# Chapter 2: Due Diligence and Other Ethical Issues





**Please note.** Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

## DUE DILIGENCE

Circular 230, §10.22(a) obligates the tax preparer to exercise due diligence in the following areas.

- Preparation of tax returns and other federal tax documents
- Ensuring that oral and written communications to the IRS are correct
- Ensuring that the practitioner's communications to the client regarding IRS-administered matters are correct

Circular 230 provides guidance on circumstances under which a practitioner is entitled to rely on information **provided by a client.** It also provides guidance about conditions under which the practitioner may rely on information when formulating **written tax advice.** Relying on **advice provided by any other person** is another area specifically addressed by Circular 230.

A tax practitioner generally may rely in good faith on the information provided by a client without verifying that information.[1] However, the practitioner cannot ignore the implications of the information provided by the client or other information they actually know. If information from a client appears incorrect, incomplete, or inconsistent with another fact, the practitioner must make additional inquiries to confirm the accuracy of the information.

Circular 230, §10.37 provides standards for all written tax advice, and the practitioner must adhere to them. One of the standards prohibits unreasonable reliance on any person's representations or statements when providing written tax advice.[2] Under this rule, reliance on information is not reasonable if the practitioner knows or reasonably should know that the information is incorrect, incomplete, or inconsistent.[3]

In addition, the practitioner may rely on the advice of others if, under all facts and circumstances, both of the following apply.

- The advice is reasonable.
- The reliance is in good faith.

1. Circular 230, §10.34.
2. Circular 230, §10.37(a)(2)(iv).
3. Circular 230, §10.37(a)(3).

Reliance on the advice of another person is not reasonable if the practitioner knows (or should know) that:

- The advice should not be relied on,
- The person who provided the advice is not competent or lacks the qualifications necessary for providing such advice, or
- The person providing the advice has a conflict of interest that violates Circular 230.

**Note.** For further details on the conflict-of-interest rules, see §10.29 of Circular 230.

In addition to the due diligence requirements of §10.22 of Circular 230, the tax return preparer may have other professional due diligence standards to consider. For example, the AICPA Code of Professional Conduct provides the following due diligence rule for CPAs.

> *The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of a member's ability with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public.*[4]

> *Members should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.*[5]

**Note.** Tax practitioners who are attorneys or other professionals may have rules of conduct relating to their professions that include due diligence requirements. These rules may differ from those found in Circular 230, which apply to practice before the IRS. Circular 230 covers preparation of tax documents and tax-related communications. Thus, it regulates more narrowly defined activities than those encompassed by the AICPA and many other professional organizations.

## EIC AND DUE DILIGENCE

Due diligence has become increasingly subject to IRS scrutiny regarding the earned income credit (EIC). The IRS estimates that it paid erroneous EIC claims of between $13.3 billion and $15.6 billion in 2013. This represents between 22.1% and 25.9% of all claims.[6]

Tax return preparers have access to specific guidance regarding their EIC due diligence obligation. EIC due diligence has four elements, each of which has specific requirements. These are summarized in the following table.[7]

4. AICPA Code of Conduct, ET Section 56, Article V, §.01.

5. AICPA Code of Conduct, ET Section 56, Article V, §.04.

6. *EITC Due Diligence and Self-Employed Taxpayers.* Jan. 5, 2015. Internal Revenue Service. [www.eitc.irs.gov/Tax-Preparer-Toolkit/sctraining/taxpayers#whyareschedulec] Accessed on Mar. 31, 2015.

7. *EITC Due Diligence Law and Regulation.* Jan. 27, 2015. Internal Revenue Service. [www.eitc.irs.gov/Tax-Preparer-Toolkit/dd/lawandregs] Accessed on May 11, 2015.

| Requirement | The Tax Returns Preparer Must… |
|---|---|
| 1. Complete and submit the eligibility checklist | • Complete Form 8867, *Paid Preparer's Earned Income Credit Checklist,* to make sure EIC eligibility criteria is considered for each claim prepared.<br>• Complete the checklist based on information provided by the client.<br>• For an EIC return or claim for refund filed electronically, submit Form 8867 to the IRS electronically with the return.<br>• For an EIC return or claim for refund not filed electronically, attach the completed form to any paper return prepared and send it to the IRS.<br>• For an EIC return or claim for refund prepared but not submitted directly to the IRS, provide the completed Form 8867 to the client to send with the filed tax return or claim for refund. |
| 2. Compute the credit | • Complete the EIC worksheet from the Form 1040 instructions, or IRS Pub. 596, *Earned Income Credit,* or a form with the same information. The worksheet shows what is included in the computation, that is, self-employment income, total earned income, investment income and adjusted gross income. Most professional tax preparation software includes the computation worksheet. |
| 3. Possess the requisite knowledge | • Does not know or have reason to know that any information used to determine the client's eligibility for or the amount of EIC is incorrect, inconsistent, or incomplete.<br>• Make additional inquiries if a reasonable and well-informed tax return preparer would know the information is incomplete, inconsistent, or incorrect.<br>• Know the law and use that knowledge to ensure asking the client the right questions to get all the relevant facts.<br>• Document any additional questions asked and the client's answers **at the time of the interview.** |
| 4. Keep Records | • Keep a copy of Form 8867 and the EIC worksheet.<br>• Keep a record of all additional questions asked of the client to comply with the due diligence requirements and the client's answers to those questions.<br>• Keep copies of any documents the client provides that were relied on to determine eligibility for, or the amount of the EIC.<br>• Verify the identity of the person providing the return information and keep a record of who provided the information and when it was received.<br>• Keep records in either paper or electronic format but make sure they can be produced if the IRS asks for them.<br>• Keep these records for three years from the latest date of the following that applies.<br>○ The original due date of the tax return (This does not include any extension of time for filing.)<br>○ If the return or claim for refund is electronically filed and signed by the return preparer, the date the tax return or claim for refund is filed<br>○ If the return or claim for refund is not filed electronically and it is signed by the return preparer, the date the tax return or claim for refund is presented to the client for signature<br>○ If the practitioner prepares part of the return or claim for refund and another preparer completes and signs the return or claim for refund, the practitioner must keep the part of the return they were responsible to complete for three years from the date it was submitted to the signing tax return preparer |

**Note.** Many of these due diligence concepts apply to other areas of tax practice, including identity theft issues.

> **Note.** For additional guidance regarding the four elements of EIC due diligence, tax return preparers may refer to Treas. Reg. §1.6695-2 and the IRS webpage at **uofi.tax/15a2x1** [www.eitc.irs.gov/Tax-Preparer-Toolkit/faqs/duediligence].

## Penalties

Penalty consequences for filing an EIC claim incorrectly may apply to the following parties because due diligence requirements were not met.

- The tax return preparer
- The tax return preparer's employer (if applicable)
- The taxpayer

**Tax Return Preparer EIC Penalties.** A tax return preparer's failure to comply with the four elements of EIC due diligence may result in a **$500 penalty** for each instance of noncompliance.[8] This penalty may be assessed even if the tax return preparer does not knowingly or willfully violate the due diligence requirements. However, the penalty may be waived if the tax return preparer can demonstrate to the IRS that, considering all the facts and circumstances, normal office procedures are in place. The procedures must be reasonably designed and routinely followed to ensure compliance with the due diligence requirements. In addition, it must be shown that the instance of noncompliance was isolated and inadvertent.[9]

> **Note.** Under IRC §6694(a), tax preparers must not take an unreasonable position on a tax return. An **unreasonable position** is one that lacks substantial authority or does not have a reasonable basis and has not been adequately disclosed. For further details on this Code section, see Treas. Regs. §§1.6694-1 and 1.6694-2, and the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Ethical Considerations. This is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive/].

Moreover, if an understatement of tax liability shown on a tax return was due to the tax preparer's **willful or reckless** conduct, §6694(b) provides an increased penalty. These Code sections set forth the following penalties.

| Code Section | Penalty |
|---|---|
| IRC §6694(a) | The greater of:<br>• $1,000, or<br>• 50% of the client fee charged to prepare the return |
| IRC §6694(b) | The greater of:<br>• $5,000, or<br>• 50% of the client fee charged to prepare the return |

A special **antistacking** provision prevents the tax return preparer from being liable for both IRC §§6694(a) and 6694(b) penalties for the same instance of noncompliance. Under this antistacking provision, the IRC §6694(b) penalty serves as the **maximum** that can be assessed for noncompliance.

8. IRC §6695(g) and Treas. Reg. §1.6695-2.

9. Treas. Reg. §1.6695-2(d).

Circular 230, §10.34 addresses standards for tax returns and other documents submitted to the IRS. This section incorporates the definition of the IRC §6694 tax return preparer penalty provision. Under §10.34, a practitioner may not willfully, recklessly, or through gross incompetence sign a return or provide advice known to contain a position that lacks a reasonable basis or that contains an unreasonable position as defined in IRC §6694(a)(2).

In addition, under §10.34, a tax return preparer may not sign a return or provide advice regarding a position on a tax return that is a willful attempt to understate tax liability or that demonstrates a reckless or intentional disregard for rules or regulations described in §6694(b)(2).

> **Observation.** The tax return preparer penalty provisions of IRC §6694 and Circular 230, §10.34 prohibit the same type of conduct. Tax return preparer conduct that violates one of these provisions generally violates the other. Accordingly, conduct that is subject to an IRC §6694 fine can also be subject to an IRS Office of Professional Responsibility (OPR) disciplinary action for the Circular 230 violation.

**EIC Penalties for the Tax Return Preparer's Employer.** A noncompliant tax return preparer's employer is also subject to the $500 EIC due diligence penalty if any of the following apply.[10]

- One or more managers or supervisors either knew of the tax return preparer's failure to comply with EIC due diligence requirements or participated in the noncompliance.
- The firm did not establish appropriate, reasonable procedures designed to ensure compliance with EIC due diligence.
- The firm established adequate procedures to ensure compliance but disregarded those procedures through willfulness, recklessness, or gross indifference.

**Taxpayer EIC Penalties.** If the taxpayer files an erroneous EIC claim, the IRS determines how that claim is treated for penalty purposes. The IRS may choose to treat the erroneous claim as one of the following.

- A mathematical or clerical error
- A deficiency

In addition, if the IRS determines that the erroneous EIC claim involves negligence or fraud, additional rules may apply (discussed later).

***EIC Claim Treated as Mathematical or Clerical Error.*** The IRS may treat the taxpayer's erroneous EIC claim as a mathematical or clerical error if any of the following circumstances apply.[11]

- After the EIC claim was reduced or denied, the required supporting documentation requested by the IRS was not submitted.[12]
- The taxpayer claimed the EIC based on self-employment (SE) income but did not pay SE tax.
- Correct taxpayer identification numbers (TIN) were not provided for the taxpayer and any spouse or qualifying children or the information provided about a TIN holder on the return does not match that provided by the Social Security Administration (SSA).
- The age of a qualifying child is not the same as the child's age as reported to the IRS by the SSA.
- A qualifying child is claimed by a noncustodial parent.

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10. Treas. Reg. §1.6695-2(c).
11. IRC §6213(g).
12. Treas. Reg. §1.32-3(d), IRC §6213(g)(2)(K).

If the erroneous EIC claim is treated as a mathematical or clerical error, the IRS may change the claim amount or deny the entire claim without providing the taxpayer with notice and the opportunity to respond and provide additional information.[13]

***EIC Claim Treated as a Deficiency.*** Generally, if an erroneous EIC claim is not treated as a mathematical or clerical error, it is treated as a deficiency.[14]

EIC claims treated in this manner require the IRS to adhere to deficiency procedures. Doing so means providing the taxpayer with **notice** of a change to the claim or disallowance of the claim. The IRS must also provide the taxpayer with the **opportunity to respond.**

Generally, if the taxpayer's EIC claim is treated as a deficiency and reduced or disallowed, the next return filed by the taxpayer that claims the EIC must include a Form 8862, *Information To Claim Earned Income Credit After Disallowance*. Form 8862 is used to prove that the taxpayer qualifies for the EIC in that year. The IRS also can request additional information from the taxpayer beyond the information indicated on Form 8862.[15]

**Note.** For a taxpayer that appears to be making an EIC claim for the first time, it is prudent for the tax return preparer to ask that taxpayer if they have ever claimed the EIC or had a prior EIC claim reduced or disallowed. Asking these questions is not one of the specific EIC due diligence requirements. However, asking them can eliminate difficulties associated with the taxpayer's EIC claim by ensuring that a Form 8862 accompanies the return when necessary.

If the taxpayer's return does not include a Form 8862 for a year in which it is required or if the submitted Form 8862 is incomplete or inaccurate, the denial of the taxpayer's EIC claim may be treated as a mathematical or clerical error and not as a deficiency.[16]

Married filing jointly (MFJ) taxpayers must file a Form 8862 if one spouse's EIC claim was previously denied and that spouse did not establish eligibility again in any subsequent year.[17]

A taxpayer whose EIC claim is treated as a mathematical or clerical error and who has that claim reduced or disallowed is not required to file a Form 8862 in a later year. Once the taxpayer has filed a Form 8862 that establishes EIC eligibility, filing Form 8862 is not required in later years. In addition, if the taxpayer's EIC was reduced or disallowed in a prior year solely because they improperly claimed a qualifying child and they claim the EIC in a later year without a qualifying child, filing a Form 8862 is not required in that later year.[18]

## EIC Claim Involving Negligence or Fraud

Generally, a taxpayer is required to make a reasonable attempt to comply with tax laws and exercise ordinary and reasonable care in preparing their return.[19] **Taxpayer negligence** with respect to tax return preparation is generally defined as a failure to adhere to this standard.[20]

13. IRC §6213(b).
14. Treas. Reg. §1.32-3(b).
15. IRS Pub. 596, *Earned Income Credit (EIC)*.
16. Treas. Reg. §1.32-3(d).
17. Treas. Reg. §1.32-3(e).
18. IRS Pub. 596, *Earned Income Credit (EIC)*.
19. Treas. Reg. §1.6662-3(b)(1).
20. Ibid.

Tax preparers who fail to exercise appropriate due diligence in preparing a taxpayer's return not only subject themselves to the preparer penalties but may also subject the taxpayer to negligence or fraud penalties. IRC §6662 imposes an accuracy-related penalty on the taxpayer for the following types of misconduct.[21]

- **Negligence** or **disregard** for tax rules or regulations
- **Substantial understatement** of income tax
- **Substantial or gross valuation misstatement** regarding the value or adjusted basis of property

> **Note.** IRC §6662 penalties are assessed against the taxpayer, not the tax preparer. Penalties that may be imposed against the tax preparer include those found in IRC §6694.

Taxpayer **negligence** includes failing to make a reasonable attempt to comply with tax law or to exercise ordinary and reasonable care in preparing their tax return.[22] The term **disregard** under IRC §6662 includes the taxpayer's carelessness, recklessness, or intentional disregard in complying with tax rules or regulations.[23]

For an individual taxpayer, a **substantial understatement** of income tax is defined as an understatement that exceeds the greater of the following two amounts.[24]

- 10% of the correct amount of income tax that should have been shown on the return
- $5,000

A **substantial valuation misstatement** occurs if the taxpayer claims a property value or basis that is 200% or more of the correct amount. A **gross valuation misstatement** occurs if the taxpayer claims a property value or basis that is 400% or more of the correct amount.[25] However, if the taxpayer makes either a substantial or gross valuation misstatement, no penalty is assessed unless the amount understated is more than $5,000.[26]

> **Note.** For additional details and guidance regarding the accuracy-related penalty imposed on taxpayers, see IRC §6662 and the underlying regulations.

Generally, the amount of the penalty is based on the amount of understated tax liability on the taxpayer's return. The penalty is 20% of the understated amount (or 40% for a substantial or gross valuation misstatement).[27]

Upon an adequate showing of reasonable cause and good faith, the taxpayer may obtain a waiver of this penalty.[28] The determination of whether the taxpayer had reasonable cause and acted in good faith is made on a case-by-case basis, and all relevant facts and circumstances are considered. The most important factor is the extent of the taxpayer's efforts to assess the proper tax liability. Reliance on a tax practitioner's advice may form the basis for a penalty waiver if the taxpayer can show that their reliance on the tax practitioner was reasonable and the taxpayer acted in good faith.[29]

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21. Treas. Reg. §1.6662-2(a).
22. IRC §6662(c).
23. Ibid.
24. IRC §6662(d)(1).
25. Treas. Reg. §1.6662-5(e).
26. Treas. Reg. §1.6662-5(b).
27. Treas. Reg. §1.6662-2(b).
28. IRC §6664(c)(1).
29. Treas. Reg. §1.6664-4(b)(1).

**Example 1.** Lara is an EA who has been preparing tax returns for two years. She meets with her new client, Pam, in connection with preparing Pam's 2015 tax return. Pam indicates that she files as head of household (HoH) and has two children, Corrina and Clark, who are 12 and 13 years old, respectively.

Pam also indicates that she has a house-cleaning business that earned $12,000 of income in 2015. Lara asks Pam about business expenses. Pam responds that she did not have any business expenses for the year, because the homeowners provided all the cleaning materials.

Lara asks Pam how many houses she cleaned during the year. Pam says that she cleaned the same 11 houses throughout the year. Lara asks Pam how many times she cleaned the houses and how much she charged. Pam indicates that each house had a different cleaning schedule and that she generally charged $50 to clean a house.

Lara completes Pam's 2015 return using a filing status of HoH.

Lara did not exercise the necessary degree of due diligence with respect to Pam's 2015 tax return. She did not make sufficient inquiries to determine if the business actually exists and how Pam calculated $12,000 of income for the year. Lara's inquiry regarding the number of houses and the general charge per house alone is not sufficient to meet the due diligence requirement. Lara should have followed up her inquiry with a request for written documentation from Pam. In addition, although it is possible for annual gross income to be a round amount, Pam's calculation of $12,000 should have alerted Lara that the amount may not be accurate.

Lara should ask Pam to provide a written record of her income and expenses for the year. In addition, Lara should not depend on Pam to determine the correct filing status. Lara must ask the client pertinent questions to determine the correct filing status.

By preparing the return without making the necessary inquiries, Lara has exposed herself to discipline under Circular 230 for her violation of the §10.22 due diligence requirements. She arguably also violated §10.34 by failing to make appropriate inquiries when the information furnished appeared incorrect or incomplete. She may be subject to the IRC §6694 accuracy-related penalty and has exposed Pam to a possible taxpayer penalty under IRC §6662.

**Note.** A taxpayer with SE income who claims the EIC is obligated to report all business expenses because the EIC is based on net SE income. The taxpayer cannot disregard business expenses.[30] For further information on EIC fraud, see **uofi.tax/15a2x2** [www.eitc.irs.gov/Tax-Preparer-Toolkit/faqs/fraud].

### Taxpayer EIC Ban

Generally, a taxpayer with a denied EIC claim can reestablish eligibility using Form 8862 (as discussed previously). However, if the IRS determines that the taxpayer's EIC claim resulted from reckless or intentional disregard of EIC rules and regulations, the taxpayer may be banned from making an EIC claim for the next **two years** following the year of the denied EIC claim. The IRS sends a CP 79A letter to the taxpayer regarding this ban. A sample of the CP 79A letter follows.[31]

30. CCA 200022051 (Apr. 6, 2000); Rev. Rul. 56-407,1956-2 CB 564.

31. *CP 79A Sample Contents.* Mar. 30, 2015. Internal Revenue Service. [www.irs.gov/Individuals/CP-79A-Sample-Contents] Accessed on May 13, 2015.

**Why We Denied Your EIC Claim**

We recently denied all or part of the Earned Income Credit (EIC) claimed on your individual income tax return for the tax period shown above. We did this for one of the two following reasons, as indicated in the notice we previously sent to you:

- You did not verify that you were entitled to the credit you claimed.
- We made adjustments to your income and/or expenses that reduces the credit in part or in full.

**Why We assessed the Two Year Ban**

We determined that your EIC claim was due to reckless or intentional disregard of the EIC rules and regulations. For this reason, the law does not allow you to claim the EIC for the next 2 years.

**When and How You Can Claim EIC In The Future**

The next year that you may be able to claim EIC is ____ . Please make sure that you qualify for EIC by reviewing Publication 596 Earned Income Credit before you claim it again. If you claim EIC due to reckless or intentional disregard of the EIC rules or regulations again, you could be assessed a penalty and be subject to another Two Year Ban.

To claim the EIC with a qualifying child or children, after the 2-year ban, you must attach a completed Form 8862, Information to Claim Earned Income Credit After Disallowance, to your return. After we receive your return with Form 8862, we will likely ask you for documents to support your EIC claim. This will delay your refund. If we need documentation, we will send you a letter requesting it - please do not attach it to your return.

To claim the EIC for taxpayers without a qualifying child, after the 2-year ban, see the Form 8862 instructions to determine if it is required.

You'll be able to get Form 8862 and Publication 596 at most locations where tax forms are available, from the IRS web site, www.irs.gov, or you can call the IRS at ***{appropriate #}***. You'll also be able to send Form 8862 electronically if you file your federal income tax return electronically.

If you have any questions about this letter, please call the number shown above. If you prefer, you may write to us at the address shown at the top of this letter.

If the IRS determines that the taxpayer made a fraudulent EIC claim, a **10-year ban** may be imposed.[32]

**Note.** For further guidance on how to address a taxpayer's EIC denial and the imposition of a 2- or 10-year ban, see IRS Pub. 596, *Earned Income Credit (EIC).*

**Observation.** The EIC due diligence rules provided by the IRS do not include a specific requirement to ask taxpayers if they are presently banned from making an EIC claim. However, it is prudent for the tax return preparer to ask this question, particularly for a taxpayer who has a tax history that is unfamiliar to the preparer. Doing so will prevent inappropriate EIC claims. Generally, if an EIC claim is made during the ban period, the IRS denies the claim and sends IRS letter CP75C, which states that the ban is still in effect.

32. IRS Pub. 4687, *EITC, The Due Diligence Must Do's*.

## IRS DUE DILIGENCE INITIATIVE

In addition to its efforts to increase compliance with EIC due diligence requirements, the IRS increased its oversight of due diligence in other areas. The IRS developed several letters that address areas of tax reporting in which tax preparers make errors because of a lack of appropriate due diligence. The following table summarizes the types of letters that were sent to select tax return preparers across the United States in November and December 2013. Additional future mailings are expected.

| Letter Identification Number | Tax Reporting Area or Issue | Nature of Letter |
|---|---|---|
| 5105 | Errors on Schedule C | Educational letter |
| 5271 | Child Tax Credit | Educational letter |
| 4911 | Practitioner's failure to comply with their own personal or business federal tax filing or payment obligations | Directive to resolve delinquencies in filing or payment obligations; possible revocation of PTIN |
| 4810 | Errors on Schedule C | Visit to review Schedule C rules |
| 5272 | Child Tax Credit and Additional Child Tax Credit; Form 8812, *Child Tax Credit* | Educational letter |

The content of IRS Letter 5105 follows.[33] The other letters have similar content. It is noteworthy that the letter makes specific references to §§10.22 and 10.34 of Circular 230, as well as IRC §6694. As discussed previously, these are the key provisions involved if the tax return preparer fails to exercise appropriate due diligence.

**Note.** Further details regarding this IRS due diligence initiative, including the contents of these letters, can be found at **uofi.tax/15a2x3** [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits-to-Return-Preparers].

**Observation.** Two of these letters involve errors on Schedule C. Due diligence specifically related to Schedule C is discussed later.

33. *IRS Letters and Visits – Letter 5105*. Jan. 7, 2015. Internal Revenue Service. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits-Letter-5105] Accessed on Mar. 25, 2015.

**Sample Letter 5105**



We reviewed tax returns you prepared in the past year and found that many have a high percentage of traits we believe typically indicate errors on Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship). This letter reminds you of your responsibilities in this area and provides educational assistance. As a paid preparer, you are responsible for ensuring your clients' returns are accurate. We ask that you pay special attention to these schedules next filing season.

**Due diligence responsibilities**

A paid tax return preparer must take multiple steps to prepare accurate tax returns on behalf of clients. These steps are a preparer's due diligence and include reviewing the applicable tax law to establish the relevance and reasonableness of income, credits, expenses, and deductions on a return. In general, you can rely in good faith without verification on information your client provides. However, you can't ignore the implication of the information you have. You must make reasonable inquiries if the information appears to be incorrect, inconsistent or incomplete.

**Schedule C reminders**

To prepare an accurate Schedule C, you must ask your clients relevant and probing questions to help you determine if the expenses are allowable. Taxpayers may not fully understand the tax laws and may incorrectly believe they can claim deductions for non-qualifying expenses. You should also ask your clients if they have receipts to support the expenses and instruct them to keep them in case we request supporting documentation.

**Helpful resources**

We provide information about the Schedule C on our website at www.irs.gov, keyword: Recommended Reading for Small Businesses. In addition, we recommend you review:

- Schedule C instructions
- Circular 230, Section 10.22, Diligence as to accuracy
- Circular 230, Section 10.34, Standards with respect to tax returns and documents, affidavits, and other papers

**Potential consequences**

In the future, both you and your clients could face negative consequences from inaccurate returns. We'll be looking for improvement in future returns you prepare. Inaccurate returns may result in any of the following consequences:

- If we examine your clients' returns and find inaccuracies, your clients may be liable for additional tax, interest, additions to tax, and penalties.
- If you prepare a client return that has an understatement of tax liability due to an unreasonable position, we can assess you a minimum penalty of $1,000 per return (IRC Section 6694(a)).
- If you prepare a client return that has an understatement of tax liability due to reckless or intentional disregard of rules or regulations by the tax preparer, we can assess a minimum penalty of $5,000 per return (IRC section 6694(b)).

I hope this letter has increased your awareness of your responsibilities as a paid tax return preparer and provided you with information on preparing accurate Schedules C for your clients.

Thank you for your attention to this matter.

Sincerely,

Carol A. Campbell
Director, Return Preparer Office

Letters from the IRS Return Preparer's Office (RPO) specifically target the practitioner's personal or business tax obligations and returns with potential errors regarding Schedule C and child tax credit claims. However, increased IRS scrutiny and/or increased litigation makes it prudent for the practitioner to take additional steps in other areas to ensure compliance with due diligence requirements. These areas include the following.

- Adhering to the documentation requirements for **charitable donations**
- Properly documenting and claiming **travel and entertainment expenses**
- Implementing the **expensing and capitalization** rules in the repair regulations[34]
- Ensuring that **reasonable compensation** requirements for S corporation shareholders are met
- Applying the rules that may limit or preclude the **deduction of S corporation losses**
- Properly applying the rules for calculating a taxpayer's **net investment income**

**Note.** For further details on net investment income and the 3.8% net investment income tax, see IRC §1411 and underlying regulations.

**Example 2.** Jason, a CPA, completes Sandra's 2014 tax return. Sandra has a custom drapery business, which she operates as an S corporation.

Sandra informs Jason that, due to a decline in business for the year, she had to work part-time for a local drapery retailer. Sandra received a Form W-2, *Wage and Tax Statement,* from the retailer showing wages of $24,000.

Jason first completes Form 1120S, *U.S. Income Tax Return for an S Corporation,* for the S corporation. Both the return and the corresponding Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* show an ordinary loss of $16,650. Jason has kept a record of Sandra's stock basis in the S corporation over the years. He determines that she has no stock basis in the S corporation at the end of 2014.

Accordingly, Jason telephones Sandra to discuss the stock basis with her. He tells her that she will not be able to deduct the $16,650 loss against her $24,000 of part-time employment income. This deduction is not allowed unless there were transactions during the year between her and the S corporation that would increase her basis. Sandra tells Jason that she borrowed $17,000 to purchase a new piece of equipment. This loan was never entered on the books and records of the S corporation because the bank paid the funds directly to the seller of the equipment.

In 2015, an audit of Sandra's return reveals that the nature of the loan Sandra mentioned was a bank loan in the name of the S corporation. Sandra signed the loan paperwork only as guarantor. Sandra's guarantee does not provide her with debt basis.

Jason exercised due diligence by telephoning Sandra to ask her about additional contributions or loans to the corporation that would affect her 2014 basis amount. However, when Sandra mentioned that she loaned money to the S corporation, **Jason should have asked about relevant details** to ensure the loan provided her with debt basis. Asking such questions was necessary for Jason to accurately apply the tax law and rules to her situation. Asking additional relevant questions would have revealed that the nature of the loan did not provide debt basis under S corporation rules.

Jason's lack of appropriate due diligence exposed him to disciplinary measures. He committed a Circular 230, §10.22 violation. Jason is also vulnerable to an accuracy-related penalty under IRC §6694. Jason's lack of due diligence exposed Sandra to an IRC §6662 penalty.

34. TD 9636, 2013-43 IRB 331.

**Example 3.** Frank is a CPA and prepares Clark's tax returns. He meets with Clark to ask questions and review information relevant to preparation of Clark's 2015 tax return. Because Clark is self-employed, he obtained health insurance coverage through the Health Insurance Marketplace exchange for 2014.

Frank notices that Clark does not have Form 1095-A, *Health Insurance Marketplace Statement,* or Form 1095-B, *Health Coverage,* for 2015. Frank knows that Clark is subject to the Affordable Care Act's individual mandate to maintain minimum essential coverage for 2015. Frank asks Clark about his health insurance for 2015.

Clark shows Frank four exemption certificates from the Marketplace exchange. The certificates include the required exemption certificate number (ECN). This provides Clark with a hardship exemption for 2015.

Clark gives the exemption certificates to Frank and says:

> *"I'm exempt this year. I got the exemption because paying for that coverage last year was way too expensive. It was easy to get this exemption. All I had to do was stop paying my electric bill for a couple of months, until I got the shut-off notice in the mail. Once I had the shut-off notice, I paid my electric bill. Then I sent the shut-off notice to the Marketplace after I was informed that this would suffice for a hardship exemption for the year. I repeated this process three more times to cover the whole year. How easy was that?"*

Clark indicates to Frank that he had no financial hardship for the year. The next day, Frank begins to complete Clark's return, including Form 8965, *Health Coverage Exemptions,* which accompanies Clark's return.

**Opinion 1.** Circular 230, §10.22(a)(2), obligates Frank to exercise due diligence in determining the correctness of oral or written representations made by Frank to the IRS. The exemption letter is valid and was issued by the Marketplace under the applicable exemption rules. Nonetheless, Frank is aware that Clark did not actually experience a hardship. It could be argued that Frank violates §10.22(a)(2) when he completes Clark's return with the hardship exemption and signs and submits the return to the IRS.

In addition, §10.51 of Circular 230 outlines several circumstances that constitute disreputable conduct on the part of the practitioner. In particular, §10.51(a)(4) indicates that disreputable conduct includes (emphasis added):

> ***Giving false or misleading information, or participating*** *in any way* ***in the giving of false or misleading information to the Department of the Treasury*** *or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters,* ***in connection with any matter pending or likely to be pending*** *before them,* ***knowing the information to be false or misleading.*** *Facts or other matters contained in testimony,* ***Federal tax returns,*** *financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral,* ***are included in the term "information."***

Section 10.51(a)(7) states that disreputable conduct includes:

> *Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.*

Arguably, Frank engages in disreputable conduct when he completes and files Clark's return with the exemption.

**Observation.** Failure to exercise due diligence does not necessarily involve incompetence or disreputable conduct. However, it is possible for a practitioner to violate one or more of the due diligence, competence, and conduct provisions of Circular 230.

**Opinion 2.** The requirements to qualify for an exception to having health insurance coverage are as follows.

- Fill out a paper hardship application and mail it to the Marketplace.
- Provide a copy of a notice from a utility company dated between January 1, 2015, and December 31, 2015, that says a service was or will be shut off. This is considered a hardship that kept the taxpayer from getting health insurance.
- Use one application to claim an exemption for anyone in the taxpayer's household who qualifies.
- Complete, sign, and mail the application. When the applicant signs the application, they agree that they are signing under penalty of perjury.

If Clark is issued an ECN and gives this to Frank for the preparation of his 2015 tax return, then Frank has performed the duties required under Circular 230, §10.22(a)(2). Frank exercised due diligence in determining the correctness of oral or written representations made by Clark. Determining whether fraud occurred is not a decision that can be made by the tax preparer; it is a decision made by the Marketplace.

As stated previously, Circular 230, §10.51(a)(7) describes **disreputable conduct** as willfully assisting, counseling, or encouraging a client in violating any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade federal taxes. Because the requirement for an exemption due to a utility shut-off does not require financial statements to prove an inability to pay, the ECN is valid for preparing Clark's 2015 tax return.

## Due Diligence and Schedule C

The two most common errors on Schedule C, *Profit or Loss From Business,* that are associated with EIC claims are as follows.[35]

- Schedule C losses that are overstated to reduce income to qualify for the EIC
- Inflated income for purposes of maximizing the EIC

Approximately 21 million Schedules C are filed annually. Most of them report income and expenses of small businesses, which are frequently home based. The IRS estimates that about one-third of the United States' $450 billion tax gap is attributable to erroneous Schedules C.[36]

Tax return preparers must exercise due diligence by making inquiries about Schedule C businesses (regardless of whether the taxpayer claims the EIC). Tax return preparers should ask relevant and probing questions. Asking these questions should determine whether there is an actual business, rather than a hobby.

It is also prudent for the tax return preparer to ask the taxpayer if they have receipts to verify the expenses claimed. The tax return preparer should advise the taxpayer to retain those receipts in case the IRS asks them to verify the claimed deductions.

Circular 230, §10.34(d) provides the standard for practitioner conduct regarding information furnished by the client. The practitioner may rely in good faith on information provided by the taxpayer without verifying that information. However, the practitioner cannot ignore the implications of that information. Making reasonable inquiries is necessary if the information appears to be incorrect, inconsistent with an important fact, or incomplete.

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35. *EITC Due Diligence and Self-Employed Taxpayers.* Jan. 5, 2015. Internal Revenue Service. [www.eitc.irs.gov/Tax-Preparer-Toolkit/sctraining/taxpayers#whyareschedulec] Accessed on Mar. 31, 2015.

36. Ibid.

**Example 4.** Laura, an enrolled agent and attorney, has completed Greg's tax return every year since 2009. Each year, Greg receives a Form W-2, *Wage and Tax Statement,* from his employer. He also receives various information returns showing his investment income. In addition, Greg files a Schedule C each year for his engineering consulting business, which he operates from his home.

Laura meets with Greg to review his tax information before completing his 2015 tax return. During the meeting, Laura notices that the income shown on Greg's W-2 is significantly higher than it has been in past years. Greg explains that the 2015 income is about $15,000 higher because his work schedule involved a substantial amount of overtime. He provides Laura with a spreadsheet showing the 2015 income and expenses for the consulting business.

After meeting with Greg, Laura starts to work on his 2015 return. She begins by reviewing Greg's returns for the past three years. She compares the Form W-2 amounts and Greg's spreadsheets for the past three years with the information he provided for 2015. Greg's spreadsheet shows the following information.

| | 2012 | | 2013 | | 2014 | | 2015 | |
|---|---|---|---|---|---|---|---|---|
| Income | | $ 23,745 | | $ 19,868 | | $ 21,659 | | $ 33,000 |
| Consulting expenses: | | | | | | | | |
| Advertising | | | | | | | $14,000 | |
| Depreciation | | | | | | | 3,800 | |
| Insurance | $ 340 | | $365 | | $ 365 | | 365 | |
| Legal fees | | | | | | | 4,255 | |
| Repairs and maintenance | 126 | | | | 331 | | 15,500 | |
| Supplies | 498 | | 443 | | 517 | | 2,694 | |
| Travel | 267 | | | | 342 | | 4,228 | |
| Meals and entertainment | | | | | | | 750 | |
| Total expenses | $1,231 | (1,231) | $808 | (808) | $1,555 | (1,555) | $45,592 | (45,592) |
| Net income/(loss) | | $ 22,514 | | $ 19,060 | | $ 20,104 | | ($ 12,592) |
| Wage income (Form W-2, box 1) | | $196,350 | | $197,500 | | $197,500 | | $212,500 |

Generally, Laura may rely on Greg's 2015 information without verification. However, additional inquiries are necessary if the information appears inconsistent with an important fact. In this case, the increased consulting business income is not consistent with Greg's statement that his employment required substantial overtime during the year. In addition, the fact that the income is a round amount (and that this is the first year Greg is showing a round amount in this 4-year period) may require Laura to ask some additional questions about the income and how Greg arrived at this income amount.

The following issues should also cause Laura to exercise appropriate due diligence and ask additional questions to ensure the accuracy of Greg's 2015 information.

- Income and expenses for years prior to 2015 are relatively stable from year to year. However, the amounts for 2015 do not fit this pattern.
- The amount for supplies is substantially larger than in prior years.
- Some expenses are being claimed for the first time for a business that has operated for several years. First-time claims for meals, advertising, and legal fees may suggest that Greg is attempting to claim nondeductible personal expenses.
- Spending a large amount on advertising for the first time is not consistent for a year that required a substantial amount of employment overtime.

- The amount spent on repairs and maintenance seems very high for a small, part-time consulting business.
- Compared with prior years, Greg claimed a substantially greater amount for business travel. This is inconsistent with substantial employment overtime.
- The amount of the loss is about the same as Greg's additional overtime income. Laura should consider the possibility that Greg may be trying to create a Schedule C loss to offset his overtime income. Because he is a single filer, his net investment income tax (NIIT) threshold is $200,000. The loss amount places him just under the NIIT threshold.

## Due Diligence and Profit Motive

Under IRC §183, if an activity is not engaged in for profit, deductions are generally limited to the amount of gross income from the activity. Amounts otherwise allowable under other Code sections without regard to whether the activity is engaged in for profit may also be deducted.[37]

For an activity to be considered a trade or business, making a profit must be the predominant purpose for engaging in the activity. An activity is not characterized as a trade or business and deductions are not allowed when the activity is dominated by a tax-savings motivation.[38]

If gross income exceeds deductions for at least three years of a consecutive 5-year period, the activity may be presumed to be engaged in for profit.[39] The taxpayer can elect not to make the profit-motive determination before the end of the fourth tax year following the tax year in which they began to engage in the activity.

**Note.** For further details on the profit motive presumption, the election, and the manner in which the election is made, see IRC §183(e); Treas. Reg. §1.183-1(c); Form 5213, *Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit;* and the instructions to Form 5213. In addition, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Hobby Losses. This is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive/].

To determine whether an activity is engaged in for profit, the applicable facts and circumstances are analyzed. Although no single factor is determinative, the following factors normally are considered in the analysis.[40]

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer and their advisors
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity may appreciate in value
5. The taxpayer's success in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with the activity
7. The amount of occasional profits, if any
8. The taxpayer's financial status
9. Elements of personal pleasure or recreation from the activity

**Observation.** To meet due diligence requirements, tax return preparers should use this list as a checklist of factors they should ask clients about in determining whether a given activity is actually engaged in for profit.

37. IRC §183(b)(1).

38. *Gajewski v. Comm'r,* 723 F.2d 1062 (2nd Cir. 1983), *cert. denied,* 105 S.Ct. 549 (1984); *International Trading Co. v. Comm'r,* 275 F.2d 578 (7th Cir. 1960).

39. IRC §183(d).

40. Treas. Reg. §1.183-2.

**Example 5.** Brent, an EA, meets with his new clients, Melvin and Morgan, to discuss details regarding their 2015 tax return. Melvin and Morgan are married and have filed jointly in past years. Both spouses work full-time, and they provide Brent with Forms W-2 from their respective employers.

Melvin and Morgan tell Brent that they started an Internet business during the year that involves buying and reselling items online. They renovated and installed a heating system in their garage so they can store items there for the business. They provide Brent with the following list of business income and expenses for 2015.

| | | |
|---|---|---|
| Income | | $ 470 |
| Expenses: | | |
| Advertising | $1,300 | |
| Garage renovations | 6,320 | |
| Supplies | 1,400 | |
| Meals and entertainment | 620 | |
| Total expenses | $9,640 | (9,640) |
| Net income/(loss) | | ($9,170) |

Melvin and Morgan's new endeavor may be a legitimate business with a bona fide profit motive. Nonetheless, Brent's due diligence obligation requires him to make inquiries. His questions should focus on whether this activity is operated in a businesslike fashion.

Brent should ask Melvin and Morgan the following questions.

- How do they conduct their recordkeeping?
- How much time/space in their garage is for personal versus business use?
- What is the nature of the garage renovations?
- Were any online purchases kept for personal use?
- Did they obtain any professional advice before starting the business?
- Do they believe this Internet business will be a profit-making activity given the large loss they experienced in 2015?
- What is the past business history of each spouse?
- How much time does each spouse devote to the activity?

By asking appropriate due diligence questions, as required by Circular 230, §§10.22(a) and 10.34(d), Brent must satisfy himself that Melvin and Morgan have a bona fide business operation and that they operate it with a clear profit motive. Only then can Brent treat this activity as a business on Melvin and Morgan's 2015 return.

# COMPETENCE

## COMPETENCE UNDER CIRCULAR 230

Changes to Circular 230 finalized on June 12, 2014, include a competence standard for tax practitioners. Section 10.35 states that the practitioner must be competent to engage in practice before the IRS. This new standard requires the practitioner to possess the appropriate level of knowledge, skill, thoroughness, and preparation necessary for work that they are engaged to perform.

The IRS recognizes that a highly experienced practitioner may require less preparation than a practitioner handling the same matter for the first time.[41] Moreover, the IRS expects that a practitioner who is not competent in a particular matter will advise a client to seek counsel from another practitioner who meets the competence standard with respect to the client's situation.

> **Observation.** The §10.35 competence standard states that a practitioner who is not competent may become competent through studying the client's matter and applicable rules or through consulting with more experienced colleagues.

## COMPETENCE UNDER THE AICPA

The AICPA rule regarding competence follows.

> ***AICPA Code of Professional Conduct, ET §201.02***
>
> *A member's agreement to perform professional services implies that the member has the necessary competence to complete those professional services according to professional standards, applying his or her knowledge and skill with reasonable care and diligence, but the member does not assume a responsibility for infallibility of knowledge or judgment.*
>
> *Competence to perform professional services involves both the technical qualifications of the member and the member's staff and the ability to supervise and evaluate the quality of the work performed. Competence relates both to knowledge of the profession's standards, techniques and the technical subject matter involved, and to the capability to exercise sound judgment in applying such knowledge in the performance of professional services.*
>
> *The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. In some cases, however, additional research or consultation with others may be necessary during the performance of the professional services. This does not ordinarily represent a lack of competence, but rather is a normal part of the performance of professional services.*
>
> *However, if a member is unable to gain sufficient competence through these means, the member should suggest, in fairness to the client and the public, the engagement of someone competent to perform the needed professional service, either independently or as an associate.*

The competence rule under the AICPA Code of Professional Conduct is similar to §10.35 of Circular 230 in some important ways. **Common features** include the following.

- The degree of required competence is determined by the work to be performed for the client.
- It is possible to become competent through performing additional research or consulting with others.
- If the practitioner is not competent, they have the duty to refer the client to another person who is competent.

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41. 79 Fed. Reg. 33,685, 33,690 (Jun. 12, 2014).

**Differences** between the two rules include the following.



- The AICPA rule specifically includes a supervisory aspect, whereas the Circular 230 rule does not.
- The AICPA rule includes the technical qualifications of the accountant's staff as part of the accountant's competence, whereas the Circular 230 rule does not.
- The AICPA rule does not define competence using the four elements used in the Circular 230 rule (i.e., skill, thoroughness, knowledge, and preparation).
- Circular 230 does not specifically indicate that the practitioner "does not assume a responsibility for infallibility of knowledge or judgment," as stated in the AICPA rule.

**Example 6.** Gladys is a CPA who passed the CPA exam two years ago. She now operates her own accounting and tax preparation firm as a sole practitioner. For the past two years, she completed Forms 1040, 1120S, and 1065 and related forms and schedules for her small but growing number of clients.

In June 2013, Gladys met with Bob and Barbara. They are married and moved to the United States from Canada to work for a U.S. company. They told Gladys that they would receive Forms W-2 after the end of the year showing their respective salaries for 2013. They also indicated that they would have some Canadian wage and investment income in the form of interest and dividends. They received this income in early 2013 before moving to the United States.

Bob and Barbara asked Gladys to complete their 2013 tax return, which was the first U.S. tax return they filed. Gladys had never prepared an initial tax return for a new U.S. resident. However, she thought that Bob and Barbara's 2013 U.S. tax return would not be materially different from other MFJ returns she had prepared.

In early 2014, Bob and Barbara met with Gladys to discuss preparation of their tax return. They furnished Gladys with their Forms W-2 and the amounts of Canadian wage income they received and income taxes they paid in Canada. The next day, Gladys researched how to report the Canadian wage and investment income on Form 1040. She also researched how to convert the Canadian dollar amounts to the U.S. dollar equivalents that must be shown on Form 1040. Gladys completed Form 1040 and met with Bob and Barbara to review the return. After all three of them signed the return, it was filed.

In June 2015, Bob and Barbara contacted Gladys about letters they had received from the IRS and the Financial Crimes Enforcement Network (FinCEN). They furnished copies of the letters to her. The letters identified the following issues with Bob and Barbara's 2013 tax return.

- Bob and Barbara failed to report their Canadian retirement and investment accounts on FinCEN Form 114, *Report of Foreign Bank and Financial Accounts,* as required under the Bank Secrecy Act.
- Bob and Barbara failed to attach Form 8938, *Statement of Specified Foreign Financial Assets,* with their return to disclose their Canadian retirement and investment accounts.
- Bob and Barbara owe additional tax on the annual growth in their Canadian retirement accounts. They did not make the required annual election to exempt this annual growth from U.S. taxation using Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.*

Circular 230, §10.35 requires Gladys to have the necessary knowledge, skill, thoroughness, and preparation for matters on which she provides services or advice to clients. Gladys's initial preparation as a CPA and the research she conducted gave her a beginner's level of knowledge and skill. However, her preparation and research were not adequate to provide the level of competence necessary to complete Bob and Barbara's 2013 tax return.

Under §10.35, Gladys may use a variety of means to become competent. This includes consulting another tax practitioner who has experience in the preparation of tax returns for taxpayers with offshore accounts and assets.

In addition, Gladys did not exercise adequate due diligence under Circular 230, §10.22. She should become familiar with the reporting requirements associated with offshore assets. Moreover, she should ask relevant questions of her clients to determine whether they are affected by these complex tax rules. If she is not competent to complete the necessary forms, she has a professional and ethical obligation under the competence rule to refer her clients to a more experienced tax practitioner.

Under the AICPA competence rule, additional research or consultation with others may be necessary during the performance of professional services. The AICPA rule considers such consultation to be a normal part of accounting practice. Gladys did not consult with another professional. Moreover, under the AICPA rule, the professional standards to which she is required to adhere very likely would include at least some knowledge and awareness of the reporting requirements for offshore accounts and the need to ask clients questions about those accounts.

**Observation.** Exercising appropriate due diligence by asking her clients the relevant questions would have alerted Gladys to the need to increase her own competence or to refer Bob and Barbara to another practitioner.

**Note.** The Circular 230 competence rule applies only to activities that fall within the scope of Circular 230, which include those activities involving practice before the IRS. The AICPA competence rules have a wider scope and cover professional activity beyond the reach of Circular 230.

## OTHER RELATED SERVICES

In addition to preparing tax returns, practitioners may provide additional related services, such as tax planning. This section covers rules that are relevant to practitioners. Practitioners who engage in tax planning and provide tax advice must keep these rules in mind.

### TAX PLANNING

Tax planning involves arranging the taxpayer's affairs to minimize taxes. The ability of a taxpayer to avoid taxes through planning is well established. Consider the following quote from a U.S. Supreme Court case.[42]

> *[T]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted [citations omitted]. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.*

Tax planning to reduce tax liability is a legitimate goal. However, if the planning includes an element of fraud, deceit, or concealment, it becomes **tax evasion.**

Practitioners who engage in tax planning should keep the following references in mind.

- IRC §7201 relating to tax evasion
- IRC §7206 relating to false returns, concealment, and other prohibited conduct
- Requirements for written advice under Circular 230, §10.37

42. *Gregory v. Helvering,* 55 S.Ct. 266 (Jan. 1935).

### Tax Evasion

IRC §7201 states that **any person** who willfully attempts to evade any tax imposed by the Code (including evasion of tax payments assessed under the Code) is subject to felony conviction. Upon conviction, IRC §7201 provides a fine of up to $100,000 ($500,000 for a corporation), or five years' imprisonment, or both (along with the costs of prosecution).

Moreover, under the same Code section, a fine of up to $250,000 may be imposed for tax evasion.[43]

> **Note.** Although a practitioner may be convicted of tax evasion under the Code, other general federal crime provisions may also apply to their conduct. For example, a practitioner who assists in the commission of tax evasion may be liable as an accessory to the crime. The taxpayer may be convicted as the party primarily liable. A practitioner's conduct may therefore violate both federal crime provisions and the Code.

The following table provides some examples of tax avoidance and tax evasion.

| Tax Avoidance | Tax Evasion |
|---|---|
| Using an IRA or qualified retirement account to increase deductions | Deducting an IRA or qualified retirement plan contribution when no contribution was made[44] |
| Living in a house long enough to exclude up to $500,000 of gain from the sale of the principal residence | Excluding gain from the sale of a principal residence when the test was not met for either occupancy or ownership |
| Diversifying a portfolio and increasing tax-preferred income by holding foreign investments | Failing to report investment income from foreign accounts |
| Claiming all legitimate deductions associated with a business | Claiming personal expenses as business expenses |

### Filing a False Return

Under IRC §7206, several types of conduct may form the basis for a criminal conviction of a tax return preparer. These include the following.

- Willfully making a false declaration by signing a return or any document that is signed under penalty of perjury
- Willfully aiding, assisting in, or counseling a taxpayer to prepare or file a fraudulent return or other IRS document
- Removing, depositing, or concealing goods or commodities that are taxable with the intent to evade or defeat the assessment or collection of taxes
- Destroying or falsifying a taxpayer's financial records or concealing a taxpayer's property in connection with a closing agreement or offer in compromise

43. 18 USC §3571.

44. For the 2011 tax year, the Treasury Inspector General for Tax Administration (TIGTA) determined that approximately $53 million in improper claims were made for contributions to qualifying retirement accounts. See *Millions of Dollars in Potentially Improper Claims for the Qualified Retirement Savings Contributions Credit Are Not Pursued.* Mar. 26, 2014. TIGTA. Report no. 2014-10-017. [www.treasury.gov/tigta/oa_auditreports_fy14.shtml]. Accessed on Oct. 16. 2014.

The criminal fines and penalties (including augmented fines and penalties) are the same under IRC §7206 as under §7201. As with §7201, §7206 applies to **any person, including the taxpayer,** who commits the prohibited offenses. A tax preparer who is convicted of one or more offenses under either of these Code sections also violates Circular 230, §10.51.

> **Observation.** Exercising due diligence and documenting the questions asked of and answered by the taxpayer are key means of providing evidence that the practitioner did not participate in any fraud or evasion that may be discovered later.

**Example 7.** Lars is an EA who has been preparing tax returns for many years. His new client Vinnie wants Lars to complete his 2014 return. Vinnie provides Lars with his Form W-2, his property tax statements, and appropriate documentation for medical expenses. Lars determines that it is worthwhile for Vinnie to itemize, and he prepares a 2014 return for Vinnie.

In 2015, the U.S. Department of Justice charges Vinnie with tax evasion. The reason for the charge is that Vinnie failed to report income on his 2014 return from offshore accounts that he owns in the Cayman Islands. Vinnie may be charged under IRC §§7201 and 7206 for tax evasion and for signing a false return.

Lars did not have knowledge of the foreign accounts. He should have asked Vinnie relevant questions about whether Vinnie had offshore accounts or other assets that may have triggered a filing requirement. It is unlikely he will be charged with an offense, even though he may not have exercised appropriate due diligence.

Although Lars has violated Circular 230, §10.22(a), he has not committed a crime. However, if Lars had exercised due diligence and documented his questions and Vinnie's responses, he would have a potentially useful record of his professional activities. He could use that record to exonerate himself **if he were charged** as an accessory to Vinnie's IRC §§7201 and 7206 crimes.

**Abusive Return Preparer Investigations.** The following are examples of 2014 investigations of abusive return preparers. These examples are based on documents on file in the courts in which these cases were prosecuted.[45]

- **Washington Tax Preparer Sentenced on Federal Charges.** On September 19, 2014, in Seattle, Washington, Ryan Lanh Yann was sentenced to 42 months in prison, three years of supervised release, and ordered to pay $357,574 in restitution. Yann pleaded guilty in June 2014 to wire fraud, false and fictitious claims, and aggravated identity theft. According to court documents, Yann operated a tax preparation business in Kent and between 2009 and 2012 prepared income tax returns for clients — many of whom were immigrants who were not familiar with the U.S. tax system and did not have strong English language skills. Yann provided his clients with one version of their tax return and filed a different version of the tax return with the IRS. On the filed tax return, Yann claimed additional false deductions, or dependents, inflating the size of the tax refund. Yann kept the additional refund money for himself. In some instances, Yann told a client he owed taxes, and then kept the money the client provided. He then filed a second version of the return in which he claimed a tax refund, which he kept for his own use.

45. *Examples of Abusive Return Preparer Investigations – Fiscal Year 2014.* Oct. 20, 2014. Internal Revenue Service. [www.irs.gov/uac/Examples-of-Abusive-Return-Preparer-Investigations-Fiscal-Year-2014]. Accessed on May 19, 2015.

- **Return Preparer Sentenced for Tax Fraud and Identity Theft Schemes.** On September 12, 2014, in Miami, Florida, Stevens Nore, of Port Saint Lucie, was sentenced to 84 months in prison, three years of supervised release, and ordered to pay $2,761,397 in restitution. Nore was previously convicted by a jury of 30 counts, including 21 counts of preparing false tax returns, four counts of filing false individual tax returns, three counts of theft of public money, and two counts of aggravated identity theft. According to court records, from June 11, 2009 through April 2012, Nore owned and operated Fraternity Tax and Services, a tax return preparation business. Nore prepared and submitted Forms 1040, with accompanying schedules, to the IRS on behalf of taxpayers claiming false deductions and credits for tax years 2009 to 2011. Nore also filed false tax returns for 2010 through 2013 by falsely stating the amount of gross receipts and sales on Schedule C forms. Nore stole three tax refunds totaling $26,349 to which he was not entitled, and used the identity of two individuals without their permission.

- **Texas Accountant Sentenced for Assisting in Preparation of False Income Tax Returns.** On July 21, 2014, in Houston, Texas, John E. Carter was sentenced to 41 months in prison, one year of supervised release, and ordered to pay $132,477 in restitution to the IRS. Carter, an accountant and income tax return preparer, was convicted in February 2014 of willfully aiding and assisting in the preparation and presentation of false income tax returns. According to court documents, Carter prepared tax returns for his clients that claimed false deductions for large charitable contributions of appreciated art. Taxes owed on the five tax returns in question were more than $400,000.

- **Delaware Woman Sentenced for Tax Fraud and Identity Theft Scheme.** On August 15, 2014, in Wilmington, Delaware, Dawn Chamberlain was sentenced to 51 months in prison, 36 months of supervised release, and ordered to pay restitution of $833,160. Chamberlain previously pleaded guilty to mail fraud and conspiracy to present false claims. According to court documents, from 2009 through 2012, Chamberlain filed more than 450 false and fraudulent federal income tax returns for others. Within those returns, Chamberlain claimed more than $730,000 in credits to which her clients were not entitled. Chamberlain directed deposits of the refunds generated by the fraudulent federal income tax returns into her own bank accounts and bank accounts of her family members. She returned less than the full amount of the refunds to her clients, converting the remaining proceeds to her personal use. Chamberlain also used her client's names, dates of birth, and social security numbers to file false and fraudulent New York income tax returns, requesting refunds of more than $210,000.

**Observation.** The previous examples show instances in which tax return preparers took advantage of immigrants, filed fraudulent Schedules C, claimed false charitable contributions, and falsely claimed credits. Some abusive tax return preparer schemes are very sophisticated. For more examples, see **uofi.tax/15a2x4** [www.irs.gov/uac/Examples-of-Abusive-Return-Preparer-Investigations-Fiscal-Year-2014.]

## Requirements for Written Advice

Circular 230, §10.37, provides standards that apply to all written advice that tax practitioners provide to clients. These standards apply to all federal tax matters, including application or interpretation of the following.[46]

- A tax law, regulation, revenue ruling or procedure, tax treaty, or other published or unpublished guidance as applied to one or more taxpayers
- A provision of law that has an impact on a taxpayer's federal tax obligation
- Any law or regulation administered by the IRS

46. Circular 230, §10.37(d).

The §10.37 standards for written advice indicate that the practitioner **must do** the following.

- Base written advice on reasonable factual and legal assumptions
- Reasonably consider all facts and circumstances that are known (or should reasonably be known)
- Use reasonable efforts to identify and ascertain the facts that are relevant to the written advice provided
- Relate applicable laws and authorities to facts

In addition, these standards indicate that the practitioner **must not do** the following.

- Take into account that there is a low probability that the taxpayer's return will be audited
- Unreasonably rely on information from others

Under these standards, the practitioner may only rely on the advice of another if the advice is reasonable. The reliance must be in good faith, considering all the facts and circumstances. Reliance is not reasonable if the practitioner knows (or reasonably should know) that the other person:[47]

- Has an opinion that should not be relied on,
- Is not competent or lacks the necessary qualifications to provide the advice, or
- Has a conflict of interest (discussed later).

**Example 8.** Angela develops a tax plan for her client Ralph, who is a single filer. Ralph currently earns about $150,000 annually. He plans to move to a neighboring state to accept a new job in the natural gas industry as a "fracking" expert. Ralph's new job will provide him with annual income substantially above $200,000.

Ralph has substantial investment income. He also receives a significant distribution each year from a gas and oil partnership in which he is one of three partners. Ralph does not materially participate in the partnership business. Even so, he was one of the original founders and investors of the partnership. He does participate in a few other activities to a limited extent.

Angela has a lengthy discussion with Ralph. She becomes familiar with relevant details about his circumstances that are important from a tax-planning perspective. Angela makes the following recommendations to Ralph, which she documents as part of his written tax plan.

- Ralph should use the income deferral arrangements available at his new place of employment, including a §401(k) plan and employee stock ownership plan (ESOP). With Ralph's permission, Angela contacts the ESOP administrator at Ralph's new employer.
- Ralph should remain in his principal residence and not sell it for a few months. Doing this will meet the IRC §121 requirements for the full exclusion of the $250,000 gain that is anticipated on the sale of Ralph's home.
- Ralph's higher income will put him over the $200,000 NIIT threshold for a single filer. Thus, he will be subject to the NIIT on his interest, dividends, and other investment income. In accordance with Treas. Reg. §1.1411-3, Ralph should claim his investment-related expenses that are properly allocable to the amounts that are included in net investment income (NII). Ralph should also shift some lower-yielding investments to tax-exempt municipal bonds. IRC §1411 and the underlying regulations provide that tax-exempt interest is not included in NII.

47. Circular 230, §10.37(b).

- Angela discusses with Ralph the possibility of him spending more time participating in the day-to-day operations of the gas and oil partnership from which he receives a substantial distribution each year. With Ralph's permission, Angela contacts the other partners to discuss the operation. Angela indicates to Ralph that the partnership qualifies as a trade or business. Therefore, if Ralph meets any one of the seven material participation tests under Temp. Treas. Reg. §1.469-5T, the entire distribution will not be NII. In addition, Angela points out that Ralph must appropriately document his material participation. She reviews some recent tax court cases on this subject to provide Ralph with a firm idea of the type of documentation he must maintain.
- Angela reviews Ralph's other sources of investment income and realizes that three of them form an appropriate economic unit, as provided in Treas. Reg. §1.469-4(c). Under this regulation, these activities can be grouped so that Ralph meets the material participation requirement for the three activities. In addition, Angela discusses with Ralph the "fresh start" regrouping rule. It can be applied the first year that Ralph becomes subject to the NIIT under Treas. Reg. §1.469-11.

Angela has met the written tax advice standards outlined in §10.37 of Circular 230. She asked Ralph the necessary questions to obtain facts about his situation that are relevant to the tax planning recommendations she has developed.

Each recommendation that Angela makes to Ralph to reduce his tax liability is based on a specific tax rule or regulation. She is relating applicable law and authority to the facts of Ralph's individual circumstances.

Angela obtained information from an individual in the tax department at Ralph's new employer regarding the ESOP. This is someone Angela may reasonably rely on for information about the ESOP from a tax standpoint. In addition, Angela reasonably relied on the information from the other two partners regarding the nature of the partnership business. This information is relevant to whether the partnership qualifies as a trade or business and whether Ralph should increase his level of participation to meet the material participation standard.

## USE OF TAX INFORMATION

Generally, under Circular 230, §10.20, a practitioner must furnish records or information about a matter to the IRS after the IRS makes a proper and lawful request for it. However, the practitioner is not required to furnish such information if they have a good faith belief, based on reasonable grounds, that the information is privileged.[48]

If the practitioner (or the practitioner's client) does not have the information requested by the IRS but knows who does have the information, they are obligated to tell the IRS who has the information. Furthermore, the practitioner is obligated to make a reasonable inquiry of the client regarding the identities of persons who have information requested by the IRS. If the client provides details about who has the information, the practitioner is not required to subsequently verify those details through contact with any third parties.[49]

> **Note.** For further details on privileged information and privileges including the attorney–client privilege and the federally authorized tax practitioner privilege, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 12: Ethics. This is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive/].

48. Circular 230, §10.20(a)(1).

49. Circular 230, §10.20(a)(2).

In addition, Circular 230, §10.28 obligates the practitioner to promptly return records to a requesting client that are needed by the client to comply with federal tax obligations. The practitioner may retain copies of such records.

Generally, this obligation to return client records exists even if the practitioner and the client have a fee dispute. However, if state law grants the practitioner the right to retain records in the event of a fee dispute, then §10.28 requires the practitioner to return to the client only those records that must be attached to the federal return. (The practitioner must still provide the client with reasonable access to review or copy other retained records that they need to comply with federal tax obligations.)[50]

Sections 10.20 and 10.28 provide some Circular 230 guidance regarding the use of tax information. In addition, the Code provides tax preparers with some obligations not found in Circular 230.

Under IRC §7216, a tax return preparer generally may not use or provide a taxpayer's **return information** to another party, unless:[51]

- The **use** or **disclosure** is specifically permitted by §7216 or Treas. Reg. §301.7216-2, or
- The tax return preparer obtains valid consent from the taxpayer.

Under these rules, the information provided by the taxpayer must be used only for purposes of return preparation.[52] Violation of §7216 constitutes a misdemeanor, and criminal and civil penalties may be imposed. Those penalties are as follows.[53]

- Criminal penalties include a fine of up to $1,000, incarceration of up to one year, or both (plus the costs of prosecution).
- Civil penalties include a fine of $250 for each prohibited disclosure (up to a maximum of $10,000 per calendar year).

## TAX RETURN PREPARER

Under §7216, a **tax return preparer** is defined as a person:[54]

- Who is engaged in the business of preparing or assisting in the preparation of returns,
- Who is engaged in the business of providing auxiliary services related to tax preparation (including tax software development or providing authorized IRS e-file services),
- Who assists in tax return preparation or services auxiliary to tax return preparation as part of their employment duties, or
- Who is compensated for the tax preparation (or assistance with the tax preparation) of any person's tax return.

**Note.** Providing services that are only incidental to tax preparation does not make a person a tax return preparer.

A person is **engaged in the business** of tax preparation if they promote themselves to the public as someone who prepares returns. Whether a fee is charged and whether tax preparation is that person's only business are both irrelevant.

50. Circular 230, §10.28(a).
51. IRC §7216(a)(1); Treas. Reg. §301.7216-3.
52. IRC §7216(a)(2).
53. Treas. Reg. §301.7216-1(b).
54. Treas. Reg. §301.7216-1(b)(2).

**Example 9.** Samantha is a CPA who is a sole practitioner. She employs Barry as a full-time assistant. Before the busy tax preparation season begins, Samantha hires Sandy and Carl to assist with tax preparation.

Sandy meets with clients to obtain their tax information and ask them the initial questions necessary for preparation of their returns. Samantha prepares the returns and meets with clients to review them, and Carl handles e-filing of the returns. Carl and Barry archive any electronic and paper records associated with the returns.

Samantha is the only person in the firm who actually prepares tax returns. Nonetheless, all four individuals working at the firm are considered tax return preparers under §7216. Samantha is considered a tax return preparer because she promotes herself as a return preparer. Barry, Sandy, and Carl are considered tax return preparers because they assist in tax return preparation services as part of their employment duties.

## TAX RETURN INFORMATION

Under §7216, the term **tax return information** means any information furnished to the tax return preparer for purposes of preparing a tax return. The method used to provide or communicate the information to the tax return preparer is irrelevant. Information provided to the tax return preparer by the taxpayer, a third party, or the IRS is considered tax return information.

Furthermore, a statistical compilation or summary of tax return information is considered tax return information. This is true even if the compilation or summary is provided in a format that makes it impossible to trace specific information to a particular taxpayer.

**Note.** If the tax return preparer obtains information from a source outside the scope of tax return preparation activity, that information is **not** included in the definition of tax return information.[55]

**Observation.** Information that is not tax return information may later become tax return information if it is used to prepare a tax return.

**Example 10.** Lissa has a stock brokerage account with SmartStreet Securities, LLP (SmartStreet). She can access her SmartStreet account through the SmartStreet website to purchase or sell securities and to complete other types of transactions. To use SmartStreet's online account feature, Lissa first had to register for this service by providing her name, address, and other personal information. SmartStreet maintains information in its databases about Lissa's securities transactions, basis information, capital gains and losses, and dividends and interest.

SmartStreet also makes tax preparation software available to Lissa through its website. Lissa uses this software to complete her 2015 return. The software automatically populates fields of the tax software and lines on Lissa's Form 1040 from the databases that SmartStreet retains.

SmartStreet is a tax return preparer under §7216 because it develops and provides software for tax preparation. However, the information in the SmartStreet databases relating to Lissa's account transactions is not tax return information. SmartStreet did not receive that information for the purpose of tax return preparation. However, once Lissa uses that information to populate fields of the tax software and lines on her tax return, the information associated with the return becomes tax return information under §7216.

If SmartStreet retains this information in a manner that allows it to be identified as information used in the preparation of a return, that information is considered tax return information. However, if this information is retained within SmartStreet's databases in a format that cannot identify whether it was used for return preparation, that information is not considered tax return information under §7216.

55. Treas. Reg. §301.7216-1(b)(3)(C).

## DISCLOSURE AND USE

Regulations under §7216[56] define **disclosure** as making tax return information known to any other person in any manner. **Use** includes any circumstance in which the tax return preparer acts on tax return information (or permits an action to take place because of the tax return information).

> **Note.** The prohibition on the use of tax information has implications for tax return preparers who also sell investments or life insurance or provide certain other services, including tax planning.

### Specifically Permitted Disclosures

In some situations, the tax return preparer is permitted to use and disclose tax return information without the taxpayer's consent.[57] However, such disclosures are generally limited to the following instances.

- Disclosures to the IRS
- Certain disclosures associated with tax preparation
- Certain disclosures to clients who are related
- Disclosures pursuant to various types of court orders or administrative orders
- Certain disclosures associated with the investigation of a tax preparer
- Various types of disclosures by accountants or lawyers
- Certain disclosures by corporate fiduciaries

In addition, specific rules apply to the use of lists that include client tax information and the use of client tax information in marketing efforts.

**Disclosures to the IRS.** The prohibition on disclosure of tax information generally does not apply to a disclosure made under a Code or regulatory provision. Disclosure of a client's information to an officer or employee of the IRS is specifically permitted.

**Disclosures Associated with Tax Preparation.** There are two categories of rules associated with a tax return preparer's disclosure of a client's tax information to another tax return preparer.

1. A disclosure to another preparer who is an officer or employee of the same firm
2. A disclosure to another preparer (or a contractor) who belongs to another firm

***Same-Firm Disclosures.*** If the client furnishes their tax information to a tax return preparer located in the United States, that tax return preparer may disclose the client's information to another officer or employee of the same firm within the United States for the purposes of performing tax preparation or related services for the client. Information initially provided by the client to a tax return preparer in the United States may not be disclosed to another officer or employee of the same firm outside the United States without the client's consent. However, furnishing that information to another officer or employee of the same firm outside the United States does not require client consent if the client originally furnished their tax information to a tax return preparer outside the United States.

***Different-Firm Disclosures.*** A tax return preparer may disclose a client's tax information to a tax return preparer who works for another tax preparation firm within the United States if that information is provided for the purposes of preparing (or assisting in preparation of) the client's return.

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56. Treas. Reg. §301.7216-1(b)(5).

57. Treas. Reg. §301.7216-2.

The information may also be furnished for the purposes of obtaining or providing services ancillary to tax return preparation. However, such a disclosure is permissible without the client's consent **only** if the services provided by the other tax preparation firm do not involve substantive determinations or advice that affects the client's tax liability. (A **substantive determination** is an analysis, interpretation, or application of the law.) This disclosure is therefore limited to providing a client's tax information to another tax return preparer who will input that information into tax software (or another system) that calculates the tax liability and completes the return. Disclosure of a client's tax information to an authorized IRS e-file provider is included as an acceptable disclosure under this rule.

> **Observation.** If disclosure to a different firm is made for the purpose of having that firm provide tax advice regarding the client or to interpret and apply a Code provision, regulation, or other law, then client consent is required prior to the disclosure. Consent is necessary because the other firm is making a substantive determination regarding the client's tax liability.

In addition, a tax return preparer may disclose client information to a contractor or software provider for the purposes of obtaining equipment or software for tax return preparation (or for maintaining, repairing, or testing tax preparation equipment or software). However, such disclosure is permitted without client consent only if the tax return preparer takes the following steps.

- Ensures that the contractor or software provider receives written notice of the applicability of IRC §§7216 and 6713
- Ensures that the written notice describes the requirements of §§7216 and 6713 and outlines the applicable penalties associated with violating either provision

> **Note.** IRC §7216 provides criminal penalties for the unlawful use or disclosure of a client's tax information. IRC §6713 provides civil penalties for such use or disclosure. These provisions prohibit a paid tax return preparer from disclosing any client tax information or using that information for purposes other than tax preparation. The rules and exceptions under §7216 also apply to §6713. The civil penalty under §6713 is $250 per violation, up to a maximum of $10,000 per calendar year.

> **Observation.** Upon receipt of client tax information from the tax return preparer, the contractor or software provider also becomes a tax return preparer under the terms of §7216 (and subject to its rules). The reason for this determination is that the contractor or software provider is delivering services in connection with tax preparation.

**Disclosures to Related Clients.** A tax return preparer frequently has clients who are related. Related clients may include individuals and various entities. A tax return preparer may disclose one taxpayer's tax information to a second taxpayer if **all** the following apply.

- The information disclosed to the second taxpayer is in the form in which it appears on the return being prepared for the first taxpayer.
- The second taxpayer is related to the first taxpayer.
- The first and second taxpayers do not have conflicting interests in the tax information being disclosed.
- The first taxpayer has not expressly prohibited the disclosure.

Under this disclosure rule, taxpayers are related if any of the following relationships exist between the first and second taxpayers.

- Spouses
- Parent and child
- Grandparent and grandchild
- Partnership and partner
- Trust or estate and beneficiary
- Corporation and shareholder
- Members of a controlled group of corporations

> **Note.** See IRC §1563 for further details on the definition of **controlled group of corporations** as it applies to disclosures between related taxpayers.

**Disclosures Pursuant to a Court or Administrative Order.** Consent from the client is not required if their tax information is disclosed to a third party pursuant to any of the following directives.

- A federal, state, or local court order
- A federal or state grand jury subpoena
- A U.S. congressional subpoena
- A federal agency administrative order, demand, summons, or subpoena
- An administrative order, demand, summons, or subpoena issued by a state agency or body that oversees tax preparer licensing, registration, or regulation
- A professional association ethics committee or board request in the course of an investigation into the ethical conduct of the tax return preparer
- A public company accounting oversight board request made in connection with an inspection under the Sarbanes-Oxley Act of 2002

> **Note.** Generally, a tax return preparer may disclose any tax return information to an appropriate federal, state, or local official to inform them of activities that may constitute a crime or to assist in an official investigation or prosecution of a crime. A tax return preparer who makes such a disclosure under a genuine but mistaken belief that a crime has been committed is not subject to any penalties.[58]

**Disclosures Associated with Investigation of a Tax Return Preparer.** A tax return preparer may disclose a client's tax information to an attorney to obtain legal advice. Disclosure of a client's tax information can also be made to the Treasury Department for use in an investigation of the tax return preparer.

In addition, disclosure of a client's tax information can be made to an officer of any court for use in a court proceeding against the tax return preparer.

58. Treas. Reg. §301.7216-2(q).

**Disclosures by Lawyers or Accountants.**[59] A lawyer or accountant who prepares a return for a client may use the client's tax information or disclose that information to another member or employee of the same law or accounting firm for the purposes of providing other legal or accounting services to the client. Disclosure of the client's tax return information to outside third parties in the normal course of providing legal or accounting services also constitutes acceptable disclosure that may be made without consent of the client. (The exception is a situation in which the client has indicated such disclosure should not be made.) However, this rule does not include disclosure to another affiliated firm. Disclosing a client's tax information to another affiliated law or accounting firm requires client consent.

A lawyer or accountant who prepares a return for a client may consider or act on that information if necessary to properly perform services for another client. However, this exception applies only if the first client's tax information is (or may be) relevant to the legal or accounting services performed for the second client. Under this rule, disclosure may also be made to another member or employee within the same law or accounting firm.

> **Note.** Treas. Reg. §301.7216-2 indicates that these disclosures are subject to other ethics rules of lawyers and accountants. Conflict-of-interest rules must be taken into account under these §7216 disclosure exceptions.

**Example 11.** Victoria is an attorney and completes Allu's 2015 tax return. In May 2016, Allu contacts Victoria to let her know that he is selling his equestrian business. Victoria discusses some key points about selling the business with Allu. She also obtains Allu's agreement to let her firm represent him in the sale of the business.

Subsequently, Victoria gathers all the information she feels may be relevant to providing legal advice to Allu regarding the sale of the business, including Allu's 2015 tax return. Victoria provides all the information to her partner Clara, who is an expert in legal issues associated with the purchase and sale of a business. Victoria also provides Allu's return to the accountant for the business and to Allu's bank. The bank indicated it needed the most recent tax return information to close out an existing loan prior to the sale.

Victoria's disclosures of Allu's tax return information to Clara, the accountant, and the bank are all permissible under Treas. Reg. §301.7216-2(h)(1)(i). This regulation permits an attorney to disclose tax return information without the client's consent to provide other legal services to them. However, Victoria must ensure that she is also adhering to the confidentiality and other bar association rules applicable in the state in which she practices law.

> **Observation.** Although disclosure rules do not require a lawyer or accountant to obtain consent to disclose information to third parties in the normal course of providing services, it is prudent to obtain written consent from the client.

**Disclosures by Corporate Fiduciaries.**[60] Unless the client directs otherwise, a corporate fiduciary (such as a trust company) who provides a client with fiduciary, investment, or other financial management services may disclose or use the client's tax information in the ordinary course of providing those services. The corporate fiduciary may also disclose the information to the client's attorney, accountant, or other investment advisor.

In addition, if a client dies or becomes mentally incapable, insolvent, or bankrupt after the tax return preparer receives their tax information, the information may be disclosed to the client's appointed fiduciary.

> **Note.** If the tax return preparer dies or becomes mentally incapable, disclosure of a client's tax information is permitted to either the tax return preparer's estate or the legal representative to continue the tax preparation service. The estate or legal representative receiving the information becomes a tax return preparer under the definition found in Treas. Reg. §301.7216-1(b). The estate or legal representative is bound by the tax preparer disclosure rules discussed previously.[61]

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59. Treas. Reg. §301.7216-2(i).

60. Ibid.

61. Treas. Reg. §301.7216-2(r).

**Use of Lists with Tax Return Information.**[62] Generally, the tax return preparer who prepares the client's tax return may compile a list that can be used to contact clients by mail or otherwise **only** for the following purposes.

- To provide tax, general business, or economic information or analysis for educational purposes
- To solicit additional tax return preparation services

**Note.** The list may **not** be used to solicit any products or services other than tax preparation services.

**Observation.** This exception applies only to the tax return preparer who completed the return. The exception is not available to someone who is a tax return preparer under Treas. Reg. §301.7216-1(b)(2)(i)(D) solely because they provided auxiliary services related to tax preparation.

Under Treas. Reg. §301.7216-2(n), only the following types of information can be included in the list.

- Names, mailing addresses, and phone numbers
- E-mail addresses
- Taxpayer entity classification (e.g., individual or the specific type of business entity)
- Tax return form number applicable to the client (e.g., Form 1040 or Form 1065)

**Note.** The term **list** includes any record or system in which these types of information are stored.

The tax return preparer may not transfer this list or any portion of it to another person unless doing so is part of the sale or other disposition of the tax preparation business. The parties to the sale may disclose the list on a presale basis (to provide details about the clients to the potential buyer, to enable the parties to negotiate the business purchase price, or other prepurchase reasons related to the disposition of the tax preparation business). However, if the list (or part of the list) is provided for these purposes, the transfer of the list information must be pursuant to a written confidentiality agreement. The written confidentiality agreement must expressly prohibit any further use or disclosure of the list information beyond that necessary for disposition of the tax preparation business.

In addition, a preparer may use tax return information to produce **statistical information** that is directly related to the internal management or functions within their business. (Additional purposes may include research or public policy discussions about state or federal taxation.) Disclosure of such statistical information is permitted only if the data does not identify specific taxpayers or include aggregate amounts compiled from fewer than 10 tax returns.

**Note.** A tax return preparer's use of statistical information or compilations in advertising is permissible as long as the advertising is not misleading or unduly influential and the preparer complies with rules concerning use of statistical information (as stated previously).

**Note.** Disclosure of statistical compilations by the tax return preparer to comply with accounting or regulatory reporting requirements is permitted even if particular clients may be identified and/or those statistics arise from fewer than 10 tax returns.

62. Treas. Reg. §301.7216-2(n).

**Use of Client Tax Information in Marketing.** Tax return preparers may be licensed to sell investments, life insurance, and other products. Preparers also may provide other services, such as financial planning. A tax return preparer must not use client tax information to market these other products or services in a manner that violates §7216, as previously discussed.

**Example 12.** Guido is an EA. In late 2015, he prepares to contact clients in connection with the upcoming tax season by using his tax software to compile a list of clients. The list consists of names and mailing addresses of all clients for whom he prepared 2014 tax returns.

Guido then develops a newsletter to mail to the clients on the list. The newsletter includes an article about new tax legislation and the types of taxpayers most affected by it.

Guido's employee Carlos specializes in S corporation tax returns and issues. Carlos contributes an article to the newsletter regarding the general pass-through tax treatment associated with S corporations and the tax reporting requirements.

In addition, Guido writes an article about the upcoming tax season. In it, he asks clients to contact him early if they have unusual or special issues that he should research or be aware of before preparing their tax returns. Guido also asks clients to call for appointments to discuss preparation of their 2015 returns. Guido mails the completed newsletter to the clients.

Guido's marketing initiative is very likely in full compliance with §7216. The list he compiled included only information that is permitted under Treas. Reg. §301.7216-2(n). In addition, the newsletter content is limited to providing tax information for educational purposes and soliciting additional tax preparation services. Both purposes are allowed under Treas. Reg. §301.7216-2(n).

**Example 13.** Use the same facts as **Example 12,** except Guido is licensed to sell mutual funds. He places an additional note in the newsletter that says, "Don't forget to contact us about your 2015 IRA contribution using a new, five-star-rated mutual fund. Reduce your tax bill now!"

Guido's solicitation of mutual fund sales in this manner is outside the scope of acceptable marketing of tax preparation services under Treas. Reg. §301.7216-2(n). It does not constitute general tax, business, or economic information that is acceptable under the regulation. Guido has violated §7216 and may be subject to a criminal penalty for misusing client tax return information. Guido has also likely violated §6713 and may be liable for a civil penalty for misusing the information.

**Note.** The Personal Financial Planning Section of the AICPA has issued new compliance standards for CPAs who provide personal financial planning services. These rules became effective July 1, 2014, and apply to AICPA members who make personalized recommendations in areas such as tax planning, retirement planning, estate and gift planning, charitable and education planning, and a number of other areas. For further details, see **uofi.tax/15a2x5** [www.aicpa.org/interestareas/personalfinancialplanning/resources/practicecenter/professionalresponsibilities/pages/pfpexposuredraft.aspx].

## Obtaining Client Consent

A tax return preparer may use or disclose a client's tax return information if the preparer obtains the client's consent. However, the consent must meet several requirements before it is considered valid.

The following sources offer guidance about obtaining consent.

| Reference | Description of Guidance |
|---|---|
| Treas. Reg. §301.7216-3 | General regulation regarding consent |
| Rev. Proc. 2013-14[63] | Format and content of consent |
| Rev. Proc. 2013-19 | Use of mandatory language |

**General Requirements.** The consent obtained from a client must be knowing and voluntary. Generally, if the tax return preparer makes the client's consent a condition to providing services, the consent is deemed involuntary and does not constitute valid consent. However, the tax return preparer may need the client's consent to disclose return information to another tax return preparer to provide tax preparation services. The tax return preparer may make obtaining such consent a condition to providing tax preparation services.

Rev. Proc. 2013-14 states precise requirements for what constitutes valid consent. Under the terms of Rev. Proc. 2013-14, a written consent form provided to the client must meet the following requirements.

- Generally, the consent form for each separate disclosure or use must be provided to the client as a separate written document.
- The consent must be furnished to the client on one or more sheets of 8.5 × 11-inch paper (or larger).
- All text on the page(s) must relate exclusively to the information use or disclosure to which the consent applies. (No other text can relate to any other items or subjects.)
- All text on the page(s) must be presented in at least a 12-point font. (There can be no more than 12 characters per inch.)

The general rule requires the tax return preparer to use a separate consent form for each use or disclosure. A special rule allows consent forms to be used that allow the client either to consent to multiple uses on the same form **or** to authorize multiple disclosures on the same form. However, the multiuse consent or multidisclosure consent must separately identify each use or disclosure to which the client agrees. A single form **cannot** be used to authorize **both** uses **and** disclosures.[64]

A consent form may be provided to the client electronically. The following rules apply to electronic request forms.

- One or more computer screens must be used for the consent.
- All the text on all the screens must pertain exclusively to the disclosure or use for which consent is requested.
- The text used in the electronic consent request must be at least the same size as the normal or standard size of text used by the website or software package that furnishes the consent request. Moreover, there must be sufficient contrast between the text and background colors.
- The consent request must be formatted in a readable and printer-friendly format.

63. Rev. Proc. 2013-14, 2013-3 IRB 283 modifies and supersedes Rev. Proc. 2008-35, 2008-29 IRB 132.

64. Treas. Reg. §301.7216-3(c)(1).

**Required Signature.** Both paper and electronic forms of consent must provide a place for the client to sign and date the consent. Paper consent forms require the client's handwritten signature. For electronic forms, it is necessary to use an electronic signature that verifies the client has provided affirmative, knowing consent to the disclosure or use outlined. An electronic signature from the client must be obtained in one of the following ways.

- The client is assigned a 5-digit personal identification number (PIN) that the client enters to verify consent. This requirement is not met if the software automatically assigns the client a PIN and uses a method in which the client need only click a button to validate the electronic signature. The client must affirmatively enter the PIN to establish that consent has been given.
- The client types in their name and then presses "enter" to authorize consent. The software must not automatically provide the client's name and make it necessary only for the client to press the "enter" key. The client must affirmatively type their name for the consent to be valid.
- Any other manner may be used in which the client affirmatively enters five or more characters unique to them that are used to verify their identity and authorize the consent requested.

**Note.** For all consent requests provided by the tax return preparer to the client, affirmative consent is necessary for the consent to be valid. It is not sufficient to use a consent method that allows the client to deselect or opt out of disclosures or uses that they do not consent to while leaving in place other types of uses or disclosures that they apparently authorize.

**Mandatory Language.** Specific mandatory content must be included in the consent request that the tax return preparer provides to the client for signature. The specific content depends on which of the following contexts applies.

1. A request for consent to **disclose** tax return information for **purposes other than return preparation or auxiliary services**
2. A request for consent to **disclose** tax information for **purposes of tax preparation or auxiliary services**
3. A request for consent to **use** tax return information

In addition, mandatory language must be contained in **all** consent requests. The table on the following page indicates the language required for **all** consent requests and the language required in **each** of the three contexts in which a consent request may be presented to a client for signature.[65]

**Note.** This guidance applies to tax return preparers who seek authorization to use or disclose tax return information from clients who file Form 1040 returns. For clients filing other types of returns, the tax return preparer has the option of adhering to the language in the following table and the guidance on format mentioned earlier. In any event, the consent requests provided to non-Form 1040 filers must adhere to Treas. Reg. §301.7216-3.[66]

65. Rev. Proc. 2013-14, 2013-3 IRB 283.

66. Ibid.

| Context | Mandatory Language to Include |
|---|---|
| All consent requests | If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800-366-4484, or by email at complaints@tigta.treas.gov. |
| Disclosure for purposes other than tax return preparation or auxiliary services | Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose your tax return information to third parties for purposes other than the preparation and filing of your tax return without your consent. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.<br><br>You are not required to complete this form to engage our tax return preparation services. If we obtain your signature on this form by conditioning our tax return preparation services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year from the date of signature. |
| Disclosure for tax return preparation or provision of auxiliary services | Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose your tax return information to third parties for purposes other than those related to the preparation and filing of your tax return without your consent. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.<br><br>You are not required to complete this form. Because our ability to disclose your tax return information to another tax return preparer affects the tax return preparation service(s) that we provide to you and its (their) cost, we may decline to provide you with tax return preparation services or change the terms (including the cost) of the tax return preparation services that we provide to you if you do not sign this form. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year from the date of signature. |
| Use of information | Federal law requires this consent form be provided to you. Unless authorized by law, we cannot use your tax return information for purposes other than the preparation and filing of your tax return without your consent.<br><br>You are not required to complete this form to engage our tax return preparation services. If we obtain your signature on this form by conditioning our tax return preparation services on your consent, your consent will not be valid. Your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year from the date of signature. |

In addition, if the consent request seeks the client's authorization to disclose a copy of their entire tax return (or all the information contained in the return), the consent must allow the client to request an alternate disclosure that is more limited in scope.

> **Note.** Rev. Proc. 2013-19 indicates that the use of the mandatory language provided in the preceding table is required for all consents obtained on or after January 1, 2014.

> **Note.** For additional guidance on the required language necessary to disclose a client's tax return information to a return preparer located outside the United States, see Treas. Reg. §§301.7216-3(a)(3)(i)(D) and 301.7216-2(c) and (d) and Rev. Proc. 2013-14. If the tax return preparer is disclosing the client's social security number to a preparer located outside the United States, both preparers are required to have adequate data protection safeguards that meet specific criteria. For further details, see Rev. Proc. 2013-14 and Treas. Reg. §301.7216-3(b)(4).

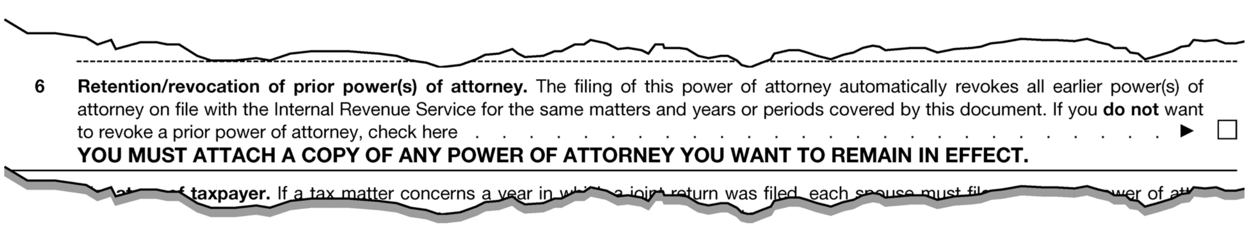
## NEW CLIENTS WITH PREVIOUS PREPARERS

For a qualified tax return preparer to have full authority to represent a new client before the IRS, the preparer must be appointed by the client. This is typically accomplished by using Form 2848, *Power of Attorney and Declaration of Representative.* Only practitioners eligible to practice before the IRS can use this form to obtain full representational authority. An eligible practitioner is one who has not been disbarred or suspended from IRS practice and is one of the following.

- An attorney
- A CPA
- An enrolled agent
- An enrolled actuary
- An enrolled retirement plan agent

> **Note.** All practitioners practicing before the IRS are individuals. It is not possible for a firm or entity to practice before the IRS under Circular 230.

Filing a new Form 2848 to appoint a new practitioner automatically revokes the appointment of the previous practitioner who was engaged for the same matters and years covered by Form 2848. However, should the client want to retain a previously appointed practitioner, Form 2848 provides an option for doing so. In addition to checking the appropriate box on Form 2848, a copy of the Form 2848 that appointed the previous practitioner must be attached to the Form 2848 that appoints the new practitioner.


**6** **Retention/revocation of prior power(s) of attorney.** The filing of this power of attorney automatically revokes all earlier power(s) of attorney on file with the Internal Revenue Service for the same matters and years or periods covered by this document. If you **do not** want to revoke a prior power of attorney, check here . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ▶ ☐

**YOU MUST ATTACH A COPY OF ANY POWER OF ATTORNEY YOU WANT TO REMAIN IN EFFECT.**

If a client wishes to retain a previously appointed practitioner, the new practitioner must take into account possible conflicts of interest that may result from this decision. Circular 230, §10.29(a) states (in relevant part, with emphasis added):

> *...a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if ... there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client* ***or a third person, or by a personal interest of the practitioner.***

Frequently, a conflict of interest arises with the previous practitioner because of the requirement placed on the new practitioner under Circular 230, §10.21, which states (in relevant part):

*A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or an omission from any return, document … or other paper which the client submitted … must advise the client promptly of the … noncompliance, error, or omission … [and] … of the consequences under the Code and regulations…*

**Example 14.** Clark, a CPA, meets with his new client Alfred. Alfred shows Clark copies of the 2012, 2013, and 2014 Forms 1040 and 1120S completed by his previous tax preparer, Gordon. Gordon operates a tax practice on the other side of town. Clark reviews Alfred's returns, including the Schedules K-1 from Alfred's S corporation.

Clark notices that in each of the three years Alfred claimed a large loss from the S corporation. Clark asks Alfred a few questions about the loss deductions, including relevant questions about Alfred's share and debt basis in the S corporation and his at-risk amount. Based on Alfred's answers to these questions, Clark concludes that Alfred was not entitled to the S corporation loss deductions in any of the three years.

Alfred mentions to Clark that Gordon never asked him any questions regarding his debt basis or at-risk amounts. However, Alfred wishes to retain Gordon as a practitioner and add Clark as a newly appointed practitioner.

Clark has known Gordon for many years, plays in an annual golf tournament with him, and talks with him regularly at local CPA meetings and conventions. Clark also co-chairs a local charity with Gordon.

Clark must consider his obligation under Circular 230 to disclose the tax return error to Alfred and to indicate to Alfred the consequences of these errors. It is up to Alfred whether to amend the returns.

In addition, Clark must fully and objectively consider the problems associated with representing Alfred if he also retains Gordon as a representative. Clark's professional and social relationship with Gordon may limit his ability to properly advise Alfred on this matter.

**Opinion 1.** Unless the practitioner will be representing a taxpayer before the IRS on a federal tax matter, a Form 2848 appointing the practitioner as the taxpayer's power of attorney and representative should never be executed. Once the practitioner has been appointed as the taxpayer's power of attorney and representative, the practitioner becomes **obligated** to adhere to all aspects of Circular 230 with respect to that taxpayer.

Such an appointment without an actual need for representation creates potential liability issues for the practitioner. Executing a "blanket" Form 2848 each year may also imply to the taxpayer that the practitioner will (or has) automatically addressed any inquiries from the IRS, including issues that the practitioner may choose not to deal with on behalf of the taxpayer (which may have arisen from the work of a previous tax preparer or adviser).

Executing a Form 2848 only when required for actual representation allows the practitioner to decide whether to represent that taxpayer on the particular issue(s) involved and allows the practitioner to discuss the scope of the representation with the client. It also allows the practitioner to limit the scope of Form 2848 with respect to the specific acts authorized in part I, item 3 (and other areas of the form, as desired). This is not possible with a "blanket" Form 2848 that is executed each year without full knowledge of the particular type of representation authorized, the issues involved, and the need to limit potential practitioner liability in the representation of the taxpayer.

Further, because of the potential conflict that may occur by having multiple tax advisors for the same taxpayer (and issues concerning a practitioner's liability for the effects of another practitioner's advice), it is usually prudent to ensure that all previous practitioners appointed by the taxpayer have been revoked on Form 2848. A practitioner's malpractice insurance carrier may be able to provide further guidance about best practices on these issues.

**Opinion 2.** A power of attorney is most often required when a client wants to authorize another individual to perform at least one of the following acts on their behalf.

1. Represent them at a meeting with the IRS
2. Prepare and file a written response to an IRS inquiry



Some practitioners feel that they should have their clients annually complete and sign a Form 2848 when the tax return is completed and retain it in the client's file. This allows the practitioner to handle any IRS issues that may arise in the coming year. The "third party designee" on the tax return only allows preparers to discuss preparation of the return, and it expires one year after the return is filed. Having the Form 2848 on hand expedites the response time and allows tax preparers to use e-services to handle any issues that may arise from that year's tax return.

Even when the taxpayer has another active power of attorney,  this does not interfere or provide a conflict of interest to anyone else who holds a power of attorney for the same taxpayer.

### FILING A COMPLAINT AGAINST A PREPARER

A client who wishes to file a complaint against a practitioner or tax preparation business may do so using Form 14157, *Complaint: Tax Return Preparer.* This form may also be used by a tax practitioner who wishes to lodge a complaint against another practitioner. A copy of this form follows.

| Form **14157** (Rev. October 2014) | Department of the Treasury - Internal Revenue Service **Complaint: Tax Return Preparer** | OMB Number 1545-2168 |
|---|---|---|

*Use this form to file a complaint with the IRS against a tax return preparer or tax preparation business.*

**CAUTION: READ THE INSTRUCTIONS BEFORE COMPLETING THIS FORM. There may be other more appropriate forms specific to your complaint. (For example, if you believe you are a victim of identity theft, please complete Form 14039, Identity Theft Affidavit).**

**Section A - Return Preparer Information** *(complete all known information)*

1. Preparer's professional status *(check all that apply)*

☐ Attorney ☐ Certified Public Accountant ☐ Other/Unknown

☐ Enrolled Agent ☐ Payroll Service Provider

| | |
|---|---|
| 2. Preparer's name and address | 3. Preparer's business name and address *(if different)* |
| 4. Preparer's telephone number(s) *(include area code)* | 5. Preparer's email address |
| 6. Preparer's website | 7. Preparer Electronic Filing Identification Number (EFIN) |
| 8. Preparer Tax Identification Number (PTIN) | 9. Employer Identification Number (EIN) |

**Section B - Complaint Information**

10. Tax period(s) impacted

11a. Review the complaints below and check all that apply

☐ Theft of Refund *(Diverted refund to unknown account; return filed does not match taxpayer's copy)*

☐ E-File *(e-filed returns using pay stub, non-commercial software or Free File without properly securing taxpayer's signature)*

☐ Preparer Misconduct *(Failed to provide copy of return, return records, sign returns or remit payments for taxes due; misrepresentation of credentials; agreed to file return but did not; filed return without authorization or consent.)*

☐ PTIN Issues *(Failed to include Preparer Tax Identification Number (PTIN) on tax return; improperly used a PTIN belonging to another individual)*

☐ False Items/Documents *(False expenses, deductions, credits, exemptions or dependents; false or altered documents; false or overstated Form W-2 or 1099; incorrect filing status)*

☐ Employment Taxes *(Failed to file forms 940, 941, 943, or 945 or remit Employment Tax payment)*

☐ Other *(explain below)*

Attach a **copy** of any documents you received from the tax return preparer (e.g. **tax returns**, advertisements, business cards, Form 8879, IRS e-file Signature Authorization, Form 8888, Allocation of Refund (including savings bond purchases), Contract for Service Agreement, and Refund Transfer Agreement). Do not send original returns or payments with this form.

Catalog Number 55242M www.irs.gov Form **14157** (Rev. 10-2014)

11b. Provide facts and other information related to the complaint *(attach additional sheets if necessary).*

______________________________________________

______________________________________________

______________________________________________

______________________________________________

______________________________________________

**Section C - Taxpayer's Information** **Are you the taxpayer?** ☐ Yes ☐ No

*(We never share this information with the person or business you are reporting)*
This information may be necessary to process your complaint. If you are the taxpayer complete section C only. If you are not the taxpayer, complete sections C and D.

| | |
|---|---|
| 12. Name *of individual or business* | |
| 13. Mailing address *(street, city, state, ZIP code)* | 14. Telephone number(s) *(include area code)* |
| | 15. Email address |
| 16. Taxpayer's signature | 17. Date of complaint |

**Section D - Your Information** *(do not complete if you are the taxpayer)*

*(We never share this information with the person or business you are reporting)*
This information is not required to process your complaint but is helpful if we need to contact you for additional information.

| | |
|---|---|
| 18. Name *(Last, First, MI)* | 19. Date of complaint |
| 20. Mailing address *(street, city, state, ZIP code)* | 21. Telephone number(s) *(include area code)* |
| | 22. Email address |

23. Your relationship to Preparer

☐ Client ☐ IRS employee

☐ Return preparer working for a different firm* ☐ Other *(specify)* ____________________

☐ Return preparer working for the same firm*

* Taxpayers' information and any information relating to another professional are confidential. Please obtain your client's consent before sharing any protected tax information, even with the IRS.

The completed form along with all supporting information can be filed by fax or regular mail.

If mailing Form 14157 send to:
**Attn: Return Preparer Office**
**401 W. Peachtree Street NW**
**Mail Stop 421-D**
**Atlanta, GA 30308**

If faxing Form 14157 send to: **855-889-7957**

## Privacy Act and Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to ensure that preparers are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time require to complete this form will vary depending on individual circumstances. The estimated average time is 15 minutes. The primary purpose of this form is to report potential violations of the Internal Revenue laws by tax return preparers. We are requesting this information under authority of 26 U.S.C. § 7801 and § 7803. Providing this information is voluntary, and failure to provide all or part of the information will not affect you. Providing false or fraudulent information may subject you to penalties. We may disclose this information to the Department of Justice to enforce the tax laws, both civil and criminal, and to cities, states, the District of Columbia, and U.S. commonwealths or possessions to carry out their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal non-tax criminal laws, and to federal law enforcement and intelligence agencies to combat terrorism.

Catalog Number 55242M www.irs.gov Form **14157** (Rev. 10-2014)

Form 14157 is filed directly with the RPO in Atlanta, Georgia. The RPO reviews each complaint and determines whether an investigation should be initiated. Complaints with criminal issues may be referred to the U.S. Department of Justice for investigation. Some common types of return preparer misconduct that may lead to an investigation include instances in which the return preparer:

- Did not provide the client with a copy of the return they prepared and refused to provide a copy after a request;
- Did not return some or all of the client's original records (which is a violation of Circular 230, §10.28);
- Did not sign a federal tax return they prepared;
- Claimed to be an attorney, CPA, enrolled agent, or registered tax return preparer without actually having the credential claimed or without a valid credential (e.g., it expired, was suspended, or revoked);

**Observation.** Frequently, a state's professional licensing agency provides the general public with online tools to verify the credentials and/or licensing of attorneys and accountants. For example, the Attorney Registration & Disciplinary Commission of the Supreme Court of Illinois provides a lawyer search at **uofi.tax/15a2x6** [www.iardc.org/lawyersearch.asp]. Other licenses, such as those for Illinois public accountants, may be found at the website for the Illinois Department of Financial and Professional Regulation at **uofi.tax/15a2x7** [https://ilesonline.idfpr.illinois.gov/Lookup/LicenseLookup.aspx].

- Indicated to the client that their return would be filed but failed to file the return;
- Charged for services that were never performed;
- Failed to remit the client's money for taxes due when their relationship with the client made them responsible for doing so;
- Filed a return or submitted other information for a client document without that client's knowledge, authorization, or consent;
- Failed to explain that a cash advance, fast refund, or instant refund was actually a refund anticipation loan borrowed against an income tax refund and/or failed to explain the related fees and interest charges;
- Was misleading or failed to ensure that the client understood financial products and related fees;
- Used a PTIN belonging to another preparer; or
- Prepared a return without a PTIN or failed to indicate their PTIN on a return they prepared.

Grounds that frequently warrant investigation in three areas of return preparer conduct are summarized in the following table.[67]

67. Instructions for Form 14157.

| Theft Issues | E-File Issues | False Items or Documents |
|---|---|---|
| A preparer:<br>• Embezzled or stole all or a portion of a client's federal tax refund;<br>• Diverted a refund to an account that was not the client's;<br>• Provided a copy of the return to the client that had direct deposit information that is not theirs;<br>• Provided a copy of the return to the client that does not match the return that was filed with the IRS; or<br>• Failed to explain that a cash advance, fast refund, or instant refund was actually a refund anticipation loan borrowed against an income tax refund and the related fees and interest charges. | A preparer:<br>• Filed a return electronically using a last payroll stub or a leave and earnings statement without waiting for the official Form W-2 from the employer (i.e., return preparers are generally prohibited from filing a return prior to receipt of Forms W-2, W-2G, and 1099-R);<br>• Used noncommercial software to prepare returns that appear self prepared by the taxpayer and is not including their name, PTIN, or firm name (or similarly, the preparer used the Free File program to prepare and file tax returns for clients); or<br>• Filed a return electronically without securing the taxpayer's signature on Form 8879 (i.e., IRS e-File Signature Authorization). | A preparer:<br>• Knowingly claimed false or fictitious expenses and/or deductions on a tax return;<br>• Claimed unrelated, nonexistent, unknown or additional information on a tax return;<br>• Made changes to a client's original tax documents or used false or incorrect documents to complete return;<br>• Claimed false or fictitious income and/or federal withholding on a tax return;<br>• Claimed an improper filing status on a tax return; or<br>• Claimed a filing status that did not accurately reflect the taxpayer's family situation. |

## IRS ENFORCEMENT AND THE E-FILE PROGRAM

Beginning January 1, 2012, tax return preparers are required to file tax returns electronically if they anticipate filing 11 or more returns during a calendar year. Tax return preparers who are members of the same firm must aggregate the number of returns they anticipate preparing and filing for the year to determine whether they exceed this threshold for the electronic filing requirement.[68]

> **Note.** Under §10.51(a)(16) of Circular 230, willful failure to file electronically when required to do so constitutes disreputable conduct.

### SUITABILITY CHECK

Part of the application process for participating in the IRS e-file program involves a suitability check. This may include a criminal background check, a credit history check, and a check to ensure that the preparer has not engaged in any previous noncompliance within the e-file program. In addition, a tax compliance check may be conducted to ensure that the tax return preparer has filed their own required personal and business returns and paid their own tax liabilities.[69]

> **Note.** Under §10.51(a)(6) of Circular 230, a tax return preparer who willfully fails to file required tax returns has engaged in disreputable conduct. Under the terms of §10.82(b)(5), if the tax return preparer has not filed annual returns for four of the last five years (or five of the last seven years for returns required more frequently than annually) immediately preceding the initiation of expedited suspension proceedings, then they may be sanctioned.

68. IRS Pub. 3112, *IRS e-file Application and Participation.*

69. Ibid.

## ISSUANCE OF AN EFIN

After the tax return preparer has been accepted as an IRS e-file participant, they are issued an electronic filing identification number (EFIN). Once the preparer has an EFIN, reapplying each year is not necessary as long as the EFIN is regularly used to file returns. However, if no returns are electronically filed for two consecutive years, the IRS will deactivate the EFIN. The preparer does not need to reapply for an EFIN if they request that the IRS reactivate their EFIN within 60 days of deactivation.

## DENIAL OF PROGRAM PARTICIPATION

An applicant may not be allowed to participate in the IRS e-file program for a variety of reasons. These reasons include situations in which the preparer:[70]

- Is under a federal or state court injunction that precludes them from preparing tax returns;
- Is indicted or convicted of any criminal offense under federal or state law or is the subject of an active IRS criminal investigation;
- Has failed to file accurate federal or state tax returns for their own tax situation or to pay federal or state tax liabilities;
- Is the subject of a fraud penalty assessment;
- Is suspended or disbarred from practice before the IRS or a state or local tax agency;
- Engages in disreputable conduct or other actions that may adversely affect the use of the IRS e-file program;
- Engages in misrepresentation in applying to participate in the IRS e-file program;
- Engages in unethical tax return preparation practices;
- Does not comply with the EIC due diligence requirements and rules;
- Stockpiles returns before being officially accepted as an IRS e-file program participant;
- Knowingly employs or accepts assistance from another individual who has been denied participation in or has been suspended or expelled from the IRS e-file program (or whose actions caused the denial, suspension, or expulsion of a firm from the program); or
- Knowingly becomes employed by a firm or individual who has been denied participation in or has been suspended or expelled from the IRS e-file program.

Maintenance of an EFIN to continuously enable the preparer to electronically file tax returns (and comply with the electronic filing requirements under Circular 230) is subject to continuous monitoring by the IRS to ensure compliance with the program. This monitoring includes the following items.[71]

- Conducting continuous suitability checks
- Reviewing the quality and accuracy of the tax returns filed electronically
- Ensuring that the tax return preparer signs the returns submitted electronically
- Scrutinizing the tax return preparer's advertising materials to ensure they comply with Circular 230 and the standards set for participation in the IRS e-file program

> **Note.** For further details regarding the IRS e-file program advertising standards, see IRS Pub. 3112, *IRS e-file Application and Participation.*

- Examining the tax return preparer's records and office procedures

> **Observation.** Many of the grounds for EFIN denial involve reasons that also constitute violations under Circular 230, including the provisions of §10.51.

70. Ibid.

71. Ibid.

## REVOCATION OF EFIN

The IRS may revoke the tax return preparer's ability to participate in the IRS e-file program if a federal court order prevents the preparer from preparing returns or if a federal or state legal action prohibits participation. Revocation on these grounds does not entitle the tax return preparer to any administrative review process. However, if the court order or legal action has expired or is reversed, the tax return preparer may reapply for an EFIN.

**Note.** For further details regarding the sanctions that may be imposed on tax return preparers who are noncompliant with the IRS e-file program rules, see IRS Pub. 3112, *IRS e-file Application and Participation.*

**Note.** The denial or revocation of an EFIN by the IRS and/or the U.S. Department of Justice without due process is currently a controversial issue. Either action effectively removes the tax return preparer's ability to complete and file returns in compliance with the Circular 230 electronic filing requirements.

## PENDING LITIGATION OF E-FILE PROGRAM DENIAL

Scott E. Davis, CPA, was convicted of aiding and assisting in the preparation of false federal tax returns.[72] This led to the loss of his CPA license and to his disbarment from practice before the IRS.

After fulfilling the terms of his sentence, Davis's state license to practice as a CPA was restored. In 2013, his ability to practice before the IRS was reinstated.[73] However, the IRS advised Davis that he cannot reapply to use the e-filing system until 2099. In addition, the IRS advised him that he cannot associate with any tax return preparers who use the e-filing system without placing their participation at risk.

In a lawsuit filed by Davis against the IRS,[74] Davis asserts that this EFIN denial has effectively precluded him from earning a living as a tax return preparer. To be compliant with the electronic filing rules, he can prepare and file only 11 tax returns a year. Davis alleges in his complaint that the IRS has indicated to him that he has no administrative recourse. He also alleges that the IRS refusal to allow him to reapply for participation in the e-file program violates due process and his right to obtain reinstatement to practice before the IRS.

**Note.** This case was filed in U.S. District Court for the Northern District of Ohio on February 7, 2014. Court records indicate that Davis filed a Notice of Dismissal on December 8, 2014, and the case was dismissed on that date.[75] Davis and the IRS reached a settlement before the scheduled date for the court hearing.

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72. IRS Ann. 2011-74,, 2011-47 IRB 796. (Announcement of Disciplinary Sanctions From the Office of Professional Responsibility, Announcement 2011-74 indicating that Davis was suspended indefinitely from IRS practice by expedited suspension proceeding as a result of conviction under 26 USC §7206(2). This statute involves the offense of aiding and assisting in the preparation of false U.S. income tax returns.)

73. IRS Ann. 2014-13, 2014-10 IRB 620.

74. *Scott E. Davis v. IRS, et. al*, Case: 1:14-cv-00261-SO Doc #: 5-2 Filed: 03/25/14 (N.D. Ohio, 2014).

75. *Davis v. Internal Revenue Service, et al.* Mar. 28, 2015. PacerMonitor.com [www.pacermonitor.com/public/case/2694040/Davis_v_Internal_Revenue_Service_et_al] Accessed on Mar. 30, 2015.