

## Chapter 3: Putting Ethics into Practice

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**Please note.** Corrections were made to this workbook through January of 2018. 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 short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

### About the Author

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## Chapter Summary

Tax practitioners are required to be familiar with the regulations governing practice before the IRS set out in Circular 230,<sup>1</sup> as well as professional codes of conduct and other ethical guidelines (discussed later). However, the application of Circular 230, relevant professional codes of conduct, and other ethical guidelines is frequently complex. The purpose of this chapter is to show how ethics are put into practice by examining real-world scenarios. Specific ethical issues considered in this chapter include the following.

- Best practices
- Client confidentiality and information disclosure
- Competence
- Conflict of interest
- Diligence as to accuracy
- Fees
- Knowledge of client's omission
- Preparer penalties
- Solicitation
- Standards with respect to tax returns

The chapter begins with three scenarios for existing clients. These scenarios include ethical issues for clients with long-term business activities, children going to college, and divorced spouses. Subsequently, four scenarios pertaining to new clients are explored, including a new client engagement, IRS audit representation, amended tax returns, and a business acquisition. Social media and public settings may offer business opportunities but tax practitioners should be aware of the ethical considerations in such settings. Appropriate ethical behavior in two such scenarios is discussed. Lastly, guidelines are provided for written communications, particularly by email.

Various tax practice aids are provided in the appendix including a client information confidentiality letter, new client engagement letter, new client representation letter, and consent/conflict resolution letters. Relevant sections from Circular 230 are also included in the appendix.

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<sup>1</sup>. Treasury Department Circular No. 230 (Rev. 6-2014).

## INTRODUCTION

**Practice before the IRS** is defined in Circular 230 as comprehending “all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service.”<sup>2</sup> Tax practitioners subject to Circular 230 include attorneys, certified public accountants (CPAs), and enrolled agents (EAs).

**Note.** Noncredentialed tax preparers cannot represent taxpayers before the IRS. They are nevertheless subject to Circular 230 requirements as tax return preparers.<sup>3</sup>

Attorneys and CPAs are also subject to state bar association ethics rules and the AICPA code of conduct, respectively. Four states currently license tax preparers (California, Maryland, New York, and Oregon).<sup>4</sup> Tax practitioners should be aware of any state-mandated licensing and/or ethics requirements. For example, Oregon requires resident EAs to be state licensed and to complete 30 hours of annual continuing education, including two hours of ethics.<sup>5</sup>

**Note.** In Illinois, the 2015 Illinois Tax Return Preparation Task Force concluded that preparers can be effectively monitored via their preparer tax identification numbers (PTIN).<sup>6</sup> Thus, the State Tax Preparer Oversight Act (Public Act 99-0641) was passed by the Illinois legislature. Effective January 1, 2017, Illinois tax preparers must report their PTINs on income tax returns and claims for refund filed with the state. The Illinois Department of Revenue (IDOR) is to develop a program to identify high error rates, patterns of suspected fraud, and unsubstantiated bases for tax positions by tax return preparers. IDOR will exchange information with the IRS and other states on tax return preparers who are suspected of fraud, disciplined, or barred from filing Illinois state tax returns. A tax preparer’s willful failure to provide a PTIN will result in a \$50 penalty per offense, not to exceed \$25,000 per year.<sup>7</sup>

This chapter discusses the ethical rules contained in Circular 230 that apply to tax practitioners engaged in tax compliance and representation activities. Other ethical requirements that these practitioners should be aware of include the information disclosure requirements of IRC §7216 and the “safeguards rule” contained in the Gramm-Leach-Bliley Act (GLBA).<sup>8</sup> In addition, practitioners who prepare tax returns with unreasonable positions (lacking substantial authority or a reasonable basis) are subject to penalties under IRC §6694. Such returns may also subject the client to similar penalties under IRC §6662. Besides the due diligence requirements stated in §10.22 of Circular 230, the IRS has specific due diligence guidelines for the earned income credit (EIC), child tax credit (CTC), and the American opportunity credit (AOC), which are described in IRS Pub. 4687, *Refundable Credits Due Diligence*, and have also been statutorily mandated by IRC §6695(g). This was a recent change.<sup>9</sup>

<sup>2</sup> Circular 230, §10.2(a)(4).

<sup>3</sup> Circular 230, §10.2(a)(8).

<sup>4</sup> *The AICPA Position on State-Level Oversight of Tax Preparers*. AICPA. [www.aicpa.org/Advocacy/State/Documents/AICPA-Position-on-State-Tax-Preparers-2014.pdf] Accessed on Feb. 23, 2017.

<sup>5</sup> *Licensing Information*. Oregon Board of Tax Practitioners. [www.oregon.gov/OBTP/Pages/licensing\_info.aspx] Accessed on Feb. 17, 2017.

<sup>6</sup> *Illinois Tax Return Preparation Task Force*. Dec. 1, 2015. Illinois Tax Return Preparation Task Force. [www.idfpr.com/Forms/PDFs/IllinoisTaxReturnPreparationTaskForceReport2015.pdf] Accessed on Feb. 17, 2017.

<sup>7</sup> Illinois PA 099-0641.

<sup>8</sup> PL 106–102 (Nov. 12, 1999).

<sup>9</sup> See TD 9799, 2016-51 IRB 821.

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Circular 230 is administered and enforced by the Office of Professional Responsibility (OPR). A list of Internal Revenue Bulletins describing disciplinary sanctions imposed by the OPR is available from **uofi.tax/17a3x1** [[www.irs.gov/Tax-Professionals/Enrolled-Actuaries/Disciplinary-Sanctions-Internal-Revenue-Bulletin](http://www.irs.gov/Tax-Professionals/Enrolled-Actuaries/Disciplinary-Sanctions-Internal-Revenue-Bulletin)].

Ethical tax practice requires tax professionals to be constantly alert even in seemingly innocuous situations. This chapter examines various scenarios that involve one or more ethical considerations, and recommendations are provided to handle these issues.

**Note.** There are often multiple equally valid methods for handling tax practice situations involving ethical considerations. Therefore, the recommendations discussed in this chapter should be considered in that light.

## EXISTING CLIENTS

### SCENARIO 1: ONCE A SCHEDULE C, ALWAYS A SCHEDULE C?

Earnest Workman has been employed for many years at ABC Corp. In 2013, Earnest decided to supplement his \$50,000 annual salary by starting a small sole proprietorship towing business. In February 2017, he meets with Prudence to have his 2016 tax return prepared. Prudence, a diligent CPA, reviews Earnest's spreadsheet of annual income and expenses since the business's inception. Earnest's spreadsheet provides the following information.

	2013	2014	2015	2016
Income	\$9,460	\$13,600	\$8,900	\$25,250
Expenses				
Advertising	\$ 540	\$ 2,432	\$2,101	\$ 6,457
Insurance	1,523	1,983	2,002	2,107
Repairs	644	1,752	1,504	9,983
Supplies	1,797	2,610	2,430	2,740
Truck expenses	3,421	4,734	1,074	7,464
Meals	564	1,240	740	1,750
Total expenses	\$8,489 (8,489)	\$14,751 (14,751)	\$9,851 (9,851)	\$30,501 (30,501)
Net income/(loss)	\$ 971	(\$ 1,151)	(\$ 951)	(\$ 5,251)

Prudence immediately believes that Earnest has fallen afoul of the “hobby loss” rules<sup>10</sup> because Earnest did not show profits for at least three of the five years since the commencement of the business. Prudence decides that Earnest's business activity is in fact a hobby and accordingly reports his revenues as other income on line 21 of Form 1040, *U.S. Individual Income Tax Return*. As required by the IRS for hobby expenses, she reports his expenses to the extent of income on Schedule A, *Itemized Deductions*.<sup>11</sup>

Prudence emails Earnest an encrypted draft of his 2016 tax return and then calls Earnest with the bad news, including the need to file amended 2014 and 2015 tax returns. Earnest is astounded and tells Prudence not to proceed further until he considers what to do. After some thought, Earnest remembers that a friend of his spoke highly of his EA tax preparer, Art Sedulous. Earnest hastily arranges a meeting with Art and brings him all his tax information.

<sup>10</sup> IRC §183.

<sup>11</sup> *Five Basic Tax Tips about Hobbies*. Aug. 6, 2014. IRS. [[www.irs.gov/uac/newsroom/five-basic-tax-tips-about-hobbies](http://www.irs.gov/uac/newsroom/five-basic-tax-tips-about-hobbies)] Accessed on Feb. 22, 2017.

Art reassures Earnest that determining when a business is a hobby is not clear-cut. While the “three-out-of-five-year” rule for profits does exist, it supports the presumption that the activity is engaged in for profit if three or more of the tax years in a consecutive 5-year period are profitable, unless the IRS proves otherwise.<sup>12</sup> There is no such presumption that the activity is **not** for profit when there are three or more years of losses in a 5-year period.

Art notes that there was a small profit in the first year, followed by two small losses. In 2016, revenues rose significantly but so did advertising, repairs, and truck expenses. Art asks Earnest for further explanations.<sup>13</sup> Earnest informs Art that his business activity increased because he gained new clients from advertising campaigns and continues to do so. Furthermore, Earnest’s repairs expense included \$8,000 for installing a new crane on his truck in December 2016.

Art asks Earnest about the activity’s prospects for 2017 onward, to which Earnest responds enthusiastically that “business is good.” This year, he expects a net profit of \$10,000 and states that maybe in the future he can give up his salaried position.

Art wonders aloud why Prudence rushed into a determination that the activity was not for profit when such a determination could have been delayed by filing Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*, with the IRS. Earnest does not know but assures Art that he was never asked to sign Form 5213.

**Note.** Form 5213 must be filed within three years of the due date (determined without extensions) of the first year of activity (no later than April 18, 2017, in this case). If the taxpayer files the form, the IRS generally postpones the determination until after the end of the fourth consecutive tax year (sixth tax year for an activity that consists mainly of breeding, training, showing, or racing horses) after the first tax year that the taxpayer engaged in the activity.

Filing Form 5213 extends the statute of limitations until two years after the due date for filing the return (determined without extensions) for the last tax year in the presumption period. This statute extension applies to all five years in the 5-year presumption period (or 7-year presumption period for horse activities).<sup>14</sup>

Art informs Earnest that in his opinion Prudence’s tax treatment of Earnest’s activity was conservative. A for-profit determination can be delayed simply by filing Form 5213 if Earnest does not mind extending the statute of limitations. Additionally, the \$8,000 crane could have been depreciated rather than expensed, which probably would make the activity profitable in 2016. Art informs Earnest that a for-profit determination is based on all relevant facts and circumstances.

Art suggests they meet again later in 2017 when a preliminary determination of 2017 profitability can be made.

Finally, Art asks Earnest if he paid Prudence’s fees yet. Earnest says that he has not. Art suggests that Earnest review his engagement letter with Prudence and question any fees associated with his towing activity.

Earnest tells Art that he will terminate his tax preparer relationship with Prudence and asks Art to take over preparation of his 2016 tax return.

<sup>12</sup> IRC §183(d).

<sup>13</sup> See Circular 230, §10.33(a)(2).

<sup>14</sup> Instructions for Form 5213.

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1. What ethical issues should Prudence and Art be concerned about in this scenario?

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2. What best practices should Prudence and Art have used?

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## Scenario 1 Discussion

**Best Practices.** Circular 230, §10.33(a)(2), requires practitioners to ascertain all the facts, decide which are relevant, and then apply the law appropriately to arrive at a conclusion supported by the law and the facts.

Prudence's actions indicate the following.

- She did not consider all nine factors (discussed later) when arriving at the decision that the towing business was a hobby. She only considered the “three-out-of-five-year” rule.
- She did not consider that 2016 would have been profitable if he had not expensed the crane.
- She did not discuss with Earnest the probability of future profits.
- She did not offer Earnest the opportunity to delay the determination that the activity was not for profit by filing Form 5213.
- She made decisions about the tax return without consulting Earnest.

Art's actions include the following.

- He educated Earnest on the nine factors (discussed later).
- He explained the opportunity for Earnest to file Form 5213 to delay the determination of whether the activity was not for profit.
- He explained that if profit was important, depreciation could have been utilized on the purchase of the crane rather than expensing.
- He explained the choices Earnest had about his return rather than making decisions for Earnest without his informed consent.

**Competence.** Circular 230, §10.35, requires that practitioners have the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. Prudence appears to have failed this requirement because she did not seem to know of the nine factors for determining for-profit activities (discussed later) or be aware of Form 5213.

**Diligence as to Accuracy.** Circular 230, §10.22(a), sets forth a general requirement that tax preparers exercise due diligence in tax practice **both** before the IRS as well as to their clients. This means practitioners must use due diligence when submitting documents to the IRS, communicating with the IRS, and communicating to a client about a tax matter.

Prudence did not exercise due diligence because she failed to obtain important information from Earnest and prepared a draft tax return without informing Earnest of the different options for reporting his towing activity. Furthermore, Prudence's research of the pertinent tax rules was inadequate because she did not consider the following nine relevant factors mentioned in Treas. Reg. §1.183-2 for determining whether an activity is engaged in for profit.

1. **Manner in which the taxpayer carried on the activity.** The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate **books and records** may indicate that the activity is engaged in for profit. In addition, if an activity is carried on in a manner substantially similar to other activities of the same nature that are profitable, a profit motive may be indicated. Operational changes, adoption of new techniques, or abandonment of unprofitable methods may also indicate a profit motive.
2. **The expertise of the taxpayer or their advisors.** If the taxpayer prepared for the activity through an extensive study of accepted business, economic, and scientific practices, or consulted with experts in the field, this may indicate a profit motive. If the study occurred but the taxpayer does not carry on the business in accordance with the findings or recommendations, it might indicate that there is no profit motive. However, if the taxpayer is trying to develop new or superior techniques, it might indicate that a profit motive exists.
3. **The time and effort expended by the taxpayer in carrying on the activity.** If the taxpayer devotes substantial personal time to an activity that does not have recreational aspects, it could indicate a profit motive exists. If the taxpayer leaves another occupation to devote most of their energy to the activity, it may indicate the activity is engaged in for profit. However, the fact that the taxpayer devotes limited time to the activity does not necessarily indicate the lack of a profit motive when competent and qualified persons are employed to carry on the business.
4. **An expectation that assets used in the business may appreciate in value.** The term "profit" encompasses the appreciation of assets, such as land, used in the activity. Therefore, the taxpayer may intend to derive a profit from the operation of the activity even if no profit from current operations is derived.
5. **The success of the taxpayer in carrying on similar or dissimilar activities.** The fact that the taxpayer has undertaken similar activities in the past and converted them from unprofitable to profitable may indicate that the taxpayer has a profit motive.
6. **The taxpayer's history of income and losses with respect to the activity.** A series of losses in the start-up years of an activity does not necessarily indicate the activity is not engaged in for profit. However, if unexplained losses continue beyond that period, it may indicate the activity is not being carried on to make a profit. Losses due to business reversals or customary business risks are explained losses. Losses due to unforeseen circumstances that are beyond the taxpayer's control such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions are not indications that the activity is not engaged in for profit. A series of prior profitable years is an indication of a for-profit activity even if the most recent years have resulted in losses.
7. **The amount of occasional profits, if any, which are earned.** The amount of profits in relation to the amount of losses incurred and to the taxpayer's investment and the value of the assets used is a factor considered in making the for-profit determination. An occasional small profit from an activity that generates large ongoing losses is not generally indicative of whether the activity is engaged in for profit. However, large occasional profits are generally an indication of a profit motive if the investment or losses are comparatively small. An opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate the activity is engaged in for profit. This is the case even though losses or only occasional small profits are actually generated.



8. **The financial status of the taxpayer.** A taxpayer without substantial income or capital from other sources is more likely to engage in an activity for profit. If the taxpayer has substantial income from other sources and engages in an activity that generates substantial tax benefits, this may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved.
9. **Elements of personal pleasure or recreation.** If the taxpayer has personal motives in carrying on the activity, it could indicate that the activity is not engaged in for profit. This is especially true if the activity involves recreational or personal elements. This is not true for an activity that lacks any appeal other than profit. It is not necessary to engage in the activity with the exclusive intent to make a profit or with the intention of maximizing profits. For example, the availability of other investments that would yield a higher return or that would more likely be profitable is not evidence that no profit motive exists. In addition, an element of personal pleasure from engaging in the activity is not determinative of the lack of a profit motive.

If Prudence had considered the preceding factors to make a reasonable determination, she could have satisfied the due diligence requirements.

## SCENARIO 2: DUE DILIGENCE UNDER THE PATH ACT

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) introduced new due diligence requirements for tax practitioners. In addition to due diligence requirements with respect to the EIC, practitioners now have specific due diligence requirements regarding the child tax credit (CTC), the additional child tax credit (ACTC), and the American opportunity credit (AOC).<sup>15</sup>

1. The tax preparer must complete Form 8867, *Paid Preparer's Due Diligence Checklist*, and submit it to the IRS with **every** electronic or paper return or claim for refund claiming the EIC, CTC, ACTC, or AOC.
2. The tax preparer must complete any applicable worksheet(s) to correctly determine the allowable EIC, CTC, ACTC, or AOC.
3. The tax preparer must keep copies of all records used to determine these refundable credits for at least three years.
4. The tax preparer must meet the knowledge requirement by being knowledgeable in the law, evaluating client information, asking questions to determine eligibility, and documenting questions asked and answers received.

A further restriction on claiming the AOC was introduced by the Trade Preferences Extension Act of 2015 (TPEA).<sup>16</sup> The AOC can be claimed only for qualified education expenses, including those reported on Form 1098-T, *Tuition Statement*. A Form 1098-T is required to be eligible for the AOC.

The following scenario illustrates the new ethical requirements that tax preparers must now adhere to when preparing tax returns claiming the AOC.

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<sup>15</sup> Joint Committee on Taxation. *Technical Explanation of the Protecting Americans From Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029*. JCX-144-15. (Dec. 17, 2015); IRS Pub. 4687, *Refundable Credits Due Diligence*.

<sup>16</sup> Trade Preferences Extension Act of 2015, §804(a). PL 114-27. (Jun. 29, 2015).



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Dan Teacher is a married U.S. citizen whose sole annual income is \$100,000 of wages. Dan's wife Miriam has no income. In 2016, Dan and Miriam's dependent son Ed completed his final year of an undergraduate degree in architectural studies at Arizona State University.

In February 2017, Dan meets with Larry Lackadaisical for preparation of his 2016 tax return. Larry, Dan's CPA for the last four years, asks Dan how Ed is doing and congratulates Dan on his son's graduation. Dan provides Larry with the following Form 1098-T for Ed's tuition expenses, along with his other tax documents.

3

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		1 Payments received for qualified tuition and related expenses	OMB No. 1545-1574
Arizona State University Tempe, AZ 85281		\$ 10500.00	2016 Form 1098-T
FILER'S federal identification no. 11-2233456		2 Amounts billed for qualified tuition and related expenses \$	
STUDENT'S taxpayer identification no. 123-45-6789		3 If this box is checked, your educational institution has changed its reporting method for 2016 <input type="checkbox"/>	
STUDENT'S name Edward Teacher		4 Adjustments made for a prior year \$	5 Scholarships or grants \$
Street address (including apt. no.) 25 Lake Place		6 Adjustments to scholarships or grants for a prior year \$	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January – March 2017 <input type="checkbox"/>
City or town, state or province, country, and ZIP or foreign postal code Westmont, IL 60559		8 Check if at least half-time student <input checked="" type="checkbox"/>	9 Checked if a graduate student <input type="checkbox"/>
Service Provider/Acct. No. (see instr.)		10 Ins. contract reimb./refund \$	<b>Copy B For Student</b>  This is important tax information and is being furnished to the Internal Revenue Service. This form must be used to complete Form 8863 to claim education credits. Give it to the tax preparer or use it to prepare the tax return.
Form 1098-T (keep for your records)		www.irs.gov/form1098t Department of the Treasury - Internal Revenue Service	

Dan thanks Larry on behalf of his son and remarks on the costs of a college education these days. Larry reassures Dan that he should still get some relief from the AOC, like he's had since Ed started college in 2012. However, Larry remembers that there were a couple of recent tax acts introducing new tax preparer procedures. Dan's provision of Form 1098-T to Larry meets the new TPEA requirement.

**Note.** Tax practitioners should carefully review IRS Pub. 4687, *Refundable Credits Due Diligence*, for the new AOC due diligence reporting requirements.

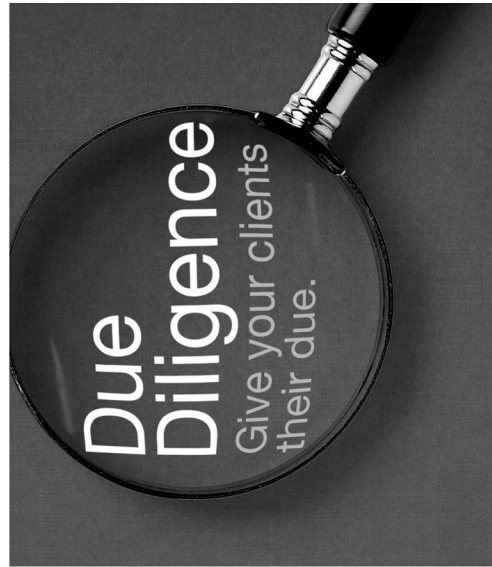
Larry consults IRS Pub. 4687 and decides to complete Form 8867 during the interview with Dan. A copy of Pub. 4687 and the completed form follows.

## For Scenario 2



## Refundable Credits Due Diligence

is more than a check mark on a form



### The Due Diligence Must Do's

- Know the law
- Apply your knowledge
- Ask all the right questions
- Get all the facts
- Document as you go and keep records

#### Most Common AOTC Errors

- Claiming AOTC for a student who didn't attend an eligible educational institution.** The AOTC is for post-secondary education, which may include education at a college, university or technical school. To be an eligible institution, the school must be able to participate in the student aid program administered by the U.S. Department of Education (note: they don't have to participate but must be eligible to participate).
- Claiming AOTC for a student who didn't pay qualifying college expenses.** Educational expenses must be paid or considered paid by your client, your client's spouse or the dependent student claimed on the tax return.
- Claiming AOTC for a student for too many years.** The AOTC is only available for the first four years of post-secondary education and your client can only claim it for four tax years per eligible student. This limitation includes any year(s) your client claimed the Hope Credit.

#### Most Common CTC/ACTC Errors

- Claiming the CTC/ACTC a child who does not meet the age requirement.** The child must be under the age of 17 at the end of the tax year. There are no exceptions to this rule.
- Claiming the CTC/ACTC a child who does not meet the dependency requirements.** The child must be claimed as a dependent on your client's return and meet all the eligibility rules for a dependent.
- Claiming the CTC/ACTC a child who does not meet the residency requirement.** The child must be a U.S. citizen, U.S. national or a U.S. resident alien and the child must have lived with your client for more than half the year. If the qualifying child uses an ITIN, Individual Taxpayer Identification Number, the child must meet the substantial presence test to qualify.

### The Tax Preparer Toolkit on EITC and Refundable Credits Central, [eic.irs.gov](http://eic.irs.gov), is your place for more information on Refundable Credit Due Diligence.

- Training opportunities, videos and training modules such as the Refundable Credit Due Diligence, Schedule C and Record Reconstruction
- Interview tips and best practices
- Frequently asked questions
- More

Publication 4687 (Rev. 8-2016) Catalog Number 51636Y  
Department of the Treasury **Internal Revenue Service** [www.irs.gov](http://www.irs.gov)

#### Due diligence promotes accurate EITC, CTC and AOTC claims.

#### Incorrect tax returns and failure to comply with the due diligence requirements can adversely affect you and your client:

- The IRS can examine your client's return, and if it is found incorrect, can assess accuracy or fraud penalties on your client. The IRS can also ban your client from claiming EITC, CTC and AOTC for 2 or 10 years.
- If you fail to comply with the EITC, CTC and AOTC due diligence requirements, the IRS can assess a \$500 penalty (adjusted for inflation) against you and your employer for each failure. IRS can assess you up to three penalties to a return that claims all three credits. (IRC § 6695(g)).
- If you prepare a client's return and any part of an understatement of tax liability is due to an unreasonable position, the IRS can assess a minimum penalty of \$1,000 (IRC § 6694(a)) against you.
- If the understatement is due to reckless or intentional disregard of rules or regulations, the minimum penalty is \$5,000 (IRC § 6694(b)).
- You and your firm can face suspension or expulsion from participation in IRS e-file.
- You can be barred from preparing tax returns.
- You can be subject to criminal prosecution.

#### Each refundable credit has different eligibility rules. Take these simple steps to avoid errors:

- Know the tax law for each refundable credit including eligibility rules
- Remember, software is not a substitute for knowledge of the tax law
- Follow the Due Diligence Must Do's

#### Pay particular attention to the following issues to avoid EITC, CTC or AOTC claim errors:

##### Most Common EITC Errors

- **Claiming EITC for a child who does not meet the qualifying child requirements.** Make sure you find out if the child lived with your client for more than half the year, is related to him or her and meets the age test. You must ask how long the child lived with your client, at what address, and did anyone else live with the child for more than half the year. Also, find out how the child is related – by blood, by marriage or by law. Age is a bit easier, but if the child is a student or permanently and totally disabled, make sure your client has the documents needed to show the IRS if audited.
- **Filing as single or head of household when married.** Ask the questions to find out if your client is married under state law, including common law, or was ever married. Also, if your client is married, make sure your client did not live with his or her spouse at any time during the last six months of the year.
- **Incorrectly reporting institution income or expenses.** Does the Form W-2 look similar to the Forms W-2 of other clients who have the same employer? Is your client saying they own a business but not claiming any business expenses? Ask enough questions to make sure your client has a true business and claims all income and deducts all allowable expenses.

## For Scenario 2

**BY**law, if you are paid to prepare tax returns claiming one or more of the Earned Income Tax, the Child Tax or the American Opportunity Tax credits, you must meet four due diligence requirements. The 2015 PATH Act extended the due diligence requirements from EITC, Earned Income Tax Credit, to both the CTC, Child Tax Credit, and the AOTC, American Opportunity Tax Credit. These requirements focus on accurately determining your client's eligibility for and the amount of each credit.

The first three requirements have to do with completing forms and keeping records. **The fourth, the one most often missed, is the knowledge requirement. It requires you to:**

- Know the EITC, CTC and AOTC tax laws thoroughly
- Evaluate your client's information
- Ask questions based on your client's information to determine each client's personal situation and eligibility
- Document the questions you ask and your client's answers

**To meet your four due diligence requirements, you must:**

1. Complete Form 8867, *Paid Preparer's Due Diligence Checklist*, and submit this completed form to the IRS with every electronic or paper return or claim for refund you prepare with the EITC, CTC or AOTC.
    - Make sure your software includes the Form 8867 and that it is transmitted with every electronic return and included with every paper return you prepare with the EITC, CTC or AOTC.
    - Answer each question on the form based on information from your client and information you know is true.
    - You must also personally answer question 12, *Credit Eligibility Certification*.
  2. Complete the applicable worksheet(s), or your own worksheet(s) with the same information, for any EITC, CTC and AOTC claimed on the return.
    - Most professional tax return preparation software includes the worksheets.
  3. Keep copies of the following either electronically or on paper for your records:
    - Form 8867
    - The applicable worksheet(s) for EITC, CTC and AOTC claimed on the return
    - Any documents you relied on to complete the Form 8867 or to determine eligibility for and the amount of the credit(s)
    - A record of how, when, and from whom the information you obtained to prepare the tax return and worksheet(s)
    - A record of any additional questions you asked to determine eligibility for and the amount of the credits and your client's answers.
- Keep these documents for three years from the latest of:
- The due date of the tax return.

- The date the tax return was electronically filed.
  - For a paper return, the date the return was presented to your client for signature.
  - If you are a non-signing tax return preparer, the date you give the part, for which you are responsible to the signing tax return preparer.
- You can keep these records in either paper or electronic format but you must produce the records if IRS requests them. You should keep a backup of these records in a separate, secure location.
4. Not know, or have reason to know, that any information used to determine if your client is eligible for or to compute the amount of the credit(s) is not correct, not consistent or not complete.
    - You must ask your client additional questions if a reasonable and well-informed tax return preparer, knowledgeable in the law, would conclude the information furnished seems incorrect, inconsistent or incomplete.
  - At the time of the interview, you must document in your files the questions you asked and your client's answers.

**The IRS assesses most due diligence penalties for failure to comply with the knowledge requirement. To meet the knowledge requirement, you should:**

- Apply a common sense standard to the information provided by your client
- Evaluate whether the information is complete and gather any missing facts
- Determine if the information is consistent; recognize contradictory statements and statements you know are not true
- Conduct a thorough, in-depth interview with each client, every year
- Ask enough questions to know the return is correct and complete
- Document in the file at the time it happens any questions you asked and your client's responses

**An employer may be penalized for an employee's failure to exercise due diligence, if any of the following apply:**

- An employer or a principal member of management participated in, or prior to the time the return was filed, knew of the failure to comply with the due diligence requirements; or
- The firm failed to establish reasonable and appropriate procedures to ensure compliance with due diligence requirements; or
- The firm disregarded its reasonable and appropriate compliance procedures in the preparation of the tax return or claim for refund through willfulness, recklessness, or gross indifference. This failure includes ignoring facts that would lead a person of reasonable prudence and competence to investigate.

**Following are examples of situations when you should ask additional questions to meet your due diligence knowledge requirement:**

- A client and spouse want to claim the CTC and the AOTC. Your client is a resident alien with one child and has higher education expenses.

- You should ask enough questions to determine if the child and spouse are citizens, resident aliens, or non-resident aliens. You should also ask enough questions to determine if your client is eligible for the AOTC.
- A client wants to claim his niece and nephew for EITC. You should ask enough questions to determine whether each child is a qualifying child of your client. You should also ask enough questions to find out if the child is the qualifying child of another person. And, if so, will the other person claim the child. If more than one person claims the same child, the IRS will apply the tiebreaker rules.
  - An 18-year-old client with an infant has \$3,000 in earned income and states she lives with her parents. She wants to claim the infant as a qualifying child for the EITC. This information seems incomplete and inconsistent because your 18-year-old client lives with her parents and earns very little income. You must ask additional questions to determine if your client is the qualifying child of her parents. If she is the qualifying child of her parents, she is not eligible to claim the EITC.
  - A 22-year-old client wants to claim two sons, ages 10 and 11, as qualifying children for the EITC. You must make additional reasonable inquiries regarding the relationship between your client and the children since the age of the client seems inconsistent with the ages of the children claimed as your client's sons.
  - A client has two qualifying children and wants to claim the EITC. She tells you she had a Schedule C business and earned \$10,000 in income and had no expenses. This information appears incomplete because it is unusual that someone who is self-employed has no business expenses. You must ask additional reasonable questions to determine if the business exists and if the information about her income and expenses is correct.
  - A 32-year-old client indicates he's been going to college for many years and would like to claim the AOTC. He provides a Form 1098-T, Tuition Statement, showing \$4,000 received for tuition and that your client was at least a half-time undergraduate student. You must ask more questions. The Form 1098-T is a good indicator that your client is eligible for the AOTC but does not contain all the information needed to determine eligibility or to compute the amount of the credit. You must also find out if your client received any scholarships, how and when the expenses were paid, if your client has a felony drug conviction, and if your client claimed AOTC or the Hope Credit previously and if so, for how many years.
  - A client wants to claim the CTC for three children. Your client is a resident alien. The children all have ITINs and lived part of the year outside the U.S. You must ask questions to determine that each child is related to your client and meets the residency requirements for the CTC. You must also complete Part 1 of Schedule 8812 for each child with an ITIN to show the child meets the residency test.



# 2017 Workbook

## For Scenario 2

Form <b>8867</b> Department of the Treasury Internal Revenue Service	<b>Paid Preparer's Due Diligence Checklist</b> <i>Earned Income Credit (EIC), Child Tax Credit (CTC), and American Opportunity Tax Credit (AOTC)</i> <b>► To be completed by preparer and filed with Form 1040, 1040A, 1040EZ, 1040NR, 1040SS, or 1040PR.</b> <b>► Information about Form 8867 and its separate instructions is at <a href="http://www.irs.gov/form8867">www.irs.gov/form8867</a>.</b>	OMB No. 1545-1629 <div style="text-align: center; font-size: 2em; font-weight: bold;">2016</div> Attachment Sequence No. <b>70</b>
Taxpayer name(s) shown on return <b>Daniel Teacher &amp; Miriam Teacher</b>		Taxpayer identification number <b>987-65-4321</b>
Enter preparer's name and PTIN <b>Larry Lackadaisical P01045678</b>		
<b>Due Diligence Requirements</b>		
Please complete the appropriate column for all credits claimed on this return (check all that apply).		EIC      CTC/ACTC      AOTC
<b>1</b> Did you complete the return based on information for tax year 2016 provided by the taxpayer or reasonably obtained by you?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>2</b> Did you complete the applicable EIC and/or CTC/ACTC worksheets found in the Form 1040, 1040A, 1040EZ, or 1040NR instructions, and/or the AOTC worksheet found in the Form 8863 instructions, or your own worksheet(s) that provides the same information, and all related forms and schedules for each credit claimed?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>3</b> Did you satisfy the knowledge requirement? Answer "Yes" only if you can answer "Yes" to both 3a and 3b. To meet the knowledge requirement, did you:		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>a</b> Interview the taxpayer, ask adequate questions, and document the taxpayer's responses to determine that the taxpayer is eligible to claim the credit(s)?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>b</b> Review adequate information to determine that the taxpayer is eligible to claim the credit(s) and in what amount?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>4</b> Did any information provided by the taxpayer, a third party, or reasonably known to you in connection with preparing the return appear to be incorrect, incomplete, or inconsistent? (If "Yes," answer questions 4a and 4b. If "No," go to question 5.)		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>a</b> Did you make reasonable inquiries to determine the correct or complete information?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>b</b> Did you document your inquiries? (Documentation should include the questions you asked, whom you asked, when you asked, the information that was provided, and the impact the information had on your preparation of the return.)		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>5</b> Did you satisfy the record retention requirement? To meet the record retention requirement, did you keep a copy of any document(s) provided by the taxpayer that you relied on to determine eligibility or to compute the amount for the credit(s)? In addition to your notes from the interview with the taxpayer, list those documents, if any, that you relied on. <b>Form 1098-T</b> _____ _____ _____		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>6</b> Did you ask the taxpayer whether he/she could provide documentation to substantiate eligibility for and the amount of the credit(s) claimed on the return?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>7</b> Did you ask the taxpayer if any of these credits were disallowed or reduced in a previous year? (If credits were disallowed or reduced, go to question 7a; if not, go to question 8.)		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>a</b> Did you complete the required recertification form(s)?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>8</b> If the taxpayer is reporting self-employment income, did you ask adequate questions to prepare a complete and correct Form 1040, Schedule C?		<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No
For Paperwork Reduction Act Notice, see separate instructions. <span style="float: right;">Cat. No. 26142H      Form <b>8867</b> (2016)</span>		

## For Scenario 2

Form 8867 (2016)

Page **2**

### Due Diligence Questions for Returns Claiming EIC (If the return does not claim EIC, go to question 10.)

	EIC	CTC/ACTC	AOTC
<b>9a</b> Did you explain to the taxpayer the rules about claiming the EIC when a child is the qualifying child of more than one person (tie-breaker rules), and have you determined that this taxpayer is, in fact, eligible to claim the EIC for the number of children for whom the EIC is claimed? . . . . .	<input type="checkbox"/> Yes <input type="checkbox"/> No		
<b>b</b> Did you explain to the taxpayer that he/she may not claim the EIC if the taxpayer has not lived with the child for over half the year, even if the taxpayer has supported the child? . . . . .	<input type="checkbox"/> Yes <input type="checkbox"/> No		

### Due Diligence Questions for Returns Claiming CTC and/or additional CTC (If the return does not claim CTC or Additional CTC, go to question 11.)

<b>10a</b> Does the child reside with the taxpayer who is claiming the CTC/ACTC? (If "Yes," go to question 10c. If "No," answer question 10b.) . . . . .	<input type="checkbox"/> Yes <input type="checkbox"/> No	
<b>b</b> Did you ask if there is an active Form 8332, Release/Revocation of Claim to Exemption for Child by Custodial Parent, or a similar statement in place and, if applicable, did you attach it to the return? . . . . .	<input type="checkbox"/> Yes <input type="checkbox"/> No	
<b>c</b> Have you determined that the taxpayer has not released the claim to another person? . . . . .	<input type="checkbox"/> Yes <input type="checkbox"/> No	

### Due Diligence Questions for Returns Claiming AOTC (If the return does not claim AOTC, go to *Credit Eligibility Certification*.)

<b>11</b> Did the taxpayer provide substantiation such as a Form 1098-T and receipts for the qualified tuition and related expenses for the claimed AOTC? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
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► **You have complied with all due diligence requirements with respect to the credits claimed on the return of the taxpayer identified above if you:**

- A. Complete this Form 8867 truthfully and accurately and complete the actions described in this checklist for all credits claimed;
- B. Submit Form 8867 in the manner required;
- C. Interview the taxpayer, ask adequate questions, document the taxpayer's responses on the return or in your notes, review adequate information to determine if the taxpayer is eligible to claim the credit(s) and in what amount(s); **and**
- D. Keep all five of the following records for 3 years from the latest of the dates specified in the Form 8867 instructions under *Document Retention*.
  1. A copy of Form 8867,
  2. The applicable worksheet(s) or your own worksheet(s) for any credits claimed,
  3. Copies of any taxpayer documents you may have relied upon to determine eligibility for and the amount of the credit(s),
  4. A record of how, when, and from whom the information used to prepare this form and worksheet(s) was obtained, and
  5. A record of any additional questions you may have asked to determine eligibility for and amount of the credits, and the taxpayer's answers.

► **If you have not complied with all due diligence requirements for all credits claimed, you may have to pay a \$510 penalty for each credit for which you have failed to comply.**

### Credit Eligibility Certification

<b>12</b> Do you certify that all of the answers on this Form 8867 are, to the best of your knowledge, true, correct and complete? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
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Form **8867** (2016)

**3**

# 2017 Workbook

Larry verifies with Dan that Ed did not receive any tax-free educational assistance or refunds of educational expenses. Larry completes the “adjusted qualified education expenses worksheet” contained in the instructions to Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*, as follows.

## Adjusted Qualified Education Expenses Worksheet

See *Qualified Education Expenses*, earlier, before completing.

Complete a separate worksheet for each student for each academic period beginning or treated as beginning (see below) in 2016 for which you paid (or are treated as having paid) qualified education expenses in 2016.

1. Total qualified education expenses paid for or on behalf of the student in 2016 for the academic period . . . . .	<u>10500</u>
2. Less adjustments:	
a. Tax-free educational assistance received in 2016 allocable to the academic period . . . . .	<u>0</u>
b. Tax-free educational assistance received in 2017 (and before you file your 2016 tax return) allocable to the academic period . . . . .	<u>0</u>
c. Refunds of qualified education expenses paid in 2016 if the refund is received in 2016 or in 2017 before you file your 2016 tax return . . . . .	<u>0</u>
3. Total adjustments (add lines 2a, 2b, and 2c) . . . . .	<u>0</u>
4. Adjusted qualified education expenses. Subtract line 3 from line 1. If zero or less, enter -0- . . . . .	<u>10500</u>

Larry informs Dan that he should now have everything he needs to handle the AOC on Dan’s 2016 federal income tax return. The interview concludes, and Larry documents the interview.

Later, Larry starts preparing Dan’s tax return. For the Form 8863, page 2 (which follows), Larry reviews his interview notes, the 2016 Form 1098-T, and Dan and Miriam’s 2015 tax file. For line 23, Larry remembers from the interview that Ed completed his undergraduate degree in 2017, so he responds “no,” as he does for line 25. Knowing the Teacher family well, Larry responds “no” to item 26 because Ed has never been in any kind of trouble.

## For Scenerio 2

Form 8863 (2016)

Page **2**

Name(s) shown on return

**Daniel & Miriam Teacher**

Your social security number

**987 65 4321**



**Complete Part III for each student for whom you're claiming either the American opportunity credit or lifetime learning credit. Use additional copies of page 2 as needed for each student.**

### Part III Student and Educational Institution Information

See instructions.

<b>20</b> Student name (as shown on page 1 of your tax return) <b>Edward Teacher</b>	<b>21</b> Student social security number (as shown on page 1 of your tax return) <b>123 45 6789</b>
<b>22</b> Educational institution information (see instructions)	
<b>a.</b> Name of first educational institution <b>Arizona State University</b>	<b>b.</b> Name of second educational institution (if any)
<b>(1)</b> Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions. <b>Arizona State University, Tempe, AZ 85281</b>	<b>(1)</b> Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions.
<b>(2)</b> Did the student receive Form 1098-T from this institution for 2016? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<b>(2)</b> Did the student receive Form 1098-T from this institution for 2016? <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>(3)</b> Did the student receive Form 1098-T from this institution for 2015 with box <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No 2 filled in and box 7 checked?	<b>(3)</b> Did the student receive Form 1098-T from this institution for 2015 with box <input type="checkbox"/> Yes <input type="checkbox"/> No 2 filled in and box 7 checked?
If you checked "No" in <b>both (2) and (3)</b> , skip <b>(4)</b> .	If you checked "No" in <b>both (2) and (3)</b> , skip <b>(4)</b> .
<b>(4)</b> If you checked "Yes" in <b>(2) or (3)</b> , enter the institution's federal identification number (from Form 1098-T). <b>1 1 - 2 2 3 3 4 5 6</b>	<b>(4)</b> If you checked "Yes" in <b>(2) or (3)</b> , enter the institution's federal identification number (from Form 1098-T). <b>- - - - -</b>
<b>23</b> Has the Hope Scholarship Credit or American opportunity credit been claimed for this student for any 4 tax years before 2016? <input type="checkbox"/> Yes — <b>Stop!</b> Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 24.	
<b>24</b> Was the student enrolled at least half-time for at least one academic period that began or is treated as having begun in 2016 at an eligible educational institution in a program leading towards a postsecondary degree, certificate, or other recognized postsecondary educational credential? See instructions. <input checked="" type="checkbox"/> Yes — Go to line 25. <input type="checkbox"/> No — <b>Stop!</b> Go to line 31 for this student.	
<b>25</b> Did the student complete the first 4 years of postsecondary education before 2016? See instructions. <input type="checkbox"/> Yes — <b>Stop!</b> Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 26.	
<b>26</b> Was the student convicted, before the end of 2016, of a felony for possession or distribution of a controlled substance? <input type="checkbox"/> Yes — <b>Stop!</b> Go to line 31 for this student. <input checked="" type="checkbox"/> No — Complete lines 27 through 30 for this student.	



**You *can't* take the American opportunity credit and the lifetime learning credit for the *same* student in the same year. If you complete lines 27 through 30 for this student, don't complete line 31.**

<b>American Opportunity Credit</b>	
<b>27</b> Adjusted qualified education expenses (see instructions). <b>Don't enter more than \$4,000</b> . . . . .	<b>27</b> <b>4,000</b>
<b>28</b> Subtract \$2,000 from line 27. If zero or less, enter -0- . . . . .	<b>28</b> <b>2,000</b>
<b>29</b> Multiply line 28 by 25% (0.25) . . . . .	<b>29</b> <b>500</b>
<b>30</b> If line 28 is zero, enter the amount from line 27. Otherwise, add \$2,000 to the amount on line 29 and enter the result. Skip line 31. Include the total of all amounts from all Parts III, line 30, on Part I, line 1 . . . . .	<b>30</b> <b>2,500</b>
<b>Lifetime Learning Credit</b>	
<b>31</b> Adjusted qualified education expenses (see instructions). Include the total of all amounts from all Parts III, line 31, on Part II, line 10 . . . . .	<b>31</b>

Form **8863** (2016)



# 2017 Workbook

1. What questions should Larry ask to satisfy due diligence requirements?

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2. Where does Larry's due diligence fall short?

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## Scenario 2 Discussion

**Refundable Tax Credit Due Diligence.** In many ways, Larry's due diligence is good. He remembers, for example, the recent legislation introducing new due diligence requirements for refundable tax credits, including the AOC. Larry consults IRS Pub. 4687 and completes the adjusted qualified education expenses worksheet during the interview. Furthermore, Larry asks Dan appropriate questions and documents the responses.

Unfortunately, Larry makes some mistakes. Although Larry can complete Form 8867 during the interview, it makes more sense to fill this checklist out after completing Form 8863 for the AOC. If he completed Form 8863 during the interview, Larry would have remembered to question Dan about his son's criminal record. As it is, Larry should follow up on this and not assume he knows the answer.

The AOC can only be claimed for a student attending an eligible educational institution.<sup>17</sup> Larry assumes that because the expenses are reported on Form 1098-T, Arizona State University is an eligible educational institution. While it is true that eligible academic institutions are required to file Form 1098-T with the IRS, nothing prevents ineligible academic institutions from filing the form. To be on the safe side, Larry could verify the university's eligibility by contacting the university or by accessing the publicly available federal school code list, which is available at **uofi.tax/17a3x8** [<https://ifap.ed.gov/ifap/fedSchoolCodeList.jsp>].

Larry's most glaring oversight concerns his assumption that Ed is in the fourth year of his undergraduate degree because he graduated in 2016. However, Larry even notes that Ed started college in 2012 during his chat with Dan.

**Note.** A 2016 report from the National Student Clearinghouse Research Center states that the average time to complete a bachelor's degree is 5.1 years.<sup>18</sup>

IRS Pub. 4687 states that, of the four due diligence requirements, the knowledge requirement is the most often missed. Larry stumbles here by not evaluating his client's information thoroughly. A quick check of Dan's tax returns going back to 2012 would confirm that the AOC has already been claimed for four years (from 2012 to 2015).

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<sup>17</sup> IRC §25A(f)(2).

<sup>18</sup> *Time to Degree: A National View of the Time Enrolled and Elapsed for Associate and Bachelor's Degree Earners*. Sep. 18, 2016. National Student Clearinghouse Research Center. [<https://nscresearchcenter.org/signaturereport11/>] Accessed on Feb. 23, 2017.

**Preparer Penalty for Failure to meet Due Diligence Requirement.** Because of the PATH Act, the preparer penalty (\$510 for 2017)<sup>19</sup> now applies to all the refundable tax credits (EIC, CTC, ACTC, and AOC). A firm employing a tax preparer may also be subject to this penalty.<sup>20</sup> Under IRC §6695(g), a tax return preparer is subject to this penalty; however, the associated regulations define the term “tax return preparer” to include both signing and nonsigning preparers.<sup>21</sup> Consequently, even nonsigning preparers can be subject to this penalty if they are substantially involved in the preparation of a tax return, including a refundable tax credit.

## SCENARIO 3: EX-SPOUSES FILING SEPARATELY

Unless IRC §7216 or the regulations thereunder specifically authorize the disclosure of tax return information, tax practitioners may only disclose their client’s information with their client’s consent.<sup>22</sup> Tax preparers are only permitted to use tax return information for preparation of federal and state tax returns and declarations of estimated tax.<sup>23</sup> Any other use of this information requires the client’s consent. The IRS provided very specific disclosure guidance to tax preparers about these issues in Rev. Proc. 2013-14.<sup>24</sup> The procedure provides rules regarding the format and content of taxpayer consents to **disclose** and **use** tax return information, including mandatory language that must be used depending on which of the following three contexts apply.

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 for purposes other than the preparation and filing of a tax return

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<sup>19</sup> Rev. Proc. 2016-55, 2016-45 IRB 707.

<sup>20</sup> Treas. Reg. §1.6695-2.

<sup>21</sup> Treas. Reg. §301.7701-15.

<sup>22</sup> Treas. Reg. §301.7216-3.

<sup>23</sup> IRC §7216.

<sup>24</sup> Rev. Proc. 2013-14, 2013-3 IRB 283.

# 2017 Workbook

The following table summarizes the mandatory language for all consent requests and in each of the three specific contexts.<sup>25</sup>

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 <a href="mailto:complaints@tigta.treas.gov">complaints@tigta.treas.gov</a> .
Disclosure for purposes other than tax return preparation or auxiliary services	<p>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.</p> <p>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.</p>
Disclosure for tax return preparation or provision of auxiliary services	<p>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.</p> <p>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.</p>
Use of information	<p>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.</p> <p>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.</p>

<sup>25</sup> Ibid.

The following scenario illustrates tax return information disclosure issues facing a tax preparer dealing with divorced clients.

Ron and Lisa Keller, who file jointly, are long-time Illinois residents and clients of Dexter Arbiter, who is a CPA. Ron is unemployed with no income, and Lisa is a pharmaceuticals executive earning \$250,000 annually. On January 17, 2017, Ron and Lisa divorce. In February, Ron calls Dexter to arrange a meeting to discuss his 2016 taxes and mentions that he is coming in on his own because he and Lisa divorced the previous month. During the meeting, Ron informs Dexter that he and Lisa agreed to file separately. Because Ron has no income and no special situations apply,<sup>26</sup> Dexter informs Ron that he is not required to file a tax return. Satisfied with this response, Ron leaves the meeting in good spirits.

Dexter later meets with Lisa and informs her that he had a meeting with Ron. Lisa starts the interview by informing Dexter that she and Ron will file jointly. Dexter asks to see the divorce agreement. Lisa produces it, but there are no provisions in it regarding their tax returns.

1. What should Dexter do next?

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2. What could Dexter have done differently?

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## Scenario 3 Discussion

Dexter is now in a predicament. Ron and Lisa disagree about their filing status, and Dexter finds himself with a conflict of interest.<sup>27</sup> Because he already met with Ron and provided him with advice regarding filing separately, he cannot fairly represent Lisa if she disagrees with this position. Furthermore, without Ron's written consent, Dexter cannot disclose to Lisa that Ron has chosen not to file a tax return.<sup>28</sup>

In addition, Dexter should advise both Ron and Lisa of their filing options so that they can make an informed decision. A discussion about joint and several liability for tax on a married filing jointly (MFJ) return should be part of this conversation.

**Information Disclosure.** The specific rules regarding information disclosure vary depending on whether the client is a tax return filer or not.<sup>29</sup> Ron elects to use the married filing separately status and is not required to file a tax return. Therefore, Ron must provide Dexter with the necessary written consent under Treas. Reg. §301.7216-3(a)(3)(iii) before Dexter can communicate Ron's decision to Lisa.

<sup>26</sup> IRS Pub. 17, *Your Federal Income Tax*.

<sup>27</sup> Circular 230, §10.29.

<sup>28</sup> Treas. Reg. §301.7216-3(a)(3)(iii).

<sup>29</sup> Treas. Reg. §301.7216-3.

**Tax Practitioner Assistance Options.** Dexter has two obvious courses of action open to him.

1. Decline to prepare Lisa's tax return, explaining to her that he cannot fairly assist her because he is already assisting Ron
2. Ask Lisa to return with Ron so that they can jointly execute a conflict of interest waiver (see sample in appendix) and provide their informed consent to Dexter assisting both of them in the preparation of a joint tax return

If Ron refuses to return with Lisa or otherwise indicate to Dexter that he is open to filing jointly, then Dexter will have a conflict of interest if he also prepares Lisa's return.

Could Dexter have handled this situation differently? Upon receiving Ron's initial telephone call, Dexter could have asked Ron and Lisa to come in together to discuss the situation.

## NEW CLIENTS

### SCENARIO 4: INADEQUATE PREVIOUS INFORMATION

Kathy is a recently qualified EA with a small tax practice in Carbondale, Illinois. Tom Flashman emails her in early February, stating that he moved to Carbondale in December 2015 to invest in local real estate. Tom asked around for a tax preparer and Kathy was highly recommended. Kathy, flattered to be the "best tax preparer in town," emails Tom asking if he would like to come in for an interview. Tom responds by email, stating that he is busy with acquisitions. He asks Kathy to review his attached 2016 tax information and provide him with a fee quote. When Kathy asks for Tom's previous tax returns, he tells her not to worry because he always has a zero-tax liability. The only relevant item she needs to consider is a \$54,325 long-term capital loss carryover from 2015.

Tom's tax information consists of a spreadsheet for his sole proprietorship and real estate sales business and some general personal information. Kathy reviews the information and emails Tom a fee quote of \$7,500 for 2016 tax preparation, even though her experience with real estate transactions is limited to home sales and the occasional rental property sale. Tom promptly accepts Kathy's fee quote.

Kathy completes and e-files 2016 federal and Illinois tax returns for Tom. The Schedule C, *Profit or Loss From Business*, shows income of \$52,500 and expenses of \$29,800. A net \$50,000 long-term capital gain from the real estate sales is reported on Schedule D, *Capital Gains and Losses*. Netting this gain with the carryover from 2015 generates a \$3,000 loss offset against other income. Tom and his wife file jointly, claiming two personal exemptions and the standard deduction. The result is negative taxable income of \$1,000 (\$52,500 Schedule C income – \$29,800 expenses – \$3,000 capital loss – \$8,100 personal exemptions – \$12,600 standard deduction). Kathy, sure that Tom will be delighted with the result, emails Tom her invoice for \$7,500 and never hears from Tom again.

1. What ethical issues should Kathy be concerned about in this scenario?

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2. What best practices should Kathy have used?

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## Scenario 4 Discussion

Clearly, Kathy has committed a litany of ethical violations. She even fails to positively identify Tom. In the absence of any tax reporting forms, Kathy should ask Tom for proof of his identity and social security number, preferably at a face-to-face meeting. As it is, Tom could be impersonating someone else.

**Note.** Some states require verification of drivers license or state-issued identification.

**Best Practices.** There are several best practices that Kathy can use.<sup>30</sup> First, Kathy should prepare an engagement letter countersigned by Tom setting out the scope of the engagement (along the lines of the proforma engagement and client confidentiality sample letters included in the appendix). Second, Kathy should make a better effort to establish the facts of Tom's situation by, for example, insisting on reviewing prior tax returns, asking more questions about the nature of Tom's business and investment activity, and obtaining copies of invoices and receipts.

**Note.** While a practitioner may generally rely in good faith upon information furnished by the client without further verification, Kathy should make further inquiries when Tom's information appears to be incomplete, incorrect, or inconsistent.<sup>31</sup>

**Note.** During November 2013, the IRS sent out Letter 4810 to select tax preparers and made visits to them because of possible errors made by those tax preparers on Schedule C. During the visits, the IRS reviewed the rules associated with Schedule C. See **uofi.tax/17a3x9** [[www.irs.gov/tax-professionals/irs-letters-and-visits-return-preparer-letter](http://www.irs.gov/tax-professionals/irs-letters-and-visits-return-preparer-letter)].

An additional issue Kathy fails to consider is whether Tom is a dealer rather than an investor<sup>32</sup> in real estate and the potential for accuracy-related penalties. As things stand, Kathy did not act fairly and with integrity in practice before the IRS.

**Competence.** Section 10.35 of Circular 230 states that "a practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service." While Kathy is an EA, she lacks experience with dealer/investor situations. To address this competence shortfall, Kathy should study the applicable laws or consult with a practitioner experienced with the issue.

**Note.** Treating the real estate sales as capital asset dispositions rather than ordinary income may mean that Kathy took an unreasonable position in violation of Circular 230, §10.34, if further inquiries would show that Tom is a dealer.

**Diligence as to Accuracy.** Kathy is required to exercise due diligence.<sup>33</sup> She does not do this with respect to Tom's situation because the information he provided is incomplete and she does not consider the possibility that Tom is a dealer. To meet the due diligence requirement, Kathy should obtain a Schedule D for the prior year to document the capital loss carryforward. She should also obtain Forms 1099 to document the income amount. She should also ask relevant questions concerning the nature of the business activity.

<sup>30</sup> See Circular 230, §10.33.

<sup>31</sup> Circular 230, §10.34(d).

<sup>32</sup> *The "Shovel in the Ground Problem": Planning for Real Estate Development Activities*. Bakatsias, Nicholas J. Carruthers & Roth, P.A. [[crlaw.com/news/wp-content/uploads/2012/01/The-Shovel-in-the-Ground-Problem-Planning-for-Real-Estate-Development-Activities\\_12-05-07.pdf](http://crlaw.com/news/wp-content/uploads/2012/01/The-Shovel-in-the-Ground-Problem-Planning-for-Real-Estate-Development-Activities_12-05-07.pdf)] Accessed on Feb. 22, 2017.

<sup>33</sup> Circular 230, §10.22.

**Fees.** Practitioners are prohibited from charging unconscionable fees.<sup>34</sup> It is possible that Tom's desire to pay zero income tax contributes to the fee that Kathy quoted. However, by not itemizing her fees, Kathy leaves herself contractually bound to prepare any tax forms necessary to meet Tom's 2016 tax compliance obligations.

**Penalties.** If Tom is treated as a dealer, his taxable income is at least \$49,000 (\$52,500 income + \$50,000 ordinary gain – \$29,800 expenses – \$3,000 capital loss – \$8,100 personal exemptions – \$12,600 standard deduction). His taxable income may be even higher depending on the validity of the capital loss carryforward and the business deductions.

Inaccurate tax returns are subject to penalties ranging from 20% to 75% on the underpaid tax pursuant to IRC §§6662 and 6663. These penalties are assessed against the taxpayer.

Preparer penalties for understatement of a taxpayer's liability range from \$1,000 to \$5,000 or more,<sup>35</sup> as shown in the following table.

Code Section	Infraction	Penalty
IRC §6694(a)	Unreasonable position	The greater of \$1,000 or 50% of the client fee charged to prepare the return
IRC §6694(b)	Willful or reckless conduct	The greater of \$5,000 or 50% of the client fee charged to prepare the return

Besides a preparer penalty, Kathy also risks proceedings from the OPR if her conduct is considered reckless or grossly inadequate, for example.<sup>36</sup> This can lead to censure, suspension, or disbarment depending on the judged gravity of the violations.<sup>37</sup>

**Client Confidentiality/Information Disclosure.** Tax preparers are required to maintain the confidentiality of their clients' tax information.<sup>38</sup> Two important exceptions to this rule relate to required disclosures to the IRS governed by Circular 230, §10.20(a), or to a court pursuant to IRC §7216(b).

Earlier, it was mentioned that Tom could be impersonating someone else. Alternatively, Tom Flashman may be an entirely fictitious person, invented as a scammer's lure to steal Kathy's personal and client data.

**Note.** In January 2017, the IRS warned tax practitioners regarding a 2-step phishing scheme.<sup>39</sup> In the first step, the cybercriminal contacts an unsuspecting tax practitioner by email asking for tax preparation services. If the practitioner responds by asking for more information, the cybercriminal emails an attachment with embedded malware to steal valuable information from the practitioner's computer. This may ultimately lead to client identity theft.

<sup>34</sup> Circular 230, §10.27(a).

<sup>35</sup> IRC §6694.

<sup>36</sup> Circular 230, §10.52(a)(2).

<sup>37</sup> Circular 230, §10.50.

<sup>38</sup> IRC §7216.

<sup>39</sup> IRS News Rel. IR-2017-03 (Jan. 11, 2017).



What should Kathy do to protect her clients' confidential information? At the very least, Kathy should protect her computer with quality anti-virus software capable of scanning email attachments before they are opened. Kathy should also avoid clicking on hyperlinks embedded in emails. Further computer data protection strategies are discussed in Scenario 9 and the section on "Other Ethics Discussions."

**Note.** Kathy should periodically review IRS practitioner resources, such as that provided at [www.irs.gov/individuals/protect-your-clients-protect-yourself](http://www.irs.gov/individuals/protect-your-clients-protect-yourself). This includes IRS Pub. 4557. She can also sign up for IRS email practitioner alerts at [uofi.tax/17a3x3](http://uofi.tax/17a3x3) [[www.irs.gov/uac/join-e-news-for-tax-professionals](http://www.irs.gov/uac/join-e-news-for-tax-professionals)]. See the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 4: IRS Update, for additional information about protecting taxpayer data from cyber attacks.

## SCENARIO 5: NEW IRS TAX AUDIT CLIENT

On February 6, 2017, Debbie Disparate receives a 2015 IRS CP2000 notice proposing \$30,000 in additional taxes and penalties. The notice is dated January 25, 2017. It was automatically generated by the IRS's matching program due to a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, that Debbie failed to report on her self-prepared 2015 tax return.

**Note.** The IRS can issue a CP2000 notice when income and/or payment information they have on file does not match the information reported on an individual's tax return.<sup>40</sup>

Debbie calls her attorney Adie to ask what to do. Adie, who has never handled Debbie's tax affairs before, asks Debbie to meet her on February 10, 2017, and bring a copy of the IRS notice along with cost basis evidence for the securities sold. At the meeting, Adie notes that the Form 1099-B reported \$120,000 of sales proceeds for noncovered securities, with no cost basis indicated. After deducting Debbie's documented cost basis, Debbie has a small long-term capital loss from this brokerage account. Adie, knowing that Debbie is a divorcee with limited financial resources, reassures Debbie that the \$30,000 proposed tax increase can be challenged and offers her the following four options to do so.

<sup>40</sup> *Understanding Your CP2000 Notice*. Sep. 26, 2016. IRS. [[www.irs.gov/individuals/understanding-your-cp2000-notice](http://www.irs.gov/individuals/understanding-your-cp2000-notice)] Accessed on Mar. 27, 2017.

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Option	Description	Fee
1	Debbie sends a letter to the IRS (within the 30-day period allowed) disagreeing with the CP2000 and providing cost basis documentation of the securities sold along with an amended 1040, which may be filed along with the corrected Schedule D, <i>Capital Gains and Losses</i> , and associated Forms 8949, <i>Sales and Other Dispositions of Capital Assets</i> .	\$100
2	Debbie calls the IRS to obtain an extension of time to respond.  Adie completes and files with the IRS Form 2848, <i>Power of Attorney and Declaration of Representative</i> , signed by Debbie and herself.  Later, Adie sends a letter to the IRS (within the time allowed for a response) disagreeing with the CP2000 and providing cost basis documentation of the securities sold along with an amended 1040 (1040X), which may be filed along with the corrected Schedule D and associated Forms 8949.	600
3	Adie prepares, signs, and mails a letter to the IRS (within the 30-day period allowed) disagreeing with the CP2000 on behalf of Debbie and providing cost basis documentation of the securities sold along with an amended 1040, which may be filed along with the corrected Schedule D and associated Forms 8949.	500
4	Adie prepares a letter to the IRS (within the 30-day period allowed) in Debbie's name disagreeing with the CP2000 and providing cost basis documentation of the securities sold along with an amended 1040, which may be filed along with the corrected Schedule D and associated Forms 8949.  Debbie signs and mails the letter.	450

1. What ethical issues do these options raise?

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## Scenario 5 Discussion

Before discussing this scenario, it is useful to review what constitutes practice before the IRS, including who may practice, when a power of attorney is required to represent a taxpayer, and the definition of a tax return preparer. Under Circular 230, §10.2(a)(4), practice before the IRS includes “preparing documents; filing documents; corresponding and communicating with the Internal Revenue Service... and representing a client at conferences, hearings and meetings.” IRS Pub. 947, *Practice Before the IRS and Power of Attorney*, provides a list of categories of individuals who may practice before the IRS and states when a power of attorney is required. For example, a power of attorney is required to represent a client at a meeting with the IRS and to receive a client's confidential tax information from the IRS.

A tax return preparer is defined in Treas. Reg. §301.7701-15 as “any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code.” However, a tax return preparer does **not** include an individual preparing a claim for refund for a taxpayer in response to a notice of deficiency issued to a taxpayer.<sup>41</sup>

<sup>41</sup> Treas. Reg. §301.7701-15(f)(1)(xi)(A).

Each of the four options proposed by Adie is discussed in further detail next.

- Option 1.** Although Adie is not engaged in practice before the IRS, she is required to exercise due diligence in either oral or written advice she provides to Debbie.<sup>42</sup> Adie's advice to Debbie satisfies this due diligence requirement.
- Option 2.** When Debbie makes the telephone call to the IRS requesting the extension of time to respond to the IRS notice, Adie is not engaged in practice before the IRS but must exercise due diligence in oral advice she provides to Debbie. However, once Adie completes Form 2848 and she and Debbie sign it, Adie is thereafter authorized to represent Debbie before the IRS<sup>43</sup> for any subsequent communication Adie has with the IRS on Debbie's behalf. Because practice before the IRS includes client representation,<sup>44</sup> Adie is also engaged in practice before the IRS and must exercise due diligence with respect to her client and the IRS.

**Note.** Only those representing a client before the IRS can receive communications from the IRS regarding their clients' tax affairs.<sup>45</sup>

- Option 3.** Adie may provide information to the IRS on Debbie's behalf.<sup>46</sup> In this case, although Adie is not representing Debbie before the IRS, she is nevertheless engaged in practice before the IRS because she is corresponding and communicating with the IRS.<sup>47</sup>
- Option 4.** This is similar to option one. Adie is neither representing Debbie before the IRS nor otherwise engaged in practice before the IRS. Nevertheless, Adie is required to exercise due diligence in preparing the letter (and accompanying tax forms) to the IRS that she gives Debbie to sign.

**Fee Schedule.** There is no contingent-fee aspect to Adie's proposed fees nor are they unconscionable.<sup>48</sup>

**Conclusion.** This scenario shows how a practitioner may assist a client in dealing with the IRS, both as the client's representative and otherwise. In some of the options discussed, the practitioner is engaged in practice before the IRS, but in **all** cases the practitioner must exercise due diligence in oral or written advice provided to the client.

**Note.** IRS Pub. 5181, *Tax Return Reviews by Mail*, provides useful information on handling IRS correspondence audits.

<sup>42</sup> Circular 230, §10.22(a)(3).

<sup>43</sup> Circular 230, §10.2(a)(4).

<sup>44</sup> Ibid.

<sup>45</sup> IRS Pub. 947, *Practice Before the IRS and Power of Attorney*.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid; Circular 230, §10.2(a)(4).

<sup>48</sup> Circular 230, §10.27.

## SCENARIO 6: AMENDED TAX RETURN

Advertising and solicitation restrictions are addressed in Circular 230, §10.30. Unacceptable behavior includes “public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim.” Practitioners may also not make, directly or indirectly, an **uninvited** written or oral solicitation in violation of federal or state laws. When lawful solicitations are made, a practitioner must clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient. Furthermore, “a practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited.”<sup>49</sup>

The next scenario deals with solicitation, fees, and other ethical issues.

Marsha Stack, CPA, has handled Adam Carson’s taxes for several years. Marsha is also licensed to sell securities and she receives commission income as compensation for doing so. She frequently sells securities to clients in accordance with the tax and retirement planning she provides to her clients.

Adam is retired. Adam’s son, Jack, is a petroleum engineer who was previously employed in London by an international oil company. PCW LLP, a major international accounting firm, prepares Jack’s U.S. federal income tax returns. Marsha would like to provide tax preparation services to Jack, who is now self-employed. Adam tells her that his son prefers dealing with a prestigious international accounting firm. Marsha offers to make any necessary corrections after reviewing Jack’s returns and asks for copies of Jack’s latest U.S. tax returns.

During her review of Jack’s returns, Marsha notes that Jack paid alternative minimum tax (AMT) for several years but no Forms 8801, *Credit for Prior Year Minimum Tax — Individuals, Estates, and Trusts*, were ever included. Now that he is self-employed, Jack’s regular tax liability is less than the AMT. After running some calculations, Marsha concludes that, if Forms 8801 were included in prior year returns, there is a substantial accumulated AMT credit carryover that could offset Jack’s future regular tax liabilities. Eager for Jack’s business, Marsha proposes to prepare amended tax returns for a fee of 30% of the tax refunds.

Jack agrees. Marsha also discusses with Jack the need for some retirement planning because Jack has not accumulated sufficient retirement funds and his self-employed status provides some additional opportunities to shelter money for retirement. Jack agrees. Marsha refers to amounts on Jack’s tax returns to arrive at an estimate of how much Jack could defer in a simplified employer pension (SEP) plan annually. She discusses this with Jack, who is pleased with the idea of using a new SEP plan. Marsha opens a new SEP for Jack. In accordance with Marsha’s investment recommendations, Jack agrees to let Marsha purchase some mutual funds for him with the amount he deposits in the SEP account.

1. What ethical considerations does Marsha Stack’s conduct raise?

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<sup>49</sup> Circular 230, §10.30(c).

## Scenario 6 Discussion

**Solicitation.** Marsha solicited Jack’s business. She did not make any false claims in her doing so. Whether her solicitation was “invited” is debatable. She clearly took advantage of her long-standing professional relationship with Adam in soliciting his son’s business. While Marsha was persistent in her solicitation of Jack’s business, at no time did either Adam or Jack tell Marsha to desist.

**Consent to Use Client Information.** Marsha’s use of Jack’s tax information for the purpose of preparing amended returns is a permitted use of that tax information without specific consent from Jack. However, the further use of that tax information for the purpose of retirement planning and selling Jack investments first requires Jack’s consent. Marsha’s failure to obtain Jack’s consent prior to using his tax information for these purposes violates IRC §7216.

**Fees.** In general, a practitioner may not charge contingent fees except in connection with a response to an IRS examination of an original tax return or an amended tax return filed in response to an IRS examination of an original tax return.<sup>50</sup> A practitioner may also charge contingent fees in connection with the recovery of IRS assessed penalties and interest or for services pertaining to a judicial proceeding.<sup>51</sup> Marsha’s proposal to prepare amended tax returns for a fee of 30% of the tax refunds violates this rule. However, in the 2014 case of *Ridgely v. Lew et al.*, the U.S. District Court for the District of Columbia ruled that the IRS did not have the authority to regulate Gerald Ridgely in his role as a tax preparer for the contingent fee arrangement used in preparation of an ordinary refund claim.<sup>52</sup>

**Note.** For more information about the *Ridgely* case, see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Ethical Considerations. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [taxschool.illinois.edu/taxbookarchive].

**Note.** The *Ridgely* case was not the first time that the IRS’s authority to regulate tax return preparers was challenged. In the 2013 case of *Loving et al. v. IRS et al.*, the U.S. Court of Appeals for the District of Columbia<sup>53</sup> upheld the previous decision by the U.S. District Court for the District of Columbia declaring that the IRS lacks the statutory authority to enforce its 2011 regulatory scheme for registered tax return preparers. The D.C. court also issued a permanent injunction barring the IRS from enforcing registration requirements for tax return preparers. However, the decision did not address provisions of Circular 230 relating to practitioners such as lawyers, CPAs, and enrolled agents. Nevertheless, Steve Johnson, Florida State University College of Law professor, suggests that the *Loving* and *Ridgely* district court decisions indicate that the IRS may be exceeding its authority in regulating the practice of any tax return preparers under Circular 230. Professor Johnson concludes that “if the approach of recent cases is confirmed by litigation and if Congress chooses not to act, significant portions of Circular 230 may be at risk of invalidation.”<sup>54</sup>

<sup>50</sup> Circular 230, §10.27.

<sup>51</sup> Ibid.

<sup>52</sup> *Ridgely v. Lew*, No. 1:12-cv-00565 (DC Cir. Jul. 16, 2014).

<sup>53</sup> *Loving et al. v. IRS et al.*, 917 F.Supp.2d 67 (D.C. Cir. 2013), *aff’d* 742 F.3d 1013 (Feb. 11, 2014).

<sup>54</sup> *How Far Does Circular 230 Exceed Treasury’s Statutory Authority?* Johnson, Steve R. Jan. 12, 2015. Tax Analysts. [taxprof.typepad.com/files/146tn0221.pdf] Accessed on Jan. 27, 2017.

## SCENARIO 7. BUYING A BUSINESS

A sole proprietorship is a business that has no separate existence apart from its owner. Income and business expenses are reported on Schedule C, *Profit or Loss From Business*, and included in the owner's federal income tax return. This is the simplest form of business entity. Generally, a sole proprietorship can only have one owner. However, the following exceptions allow a business owned by a husband and wife to be treated as a sole proprietorship.<sup>55</sup>

1. A qualified joint venture<sup>56</sup>
2. A business jointly owned and operated by a husband and wife in a community property state

For tax years after 2006, a husband and wife can elect to treat a jointly owned unincorporated business as a qualified joint venture. Following are the key requirements of a qualified joint venture.<sup>57</sup>

- The only members of the joint venture are a husband and wife who file a joint return.
- Both spouses materially participate in the trade or business.
- Both spouses elect to be treated as a qualified joint venture.

**Note.** See **uofi.tax/17a3x4** [[www.irs.gov/businesses/small-businesses-self-employed/election-for-husband-and-wife-unincorporated-businesses](http://www.irs.gov/businesses/small-businesses-self-employed/election-for-husband-and-wife-unincorporated-businesses)] for more information on qualified joint ventures, including instructions for making the election and tax reporting requirements.

**Note.** An LLC owned by a husband and wife in a noncommunity property state should file as a partnership. Under Rev. Proc. 2002-69,<sup>58</sup> husband and wife owners of an unincorporated entity in a community property state may choose to treat the business as either a disregarded entity or a partnership for tax reporting purposes. See **uofi.tax/17a3x5** [[www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies](http://www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies)] for more information.

Deciding on appropriate ownership structures for husband-and-wife owned businesses requires careful thought. The following scenario helps to illustrate this.

Recently laid off from an executive position with a Fortune 500 company, Sam receives \$1 million in severance compensation. Rather than seek alternative employment, Sam talks with his wife of many years and they decide to purchase an established small business. After some research, they find an antique shop for sale in a wealthy Illinois neighborhood near their home. The owners have built up a business generating \$100,000 per year in profits but now wish to retire. The \$750,000 asking price includes the existing unsold inventory, shop furnishings, transfer of the lease on the retail premises, and goodwill.

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<sup>55</sup> IRS Pub. 334, *Tax Guide for Small Business*.

<sup>56</sup> Joint Committee on Taxation. *Technical Explanation of the "Small Business and Work Opportunity Tax Act of 2007" Contained in H.R. 1591 as Reported by the Conference Committee*. H.R. 2206, PL 110-28. (May 24, 2007).

<sup>57</sup> Ibid; IRC §761(f)(2).

<sup>58</sup> Rev. Proc. 2002-69, 2002-2 CB 831.

Anxious to find a qualified tax return preparer, Sam consults the directory of federal tax return preparers on the IRS website **uofi.tax/17a3x10** [irs.treasury.gov/rpo/rpo.jsf] for his neighborhood and calls Ava Shingle, who is an EA. Sam summarizes the proposed business purchase and asks if Ava can advise him on the best acquisition structure. Ava, who specializes in low-fee individual income tax returns, arranges to meet with Sam and suggests he bring any pertinent papers with him. At the meeting, Sam informs Ava that he really needs her help on three important questions.

1. How should the purchase be structured from a legal and tax perspective?
2. What would be an appropriate allocation of the purchase price between goodwill, inventory, and shop furnishings?
3. Which accounting method would be best for the inventory?

Ava is torn. She realizes that Sam's situation is much more complicated than the clients she typically serves. On the one hand, she can charge more for this work. On the other hand, she does not want to overcomplicate her life. Accordingly, Ava starts by giving Sam a brief overview of various ownership structures (sole proprietorship, corporation, partnership, and LLC). Sam, while impressed with Ava's knowledge, is confused and asks Ava what she would recommend. Delighted that the conversation is going in her direction, Ava suggests a sole proprietorship structure and tells Sam that if he is worried about personal liability, a single-member LLC could be "just the ticket." Sam reminds Ava that the business will be jointly owned with his wife, but Ava reassures Sam that husband and wife are considered a single taxpayer for this purpose.

Moving on to the second question, Ava suggests keeping things simple by just allocating the purchase price equally between the three items.

On the third question Ava, remembering two common methods for determining cost of goods sold, compares "first-in, first-out" (FIFO) with "last-in, first-out" (LIFO).<sup>59</sup> Once more, Sam defers to Ava, and she chooses LIFO, explaining that this "will keep his profits down."

After receiving answers to all his questions, Sam asks Ava for a fee quote. She informs him that she will charge \$750 for annual tax compliance.

Finally, Sam asks Ava what he should do next. Ava tells Sam just to show up next February with his invoices, receipts, and other records.

1. What are the most serious ethical concerns here?

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<sup>59</sup> IRC §472.



## Scenario 7 Discussion

Ava has broken many rules. The discussion that follows is limited to the most serious issues that Ava faced in advising Sam regarding his proposed business purchase.

**Competence.** There are many aspects of this engagement that Ava is not competent to handle — for example, legal, valuation, and other business considerations. Ava should direct her client to seek appropriate counsel from qualified advisors in these areas<sup>60</sup> and offer to work with these advisors in meeting Sam's tax needs.

The facts suggest that Sam and his wife have little or no business experience. Therefore, Ava could discuss the appropriateness of a formal business plan and the contributions to such a plan that Ava can make (for example, projected profit and loss statements and tax advice).

Finally, Ava should remedy her ignorance of applicable tax rules (e.g. appropriate husband and wife entity structures, inventory accounting options, etc.) before making inappropriate recommendations to a client.

**Conflict of Interest.**<sup>61</sup> When Sam mentions the participation of his wife in the business ownership structure, Ava should insist that Sam bring his wife to the meeting. Then, at the start of the meeting, Ava should ask if Sam and his wife both wish to engage Ava for consulting regarding the business and any eventual compliance. Ava should also discuss the merits of Sam and his wife having separate tax advisors. Once Sam and his wife decide on who Ava will assist, she should draw up appropriate consent and use agreements.<sup>62</sup> If necessary, a conflict resolution agreement should also be made (e.g., for 50/50 ownership). Examples of consent, use, and conflict resolution agreements are included in the appendix.

**Choice of Ownership Entity.** Because Illinois is not a community property state,<sup>63</sup> if Sam and his wife want to operate as a sole proprietorship, then the business should be organized as a qualified joint venture. Ava's assertion that husband and wife are considered one taxpayer is incorrect both for a sole proprietorship and for an LLC owned by a husband and wife in a noncommunity property state.

Ultimately, the choice of appropriate ownership entity is not just a tax issue but also has legal and other ramifications. Evidently, Ava lacks the necessary knowledge and experience to address all these issues and therefore should recommend that Sam and his wife seek additional advice (e.g., from an attorney, local Small Business Administration office, etc.).

**Acquisition Cost Allocation.** Sam states that the proposed acquisition price is \$750,000. Ava's advice to split the acquisition cost equally between inventory, shop furnishings, and goodwill is unprofessional because it lacks any substantive basis. Instead, Ava should adhere to best practices in advising her client by, for example, recommending that Sam seek the services of a qualified appraiser to carry out valuations and of an attorney to assist in preparation of the acquisition documents.<sup>64</sup>

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<sup>60</sup> Circular 230, §10.35.

<sup>61</sup> Circular 230, §10.29.

<sup>62</sup> Treas. Reg. §301.7216-3.

<sup>63</sup> *Division of Property*. Millard, Isabel M. 2017. Isabel M. Millard, PC. [www.divorce-law-illinois.com/division.html] Accessed on Jan. 30, 2017.

<sup>64</sup> Circular 230, §10.33.

**Inventory Accounting.** When asked about inventory accounting, Ava should refrain from long, complex explanations of accounting options because there is no current need to decide on an inventory accounting method. Furthermore, there is no need to confuse Sam with technical details he may not yet grasp. Instead, Ava could use the opportunity to advise Sam to consider hiring a bookkeeper for his business or to purchase some bookkeeping software. Then, Ava should suggest meeting with Sam at an appropriate time to decide on an inventory accounting method. At this early stage, a quick educational overview of the cost method and lower of cost or market method might be appropriate.<sup>65</sup> Given that antiques are generally unique items, Ava might mention the merits of specific identification expensing for the cost of items sold. As it is, Ava's decision to use the LIFO inventory method showed a lack of due diligence because all the facts necessary to make an informed decision were not yet available, and there are other inventory accounting options that she did not consider.

**Engagement Structure.** Ava's offer to provide services related to Sam's annual tax compliance for a fee of \$750 is both generous and risky. Already, Ava is "cutting corners" by rushing into decisions on ownership structure and inventory accounting without exercising due diligence. At such an early stage, it is difficult for Ava to anticipate all the tax services that may be required. Therefore, it would be wise for Ava to prepare a client service proposal for Sam to review. In the proposal, Ava can provide fees for recurring tax compliance and nonrecurring consulting work. A well thought-out engagement letter enables Ava to define services and fees for anticipated work and explain her fee structure for unexpected, nonrecurring items.

**Conclusion.** Following are the keys to a successful initial consultation concerning a potentially complex business transaction.

1. Have the client provide an overview of the intended transaction and their business goals
2. Identify areas where external expert advice is required
3. Note relevant tax issues and research them thoroughly
4. Establish the scope of the engagement
5. Define a tax service timetable
6. Document the meeting including follow-up items and responsible parties
7. Prepare an engagement letter defining the scope, timetable, and fees for the engagement

## INADVERTENT CLIENT DISCLOSURE

### SCENARIO 8. SOCIAL MEDIA

Dunn Carver is a widower with annual income of \$70,000 in retirement and social security benefits. Tod Snitcher, CPA, is his long-time tax return preparer.

One day while casually browsing Facebook, Tod's eye registers Dunn Carver's name in the friend list of an acquaintance. Tod follows the hyperlink to Dunn's Facebook profile and is drawn to the photos of hand-carved wooden chess sets on display. Tod then sees a hyperlink for a price list, order form, and information regarding Dunn's chess set woodcarving activity. Familiar with Dunn's tax situation, Tod does not recall reporting any such business activity. Perusing the price list, Tod is astonished to discover prices ranging from \$1,000 and up.

<sup>65</sup> Treas. Reg. §§1.471-2(c) and (d).

## 1. What are the most serious ethical concerns here?

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### Scenario 8 Discussion

**Knowledge of Client's Omission.** What should a tax practitioner do when they inadvertently discover a client's omission? IRS regulations state that the **taxpayer should** file an amended tax return and pay any tax due.<sup>66</sup> However, in *Badaracco Sr. v. Comm'r*,<sup>67</sup> the U.S. Supreme Court notes that "the Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead an amended return is a creature of administrative origin and grace." The Supreme Court also noted that, although the regulations (including Treas. Regs. §§1.451-1(a) and 1.461-1(a)) refer to an amended return, no regulation requires the filing of an amended return. Circular 230, §10.21, requires that a tax practitioner advise the client promptly of the fact of such noncompliance, error, or omission, along with the consequences of such noncompliance, error, or omission.

Accordingly, Tod should speak with Dunn at the earliest opportunity to question him about this activity. Clearly, Tod risks losing his client unless he handles the situation with the necessary tact. What should Tod do if Dunn refuses to file amended tax returns? Ethically speaking, Tod has fulfilled his obligations towards his client and the IRS pursuant to Circular 230 if he advised the client of the noncompliance and its consequences. Nothing further is required of Tod other than documenting his discussion with Dunn.

**Diligence as to Accuracy and Standards with Respect to Tax Returns.** A problem may arise during the next filing season if Dunn does not provide information about the woodcarving activity. Tod is required to exercise due diligence as to accuracy. Tod must also adhere to standards with respect to tax returns and cannot "ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete."<sup>68</sup> If Tod knowingly prepares Dunn's tax return potentially excluding this income, then Tod is in violation of the due diligence provisions of Circular 230, §10.22, and standards with respect to tax returns of Circular 230, §10.34. In addition, he may also be subject to preparer penalties.

Besides meeting the ethics requirements of Circular 230, tax practitioners other than EAs may also be bound by the ethics guidelines of their professional associations. For example, the American Bar Association's Model Rules of Professional Conduct bind tax attorneys.<sup>69</sup> In their discussion of this issue, Tobin et al. advise that a lawyer should withdraw from the engagement rather than be a party to a client's fraud.<sup>70</sup> CPAs and EAs may be equally well advised to follow this counsel.

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<sup>66</sup> Treas. Reg. §§1.451-1(a) and 1.461-1(a)(3).

<sup>67</sup> *Badaracco Sr. v. Comm'r*, 464 U.S. 386 (1984).

<sup>68</sup> Circular 230, §10.34(d).

<sup>69</sup> *Model Rules of Professional Conduct*. 2016. American Bar Association. [www.americanbar.org/groups/professional\_responsibility/publications/model\_rules\_of\_professional\_conduct/model\_rules\_of\_professional\_conduct\_table\_of\_contents.html] Accessed on Mar. 29, 2017.

<sup>70</sup> Donald B. Tobin, Richard Lavoie & Richard E. Trogolo, *Problems in Tax Ethics*, p. 65, (2009).

## SCENARIO 9. PUBLIC SETTING

IRC §7216 sanctions tax return preparers who knowingly or recklessly disclose client information. The terms **knowingly** and **recklessly** are neither defined in the Code nor the associated Treasury Regulations. However, Treas. Reg. §301.7216-1(b)(5) states that “the term disclosure means the act of making tax return information known to any person in any manner whatever. To the extent that a taxpayer’s use of a hyperlink results in the transmission of tax return information, this transmission of tax return information is a disclosure by the tax return preparer subject to penalty under section 7216 if not authorized by regulation.” Treas. Reg. §301.7216-1(b)(6) defines a hyperlink as “a device used to transfer an individual using tax preparation software from a tax return preparer’s webpage to a webpage operated by another person without the individual having to separately enter the web address of the destination page.” Including the hyperlink reference in the very broad definition of disclosure illustrates that the tax return preparer assumes responsibility for computer-stored client information and its possible dissemination. IRS Pub. 4557, *Safeguarding Taxpayer Data*, provides numerous recommendations regarding procedures and policies for keeping client data safe.

**Note.** For more information on client data security and identity theft issues, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 6: New Developments.

Tax professionals may need access to their client’s data at any time. Therefore, it is convenient to store this data on a portable computer. However, connecting this computer to the Internet via public Wi-Fi presents risks, which are explored in the following scenario.

Faith Innocenti, EA, is a tax return preparer subject to annual continuing education requirements.<sup>71</sup> Faith fulfills these requirements by attending tax seminars held by Second Best Tax School, an approved IRS continuing education provider. During a tax seminar, Faith uses her notebook computer to monitor her email using local public Wi-Fi access.

Sly Mover, an expert programmer who recently passed the CPA exam, also attends the seminar. Determined to improve his flagging fortunes, Sly hacks into Faith’s computer and steals all the client data he can find. Faith notices her computer slowing down and a firewall alert and wonders what is going on. A couple of weeks later, Sly uses a proxy server chain (to cover his tracks) and posts Faith’s client details on a publicly accessible website. Sly then calls Faith’s clients to alert them to the data breach (which he says he casually discovered while browsing the Internet). After presenting his qualifications and the data protection policy he uses, several clients dump Faith for Sly.

1. If Faith believes her computer was hacked or could have been hacked, what actions should she take?

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2. How can Faith keep client data safe on her computer?

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<sup>71</sup> Circular 230, §10.6.

## Scenario 9 Discussion

**Inadvertent Information Disclosure.** When Faith notices her computer's strange behavior and the firewall breach alert, she should be concerned that the confidentiality of data on her computer may have been compromised.

**Discovery of Unauthorized Client Disclosure.** When Faith notices the suspicious activity, she should immediately disconnect from the Internet. Faith should at least suspect the possibility of unauthorized client information disclosure and should consider engaging the services of a computer security professional to establish if a data breach occurred.<sup>72</sup>

Should Faith inform her clients of a data breach? Neither Circular 230, nor IRC §7216 and the underlying regulations address this issue. If Faith has professional liability insurance, she should raise the matter with her insurer. Faith should also check the terms of her engagement letters or any relevant data privacy policy documents. This will help Faith to establish what legal and contractual obligations she has to her clients in this situation. When contacting her clients, Faith may recommend that they ask major credit bureaus to put fraud alerts on their accounts. Finally, Faith should consider reporting the matter to law enforcement.

**Note.** See **uofi.tax/17a3x6** [[www.irs.gov/uac/newsroom/tax-return-preparers-data-thefts-and-protecting-client-tax-information](http://www.irs.gov/uac/newsroom/tax-return-preparers-data-thefts-and-protecting-client-tax-information)] for appropriate reactions to data theft.

**Note.** Most states have security breach notification laws. Some states require notification to affected individuals and to state authorities.<sup>73</sup>

CPAs with access to health data (e.g. medical treatment, medical care payments, and demographic information) are subject to civil and criminal penalties for unauthorized disclosure of that data.<sup>74</sup>

**Safeguarding Computer-Stored Client Information.** The “safeguards rule” contained in the Gramm-Leach-Bliley Act<sup>75</sup> (GLBA) contains detailed recommendations for the secure storage of confidential client information, whether that information is in paper or digital form. The GLBA includes a recommendation that client information be held in encrypted files.<sup>76</sup> This protects the data both in the event of theft of the device as well as when connecting to unsecured networks.

At best, Faith's computer security was the minimum required. Computer data thieves are becoming ever more sophisticated, and tax return preparers are increasingly becoming targets.

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<sup>72</sup> IRS Pub. 4557, *Safeguarding Taxpayer Data*; and IRS FS-2015-24 (Oct. 2015).

<sup>73</sup> *A Breach of Client Data: Risks to CPA Firms*. Waldron, Amy. Aug. 1, 2013. Journal of Accountancy. [[www.journalofaccountancy.com/issues/2013/aug/20138003.html](http://www.journalofaccountancy.com/issues/2013/aug/20138003.html)] Accessed on May 24, 2017.

<sup>74</sup> *How health care data security rules may affect you*. Dietrich, Mark O. Jan. 1, 2015. Journal of Accountancy. [[www.journalofaccountancy.com/issues/2015/jan/health-care-data-security-rules.html](http://www.journalofaccountancy.com/issues/2015/jan/health-care-data-security-rules.html)] Accessed on May 25, 2017.

<sup>75</sup> The Gramm-Leach-Bliley Act (GLBA) is also known as the Financial Services Modernization Act of 1999, PL 106-102 (Nov. 12, 1999).

<sup>76</sup> *Financial Institutions and Customer Information: Complying with the Safeguards Rule*. FTC. 2006. [[www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying#how](http://www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying#how)] Accessed on Feb. 02, 2017.

What can Faith do to prevent being hacked in the future when connecting to an unsecured public network? First, Faith should ensure that file and public folder sharing is disabled (via the computer's operating system). Second, Faith should use a virtual private network (VPN). This is a software application that encrypts traffic between the user's computer and the VPN server that connects to the Internet. VPNs can be installed quickly and easily and make data transmissions unintelligible to potential data thieves.

**Note.** For useful tips on safely connecting to the Internet using unsecured connections, see **uofi.tax/17a3x7** [[www.cnet.com/how-to/tips-to-stay-safe-on-public-wi-fi](http://www.cnet.com/how-to/tips-to-stay-safe-on-public-wi-fi)].

Finally, Faith should encrypt her client files. Doing this for individual files is a tiresome task. A better alternative is to encrypt a directory or volume. Some operating systems support directory/file encryption directly (e.g., Microsoft Windows 10 Pro). The level of encryption security is positively correlated to password and encryption key length — the longer the better. Software for encrypting a volume on a computer is freely available and easy to use. Once the password-protected encrypted volume is created, sensitive files can easily be moved from elsewhere on the computer to the encrypted volume.

**Note.** The user-defined access passwords to an encrypted volume should preferably be random character strings of at least 20 characters.

**Conclusion.** This scenario illustrates that practitioners can secure their clients' confidential information on their computer devices by adhering to the following recommendations.

1. Use strong passwords (the longer and more random the better).
2. Utilize good anti-virus software and a firewall.
3. Connect to unsecured networks with a VPN.
4. Store client files in secure folders/volumes.

## OTHER ETHICS DISCUSSIONS

### SAFE DIGITAL COMMUNICATION OF SENSITIVE CLIENT DATA

As discussed in Scenario 9, tax practitioners are subject to the safeguards rule contained in the GLBA. This means that tax practitioners are responsible for the security and confidentiality of their clients' personal data. The previous scenario focuses on measures to secure computer-stored client information. The focus of this section is the secure transmission of confidential client data. The safeguards rule lists sensible precautions for handling and communicating sensitive client information.<sup>77</sup>

**Note.** In IRS Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, the IRS provides data safety standards that supplement the GLBA — for example, the use of AES 128-bit as a minimum encryption standard for electronic transmission of tax return data.

<sup>77</sup> Ibid.

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Most tax practitioners prepare tax returns using commercial proprietary software. Many of these providers now offer client portals to their practitioner clients. These portals allow practitioners the possibility of safely delivering digital documents to their clients using AES 256-bit encryption. However, those practitioners who prefer not to delegate their data security to a cloud-based provider can create and store their own private encryption keys. There are software applications available from the Internet that facilitate this.

Many tax practitioners communicate with their clients by email, which may be stored by a chain of computers before reaching the recipient. When intercepted, unencrypted emails are easily read. There are also numerous instances of email accounts being hacked. Consequently, practitioners should avoid openly including sensitive personal data in email communications. Different options exist for safely transmitting sensitive data by email. Perhaps the easiest is file encryption, through which sensitive data is placed in an encrypted email attachment. The password should be as long as possible and can be based on information known to the practitioner and client (for example, some combination of social security numbers, dates of birth, address information, and/or tax return data). A safer alternative is for the practitioner and client to physically meet in a secure location to communicate stronger randomly generated passwords.

**Note.** Some states have an encryption safe harbor from data breach notification laws.<sup>78</sup>

## APPENDIX

### TAX PRACTITIONER DUE DILIGENCE TOOLKIT

The following due diligence practice aids are included in this tax practitioner toolkit.

Item	Issue	Usage	Client Type
1	Confidentiality	Client information confidentiality letter	Individual
2	Conflict of interest	Preparation of joint tax return of divorced spouses	Individual
3	Consent	Disclosure of tax return information to another U.S.-based practitioner for tax preparation	All
4	Consent	Disclosure of tax return information to another party for other (non-tax preparation) purposes	All
5	Engagement	New individual client engagement letter	Individual
6	Representation	New IRS tax examination representation letter	Individual
7	Use	Client consent to use of tax return information	All

**Note.** In the letters that follow, mandatory language (discussed earlier) is shown in *italics* so that it may be easily identified. **These letters are provided as reference samples only and are not intended for client use without appropriate modification.**

Under Rev. Proc. 2013-14, the text on all consent/use forms provided to taxpayers must be in a 12-point or larger font.

<sup>78</sup> *Data Breach Charts*. 2016. Baker & Hostetler LLP. [[www.bakerlaw.com/files/Uploads/Documents/Data%20Breach%20documents/Data\\_Breach\\_Charts.pdf](http://www.bakerlaw.com/files/Uploads/Documents/Data%20Breach%20documents/Data_Breach_Charts.pdf)] Accessed on May 25, 2017.



## 1. Client information confidentiality letter

3

Dear <Client name> ,

Confidentiality of your personal information.

We are writing to provide you with details of our policy regarding the confidentiality of your personal information.

During the course of our professional engagement, we collect nonpublic personal information about you from various sources, including:

- Interviews regarding your tax situation
- Applications, organizers, or other documents that supply such information as your name, address, telephone number, social security number, number of dependents, income, and other tax-related data
- Tax-related documents you provide that are required for processing tax returns, such as Forms W-2, 1099-R, 1099-INT, and 1099-DIV and stock transactions

Our policy is not to disclose any nonpublic personal information about our clients or former clients to anyone, except as requested by our clients or as required by law.

Access to personal information concerning you is restricted to our employees who need such information in order to provide products or services to you. We maintain physical, electronic, and procedural safeguards that comply with federal regulations to guard your personal information.

Please contact us with any questions you have about our privacy policy.

Sincerely,

<Paid Preparer Name>

<Firm Name>

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## 2. Preparation of joint tax return of divorced spouses (conflict of interest waiver under Circular 230)

Tax practitioner/firm \_\_\_\_\_

We the undersigned divorced taxpayers express our desire to retain the above stated tax practitioner/firm to:

1. Prepare our personal income tax returns,
2. Prepare our business tax returns (where applicable),
3. Prepare any other required returns and filings, and
4. Provide us with tax advice.

We hereby confirm that no disagreement or dispute currently exists within our tax situation and that we understand that all information contained in or used to prepare our tax returns (or those of our business) is available to both of us at all times. Furthermore, we agree to file our personal tax returns jointly for the tax year \_\_\_\_\_.

We understand that because of differing or conflicting interests inherent in our personal or business affairs, your advice and any agreements reached by us may benefit one of us over the other or, where applicable, benefit the business entity over us and that at such times, advice and agreements between us may be necessary. Both of us wish to enter into this agreement, even though our interests are or may become adverse, including in situations not presently known or anticipated.

We have determined that the benefits of entering into this agreement to retain your professional services outweigh any adverse implications or consequences of doing so. Both of us expressly and forever waive the conflict of interest on your part that may arise during the performance of tax preparation, tax advising, and related or ancillary services.

We understand that you, as a tax practitioner, will disclose to us any conflict that arises that may jeopardize your ability to provide competent and diligent representation of both of us. If this occurs, you may withdraw from representation of both of us immediately. We have read this agreement and fully understand it.

Full names \_\_\_\_\_

Signatures \_\_\_\_\_

Date \_\_\_\_\_

Date of divorce \_\_\_\_\_

Period of validity \_\_\_\_\_

## 3. Client consent to disclosure of tax return information to another U.S.-based practitioner for tax preparation

3

Tax practitioner/firm \_\_\_\_\_

The taxpayer(s) listed at the bottom of this form hereby provide consent to the above-stated tax practitioner/firm to disclose their tax return information to the following U.S.-based tax return preparer(s).

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

This consent applies to tax years: \_\_\_\_\_

*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.*

*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.*

*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](mailto:complaints@tigta.treas.gov).*

Taxpayer names \_\_\_\_\_

Signatures \_\_\_\_\_

Date \_\_\_\_\_

Period of validity \_\_\_\_\_

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## 4. Client consent to disclosure of tax return information to another party for other (non-tax preparation) purposes

Tax practitioner/firm \_\_\_\_\_

The taxpayer(s) listed at the bottom of this form hereby provide consent to the above-stated tax practitioner/firm to disclose their tax return information for the following purpose(s).

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

This consent applies to tax years: \_\_\_\_\_

Name and address of parties to whom this information can be disclosed:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

*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.*

*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.*

*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](mailto:complaints@tigta.treas.gov).*

Taxpayer names \_\_\_\_\_

Signatures \_\_\_\_\_

Date \_\_\_\_\_

Period of validity \_\_\_\_\_

## 5. New individual client engagement letter

3

Dear <Client name> ,

Preparation of Your <Current Tax Year> Tax Returns.

Thank you for choosing us to assist you with your tax affairs. This letter specifies the terms of our engagement with you and details the services that we will be providing to you.

We will prepare your <Current Tax Year> federal and state income tax returns. In order for us to prepare complete and accurate tax returns, we will be relying on you to provide us with the necessary information. When information you provide is incomplete or unclear, we may ask you for clarification. However, we will not audit or otherwise verify the data you submit. An Organizer is enclosed with this letter to assist you in gathering the data required for your tax returns.

We will perform accounting tasks required to prepare your tax returns. Our engagement should not be relied upon to disclose errors, fraud, or other illegal acts. However, we will, of course, inform you of any material errors, fraud, or other illegal acts we discover during the course of our engagement.

If we encounter instances of unclear tax law or of potential conflicts in the interpretation of the law, we will outline the reasonable courses of action and the risks and consequences of each. We will ultimately adopt, on your behalf, the alternative you select.

The law imposes penalties when taxpayers underestimate their tax liability. Please contact us if you require further information in this regard.

Your original records will be returned to you with your completed tax returns. Please ensure that you securely store your records, along with all supporting documents, canceled checks, etc., as these items may be needed to respond to an audit or inquiry from the tax authorities. We will retain copies of your records and our work papers for your engagement for seven years, after which these documents will be destroyed.

Our engagement to prepare your <Current Tax Year> tax returns will conclude with the delivery of the completed returns to you (if paper-filing), or your signature and our subsequent submittal of your tax return (if e-filing). If you have not elected to e-file your returns with our office, you will be solely responsible to file the returns with the appropriate taxing authorities. Review all tax-return documents carefully before signing them. We recommend that tax returns be sent to tax authorities by certified or registered mail. Please keep your mailing receipts.

Our fees for this engagement are as follows <Provide Fee Schedule>.

To confirm that this letter correctly summarizes your understanding of the arrangements for this work, please sign the enclosed copy of this letter in the space indicated and return it to us in the envelope provided.

We appreciate your business. Please contact <Provide contact name and telephone> if you have questions.

Sincerely,

<Paid Preparer Name>

<Firm Name>

Enclosures

<Current Tax Year> Tax Organizer

(Both spouses must sign for preparation of joint returns.)

Accepted By:

\_\_\_\_\_  
Taxpayer

\_\_\_\_\_  
Spouse

\_\_\_\_\_  
Date

## 6. New IRS tax examination representation letter

Dear <Client name> ,

Representation of you before the IRS.

This letter specifies the terms of our engagement with you regarding the IRS examination of your <Tax Years> income tax return(s). Before we begin this engagement, please sign the attached Form 2848, *Power of Attorney and Declaration of Representative*, so that we can notify the IRS that we are your authorized representative. Additionally, please sign, date, and return a copy of this letter to confirm your understanding of the terms of our engagement.

We will represent you before the IRS during this examination, unless either party terminates the arrangement in writing. If we cannot resolve all issues at the examination level, we will discuss the options available with you so that you can decide how you wish to proceed.

When information you provide to us is incomplete or unclear, we may ask you for clarification. Generally, we will not audit or otherwise verify the data you provide to us during the course of this IRS examination except when we notice inconsistencies with any other information we may possess. In this case, our professional standards require us to make the necessary efforts to resolve those differences.

With respect to tax advice we provide to you, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney will also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. We are federally authorized tax practitioners for this purpose. However, there is no tax practitioner-client privilege in criminal matters. Accordingly, if we are served a properly issued administrative summons to testify before the IRS or a court in a criminal proceeding, then even our confidential communications may be subject to disclosure.

If an IRS examining agent asks to interview you directly, please be aware that you have a statutory right to be represented and **not** to meet with the examining agent (unless you are served with an enforceable administrative summons). We request that you refer any questions or other contact from a revenue agent or other tax official to us without any discussion with the tax official. If you choose to appear before, or discuss this case with, a tax official against our advice, you do so at your own risk.

Our fees for this engagement are as follows <Provide Fee Schedule>. If we have not received payment in accordance with the stated terms, we reserve the right to terminate this engagement without notice.

To confirm that this letter correctly summarizes your understanding of the terms of our engagement, please sign the enclosed copy of this letter in the space indicated and return it to us in the envelope provided.

We appreciate your confidence in us. Please contact <Provide contact name and telephone> if you have questions.

Sincerely,

<Paid Preparer Name>

<Firm Name>

Enclosures

Form 2848

(Both spouses must sign for preparation of joint returns.)

Accepted By:

\_\_\_\_\_  
Taxpayer

\_\_\_\_\_  
Spouse

\_\_\_\_\_  
Date



## 7. Client consent to use of tax return information

Tax practitioner/firm \_\_\_\_\_

The taxpayer(s) listed below hereby provide consent to the above-stated tax practitioner/firm to use their tax return information for \_\_\_\_\_.

This consent applies to use of the taxpayer's(s') tax return information for the years \_\_\_\_\_.

*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.*

*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.*

*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](mailto:complaints@tigta.treas.gov).*

Taxpayer names \_\_\_\_\_

Signatures \_\_\_\_\_

Date \_\_\_\_\_

Period of validity \_\_\_\_\_

## REFERENCE MATERIAL

The following sections of Circular 230, as published in June 2014, are mentioned in this chapter. These sections are reproduced here for the reader's convenience.

### §10.2 Definitions

- a. As used in this part, except where the text provides otherwise —
  - 1. *Attorney* means any person who is a member in good standing of the bar of the highest court of any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.
  - 2. *Certified public accountant* means any person who is duly qualified to practice as a certified public accountant in any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.
  - 3. *Commissioner* refers to the Commissioner of Internal Revenue.
  - 4. *Practice before the Internal Revenue Service* comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing documents; filing documents; corresponding and communicating with the Internal Revenue Service; rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and representing a client at conferences, hearings, and meetings.
  - 5. *Practitioner* means any individual described in paragraphs (a), (b), (c), (d), (e), or (f) of §10.3.
  - 6. A *tax return* includes an amended tax return and a claim for refund.
  - 7. *Service* means the Internal Revenue Service.
  - 8. *Tax return preparer* means any individual within the meaning of section 7701(a)(36) and 26 CFR 301.7701-15.
- b. Effective/applicability date. This section is applicable on August 2, 2011.

### §10.20 Information to be furnished

- a. *To the Internal Revenue Service.*
  - 1. A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.
  - 2. Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

3. When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.
- b. *Interference with a proper and lawful request for records or information.* A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.
- c. *Effective/applicability date.* This section is applicable beginning August 2, 2011.

## §10.21 Knowledge of client's omission

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 omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

## §10.22 Diligence as to accuracy

- a. *In general.* A practitioner must exercise due diligence —
  1. In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
  2. In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
  3. In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.
- b. *Reliance on others.* Except as modified by §§10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.
- c. *Effective/applicability date.* Paragraph (a) of this section is applicable on September 26, 2007. Paragraph (b) of this section is applicable beginning June 12, 2014.

## §10.27 Fees

- a. *In general.* A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.
- b. *Contingent fees* —
  1. Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.
  2. A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to —

- i. An original tax return; or
  - ii. An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.
- 3. A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.
- 4. A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.
- c. *Definitions.* For purposes of this section —
  - 1. *Contingent fee* is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.
  - 2. *Matter before the Internal Revenue Service* includes tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.
- d. *Effective/applicability date.* This section is applicable for fee arrangements entered into after March 26, 2008.

## §10.29 Conflicting interests

- a. Except as provided by paragraph (b) of this section, 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 —
  - 1. The representation of one client will be directly adverse to another client; or
  - 2. 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.
- b. Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if —
  - 1. The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
  - 2. The representation is not prohibited by law; and

3. Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.
- c. Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.
- d. Effective/applicability date. This section is applicable on September 26, 2007.

## §10.30 Solicitation

### a. *Advertising and solicitation restrictions.*

1. A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents, enrolled retirement plan agents, or registered tax return preparers, in describing their professional designation, may not utilize the term “certified” or imply an employer/employee relationship with the Internal Revenue Service. Examples of acceptable descriptions for enrolled agents are “enrolled to represent taxpayers before the Internal Revenue Service,” “enrolled to practice before the Internal Revenue Service,” and “admitted to practice before the Internal Revenue Service.” Similarly, examples of acceptable descriptions for enrolled retirement plan agents are “enrolled to represent taxpayers before the Internal Revenue Service as a retirement plan agent” and “enrolled to practice before the Internal Revenue Service as a retirement plan agent.” An example of an acceptable description for registered tax return preparers is “designated as a registered tax return preparer by the Internal Revenue Service.”
2. A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

### b. *Fee information.*

1. i. A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information —
  - A. Fixed fees for specific routine services.
  - B. Hourly rates.
  - C. Range of fees for particular services.
  - D. Fee charged for an initial consultation.
- ii. Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.
2. A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.

- c. *Communication of fee information.* Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.
- d. *Improper associations.* A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.
- e. *Effective/applicability date.* This section is applicable beginning August 2, 2011.

## §10.33 Best practices for tax advisors

- a. *Best practices.* Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:
  - 1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
  - 2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
  - 3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
  - 4. Acting fairly and with integrity in practice before the Internal Revenue Service.
- b. *Procedures to ensure best practices for tax advisors.* Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.
- c. *Applicability date.* This section is effective after June 20, 2005.

## §10.34 Standards with respect to tax returns and documents, affidavits and other papers

- a. *Tax returns.*
  - 1. A practitioner may not willfully, recklessly, or through gross incompetence —
    - i. Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that —



- A. Lacks a reasonable basis;
    - B. Is an unreasonable position as described in section 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance); or
    - C. Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).
  - ii. Advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that —
    - A. Lacks a reasonable basis;
    - B. Is an unreasonable position as described in section 6694(a)(2) of the Code (including the related regulations and other published guidance); or
    - C. Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).
  - 2. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.
- b. *Documents, affidavits and other papers —*
- 1. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.
  - 2. A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —
    - i. The purpose of which is to delay or impede the administration of the Federal tax laws;
    - ii. That is frivolous; or
    - iii. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.
- c. *Advising clients on potential penalties —*
- 1. A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to —
    - i. A position taken on a tax return if —
      - A. The practitioner advised the client with respect to the position; or
      - B. The practitioner prepared or signed the tax return; and
    - ii. Any document, affidavit or other paper submitted to the Internal Revenue Service.
  - 2. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
  - 3. This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

- d. *Relying on information furnished by clients.* A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.
- e. *Effective/applicability date.* Paragraph (a) of this section is applicable for returns or claims for refund filed, or advice provided, beginning August 2, 2011. Paragraphs (b) through (d) of this section are applicable to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007.

## §10.35 Competence

- a. A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.
- b. *Effective/applicability date.* This section is applicable beginning June 12, 2014.

## §10.51 Incompetence and disreputable conduct

- a. *Incompetence and disreputable conduct.* Incompetence and disreputable conduct for which a practitioner may be sanctioned under §10.50 includes, but is not limited to —
  - 1. Conviction of any criminal offense under the Federal tax laws.
  - 2. Conviction of any criminal offense involving dishonesty or breach of trust.
  - 3. Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.
  - 4. 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.”
  - 5. Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.
  - 6. Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.
  - 7. 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.
  - 8. Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.

9. Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.
  10. Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.
  11. Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.
  12. Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
  13. Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (a)(13) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading. For purposes of this paragraph (a)(13), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.
  14. Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
  15. Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding instituted under §10.60.
  16. Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when the practitioner is required to do so by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
  17. Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number.
  18. Willfully representing a taxpayer before an officer or employee of the Internal Revenue Service unless the practitioner is authorized to do so pursuant to this part.
- b. *Effective/applicability date.* This section is applicable beginning August 2, 2011.

# 2017 Workbook