

## Chapter 6: Putting Ethics Into Practice

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**Please note.** Corrections were made to this workbook through January of 2019. 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

**Marshall J. Heap, PhD, EA**, is a Tax Content Development and Instruction Specialist at the University of Illinois Tax School. An EA since 1984, Marshall is an ex-Senior Manager of PriceWaterhouseCoopers and has seven years of recent experience as an approved IRS continuing education provider. Marshall's academic background is in Computing and associated fields with degrees from the following UK Universities: The Open University (BSc), London, Birkbeck College (MSc), and Reading (PhD).

Other chapter contributors and reviewers are listed at the front of this volume.

## INTRODUCTION

Credentialed tax professionals are required to meet ethical standards. Federal statutes that impose some of these standards include:

- Treasury Department Circular No. 230 (Rev. 6-2014),
- The privacy rule of the Gramm-Leach-Bliley Act,<sup>1</sup>
- The safeguards rule of the Gramm-Leach-Bliley Act,<sup>2</sup> and
- IRC §7216 requirements for disclosure or use of information by return preparers.

Failure by tax practitioners to meet these standards can result in sanctions under Circular 230, §10.50, and IRC §7407. Additionally, there are several statutorily imposed preparer penalties, which are listed later.

Tax professionals should also be cognizant of any state licensing or regulatory requirements that affect them. There are currently four states (California, Maryland, New York, and Oregon) with tax preparer licensing requirements applicable to tax preparers with a physical presence in the states.<sup>3</sup> Other states have relevant regulatory requirements. For example, the State Tax Preparer Oversight Act (Public Act 99-0641) requires Illinois tax preparers to report their preparer tax identification numbers (PTINs) on state tax returns and claims for refund. There is a \$50 preparer penalty for each failure to comply with this requirement.

Tax practitioners who are members of professional bodies may also be subject to ethical rules established by those associations. The following is a non-exhaustive list of relevant professional associations and their rules regarding professional conduct.

<b>Professional Association</b>	<b>Code of Professional Conduct</b>
American Bar Association	Model Rules of Professional Conduct <sup>4</sup>
American Institute of CPAs	AICPA Code of Professional Conduct <sup>5</sup>
National Association of Enrolled Agents	Code of Ethics and Rules of Professional Conduct <sup>6</sup>

<sup>1</sup> *Financial Privacy Rule*. FTC. [[www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/financial-privacy-rule](http://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/financial-privacy-rule)] Accessed on Mar. 6, 2018.

<sup>2</sup> *Safeguards Rule*. FTC [[www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/safeguards-rule](http://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/safeguards-rule)] Accessed on Mar. 6, 2018.

<sup>3</sup> *The AICPA Position on State-Level Oversight of Tax Preparers*. AICPA. [[www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/2014-25-09-aicpa-position-on-state-tax-preparers.pdf](http://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/2014-25-09-aicpa-position-on-state-tax-preparers.pdf)] Accessed on Apr. 12, 2018.

<sup>4</sup> *Model Rules of Professional Conduct*. 2016. ABA. [[www.americanbar.org/groups/professional\\_responsibility/publications/model\\_rules\\_of\\_professional\\_conduct/model\\_rules\\_of\\_professional\\_conduct\\_table\\_of\\_contents.html](http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html)] Accessed on Apr. 12, 2018.

<sup>5</sup> *AICPA Code of Professional Conduct*. Dec. 15, 2014. AICPA. [[www.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014december15contentasof2016august31codeofconduct.pdf](http://www.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014december15contentasof2016august31codeofconduct.pdf)] Accessed on Apr. 12, 2018.

<sup>6</sup> *Code of Ethics and Rules of Professional Conduct*. Aug. 2014. NAEA. [[www.naea.org/sites/default/files/Code%20of%20Conduct%20Approved%20August%202014.pdf](http://www.naea.org/sites/default/files/Code%20of%20Conduct%20Approved%20August%202014.pdf)] Accessed on Apr. 12, 2018.

## LIST OF TAX PREPARER PENALTIES<sup>7</sup>

The IRS can assess several tax preparer penalties. These penalties fall into four categories, as shown in the following tables.

### Administrative Penalties

IRC Section	Penalty	Amount and Description of Applicable Penalties
IRC §6695(a)	Failure to furnish tax return copy to taxpayer	This penalty is \$50 for each failure to furnish a copy of a return or claim to a taxpayer as required by IRC §6107. The maximum penalty imposed on any tax return preparer is \$25,500 for a calendar year.
IRC §6695(b)	Failure to sign return	This penalty is \$50 for each failure to sign a return or claim for refund as required by regulations. The maximum penalty imposed on any tax return preparer is \$25,500 for a calendar year.
IRC §6695(c)	Failure to furnish identifying number	This penalty is \$50 for each failure to furnish a tax preparer and/or firm identifying number on a return or claim as required by IRC §6109(a)(4). The maximum penalty imposed on any tax return preparer is \$25,500 for a calendar year.
IRC §6695(d)	Failure to retain copy or list	This penalty is \$50 for each failure by the preparer to retain a copy or list of a return or claim as required by IRC §6107(b). The maximum penalty imposed on any tax return preparer is \$25,500 for a return period.
IRC §6695(e)	Failure to file correct information returns	This penalty is \$50 for each failure by a tax preparer to file correct information returns as required by IRC §6060. The maximum penalty imposed on any tax return preparer is \$25,500 for a return period.
IRC §6695(f)	Negotiation of check	This penalty is \$520 for a tax return preparer who endorses or negotiates any check for taxes imposed by Title 26 that is issued to a taxpayer.
IRC §6695(g)	Failure to be diligent in determining eligibility for certain tax benefits	This penalty is \$520 for each failure to comply with due diligence requirements when claiming the earned income credit (EIC), child tax credit (CTC), and American opportunity credit (AOC). A similar \$520 preparer penalty is also applicable for each failure to apply due diligence in claiming the head of household (HoH) filing status.

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### Fraud Penalties

IRC Section	Penalty	Amount and Description of Applicable Penalties
IRC §7206	Fraud and false statements	This penalty is for a felony and, upon conviction, is punishable by imprisonment of not more than three years, a fine of not more than \$100,000 (\$500,000 for a corporation), or both (together with the costs of prosecution).
IRC §7207	Fraudulent returns, statements, or other documents	This penalty is for a misdemeanor and, upon conviction, is punishable by imprisonment of not more than one year, a fine of not more than \$10,000 (\$50,000 for a corporation), or both.

<sup>7</sup> Summary of Preparer Penalties under Title 26. Sep. 30, 2017. IRS. [www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26] Accessed on Apr. 12, 2018.

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## Unauthorized Disclosure or Use of Client Information

IRC Section	Penalty	Amount and Description of Applicable Penalties
IRC §6713	Disclosure or use of information by tax return preparers	This penalty is \$250 for each unauthorized disclosure or use of a client's tax return information. The maximum penalty assessable on a tax preparer is \$10,000 in a calendar year.
IRC §7216	Disclosure or use of information by tax return preparers	Paid tax return preparers who knowingly or recklessly disclose a client's tax return information can be fined up to \$1,000 and face up to one year of imprisonment.

## Understatement of Taxpayer's Tax Liability

IRC Section	Penalty	Amount and Description of Applicable Penalties
IRC §6694(a)	Understatement due to unreasonable positions	This penalty is the greater of \$1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
IRC §6694(b)	Understatement due to willful or reckless conduct	This penalty is the greater of \$5,000 or 75% of the income derived by the tax return preparer with respect to the return or claim for refund.
IRC §6701	Penalties for aiding and abetting understatement of tax liability	This penalty is \$1,000 (\$10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of a tax liability. A tax preparer can only be penalized once for documents relating to the same taxpayer for a single tax period or event.

Tax professionals need to be aware of these penalty provisions during their daily practice. Some of these penalty provisions are considered in the following tax practice scenarios.

## EXISTING CLIENTS

### SCENARIO 1: RESTAURANT WITH VIDEO POKER MACHINES

Recently, gaming has expanded beyond traditional casinos into other business locations. At least 30 states currently permit video gaming terminals (VGTs). This can pose a significant challenge to tax preparers.

The Illinois Gaming Board is a 5-member board, appointed by the governor and confirmed by the senate. It administers a regulatory and tax collection system for riverboat casino gambling and video gaming in Illinois.<sup>8</sup> The 2009 Video Gaming Act authorizes the placement of up to five VGTs in licensed retail establishments, truck stops, and veteran and fraternal establishments. These VGTs are connected to and monitored by a central communications system that provides online real-time monitoring.<sup>9</sup> Monthly video gaming reports derived from Illinois Gaming Board data are publicly available for download. These reports provide monthly net income receipts (amount played minus amount won) for Illinois licensed gaming establishments.<sup>10</sup>

<sup>8</sup> *Illinois Gaming Board*. 2018. Illinois Gaming Board. [www.igb.illinois.gov/default.aspx] Accessed on Feb. 9, 2018.

<sup>9</sup> *Ibid*; *Video Gaming Payout Device Requirements (Amended)*. Jul. 10, 2012. Illinois Gaming Board. [www.igb.illinois.gov/FilesVideoLaw/VGPayoutDeviceRequirements.pdf] Accessed on Feb. 9, 2018.

<sup>10</sup> *Video Gaming Revenue Reports*. 2018. Illinois Gaming Board. [www.igb.illinois.gov/VideoReports.aspx] Accessed on Feb. 9, 2018.

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Some Illinois municipalities have availed themselves of the opt-out provisions of the Video Gaming Act or have a current ordinance prohibiting gambling may be excluded from video gaming activity. A list of such municipalities is publicly available.<sup>11</sup> This list includes Oak Brook but not Westmont.

The following scenario illustrates the ethical issues that practitioners who have clients operating video gaming establishments may face.

Gil E. Bull is an enrolled agent (EA) in Oak Brook, Illinois, with a thriving tax practice. Mickey Macchiavelli is the owner of Elysium, a large restaurant with six adjoining private banquet rooms located on the boundary between Oak Brook and Westmont. The Elysium restaurant is organized as a single-member LLC and is reported on Mickey's Schedule C, *Profit or Loss From Business*.

Gil has been preparing Mickey's personal tax returns for the last five years. Throughout this period, Mickey was the owner and operator of the Elysium restaurant. In June 2017, Gil ran into Jean Gadabout, who was still excited about the great time she had at a wedding reception she attended at the Elysium restaurant. Jean told Gil, "Not only was the food and service great, but I won \$1,000 on the video poker machine."

In February 2018, Gil and Mickey meet to go over Mickey's tax information. During their conversation, Gil tells Mickey about his encounter with Jean. Mickey tells Gil not to worry because all the income and expenses from the video poker machines are properly reflected in the books. Mickey tells Gil that "The best thing I ever did was to install those video gaming machines in each of the private dining rooms last year." Puzzled, Gil observes that Oak Brook does not allow video gaming, but Mickey quickly dismisses Gil's concerns, pointing out that Elysium's postal address is in Westmont. The interview concludes, and later Gil starts work on Mickey's 2017 tax returns.

While reviewing the business accounts, Gil wonders if he can easily verify the video gaming income reported with the Illinois Gaming Board. He downloads a spreadsheet from their website showing the net gaming revenue earned by the Elysium restaurant in 2017. After checking, Gil is relieved to discover that the \$250,000 net gaming revenue shown there exactly matches the video gaming revenue reported in the Elysium's 2017 accounts. Mickey's 2017 income of \$550,000, rose \$50,000 from the preceding year. Gil wonders why restaurant receipts dropped \$200,000. Business deductions (apart from those relating to the video gaming machines) are about the same as those reported for 2016. After adjustments and deductions, Mickey's 2017 taxable income is \$460,000.

Gil calls Mickey to let him know that his 2017 taxes increased somewhat over 2016 due to the \$50,000 increase in income. Mickey tells Gil that he has done a good job and to send over the tax returns for his signature and Gil's invoice for payment.

1. What aspects of Mickey's business activities and accounting could cause ethical problems for Gil?

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2. What best practices should Gil have used?

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<sup>11</sup> *Municipalities Prohibiting Video Gaming*. Illinois Gaming Board [www.igb.illinois.gov/VideoProhibit.aspx] Accessed on Feb. 9, 2018.

## Scenario 1 Discussion

**Knowledge of Client's Omission.**<sup>12</sup> A practitioner who knows that a client has omitted income from a tax return must promptly advise the client of the omission and the consequences of the omission.

Concerned that his client might not be reporting all his business income, Gil mentions to Mickey his meeting with Jean. However, Mickey reassures Gil that the income from the video gaming machines was fully accounted for and Gil later verifies this with data from the Illinois Gaming Board website.

**Standards with Respect to Tax Returns.**<sup>13</sup> Generally, a practitioner preparing or signing a tax return as a preparer “may rely in good faith without verification upon information furnished by the client.” However, the practitioner may not ignore the implications of the information furnished. In fact, standards with respect to tax returns require a practitioner to make reasonable inquiries with their client “if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.”

Although Gil notices that restaurant receipts dropped \$200,000, **he does not question Mickey about this.** He assumes that the increased income will keep the IRS auditors at bay. Additionally, Gil notices that restaurant expenses remained approximately the same for 2016 and 2017 but fails to investigate this. A possible explanation here is that because Mickey had to report the net gaming revenue (due to public disclosure), he underreported cash receipts in his restaurant business to compensate. Given the serious nature of these concerns, Gil should have brought them to Mickey's attention and sought appropriate explanations.

**Diligence as to Accuracy.**<sup>14</sup> A practitioner must exercise due diligence when preparing tax returns. In this case, Gil failed to pursue the implications of the \$200,000 decrease in the Elysium restaurant's revenue, especially in light of unchanged business expenses. Tax practitioners who understate taxes on tax returns they prepare can be subject to preparer penalties under IRC §6694. When the preparer takes an unreasonable position on a return, the penalty is the greater of:

- \$1,000, or
- 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

However, if willful or reckless preparer conduct is involved, then the penalty is the greater of:<sup>15</sup>

- \$5,000, or
- 75% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

**Best Practices for Tax Advisors.**<sup>16</sup> Tax practitioners must adhere to best practices when preparing tax returns for their clients. This includes establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, and relating the applicable law to these facts to arrive at a conclusion supported by the law and the facts. Moreover, tax practitioners should assist their clients by avoiding questionable tax return positions or otherwise preparing tax returns that could be subject to accuracy-related penalties.<sup>17</sup>

Gil did not adequately evaluate the reasonableness of the restaurant receipts reported in light of prior year receipts and relatively unchanged business deductions. Consequently, Gil may have prepared a tax return subject to accuracy-related penalties for the underreporting of income.

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<sup>12</sup> Circular 230, §10.21.

<sup>13</sup> Circular 230, §10.34.

<sup>14</sup> Circular 230, §10.22.

<sup>15</sup> IRC §6694(b).

<sup>16</sup> Circular 230, §10.33.

<sup>17</sup> IRC §6662.

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**Form W-2G.**<sup>18</sup> A payor must prepare a federal Form W-2G, *Certain Gambling Winnings*, for each winner of reportable winnings and send copies to the IRS and the payee. Reportable winnings include the following.

Type of Game	Winning Amounts at Least	Reduced by Amount of Wager?
Bingo	\$1,200	No
Slot machines	\$1,200	No
Keno	\$1,500	Yes
Other wagering transactions (e.g., instant bingo, pull-tabs, raffles, etc.)	\$ 600 and at least 300 times the wager	At option of player
Poker tournaments	\$5,000.01	Yes

## SCENARIO 2: UNREIMBURSED EDUCATOR EXPENSES

An eligible educator can deduct up to \$250 of unreimbursed trade or business expenses as an “above-the-line” adjustment to gross income. Qualified expenses for this purpose include amounts paid or incurred for participation in professional development courses, books, supplies, computer equipment (including related software and services), other equipment, and supplementary materials used in the classroom.<sup>19</sup> When such expenses exceed \$250, the excess was deductible as an itemized deduction subject to the 2% limit on miscellaneous itemized deductions.<sup>20</sup> However, the Tax Cuts and Jobs Act (TCJA) temporarily repealed the deduction for miscellaneous itemized deductions that are subject to the 2% of adjusted gross income (AGI) limit for tax years beginning after December 31, 2017, and before January 1, 2026.<sup>21</sup> To be an eligible educator for any tax year, the taxpayer must have been a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.<sup>22</sup>

Form 8283, *Noncash Charitable Contributions*, must be attached to the tax return to support noncash charitable donations over \$500. If the contribution is valued at more than \$5,000, then Part IV of section B of the form must be completed and signed by the donee. In addition, a qualified appraisal of the donated property must be obtained unless publicly traded securities are donated.<sup>23</sup>

Due to the temporary repeal of the tax deduction for miscellaneous itemized deductions, taxpayers may look for alternative ways of deducting these expenses for tax purposes, as shown in the following scenario.

Abe Mollify, EA, has an established tax practice in Terre Haute, Indiana. Abe is good friends with Bob Schoolman, who teaches 10th grade at a local high school. Besides working 800 hours during the regular school year from September until June, Bob teaches 100 hours during summer school.

For several years, Abe has prepared Bob’s personal tax returns and claimed tax deductions for Bob’s unreimbursed educator expenses that average \$5,000 annually. Typically, Abe takes the maximum \$250 educator deduction and treats the excess as a miscellaneous itemized deduction.

<sup>18</sup> IRS Pub. 3079, *Tax-Exempt Organizations And Gaming*.

<sup>19</sup> IRC §62(a)(2)(d).

<sup>20</sup> *Topic Number 458 — Educator Expense Deduction*. Jan. 31, 2018. IRS. [www.irs.gov/taxtopics/tc458] Accessed on Feb. 19, 2018.

<sup>21</sup> IRC §67(g).

<sup>22</sup> IRC §62(d).

<sup>23</sup> *Charitable Organizations — Substantiating Noncash Contributions*. Aug. 4, 2017. IRS. [www.irs.gov/charities-non-profits/charitable-organizations/charitable-organizations-substantiating-noncash-contributions] Accessed on Feb. 19, 2018; Treas. Reg. §1.170A-13(c).

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In February 2019, Abe and Bob meet to go over Bob's 2018 tax data. Bob provides the following information.

Filing status	Single
Teacher's wages	\$50,000
Educator expenses	5,250
Other itemized deductions	12,500

The \$5,250 educator expenses consist of a single donation of supplies for use in the classroom in September 2018 to Bob's school. Following the donation, Bob derived no personal benefit from any of these items. Bob furnishes a receipt, handwritten by the school's principal, in support of the donation, describing the gift as "classroom supplies."

Now that miscellaneous itemized deductions are no longer allowed under the TCJA, Bob would like to preserve his tax deduction for the \$5,000 excess educator expenses (\$5,250 – \$250 educator deduction). Abe accesses the IRS's tax-exempt organization search tool at **uofi.tax/18a6x1** [[www.irs.gov/charities-non-profits/tax-exempt-organization-search](http://www.irs.gov/charities-non-profits/tax-exempt-organization-search)] and verifies that the school is indeed a registered U.S. charity. Abe decides to treat the \$5,000 excess as a charitable contribution.

During the preparation of the tax return, Abe realizes that he needs to include Form 8283, which he completes as follows.

# 2018 Workbook

## For Scenario 2

Form **8283**  
(Rev. December 2014)  
Department of the Treasury  
Internal Revenue Service

### Noncash Charitable Contributions

▶ **Attach to your tax return if you claimed a total deduction of over \$500 for all contributed property.**

▶ **Information about Form 8283 and its separate instructions is at [www.irs.gov/form8283](http://www.irs.gov/form8283).**

OMB No. 1545-0908

Attachment Sequence No. **155**

Name(s) shown on your income tax return

**Bob Schoolman**

Identifying number  
**111-22-3333**

**Note.** Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

**Section A. Donated Property of \$5,000 or Less and Publicly Traded Securities**—List in this section **only** items (or groups of similar items) for which you claimed a deduction of \$5,000 or less. Also list publicly traded securities even if the deduction is more than \$5,000 (see instructions).

**Part I Information on Donated Property**—If you need more space, attach a statement.

1	(a) Name and address of the donee organization	(b) If donated property is a vehicle (see instructions), check the box. Also enter the vehicle identification number (unless Form 1098-C is attached).	(c) Description of donated property (For a vehicle, enter the year, make, model, and mileage. For securities, enter the company name and the number of shares.)
<b>A</b>	<b>Apex High School, Terre Haute, IN</b>	<input type="checkbox"/>	<b>Classroom supplies</b>
<b>B</b>		<input type="checkbox"/>	
<b>C</b>		<input type="checkbox"/>	
<b>D</b>		<input type="checkbox"/>	
<b>E</b>		<input type="checkbox"/>	

**Note.** If the amount you claimed as a deduction for an item is \$500 or less, you do not have to complete columns (e), (f), and (g).

A	(d) Date of the contribution	(e) Date acquired by donor (mo., yr.)	(f) How acquired by donor	(g) Donor's cost or adjusted basis	(h) Fair market value (see instructions)	(i) Method used to determine the fair market value
<b>A</b>	<b>09-16-2018</b>	<b>Various</b>	<b>Purchased</b>	<b>5,000</b>	<b>5,000</b>	<b>Comparable sales</b>
<b>B</b>						
<b>C</b>						
<b>D</b>						
<b>E</b>						

**Part II Partial Interests and Restricted Use Property**—Complete lines 2a through 2e if you gave less than an entire interest in a property listed in Part I. Complete lines 3a through 3c if conditions were placed on a contribution listed in Part I; also attach the required statement (see instructions).

- 2a** Enter the letter from Part I that identifies the property for which you gave less than an entire interest ▶ \_\_\_\_\_  
If Part II applies to more than one property, attach a separate statement.
- b** Total amount claimed as a deduction for the property listed in Part I: **(1)** For this tax year ▶ \_\_\_\_\_  
**(2)** For any prior tax years ▶ \_\_\_\_\_
- c** Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):  
Name of charitable organization (donee) \_\_\_\_\_  
Address (number, street, and room or suite no.) \_\_\_\_\_  
City or town, state, and ZIP code \_\_\_\_\_
- d** For tangible property, enter the place where the property is located or kept ▶ \_\_\_\_\_
- e** Name of any person, other than the donee organization, having actual possession of the property ▶ \_\_\_\_\_

<b>3a</b> Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property? . . . . .	<b>Yes</b>	<b>No</b>
<b>b</b> Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire? . . . . .		
<b>c</b> Is there a restriction limiting the donated property for a particular use? . . . . .		

**For Paperwork Reduction Act Notice, see separate instructions.**

Cat. No. 62299J

Form **8283** (Rev. 12-2014)

# 2018 Workbook

## For Scenario 2

Form 8283 (Rev. 12-2014)

Page **2**

Name(s) shown on your income tax return

Identifying number

**Section B. Donated Property Over \$5,000 (Except Publicly Traded Securities)**—Complete this section for one item (or one group of similar items) for which you claimed a deduction of more than \$5,000 per item or group (except contributions of publicly traded securities reported in Section A). Provide a separate form for each property donated unless it is part of a group of similar items. An appraisal is generally required for property listed in Section B. See instructions.

**Part I Information on Donated Property**—To be completed by the taxpayer and/or the appraiser.

**4** Check the box that describes the type of property donated:

- |   |   |   |   |
|---|---|---|---|
| <b>a</b> <input type="checkbox"/> Art* (contribution of \$20,000 or more) | <b>d</b> <input type="checkbox"/> Art* (contribution of less than \$20,000) | <b>g</b> <input type="checkbox"/> Collectibles**        | <b>j</b> <input type="checkbox"/> Other |
| <b>b</b> <input type="checkbox"/> Qualified Conservation Contribution     | <b>e</b> <input type="checkbox"/> Other Real Estate                         | <b>h</b> <input type="checkbox"/> Intellectual Property |   |
| <b>c</b> <input type="checkbox"/> Equipment                               | <b>f</b> <input type="checkbox"/> Securities                                | <b>i</b> <input type="checkbox"/> Vehicles              |   |

\*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antiques, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.

\*\*Collectibles include coins, stamps, books, gems, jewelry, sports memorabilia, dolls, etc., but not art as defined above.

**Note.** In certain cases, you must attach a qualified appraisal of the property. See instructions.

	(a) Description of donated property (if you need more space, attach a separate statement)	(b) If tangible property was donated, give a brief summary of the overall physical condition of the property at the time of the gift	(c) Appraised fair market value
<b>A</b>			
<b>B</b>			
<b>C</b>			
<b>D</b>			

	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) For bargain sales, enter amount received	See instructions	
					(h) Amount claimed as a deduction	(i) Date of contribution
<b>A</b>						
<b>B</b>						
<b>C</b>						
<b>D</b>						

**Part II Taxpayer (Donor) Statement**—List each item included in Part I above that the appraisal identifies as having a value of \$500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than \$500 (per item). Enter identifying letter from Part I and describe the specific item. See instructions. ►

Signature of taxpayer (donor) ►

Date ►

**Part III Declaration of Appraiser**

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). In addition, I understand that I may be subject to a penalty under section 6695A if I know, or reasonably should know, that my appraisal is to be used in connection with a return or claim for refund and a substantial or gross valuation misstatement results from my appraisal. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility.

**Sign**

**Here**

Signature ►

Title ►

Date ►

Business address (including room or suite no.)

Identifying number

City or town, state, and ZIP code

**Part IV Donee Acknowledgment**—To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on the following date ►

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 3 years after the date of receipt, it will file **Form 8282**, Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . . ►  Yes  No

Name of charitable organization (donee)

Employer identification number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

Authorized signature

Title

Date

Form **8283** (Rev. 12-2014)

Abe completes only part I of Form 8283, reasoning that none of the supplies donated would have exceeded \$5,000. He provides Bob with the completed tax return, which Bob promptly signs and files.

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

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

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## Scenario 2 Discussion

**Best Practices for Tax Advisors.**<sup>24</sup> An important part of preparing any tax return is establishing the facts, determining which facts are relevant, and evaluating the reasonableness of any assumptions or representations. Then, it is necessary to relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts.

Abe treats \$250 of the \$5,250 donation as an educator expense adjustment. Abe determines that the excess \$5,000 results in a charitable contribution deduction, for which no appraisal is required and section B of Form 8283 need not be completed. The receipt describes the gift as “classroom supplies” but offers no further detail. Therefore, it is unknown what supplies were gifted, in what quantity, and whether they were similar items of the same generic category or type.<sup>25</sup> This information could have had an impact on whether section B of Form 8283 is required.

Under IRC §62(d), eligible educators must have worked at least 900 hours in the school year. It is questionable whether this includes hours worked in a summer school.<sup>26</sup> Abe should have discussed this position further with Bob, including the possibility of filing Form 8275, *Disclosure Statement*, with the tax return to disclose this position.

Does the handwritten receipt meet the documentation requirements under IRC §170? Specifically, does it identify donor, donee, adequate property description, and that no goods or services were received in exchange for the donation?

**Diligence as to Accuracy.**<sup>27</sup> If Bob does not meet the requirement for 900 teaching hours in a school year, then the \$250 educator deduction is not allowable. However, even if this requirement is met, it is questionable whether Abe can segregate \$250 from the charitable contribution receipt for the purposes of the educator expense adjustment. Furthermore, Abe assumes that the handwritten receipt is sufficient corroboration that a charitable contribution was made and that because \$250 is reported as an educator deduction, only section A of Form 8283 is applicable.

Abe must exercise due diligence in preparing Bob's tax return. In order to prepare an accurate tax return, Abe must ensure that the educator deduction meets the requirements of the law and that the charitable deduction is adequately substantiated.

<sup>24</sup> Circular 230, §10.33.

<sup>25</sup> Instructions to Form 8283.

<sup>26</sup> *Schoolteachers' deduction no longer tardy*. McKinley, John W. & Kim, Do Yoon (Harold). Jul. 1, 2016. Journal of Accountancy. [www.journalofaccountancy.com/issues/2016/jul/tax-deductions-for-teachers.html] Accessed on May 3, 2018.

<sup>27</sup> Circular 230, §10.22.

# 2018 Workbook

**Competence.**<sup>28</sup> A practitioner must possess the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter in which they are engaged. Abe used inadequate information to determine the tax deductions and made questionable interpretations of the law without considering disclosure of the positions taken.

Incompetence and disreputable conduct is defined in Circular 230, §10.51. This includes “willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.” Such conduct is sanctionable under Circular 230. Possible sanctions include suspension of practice or even disbarment.<sup>29</sup>

## SCENARIO 3: QBI DEDUCTION FOR S CORPORATION SHAREHOLDER

The TCJA introduced the qualified business income deduction, (QBID) which is generally 20% of qualified business income from qualifying businesses.<sup>30</sup> For partnerships and S corporations, the QBID is determined at the **partner or shareholder** level.<sup>31</sup> Partners/shareholders take into account their shares of income, gain, deduction, and loss in determining their QBID for each qualifying business.<sup>32</sup>

A **W-2 wages/qualified property (QP) limit** under IRC §199A(b) may also affect the amount of the QBID. This limit is correlated to taxable income. For example, married filing jointly (MFJ) taxpayers with taxable income exceeding \$415,000 are fully subject to the **W-2 wages/QP limit** but this limit does not apply when their taxable income is less than \$315,000. The **W-2 wages/QP limit** is phased in between these taxable income ranges. Each partner/shareholder takes into account their allocable share of the business’s W-2 wages and unadjusted basis of QP in determining the **W-2 wages/QP limit**.<sup>33</sup>

The **W-2 wages/QP limit** for a qualifying business activity that does not have QP is the **lesser of**:<sup>34</sup>

1. 20% of the activity’s qualified business income (QBI), or
2. 50% of the activity’s W-2 wage payments.

The following payments to a taxpayer are not QBI of that taxpayer.<sup>35</sup>

- Reasonable compensation paid by any qualified business of the taxpayer for services rendered with respect to that business
- Guaranteed payments to a partner for services rendered with respect to the business
- Payments to a partner for services rendered with respect to the business

**Note.** For more information about the QBID, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues.

**Caution.** For the purposes of this scenario, changes in compensation are not in dispute. However, with the TCJA changes, manipulating compensation for the sole purpose of maximizing QBID creates an ethical issue.

<sup>28</sup> Circular 230, §10.35.

<sup>29</sup> Circular 230, §10.50.

<sup>30</sup> IRC §199A.

<sup>31</sup> IRC §199A(f)(1)(A)(i).

<sup>32</sup> IRC §199A(f)(1)(A)(ii).

<sup>33</sup> IRC §199A(f)(1)(A)(iii).

<sup>34</sup> IRC §199A(b)(2).

<sup>35</sup> IRC §199A(c)(4).

# 2018 Workbook

Cue Bid Corporation (CBC) distributes playing cards to bridge clubs. Ownership of CBC, which is organized as an S corporation, is split equally between two shareholders, Jack Diamond and Queenie Hart. Both shareholders receive an annual \$40,000 salary from the business for services performed and both are married (not to each other). For several years, CBC has generated a net annual profit of \$400,000. The business has no employees other than the owners and no QP. Pertinent information for each of the two shareholders follows.

Shareholder	Jack Diamond (50%)	Queenie Hart (50%)
Filing status	MFJ	MFJ
Annual salary from CBC	\$ 40,000	\$ 40,000
Annual profit share from CBC	200,000	200,000
Other income (not from a qualified business)	260,000	20,000
Annual taxable income	480,000	240,000

For several years, Ken Dealer, CPA, has handled the tax compliance for CBC, including preparing Form 1120S, *U.S. Income Tax Return for an S Corporation*, which Jack signs in his capacity as president. Ken also prepares Jack's individual tax returns.

In late December 2017, Jack reads about the QBID and wonders if his income from CBC could qualify for this tax deduction. Accordingly, Jack calls Ken and asks him what he thinks. Ken observes that Jack will only get a modest QBID based on his taxable income level. Jack, confused by Ken's response, replies, "I wouldn't call 20% of \$200,000 modest." Ken explains that the QBID would be limited to \$20,000 (i.e., 50% of Jack's \$40,000 share of wage payments) due to the application of the **W-2 wages/QP limit**.

Eager to gain an advantage, Jack asks Ken how much his 2018 salary needs to be in order to maximize his QBID from CBC. After some thought, Ken realizes that this is a complicated circular calculation because increased salaries reduce the net profit of the corporation. Moreover, the salary increases would also raise employment taxes. Ken explains this to Jack and suggests that he and Queenie each increase their 2018 salary to \$60,000. This would reduce CBC's annual profit to \$360,000 before consideration of employment taxes and increase Jack's QBID to \$30,000 (lesser of Jack's \$180,000 share of profit  $\times$  20% = \$36,000 and 50%  $\times$  \$60,000 wages = \$30,000).

At Jack's 2018 marginal tax rate of 35%, the additional \$10,000 QBID would save Jack \$3,500 in federal income tax. However, this is accompanied by additional employment tax of \$3,060 (\$20,000 salary increase  $\times$  15.3%). Jack tells Ken that he is happy with paying additional employment tax because this increases his earnings for social security purposes. Consequently, Ken suggests that Jack call Queenie to explain the situation and obtain her agreement to the \$20,000 increase to their respective salaries for 2018.

Later, Jack and Queenie speak and Jack explains that he has just had a great conversation with Ken regarding the new QBID. Queenie, uninformed about this new tax deduction, asks Jack to explain. Jack recounts his conversation with Ken stressing that Ken told him that a larger QBID is possible if they each raise their salaries by \$20,000 in 2018. When Jack emphasizes that the tax savings from the increased QBID more than offset the additional employment tax due, Queenie is finally convinced and agrees to the compensation restructuring for 2018.

In February 2019, Queenie meets with her accountant, who explains that Queenie's 2018 QBID would have been \$40,000 ( $\$200,000 \times 20\%$ ) had her salary not been increased. Queenie is angry and storms into Ken's office, demanding restitution. Ken asks Queenie to explain what she means. She relates what her accountant told her that due to her taxable income level, her QBID is unaffected by the wage limit. As a result, her QBID is reduced by \$4,000 ( $(\$200,000 \times 20\% = \$40,000) - (\$180,000 \times 20\% = \$36,000)$ ), leading to a tax loss of \$960 ( $\$4,000 \times 24\%$  marginal tax rate), which she demands Ken reimburse because he talked her into restructuring their salaries for 2018.

# 2018 Workbook

1. What are the most serious ethical issues that Ken should have considered?

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## Scenario 3 Discussion

**Conflicting Interests.**<sup>36</sup> A practitioner should not represent a client before the IRS if the representation involves a conflict of interest. A conflict of interest exists if the representation of one client is directly adverse to another client or if there is a significant risk that the representation of one or more clients is 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.

In this scenario, a conflict of interest arose because Ken represented both the S corporation and one shareholder. Although Queenie is not a personal client of Ken, she is a 50% owner of CBC. Ken cannot neglect her interests while performing his work for CBC and Jack.

When Jack contacted Ken in December 2017 to discuss QBID planning, Ken should have involved Queenie in the discussions from the beginning. A meeting with all parties should have been arranged. Ken did not assist Queenie with her individual taxes and, knowing the importance of taxable income in computing the QBID, Ken should have encouraged Queenie to discuss the potential changes with her tax advisor prior to the changes being implemented.

**Diligence as to Accuracy.**<sup>37</sup> Before Ken suggested to Jack to increase shareholder salaries from \$40,000 to \$60,000 annually, he should have considered whether the increased salaries would represent reasonable compensation to the shareholders.

**Disclosure of Information by Return Preparers.**<sup>38</sup> A \$250 penalty is assessable for each unauthorized disclosure or use of a client's tax return information. Paid tax return preparers who knowingly or recklessly disclose a client's tax return information can be fined up to \$1,000 and face up to one year of imprisonment.

In this scenario, Ken did not disclose Jack's personal tax information to Queenie. However, in order to protect Queenie's interests, she needs to be aware that she and Jack have different individual tax situations. Furthermore, involving Queenie's individual tax preparer in the December 2017 QBID discussions would potentially require that person receive information related to both CBC's and Jack's tax returns.

Therefore, in order for Ken to involve Queenie in the QBID discussions, he would first need to obtain the necessary written consent from Jack to disclose Jack's individual tax return information to Queenie and/or her tax advisor. Likewise, Queenie would need to offer similar consent for Jack and Ken to receive her tax return information.<sup>39</sup>

**Note.** A sample client consent form for disclosing tax return information to another U.S.-based practitioner for tax preparation is included in the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Putting Ethics Into Practice.

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<sup>36</sup> Circular 230, §10.29.

<sup>37</sup> Circular 230, §10.22.

<sup>38</sup> IRC §§6713 and 7216.

<sup>39</sup> Treas. Reg. §301.7216-3.

## NEW CLIENTS

### SCENARIO 4: EARNED INCOME CREDIT

The scope of this scenario is focused upon the behavior of the tax practitioners and not the technical correctness of the return itself.

Brenda is an associate with Busy Bs, LLC, a tax preparation business organized as a single-member LLC, which is owned by Bobbie Slacker, CPA. Brenda's job is to meet clients and walk them through a step-by-step software program that uses an "interview" process, which results in a draft tax return. Bobbie then reviews and modifies the tax return as necessary before signing the tax return as the paid preparer. Bobbie decided that because Brenda's services are incidental to tax return preparation and Bobbie signs the tax returns as paid preparer, Brenda does not need a PTIN.

In March 2018, Maria Alvarez walks into Busy Bs' office and requests preparation of her 2017 personal tax return. Maria brings her self-prepared 2016 tax returns with her, including the following Form 1040EZ, *Income Tax Return for Single and Joint Filers With No Dependents*.

# 2018 Workbook

## For Scenario 4

Form <b>1040EZ</b>		Department of the Treasury—Internal Revenue Service <b>Income Tax Return for Single and Joint Filers With No Dependents</b> (99)		<b>2016</b>	OMB No. 1545-0074	
Your first name and initial <b>Maria</b>		Last name <b>Alvarez</b>		Your social security number <b>956   87   6411</b>		
If a joint return, spouse's first name and initial		Last name		Spouse's social security number		
Home address (number and street). If you have a P.O. box, see instructions. <b>6000 Bienvenido Avenue</b>				Apt. no. <b>342</b>	▲ Make sure the SSN(s) above are correct.	
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). <b>Chicago IL 60608</b>				Presidential Election Campaign		
Foreign country name		Foreign province/state/county		Foreign postal code		
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse						
<b>Income</b> Attach Form(s) W-2 here. Enclose, but do not attach, any payment.	<b>1</b>	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.			<b>1</b>	<b>6,150</b>
	<b>2</b>	Taxable interest. If the total is over \$1,500, you cannot use Form 1040EZ.			<b>2</b>	
	<b>3</b>	Unemployment compensation and Alaska Permanent Fund dividends (see instructions).			<b>3</b>	
	<b>4</b>	Add lines 1, 2, and 3. This is your <b>adjusted gross income</b> .			<b>4</b>	<b>6,150</b>
	<b>5</b>	If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back. <input type="checkbox"/> You <input type="checkbox"/> Spouse If no one can claim you (or your spouse if a joint return), enter \$10,350 if <b>single</b> ; \$20,700 if <b>married filing jointly</b> . See back for explanation.			<b>5</b>	<b>10,350</b>
	<b>6</b>	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your <b>taxable income</b> .			<b>6</b>	<b>0</b>
<b>Payments, Credits, and Tax</b>	<b>7</b>	Federal income tax withheld from Form(s) W-2 and 1099.			<b>7</b>	<b>0</b>
	<b>8a</b>	<b>Earned income credit (EIC)</b> (see instructions)			<b>8a</b>	<b>0</b>
	<b>b</b>	Nontaxable combat pay election.		<b>8b</b>		
	<b>9</b>	Add lines 7 and 8a. These are your <b>total payments and credits</b> .			<b>9</b>	<b>0</b>
	<b>10</b>	<b>Tax</b> . Use the amount on <b>line 6 above</b> to find your tax in the tax table in the instructions. Then, enter the tax from the table on this line.			<b>10</b>	<b>0</b>
	<b>11</b>	Health care: individual responsibility (see instructions) Full-year coverage <input type="checkbox"/>			<b>11</b>	
<b>12</b>	Add lines 10 and 11. This is your <b>total tax</b> .			<b>12</b>	<b>0</b>	
<b>Refund</b> Have it directly deposited! See instructions and fill in 13b, 13c, and 13d, or Form 8888.	<b>13a</b>	If line 9 is larger than line 12, subtract line 12 from line 9. This is your <b>refund</b> . If Form 8888 is attached, check here <input type="checkbox"/>			<b>13a</b>	
	<b>b</b>	Routing number <input type="text"/>		<b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
	<b>d</b>	Account number <input type="text"/>				
<b>Amount You Owe</b>	<b>14</b>	If line 12 is larger than line 9, subtract line 9 from line 12. This is the <b>amount you owe</b> . For details on how to pay, see instructions.			<b>14</b>	
<b>Third Party Designee</b>	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> <b>Yes</b> . Complete below. <input type="checkbox"/> <b>No</b>					
<b>Sign Here</b> Joint return? See instructions. Keep a copy for your records.	Designee's name	Phone no.	Personal identification number (PIN)			
	Your signature	Date	Your occupation <b>Cleaner</b>	Daytime phone number		
	Spouse's signature. If a joint return, <b>both</b> must sign.		Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/>	
	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN	
<b>Paid Preparer Use Only</b>			Firm's name	Firm's EIN		
			Firm's address	Phone no.		

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see instructions.

Cat. No. 11329W

Form **1040EZ** (2016)

# 2018 Workbook

During the interview, Brenda makes a copy of Maria's 2016 tax returns and asks Maria several questions, noting her responses. Brenda also has Maria sign and date the interview question and answer sheet, which follows.

Question	Answer
1. What is your name and social security number?	They are on my 2016 tax return.
2. Are you or were you ever married?	No
3. What is your birth date?	November 10, 1992
4. Do you have any dependents besides yourself	No
5. How long have you resided in the U.S.?	Since October 2014
6. What is your address?	6000 Bienvenido Ave., #342, Chicago, IL 60608
7. Did you receive any IRS correspondence regarding your 2016 tax return?	I do not think so.
8. What income did you have in 2017?	Just money from cleaning houses.
9. Do you have a Form W-2?	No. I asked for one but my employer told me I should just report the cash I received on my tax return.
10. Do you have records of the amount of money you received from house cleaning?	No, but I know how much I earned.
11. How much did you receive to clean a house?	\$50 per visit
12. How many visits did you make in 2017?	133
13. Who provided the cleaning supplies?	The homeowner provided everything.

Brenda informs Maria that she can easily reconstruct her income, which she calculates to be \$6,650 ( $\$50 \times 133$ ). After inputting this income in the software program along with the rest of Maria's information, Brenda sees that the software calculates an earned income credit (EIC). Therefore, she completes Form 8867, *Paid Preparer's Due Diligence Checklist*.

For question 7, Brenda checks the 2016 tax return and sees that no EIC was claimed in 2016. She remarks on this to Maria, who explains that she did not know about this credit when she prepared the 2016 tax return. Brenda completes a 2017 draft tax return for Maria, noting that there is a tax refund of \$510 because of the EIC and that the firm will e-file the return for her.

Maria is happy that she will get a sizeable tax refund, but she tells Brenda that she prefers to file a paper tax return. Therefore, Brenda has Maria sign and date a statement to that effect as required by Rev. Proc. 2011-25. The interview concludes. Brenda prepares Form 8948, *Preparer Explanation for Not Filing Electronically*, as required.

Brenda puts the file with Maria's 2017 draft return and interview notes on the stack of files awaiting Bobbie's review. Busy Bs is a thriving practice with over 1,000 clients. When Bobbie gets to Maria's file, she does a cursory review noting that Form 8867 appears to be correctly completed. She then finalizes and signs the paper tax return. When returning the file to Brenda, Bobbie asks her to prepare the invoice and forward the paper tax return to Maria to file with the IRS. Bobbie also suggests to Brenda that she ask Maria if she would also like them to file an amended tax return to claim the EIC for 2016.

# 2018 Workbook

1. Where did Brenda and Bobbie’s due diligence fall short?

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2. What improvements to Bobbie’s best practices are appropriate?

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## Scenario 4 Discussion

**Return Preparation.**<sup>40</sup> A person who prepares all or substantially all of a tax return should have a PTIN. The IRS has frequently asked questions (FAQs) discussing situations when a PTIN is and is not required at [uofi.tax/18a6x2](https://www.irs.gov/efile/faq-ptin) [www.irs.gov/tax-professionals/frequently-asked-questions-do-i-need-a-ptin].<sup>41</sup> One of the IRS’s scenarios concerns a small tax return preparation business that employs four associates who sit with taxpayers and go through a systematic software program that uses an interview process that results in a draft tax return. The main consideration regarding the need for a PTIN is whether the associate prepares, or assists in preparing, all or substantially all of a tax return, including making determinations that affect the tax liability.<sup>42</sup> Therefore, because Brenda substantially prepares the entire tax return, reconstructs Maria’s earnings, and makes the determination regarding claiming the EIC, it seems that Brenda should have a PTIN.

**Diligence as to Accuracy.**<sup>43</sup> There is evidently a procedure in place for Brenda, Bobbie’s assistant, to follow. In fact, Brenda obtains a copy of Maria’s 2016 tax return, takes notes of the interview, which the client countersigns, and completes Form 8867 with the client when she decides that the EIC is applicable. Therefore, Bobbie and Brenda act diligently in this regard.

Having a social security number (SSN) issued by the Social Security Administration that is valid for employment is required to claim the EIC.<sup>44</sup> Brenda accepted the SSN shown on Maria’s 2016 tax return without asking to see her social security card. Brenda did not notice or suspect that Maria’s “SSN” could be an individual taxpayer identification number (ITIN) because it begins with a “9” and the middle digits fall within the prescribed values for an ITIN.<sup>45</sup> Therefore, Brenda and Bobbie were not diligent in this regard. They should have done further research and made further inquiries of Maria to ensure that Maria had a valid SSN before claiming the EIC on Maria’s 2017 tax return.

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<sup>40</sup> Circular 230, §10.8.

<sup>41</sup> *Frequently Asked Questions: Do I Need a PTIN?* Nov. 27, 2017. IRS. [www.irs.gov/tax-professionals/frequently-asked-questions-do-i-need-a-ptin] Accessed on Apr. 30, 2018.

<sup>42</sup> *Ibid.*

<sup>43</sup> Circular 230, §10.22.

<sup>44</sup> *Social Security Number and Claiming EITC.* Nov. 29, 2017. IRS. [www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/social-security-number-and-claiming-eitc] Accessed on Feb. 28, 2018.

<sup>45</sup> *General ITIN Information.* Oct. 18, 2017. IRS. [www.irs.gov/individuals/international-taxpayers/general-itin-information] Accessed on Feb. 28, 2018.

**Best Practices for Tax Advisors.**<sup>46</sup> Tax practitioners in a supervisory role should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with best practices. These practices include:

- Establishing the facts,
- Determining which facts are relevant,
- Evaluating the reasonableness of any assumptions or representations,
- Relating the applicable law to the relevant facts, and
- Arriving at a conclusion supported by the law and the facts.

When reviewing Maria's file, Bobbie did not consider that Maria might not have been a U.S. citizen or resident. Further questioning of Maria would have been necessary to establish this. Bobbie should have provided guidance to her assistants to be alert to this possibility as well as the questions that they need to ask to capture the required information.

Tax returns that include the EIC can result in IRS-assessed penalties (as described next) if the EIC is incorrectly claimed. Neither Bobbie nor Brenda mentioned this to Maria nor did they mention whether Maria could avoid accuracy-related penalties if she relied upon their advice.<sup>47</sup>

**Due Diligence Penalty.**<sup>48</sup> There is a \$520 preparer penalty for each instance of failure to exercise due diligence in claiming the EIC. This can result in both the preparer and the firm employing the preparer to be liable for this penalty. **The firm can be subject to this penalty if a principal officer of the firm knew of the failure to comply with due diligence requirements or failed to establish reasonable and appropriate procedures to ensure compliance with these requirements.**<sup>49</sup>

Having an SSN issued by the Social Security Administration that is valid for employment is a requirement to claim the EIC.<sup>50</sup> Because Maria did not have a valid SSN, the EIC should not have been claimed on Maria's tax return. Therefore, the IRS may assess both Bobbie and Brenda \$510 penalties for failure to be diligent in determining eligibility for the EIC.

**Other Preparer Penalties.** Besides the \$520 due diligence penalty, other preparer penalties the IRS can assess for failure to exercise due diligence include:

- Penalty for tax understatement due to an unreasonable position (greater of \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return);<sup>51</sup> and
- Understatement due to willful or reckless conduct (minimum \$5,000 penalty).<sup>52</sup>

Whether claiming the EIC on Maria's tax return is an unreasonable position or rises to the level of willful or reckless conduct is for the IRS to determine.

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<sup>46</sup> Circular 230, §10.33.

<sup>47</sup> *Taxpayer's reliance on tax preparer who erred was reasonable and in good faith; penalties abated.* Chen, John. Nov. 1, 2017. The Tax Adviser. [www.thetaxadviser.com/issues/2017/nov/reliance-preparer-erred-reasonable.html] Accessed on May 9, 2018.

<sup>48</sup> IRC §6695(g); *Summary of Preparer Penalties under Title 26.* Apr. 27, 2018. IRS. [www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26] Accessed on Apr. 30, 2018.

<sup>49</sup> Treas. Reg. §1.6695-2(c).

<sup>50</sup> *Social Security Number and Claiming EITC.* Nov. 29, 2017. IRS. [www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/social-security-number-and-claiming-eitc] Accessed on Feb. 28, 2018.

<sup>51</sup> IRC §6694(a).

<sup>52</sup> IRC §6694(b).

# 2018 Workbook

**Taxpayer Penalties and Other Consequences.**<sup>53</sup> If the IRS examines a tax return and denies all or a part of the EIC, the CTC, or the AOC, then the taxpayer:

- Must pay back any erroneous amount with interest;
- May be subject to the 20% accuracy-related penalty<sup>54</sup> and the 75% fraud penalty;<sup>55</sup>
- May need to file Form 8862, *Information To Claim Certain Refundable Credits After Disallowance*;
- May be banned from claiming one or more of the refundable credits for the next two years if the error is because of reckless or intentional disregard of the rules; or
- May be banned from claiming one or more of the refundable credits for the next 10 years if the error is because of fraud.

The EIC should not have been claimed on Maria's tax return. However, the decision to examine the tax return and take any of the above actions rests with the IRS.

**Practitioner Note.** This scenario serves as a reminder to tax preparers of the actions that the IRS can take in response to a tax return, including those on which an EIC was claimed when the taxpayer was not eligible.


## SCENARIO 5: HOME EQUITY LOAN

Carly Stratton has always prepared her own taxes. However, this year she decides to hire a preparer to take on this tiresome task and maybe get her a bigger tax refund.

While perusing her local newspaper, Carly spots the following ad from a tax preparer and decides to give Max Ringer a call.

**Max Ringer EA**  
100 Benjamin Franklin Ave.  
Carbondale, IL 62901  
Tel: 618-123-4567

With over 20 years experience as an IRS auditor, Max Ringer, EA, will bring your tax refund safely home!



Max Ringer, EA, is an IRS certified tax return preparer who specializes in preparing tax returns for people just like you.

<sup>53</sup> *Consequences of Not Meeting Your Due Diligence Requirements*. Sep. 28, 2017. IRS. [www.eitc.irs.gov/tax-preparer-toolkit/preparer-due-diligence/consequences-of-failing-to-meet-your-due-diligence] Accessed on Apr. 11, 2018.

<sup>54</sup> IRC §6662.

<sup>55</sup> IRC §6663.

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Delighted that his ad is attracting new business, Max sets up a data-gathering interview with Carly in March 2019. In addition to her 2018 tax data, Max asks Carly to bring in copies of her 2017 tax returns.

Max starts the meeting by reviewing Carly's 2017 tax returns. The following table provides information from Carly's 2017 federal tax return along with pertinent 2018 tax data. Carly is a single filer.

Item	2017	2018
Wages	\$200,000	\$210,000
Other income	0	0
Adjusted gross income	200,000	210,000
State income tax and real estate tax payments	10,000	10,000
Mortgage interest on \$500,000 principal residence loan	20,000	20,000
Interest on \$100,000 home equity loan used to purchase Lake Tahoe vacation home	4,000	4,000
Other deductions	0	0
Alternative minimum tax	100	Not yet determined

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Upon review of Carly's 2017 Form 6251, *Alternative Minimum Tax — Individuals*, Max notes that there is no entry on line 4 (home mortgage interest adjustment) and informs Carly that this should be \$4,000 because, although the interest on the home equity loan is deductible for regular tax purposes, it is not deductible for alternative minimum tax (AMT) purposes. Carly asks Max what she should do. He calculates that the additional AMT due would be \$1,040 ( $\$4,000 \times 26\%$ ) and suggests, given the amount, that Carly should just wait and pay this additional tax if assessed by the IRS. Carly thanks Max for his advice and they move on to discuss the 2018 tax return.

Noting that Carly's 2017 and 2018 tax situations are similar, Max informs Carly that for tax years 2018 to 2025 the TCJA suspends the deduction for home equity loan interest.<sup>56</sup> Upset that she will lose the \$4,000 home equity loan interest deduction, Max quickly tells Carly that interest on a second home is also deductible. Therefore, she need not worry because she can continue to deduct this on Schedule A. Carly is relieved, and Max adds that the tax she will save from this suggestion will more than cover his fee. "Great, I knew I did the right thing coming to you, Max," Carly says. The meeting concludes with Carly confirming Max's engagement to prepare her taxes and signing the e-file authorization.

Later, Max completes and e-files the tax return along the lines discussed.

1. What Circular 230 requirements did Max violate?

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

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<sup>56</sup> IRC §163(h)(3)(F).

## Scenario 5 Discussion

**Solicitation.**<sup>57</sup> Advertising and solicitation by tax preparers are subject to restrictions. Generally, tax practitioners may not make statements that are false, fraudulent, coercive, misleading, or deceptive. In particular, EAs may not utilize the term “certified” or in any way imply an employer/employee relationship with the IRS.

Max’s advertisement includes the prohibited term “certified” and is vague regarding his current relationship with the IRS. Therefore, he is in violation of §10.30 of Circular 230.

**Knowledge of Client’s Omission.**<sup>58</sup> A practitioner who becomes aware that a taxpayer has made a tax return error or omission must advise the client promptly of the issue and its consequences. Therefore, Max should advise Carly to file an amended tax return to correct the error that he discovered in the calculation of AMT. However, there is no statutory requirement for taxpayers to file an amended return when an originally filed tax return is discovered to be incorrect.<sup>59</sup>

**Competence/Diligence as to Accuracy.**<sup>60</sup> Under the TCJA, home equity loan interest is deductible for tax years 2018 through 2025 only if the proceeds of the loan are used to “buy, build or substantially improve the taxpayer’s home that secures the loan.”<sup>61</sup> In fact, the IRS expressly prohibits the deduction of interest on a home equity loan on a taxpayer’s principal residence when the proceeds are used to purchase a vacation home.<sup>62</sup>

Max is correct that interest on a loan to purchase a vacation home can be deductible.<sup>63</sup> However, the loan must be secured by the property in question.<sup>64</sup> For tax year 2017, home equity loan interest was deductible regardless of how the loan proceeds were spent.<sup>65</sup> The TCJA modified IRC §163 such that the interest on Carly’s home equity loan is not deductible for 2018. Evidently, Max was unaware of this change in the law and erroneously claimed the tax deduction for this interest. Consequently, he did not exercise due diligence in preparing Carly’s tax return with respect to the interest deduction.

**Best Practices for Tax Advisors.**<sup>66</sup> Included in the Circular 230 list of best practices for tax practitioners is the requirement that they relate the **applicable** law to the relevant facts and arrive at a conclusion supported by the law and the facts. This is reiterated in Circular 230, §10.35, which requires that a practitioner possess the necessary competence to engage in practice before the IRS. Max’s ignorance of the law change validates the importance of annual continuing education requirements so that EAs and other credentialed tax professionals can stay abreast of developments in the field.

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<sup>57</sup> Circular 230, §10.30.

<sup>58</sup> Circular 230, §10.21.

<sup>59</sup> *Whether to amend a return.* Lardinois, Ryan. Feb. 1, 2017. Journal of Accountancy. [www.journalofaccountancy.com/issues/2017/feb/amending-a-tax-return.html] Accessed on Mar. 5, 2018.

<sup>60</sup> Circular 230, §§10.22 and 10.35.

<sup>61</sup> IRS News Rel. IR-2018-32 (Feb. 21, 2018).

<sup>62</sup> See IRS News Rel. IR-2018-32, Example 2 (Feb. 21, 2018).

<sup>63</sup> IRC §163(h)(4)(A)(i).

<sup>64</sup> IRC §163(h)(3)(B)(i).

<sup>65</sup> IRS Pub. 936, *Home Mortgage Interest Deduction*.

<sup>66</sup> Circular 230, §§10.33(a)(2) and 10.35.

## SCENARIO 6: STATE AND LOCAL TAXES

Chase Hunt has always done his own taxes but after reading about the new tax law in December 2017, he worried about its impact on his itemized deductions. Of particular concern is the \$10,000 limit on state and local taxes (SALT), which is applicable starting in 2018. Deciding that the time has come to get professional help, Chase arranges to meet with Ernie Fastbuck, EA, in late December 2017.

Ernie, empathizing with Chase's concerns, advises him to prepay as much of his SALT as possible before the yearend. Accordingly, Chase pays \$2,500 for his 2018 real estate taxes in 2018 and also makes a 2018 state estimated tax payment of \$1,500 in December 2017. Chase indicates that he plans to prepare his own 2017 tax return and will include the tax prepayments in his itemized deductions. However, he asks Ernie to prepare his 2018 tax returns. Ernie bills Chase \$100 for the meeting.

In February 2019, Chase and Ernie meet and Chase provides the following summary of tax payments made in 2018, along with the rest of his tax information.

	Year Paid	Amount
Illinois state income tax (2018 estimate)	2017	\$ 1,500
Illinois state income tax (balance due)	2018	1,000
Illinois state income tax (estimated tax payments)	2018	1,200
Illinois real estate taxes	2018	2,500
Real estate taxes paid on a vacation home in Italy	2018	3,800
Total 2018 tax payments		\$10,000

Ernie observes that Chase is fortunate that his \$10,000 total SALT deduction does not exceed the \$10,000 limit and assures Chase that he will take a \$10,000 SALT deduction on Chase's 2018 Schedule A.

Chase then inquires about Ernie's fees for this work. Ernie informs Chase that he is likely to have a \$5,000 federal tax refund and that his fee will be 50% of that. Chase is happy to learn about the refund but tells Ernie he thinks his fees are steep and he does not currently have the necessary cash available. Ernie tells Chase that he has the perfect solution. Ernie will indicate on the tax return that half the overpayment should be credited against Chase's 2019 estimated tax and the other half should be refunded to Ernie's bank account. Chase did not realize that this was possible. He agrees to Ernie's innovative solution. Later, Chase signs and files the 2018 tax returns that Ernie completes.

1. What ethical issues are raised by this scenario?

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## Scenario 6 Discussion

**Standards with Respect to Tax Returns.**<sup>67</sup> Practitioners cannot advise a client to take a position on a tax return that lacks a reasonable basis or is an unreasonable position. Furthermore, if the client's information appears to be incorrect, inconsistent with the facts, or incomplete the practitioner should make further inquiries.

Ernie encourages Chase to prepay as much of the deductible taxes as possible in December 2017 without asking for details of the tax payments that Chase was proposing to make. For example, the prepayment of income taxes is only deductible in 2017 if the taxes were assessed in 2017.<sup>68</sup> Additionally, tax year 2018 state income tax payments made in 2017 are only deductible in 2018.<sup>69</sup> Therefore, Ernie's general advice to Chase to prepay as much SALT as possible before the yearend lacks a reasonable basis.

**Diligence as to Accuracy.**<sup>70</sup> Once Ernie reviewed Chase's 2018 tax payments and saw that they totaled \$10,000, he took the full SALT deduction permitted by the law without further investigation. For example, Ernie did not review the 2017 tax return — in particular, Schedule A. Had he done so, he should have noticed the 2018 state estimated tax payment of \$1,500 in December 2017, which should not have been deducted in 2017.<sup>71</sup> In addition, Ernie should have advised Chase to file an amended 2017 return to remove the erroneous deduction of 2018 state income taxes.

**Competence.**<sup>72</sup> A practitioner must possess the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter in which they are engaged. Ernie rushed into reassuring Chase that he could fully utilize the \$10,000 available SALT deduction on Chase's 2018 tax return. While foreign real estate taxes were deductible for years up to 2017, Ernie failed to consider that the TCJA suspended this tax deduction for years 2018 through 2025.<sup>73</sup>

**Fees.** According to Circular 230, §10.27, a contingent fee includes a fee that is based on a percentage of the refund reported on a return, a percentage of tax savings, or the specific result attained. Such contingency fees are not permissible according to Circular 230. While this is the IRS's position, the U.S. District Court for the District of Columbia disagrees. In the 2014 case of *Ridgely v. Lew et al.*,<sup>74</sup> the court 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. In reviewing a statute enacted in 1884, which the IRS cited as its source of regulatory authority, the court observed that this statute provides the IRS with authority to regulate "representatives," not tax return preparers. Consequently, it is presently unclear whether the contingency fee arrangement used by Ernie is an ethics violation.

**Negotiation of Taxpayer Checks.**<sup>75</sup> A practitioner may not endorse or otherwise direct into their bank account any check (whether paper or electronic) issued to a client by the government for a federal tax liability.

Not only was the payment of part of Chase's tax refund into Ernie's bank account an ethics violation, it is subject to a \$520 penalty.<sup>76</sup>

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<sup>67</sup> Circular 230, §10.34.

<sup>68</sup> IRS News Rel. IR-2017-210 (Dec. 27, 2017).

<sup>69</sup> IRC §164(b)(6)(B).

<sup>70</sup> Circular 230, §10.22.

<sup>71</sup> IRC §164(b)(6)(B).

<sup>72</sup> Circular 230, §10.35.

<sup>73</sup> IRC §164(b)(6)(A).

<sup>74</sup> *Ridgely v. Lew*, No. 1:12-cv-00565 (DC Cir. Jul. 16, 2014).

<sup>75</sup> Circular 230, §10.31.

<sup>76</sup> IRC §6695(f); *Summary of Preparer Penalties under Title 26*. Apr. 27, 2018. IRS. [[www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26](http://www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26)] Accessed on May 8, 2018.

## SCENARIO 7: REASONABLE COMPENSATION

Mary Kounter, CPA, is the sole shareholder in Avantgarde, an S corporation that provides accounting and auditing services. In February 2018, Mary engages Tammy Underman, EA, to prepare her 2017 Form 1120S, *U.S. Income Tax Return for an S Corporation*, and her 2017 individual tax return. During the initial meeting, Tammy notes that Mary is the only employee of Avantgarde. In 2017, she had Form W-2 wages of \$50,000. According to its profit and loss statement, Avantgarde's 2017 net profit was \$250,000. Its balance sheet lists \$15,000 of fixed assets (equipment and furnishings) and \$5,000 of shareholder capital. Tammy mentions to Mary that her \$50,000 salary appears to be low. Mary responds that she has been doing her own taxes, paying herself a \$50,000 salary for several years, and does not see why she should change her salary.

Tammy agrees to prepare Mary's 2017 business and individual tax returns using the information provided, for a total fee of \$3,000. They agree to meet in two weeks, when Tammy will provide Mary with the completed tax returns. When this meeting occurs, Tammy is about to hand over the tax returns to Mary to sign when Mary mentions that she cannot pay Tammy her fee now because she has some cash-flow problems. Mary says she can give Tammy a post-dated check. Taken aback by this, Tammy informs Mary that she prefers to keep the tax returns until Mary is ready to make payment. Furious at this response, Mary declares that if Tammy does not hand over the tax returns now, she will make a formal complaint regarding Tammy's behavior to the IRS's Office of Professional Responsibility (OPR). Tammy holds firm to her position and Mary storms out of the office.

A couple of weeks later, Mary returns to Tammy's office with \$3,000 in cash and picks up her tax returns. While leaving the office, Mary informs Tammy that she will be hearing from the OPR.

1. What additional information does Tammy need to satisfy due diligence requirements?

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2. In what regard was Tammy's behavior ethically correct?

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## Scenario 7 Discussion

S corporations are required to pay reasonable compensation to a shareholder-employee in return for their services. This is required before any nonwage distributions are made to that shareholder-employee.<sup>77</sup> Generally, the three major sources of a company's gross receipts are:<sup>78</sup>

- Services of shareholders,
- Services of nonshareholder employees, and
- Capital and equipment.

When the business's profit is due to services of a shareholder-employee, most of that income should be allocated as compensation to that employee. By contrast, when the firm's income derives from the services of nonshareholder employees and/or capital and equipment, a profit distribution of this income is more easily justified.<sup>79</sup> There have been many court cases on the issue of reasonable compensation, including the IRS's authority to reclassify payments to a shareholder-employee as a wage expense subject to employment taxes.<sup>80</sup>

Because Mary is the sole shareholder and employee of Avantgarde and the corporation has only \$15,000 of fixed assets, this suggests that most of the corporation's profit should be allocated as compensation to Mary.

**Diligence as to Accuracy.**<sup>81</sup> Although Tammy comments on Mary's low salary allocation, she accepts Mary's response without further questioning. There are no precise rules for determining how much of a business's profit should be allocated to reasonable compensation. However, reviewing prior year tax returns would have revealed to Tammy the exact salary allocation in prior years and how this compared to 2017. It might also have revealed factors in prior years that justified a smaller allocation to reasonable compensation (e.g. nonshareholder employees). This information could have helped Tammy in recommending a more appropriate 2017 compensation amount resulting in a more accurate 2017 tax return.

**Best Practices for Tax Advisors.**<sup>82</sup> It is incumbent on Tammy to carry out the necessary research so that she relates the applicable law to the relevant facts and arrives at a conclusion supported by the law and the facts. There is a substantial body of case law on the issue of reasonable compensation.<sup>83</sup> Because this profit is mostly associated with Mary's services, Tammy could have discussed with Mary the need for a larger allocation to shareholder-employee compensation as well as the IRS's position on this issue, including their authority to reclassify profit as reasonable compensation.

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<sup>77</sup> *S Corporation Compensation and Medical Insurance Issues*. Feb. 17, 2018. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues](http://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues)] Accessed on Apr. 4, 2018.

<sup>78</sup> *Ibid.*

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid*; *Joly vs. Comm'r*, 211 F.3d 1269 (6th Cir. 2000).

<sup>81</sup> Circular 230, §10.22.

<sup>82</sup> Circular 230, §10.33(a)(2).

<sup>83</sup> See, e.g., *Joly v. Comm'r*, 211 F.3d 1269 (6th Cir. 2000) and *David E. Watson, PC v. U.S.*, 668 F.3d 1008 (8th Cir. 2012).

**Penalties.** The IRS can require taxpayers who fail to properly classify profit distributions to pay the payroll taxes due along with the IRC §6651(a)(2) late-payment penalty and further penalties of up to 15% of the tax due under IRC §6656.<sup>84</sup>

**Note.** In addition to taxpayer penalties, tax preparers may also be subject to penalties. Even when a tax preparer is actively working with their clients to remedy disproportionate compensation/profit distribution allocations, they can nevertheless be subject to preparer penalties, as a California CPA recently discovered.<sup>85</sup> In fact, a \$5,000 preparer penalty is assessable by the IRS when a tax understatement occurs due to willful or reckless conduct by the preparer.<sup>86</sup>

**Return of Client's Records.**<sup>87</sup> Generally, at the request of a client, a practitioner **must promptly return a client's records** that are necessary for the client to comply with their federal tax obligations. A practitioner is not relieved of this responsibility even when there is a dispute over fees. However, the term "client records" for this purpose **does not** include any return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the practitioner. Therefore, Tammy is entitled to withhold the prepared tax returns (but not source documents) from Mary until she fulfills her contractual obligation to pay the fees due.

**Caution.** Had Mary signed her electronic filing Form 8879, Tammy would **not** be able to hold Mary's copy for nonpayment.

**Office of Professional Responsibility (OPR).** The OPR derives its authority from 31 USC 330 and is responsible for applying the rules, regulations, ethical/conduct provisions, and disciplinary procedures to tax practitioners who are subject to Circular 230.<sup>88</sup> The procedures for making a formal complaint about a tax practitioner are available on the IRS's website.<sup>89</sup> In 2016, OPR closed 889 cases of alleged practitioner misconduct. Disciplinary or corrective actions applied in 42% (369) of these cases.<sup>90</sup>

Tammy withheld the unsigned completed tax returns from Mary until she received payment of her fee. Because this action is permitted by Circular 230, §10.28, Tammy can reasonably expect the complaint to not result in any disciplinary or corrective actions from the OPR.

<sup>84</sup> *Glass Blocks Unlimited v. Comm'r*, TC Memo 2013-180 (Aug. 7, 2013).

<sup>85</sup> *\$5,000 Preparer Penalty*. Salewski, Jack and Hamann, Paul S. Jan. 1, 2016. RC Reports. [rcreports.com/blog/5000-preparer-penalty/] Accessed on Apr. 4, 2017.

<sup>86</sup> IRC §6694(b).

<sup>87</sup> Circular 230, §10.28.

<sup>88</sup> *FY 2016 Accomplishment Report*. The Office of Professional Responsibility. [www.irs.gov/pub/irs-utl/oprs\_2016\_accomplishment\_report.pdf] Accessed on Apr. 12, 2018.

<sup>89</sup> *Make a Complaint About a Tax Return Preparer*. Apr. 12, 2018. IRS. [www.irs.gov/tax-professionals/make-a-complaint-about-a-tax-return-preparer] Accessed on May 1, 2018.

<sup>90</sup> *FY 2016 Accomplishment Report*. Feb. 2017. The Office of Professional Responsibility. [www.irs.gov/pub/irs-utl/oprs\_2016\_accomplishment\_report.pdf] Accessed on May 10, 2018.

## CLIENT DATA PROTECTION

The Gramm-Leach-Bliley Act (GLBA) contains **safeguards** and **privacy** rules that apply to customer information.<sup>91</sup> The Federal Trade Commission (FTC) has jurisdiction over financial institutions that handle such information. **Tax preparation firms** are considered financial institutions whose handling of customer information is subject to FTC oversight.<sup>92</sup>

A summary of the GLBA's safeguards and privacy rules follows.

**Note.** The IRS recently updated IRS Pub. 4557, *Safeguarding Taxpayer Data: A Guide for Your Business*, which includes information about complying with the FTC Safeguards Rule.

### Safeguards Rule

Custodians of customer information **must** develop, implement, and maintain a comprehensive **written** information security program.<sup>93</sup> The objectives of this program are to:<sup>94</sup>

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

This information security program must contain the following elements.<sup>95</sup>

- Designated staff to coordinate the program
- A risk assessment analysis
- Development of safeguards to control the risks identified
- Regular testing and monitoring of safeguards
- Training and management of employees handling customer information
- Adequate oversight of external service providers handling customer information
- Procedures for modification of the program in response to observed deficiencies, changes to business operations, or any other factors affecting information security

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<sup>91</sup> The Gramm-Leach-Bliley Act is also known as the Financial Services Modernization Act of 1999, PL 106-102 (Nov. 12, 1999).

<sup>92</sup> GLBA §505(a)(7); 16 CFR §313.1(b).

<sup>93</sup> 16 CFR §314.1.

<sup>94</sup> 16 CFR §314.3.

<sup>95</sup> 16 CFR §314.4.

## Privacy Rule<sup>96</sup>

Under this rule, financial institutions must inform their customers of their data privacy policies. In particular, such financial institutions must communicate the following information to their customers.

1. Data privacy policies and practices
2. Conditions that permit the institution to disclose consumers' personal data to nonaffiliated third parties
3. "Opt-out" procedures available to consumers to prevent the financial institution from disclosing customers' personal data to most nonaffiliated third parties

When an individual or organization becomes a client for tax preparation or consulting services, the tax practitioner must provide the client with an initial privacy notice. This notice must be clear, conspicuous, and accurately reflect the tax practitioner's data privacy policies and practices.<sup>97</sup> Subsequently, clients should receive periodic data privacy notices from their tax practitioner at least annually. Data privacy notices that tax practitioners provide clients must include the following information.<sup>98</sup>

- Categories of private data collected and disclosed
- Categories of parties to whom private data is disclosed
- Similar data and disclosure arrangements for private data of former clients
- Procedures for client opt-out of private data disclosure
- Policies and practices for protecting the confidentiality and security of clients' private data

## Model Privacy Form and Safe Harbor<sup>99</sup>

FTC-regulated entities (which includes tax preparers) may rely on the model privacy form as a safe harbor to comply with disclosure requirements. Tax preparers wishing to use the model privacy form must adhere to the instructions provided so that it can be relied upon as a safe harbor. A copy of this 2-page form follows.

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<sup>96</sup> 16 CFR §313. [[www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/financial-privacy-rule](http://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/financial-privacy-rule)] Accessed on Mar. 6, 2018.

<sup>97</sup> 16 CFR §313.4(a).

<sup>98</sup> 16 CFR §313.6.

<sup>99</sup> *Final Model Privacy Form Under the Gramm-Leach-Bliley Act*. FTC. [[www.ftc.gov/sites/default/files/documents/rules/privacy-consumer-financial-information-financial-privacy-rule/model\\_form\\_rule\\_a\\_small\\_entity\\_compliance\\_guide.pdf](http://www.ftc.gov/sites/default/files/documents/rules/privacy-consumer-financial-information-financial-privacy-rule/model_form_rule_a_small_entity_compliance_guide.pdf)] Accessed on Mar. 6, 2018.

# 2018 Workbook

Rev. [insert date]

<b>FACTS</b>		<b>WHAT DOES [NAME OF FINANCIAL INSTITUTION] DO WITH YOUR PERSONAL INFORMATION?</b>	
<b>Why?</b>	Financial companies choose how they share your personal information. Federal law gives consumers the right to limit some but not all sharing. Federal law also requires us to tell you how we collect, share, and protect your personal information. Please read this notice carefully to understand what we do.		
<b>What?</b>	The types of personal information we collect and share depend on the product or service you have with us. This information can include: <ul style="list-style-type: none"> <li>■ Social Security number and [income]</li> <li>■ [account balances] and [payment history]</li> <li>■ [credit history] and [credit scores]</li> </ul>		
<b>How?</b>	All financial companies need to share customers' personal information to run their everyday business. In the section below, we list the reasons financial companies can share their customers' personal information; the reasons [name of financial institution] chooses to share; and whether you can limit this sharing.		
	<b>Reasons we can share your personal information</b>	<b>Does [name of financial institution] share?</b>	<b>Can you limit this sharing?</b>
	<b>For our everyday business purposes—</b> such as to process your transactions, maintain your account(s), respond to court orders and legal investigations, or report to credit bureaus		
	<b>For our marketing purposes—</b> to offer our products and services to you		
	<b>For joint marketing with other financial companies</b>		
	<b>For our affiliates' everyday business purposes—</b> information about your transactions and experiences		
	<b>For our affiliates' everyday business purposes—</b> information about your creditworthiness		
	<b>For our affiliates to market to you</b>		
	<b>For nonaffiliates to market to you</b>		
<b>To limit our sharing</b>	<ul style="list-style-type: none"> <li>■ Call [phone number]—our menu will prompt you through your choice(s)</li> <li>■ Visit us online: [website] or</li> <li>■ Mail the form below</li> </ul> <p><b>Please note:</b></p> <p>If you are a <i>new</i> customer, we can begin sharing your information [30] days from the date we sent this notice. When you are <i>no longer</i> our customer, we continue to share your information as described in this notice.</p> <p>However, you can contact us at any time to limit our sharing.</p>		
<b>Questions?</b>	Call [phone number] or go to [website]		

*S.*

<b>Mail-in Form</b>										
<p><b>Leave Blank OR</b></p> <p>[If you have a joint account, your choice(s) will apply to everyone on your account unless you mark below.</p> <p><input type="checkbox"/> Apply my choices only to me]</p>	<p>Mark any/all you want to limit:</p> <p><input type="checkbox"/> Do not share information about my creditworthiness with your affiliates for their everyday business purposes.</p> <p><input type="checkbox"/> Do not allow your affiliates to use my personal information to market to me.</p> <p><input type="checkbox"/> Do not share my personal information with nonaffiliates to market their products and services to me.</p> <table border="1"> <tr> <td><b>Name</b></td> <td></td> <td rowspan="4"><b>Mail to:</b></td> </tr> <tr> <td><b>Address</b></td> <td></td> </tr> <tr> <td><b>City, State, Zip</b></td> <td></td> </tr> <tr> <td><b>[Account #]</b></td> <td></td> </tr> </table> <p>[Name of Financial Institution] [Address1] [Address2] [City], [ST] [ZIP]</p>	<b>Name</b>		<b>Mail to:</b>	<b>Address</b>		<b>City, State, Zip</b>		<b>[Account #]</b>	
<b>Name</b>		<b>Mail to:</b>								
<b>Address</b>										
<b>City, State, Zip</b>										
<b>[Account #]</b>										

Who we are	
Who is providing this notice?	[insert]
What we do	
How does [name of financial institution] protect my personal information?	To protect your personal information from unauthorized access and use, we use security measures that comply with federal law. These measures include computer safeguards and secured files and buildings.  [insert]
How does [name of financial institution] collect my personal information?	We collect your personal information, for example, when you <ul style="list-style-type: none"> <li>■ [open an account] or [deposit money]</li> <li>■ [pay your bills] or [apply for a loan]</li> <li>■ [use your credit or debit card]</li> </ul> [We also collect your personal information from other companies.] <b>OR</b> [We also collect your personal information from others, such as credit bureaus, affiliates, or other companies.]
Why can't I limit all sharing?	Federal law gives you the right to limit only <ul style="list-style-type: none"> <li>■ sharing for affiliates' everyday business purposes—information about your creditworthiness</li> <li>■ affiliates from using your information to market to you</li> <li>■ sharing for nonaffiliates to market to you</li> </ul> State laws and individual companies may give you additional rights to limit sharing. [See below for more on your rights under state law.]
What happens when I limit sharing for an account I hold jointly with someone else?	[Your choices will apply to everyone on your account.] <b>OR</b> [Your choices will apply to everyone on your account—unless you tell us otherwise.]
Definitions	
<b>Affiliates</b>	Companies related by common ownership or control. They can be financial and nonfinancial companies. <ul style="list-style-type: none"> <li>■ [affiliate information]</li> </ul>
<b>Nonaffiliates</b>	Companies not related by common ownership or control. They can be financial and nonfinancial companies. <ul style="list-style-type: none"> <li>■ [nonaffiliate information]</li> </ul>
<b>Joint marketing</b>	A formal agreement between nonaffiliated financial companies that together market financial products or services to you. <ul style="list-style-type: none"> <li>■ [joint marketing information]</li> </ul>
Other important information	
[insert other important information]	

## SCENARIO 8: GLBA SAFEGUARDS AND PRIVACY RULES

The following scenario concerns the FTC investigation and response of a consumer complaint regarding identity theft stemming from a tax preparation service's inadequate data protection policies.

Tax Butchers, LLC, (TB) is a statewide tax preparation franchise located in Illinois. Franchisees receive various resources from TB including tax preparation software and a cloud-based client data portal, which franchisees and their clients can access. The client portal allows clients to upload documents and other data required for preparation of their tax returns. Client data is stored in a cloud-based database. Franchisees also receive proprietary software, which allows them to access the client portal and to interface with their tax preparation software.

In order for clients of TB to create a user account for the client portal, they need a username and password. Their default username is their email address and their password must have no less than eight characters.

Milly Jones is a new client of TB. Milly has never created an online account before. She has heard that personal information stored online is easily stolen, so she is wary about creating such an account. However, when she discusses her reservations with Rocky Strawman, her local TB franchisee, Rocky reassures her that her data will be safe in the cloud. After all, explains Rocky, all data traffic with the client portal is encrypted and this ensures it is kept safe.

While surfing the dark web, Jack Krook sees an ad for an organization willing to pay top dollar for personal identity data, including name, address, social security number, date of birth, etc. Interestingly, this organization will add a bonus if this data is accompanied by reliable income and bank account data. Jack wonders where he could easily obtain such data and ultimately thinks of a tax preparation firm. Rather than a national firm with significant resources to spend on data protection, Jack seeks out a regional franchise that uses the cloud to store client data that may have poor safeguards. Jack comes up with a short list of potential candidates. For each candidate, Jack pretends to be a client until he can determine if they use cloud-based client portals. Finally, Jack hits gold with TB. Marveling at how easy it was, Jack sets up a fake client account. An expert hacker, Jack quickly establishes the application framework used by the data portal and acquires a set of access keys to enter the database and download client data. Jack then sells the stolen data for a tidy profit.

A few days later, Milly goes to her local supermarket. When she swipes her debit card to pay, she finds that the transaction is blocked. After a call to her bank, she discovers that she has been the victim of identity theft. The bank informs Milly that whoever did this had access to her personal and financial data. She immediately thinks of her online account with TB.

Surfing the Internet, Milly finds the FTC. The FTC website mentions that she can make a complaint if she believes that she has been an identity theft victim.<sup>100</sup>

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<sup>100</sup>. *Submit a Consumer Complaint to the FTC*. FTC. [[www.ftc.gov/faq/consumer-protection/submit-consumer-complaint-ftc](http://www.ftc.gov/faq/consumer-protection/submit-consumer-complaint-ftc)] Accessed on Mar. 5, 2018.

## FTC Investigation and Response to Consumer Complaint

Upon receipt of Milly’s complaint, the FTC launches an investigation of the business practices of TB.

At the completion of their investigation, the FTC establishes that TB was in violation of both the GLBA’s safeguards and privacy rules.<sup>101</sup>

**Safeguards Rule Violations.** Besides the absence of a written information security program, the FTC found that TB failed to do an internal/external risk assessment to identify reasonably foreseeable security threats and to implement information security safeguards that would help prevent a cyberattack. For example, 8-character passwords are weak and therefore easily broken. Furthermore, clients may have chosen commonly used passwords that a hacker could easily guess. Instead, clients should have been encouraged to pick much longer passwords and to combine upper/lower case letters, numbers, and other characters. Use of multi-factor authentication (discussed later) is also a good policy, which TB could have adopted to render impersonation of a legitimate user more difficult. Nevertheless, while these policies are good practice, they would have failed to prevent this attack.

The attack on the cloud-based client data portal succeeded because there were inadequate safeguards in place to protect the client data stored there. While traffic to and from the portal is encrypted, that alone was insufficient to prevent this attack (appropriate safeguards for this situation are detailed in the subsequent discussion of this scenario).

**Privacy Rule Violations.** There is no evidence that TB had any written policy regarding client data privacy. The practices that the firm had in place were rudimentary and insufficient to protect clients’ private data. The complainant received no written data privacy notices from TB as required by law.

**FTC Response.** The FTC has the power to prohibit TB from violating the privacy rule and the safeguards rule of the GLBA for 20 years and to require the firm to obtain biennial third-party assessments of its compliance with these rules for 10 years.<sup>102</sup> The financial cost to TB to comply with such a ruling may be onerous.

1. What measures could TB have taken to better protect their clients’ data?

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## Scenario 8 Discussion<sup>103</sup>

This scenario, while fictitious, shares some similarities with the facts in the 2017 FTC complaint against TaxSlayer, LLC. According to that complaint, malicious hackers gained full access to nearly 9,000 TaxSlayer accounts between October 2015 and December 2015. The hackers then used the information obtained to engage in tax identity theft, allowing them to obtain tax refunds by filing fraudulent tax returns. TaxSlayer’s policy of allowing clients to choose weak passwords exposed them to the risk that attackers could guess commonly used passwords to access their TaxSlayer accounts.

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<sup>101.</sup> 16 CFR 314; 16 CFR 313.

<sup>102.</sup> *Operator of Online Tax Preparation Service Agrees to Settle FTC Charges That it Violated Financial Privacy and Security Rules*. Aug. 29, 2017. FTC. [[www.ftc.gov/news-events/press-releases/2017/08/operator-online-tax-preparation-service-agrees-settle-ftc-charges](http://www.ftc.gov/news-events/press-releases/2017/08/operator-online-tax-preparation-service-agrees-settle-ftc-charges)] Accessed on Mar. 7, 2018.

<sup>103.</sup> *Ibid.*

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Besides recommending strong passwords, the FTC also recommended multi-factor authentication (MFA), which is a combination of physical, logical, and biometric validation techniques used to secure a data facility. Typically, MFA requires three different security mechanism layers and formats.<sup>104</sup> In practice, 2-factor authentication (2FA), a form of MFA, can be used to access secure data hosted on the Internet. For example, after inputting login credentials, the website sends a code to the user's mobile phone which the user must then input on the website to complete their authentication.<sup>105</sup> However, as previously stated, even a strong password and MFA would not have stopped Jack Krook in this scenario because he was able to establish the application framework used by the data portal and acquire a set of access keys to enter the database. There are several other data security practices that should be in place to stop such attacks, as discussed next.

In October 2017, the RedLock CSI Team published recommendations for securing data stored in a public cloud-computing environment.<sup>106</sup> These recommendations supplement FTC guidelines for complying with the safeguards rule.<sup>107</sup> Some important recommendations/guidelines when using cloud-based data portals are as follows.

- Encrypt database data, not just inbound/outbound communications
- Force periodic rotation of access keys
- Monitor access to user accounts to identify deviations from the norm
- Configure services to accept traffic from the Internet on an as-needed basis

Two additional safeguards to consider include limiting access keys to crucial software and promptly updating software hosting the cloud-based data portal as vulnerabilities are discovered. Had these safeguards been in place, then Jack would not have been able to access TB's cloud-based client data portal so easily.

How knowledgeable do tax practitioners need to be regarding safeguards for client data stored in the cloud? The simple answer is that tax practitioners are required to abide by the GLBA's safeguards rule. In doing so, they are **not** obliged to use cloud-based client data storage. However, those tax practitioners making this choice **must** ensure that this data is kept safe. Therefore, when tax practitioners rely on third parties to manage their client data, adequate supervisory arrangements must be in place.<sup>108</sup>

In summary, in order to be compliant with the GLBA, tax practitioners must take the following actions.

- Develop, implement, and maintain a comprehensive written information security program
- Communicate data privacy policies to clients
- Fortify the information security program in response to exposed vulnerabilities
- Ensure adequate oversight of staff and/or external contractors handling client information

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<sup>104</sup>. *Multi-Factor Authentication (MFA)*. 2018. Techopedia. [[www.techopedia.com/definition/13657/multi-factor-authentication-mfa](http://www.techopedia.com/definition/13657/multi-factor-authentication-mfa)] Accessed on Mar. 7, 2018.

<sup>105</sup>. *Two-Factor Authentication: Who Has It and How to Set It Up*. Griffith, Eric. Feb. 16, 2018. PCMag. [[www.pcmag.com/feature/358289/two-factor-authentication-who-has-it-and-how-to-set-it-up](http://www.pcmag.com/feature/358289/two-factor-authentication-who-has-it-and-how-to-set-it-up)] Accessed on Mar. 7, 2018.

<sup>106</sup>. *Cloud Security Trends + 17 Tips to Fortify Your Public Cloud Computing Environment*. RedLock CSI Team. Oct. 2017. RedLock. [[info.redlock.io/cloud-security-trends-oct2017](http://info.redlock.io/cloud-security-trends-oct2017)] Accessed on Mar. 7, 2018.

<sup>107</sup>. See *Financial Institutions and Customer Information: Complying with the Safeguards Rule*. Apr. 2006. FTC. [[www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying](http://www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying)] Accessed on May 8, 2018.

<sup>108</sup>. 16 CFR §314.4(d).

## APPENDIX

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.

### §10.8 Return preparation and application of rules to other individuals.

- a. *Preparing all or substantially all of a tax return.* Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund must have a preparer tax identification number. Except as otherwise prescribed in forms, instructions, or other appropriate guidance, an individual must be an attorney, certified public accountant, enrolled agent, or registered tax return preparer to obtain a preparer tax identification number. Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C.
- b. *Preparing a tax return and furnishing information.* Any individual may for compensation prepare or assist with the preparation of a tax return or claim for refund (provided the individual prepares less than substantially all of the tax return or claim for refund), appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.
- c. *Application of rules to other individuals.* Any individual who for compensation prepares, or assists in the preparation of, all or a substantial portion of a document pertaining to any taxpayer's tax liability for submission to the Internal Revenue Service is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C. Unless otherwise a practitioner, however, an individual may not for compensation prepare, or assist in the preparation of, all or substantially all of a tax return or claim for refund, or sign tax returns and claims for refund. For purposes of this paragraph, an individual described in 26 CFR 301.7701-15(f) is not treated as having prepared all or a substantial portion of the document by reason of such assistance.
- d. *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.

## §10.28 Return of client's records.

- a. In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.
- b. For purposes of this section — Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

## §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.

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- 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.

## **§10.31 Negotiation of taxpayer checks.**

- a.** A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability.
- b.** Effective/applicability date. This section is applicable beginning June 12, 2014.

## §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).

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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.

## §10.50 Sanctions.

- a. *Authority to censure, suspend, or disbar.* The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may censure, suspend, or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable (within the meaning of §10.51), fails to comply with any regulation in this part (under the prohibited conduct standards of §10.52), or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.
- b. *Authority to disqualify.* The Secretary of the Treasury, or delegate, after due notice and opportunity for hearing, may disqualify any appraiser for a violation of these rules as applicable to appraisers.
  1. If any appraiser is disqualified pursuant to this subpart C, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Internal Revenue Service pursuant to §10.81, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of disqualification.
  2. Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. An appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.
- c. *Authority to impose monetary penalty —*
  1. *In general.*
    - i. The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may impose a monetary penalty on any practitioner who engages in conduct subject to sanction under paragraph (a) of this section.
    - ii. If the practitioner described in paragraph (c)(1)(i) of this section was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to the penalty, the Secretary of the Treasury, or delegate, may impose a monetary penalty on the employer, firm, or entity if it knew, or reasonably should have known of such conduct.
  2. *Amount of penalty.* The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty.
  3. *Coordination with other sanctions.* Subject to paragraph (c)(2) of this section —
    - i. Any monetary penalty imposed on a practitioner under this paragraph (c) may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity under paragraph (c)(1)(ii) of this section.
    - ii. Any monetary penalty imposed on an employer, firm or other entity may be in addition to or in lieu of penalties imposed under paragraph (c) (1)(i) of this section.
- d. *Authority to accept a practitioner's consent to sanction.* The Internal Revenue Service may accept a practitioner's offer of consent to be sanctioned under §10.50 in lieu of instituting or continuing a proceeding under §10.60(a).
- e. *Sanctions to be imposed.* The sanctions imposed by this section shall take into account all relevant facts and circumstances.
- f. *Effective/applicability date.* This section is applicable to conduct occurring on or after August 2, 2011, except that paragraphs (a), (b)(2), and (e) apply to conduct occurring on or after September 26, 2007, and paragraph (c) applies to prohibited conduct that occurs after October 22, 2004.

## §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.

# 2018 Workbook