the IRS on notice of the claim and challenge it if desired.

3. The position must have a **reasonable basis**. If Clark has substantial authority for the position using relevant and persuasive reasoning in the application of applicable law to the facts of Matilda's $70,000 payment and the characterization of that payment as a deduction, a reasonable basis to the position exists. The reasonable basis standard is not as strong as the substantial authority standard.

Clark also has a separate obligation under §10.34 to fully inform Matilda of possible penalties that will result in connection with the position taken with this $70,000 item on her return if the IRS successfully challenges the position.

Question 7B. Does Clark have substantial authority for the position taken on the return? What should he do to find it?

Answer 7B. Clark will only be able to make a judgment on whether substantial authority exists after thoroughly researching the tax rules and related information and case law regarding Matilda's possible $70,000 claim. "Substantial authority" is not clearly defined. As a standard, it is something more than a "reasonable basis" but less than a "more likely than not" standard. The more likely than not standard is met if the position has more than a 50% chance of being upheld. In addition, whether Clark has substantial authority depends on the degree of relevancy and persuasiveness of the information he is relying on.

Question 7C. Does he have a reasonable basis for the position?

Answer 7C. Similarly, Clark will only know if a reasonable basis exists after researching the tax rules, information, and case law on the subject of deducting Matilda's possible claim. "Reasonable basis" is not clearly defined. However, it is not as stringent as "substantial authority." Even if Clark determines he does not have substantial authority, he may have a reasonable basis for the position taken.

Example 8. Gregory, a CPA, reviews the 2010 tax information for his client, Roberta. Roberta is head of her own interior design business. During the tax year, Roberta loaned some additional money to her business. Among the tax information that she furnished to Gregory was a brief handwritten letter indicating the amount she loaned the business. After speaking with Roberta on the nature of the loan, Gregory noted that the loan was guaranteed by Roberta's sister. Under the "at risk" rules, the loan will not provide Roberta with loan basis, which she needs in order to claim the year's loss on her return. However, Gregory noticed that the guarantee was structured with several contingencies that made it highly unlikely that Roberta's sister would ever be called upon to pay. Gregory concluded that Roberta was "at risk" with respect to the loan. Gregory took the position that the guarantee was essentially worthless and that the loan would provide Roberta with enough loan basis to claim a business loss of $55,000 for the 2010 taxation year. He provides Roberta with the completed return to sign and file with the IRS.

Question 8A. Can Gregory rely on Roberta's information about the loan under Circular 230, §10.34?

Answer 8A. Gregory is allowed to rely on client information under §10.34. Gregory was correct in contacting Roberta for additional information because the handwritten note did not provide enough information about the loan basis.

Question 8B. What does Gregory need in order to properly take this position on Roberta's tax return under Circular 230, §10.34?

Answer 8B. Before concluding that the guarantee could be ignored under the "at risk" rules, Gregory should conduct appropriate tax research into this question.

Question 8C. Does Gregory have substantial authority for the position taken on the return? What should he do to find it?

Answer 8C. This research should consist of a review of the various statutory rules and underlying regulations on the matter. It might also require a review of any applicable case law on the subject. A thorough assessment of the arguments Roberta has in her favor and IRS counterarguments may be necessary. Gregory needs to apply the relevant statutory and regulatory rules and any pertinent case law to the specifics of Roberta's loan and guarantee facts and determine if there actually is substantial authority for his position.

If there is substantial authority, Gregory will not have any §10.34 liability concerns as tax preparer. If there is no substantial authority, Gregory must then ensure the position taken has a reasonable basis and is adequately disclosed. Without both of these factors, Gregory may face tax preparer liability while also exposing Roberta to understatement penalties.

Gregory must also advise Roberta of the various applicable penalties that might apply to her situation if the position is successfully challenged and what steps can be taken to avoid the penalty, including the option of not claiming the loss for the year.

Question 8D. Does he have a reasonable basis for the position?

Answer 8D. Appropriate research on the subject of the guarantee under the "at risk" rules is necessary before Gregory can make a judgment on whether a reasonable basis exists for the position about ignoring the guarantee for basis purposes. Even if a substantial basis does not exist, Gregory may still rightly conclude that he has a reasonable basis for the position. The reasonable basis standard is a lower standard than the substantial basis standard.

Example 9. Use the same facts as **Example 8,** except Gregory researches the loan basis issue and determines that there is no substantial authority for taking the position that the loan provides basis. He also concludes that there is not likely any reasonable basis for this position. Therefore, Roberta should not claim the loss for the year. Along with her return, Gregory also provides Roberta with a Form 8275, *Disclosure Statement,* that will accompany the return when it is filed. The return claims the loss. However, Roberta reads the Form 8275 and decides not to sign it or mail it with her return for 2010.

Question 9A. If a Form 8275 is filed with the return, would that be sufficient to provide adequate disclosure?

Answer 9A. Use of Form 8275 in this regard fulfills the adequate disclosure requirement. However, without at least a reasonable basis for the position to begin with, Gregory will face potential tax preparer liability. Roberta will also face exposure to penalties for understatement of taxes. This is true whether or not the Form 8275 is filed because without substantial authority, both adequate disclosure and a reasonable basis are required.

Question 9B. Does providing the Form 8275 to Roberta protect Gregory from disciplinary action for taking an unreasonable position on the return?

Answer 9B. Furnishing the Form 8275 to Roberta will not provide Gregory with immunity from disciplinary action. The position taken on the return had no reasonable basis.

Question 9C. For Roberta, what are the ramifications of not filing Form 8275?

Answer 9C. Roberta is exposing herself to penalties for understatement of tax liability. It could also be argued that her willful decision to not file the Form 8275 indicates fraud. Form 8275 is purely a disclosure statement. Roberta made a conscious decision to fail to disclose information necessary for the IRS to determine the appropriateness of the position taken on her return.