IRS Nationwide Tax Forum 2020

# Diligence in Practice Before the IRS

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## Record-Keeping

# Learning Objectives

Important goals and take-aways of the presentation:

- Due diligence in practice before the IRS requirements under Circular 230 and the Internal Revenue Code (IRC);
- Practitioner duty of due diligence in record-keeping;
- Best practices to ensure accurate and complete information is received from your clients;
- Meeting your due diligence requirement when dealing with missing client records and using estimates; and
- Best practices for keeping records safe and secure.

# Office of Professional Responsibility (OPR)

- Administers the laws and regulations governing the practice of tax professionals before the IRS;
  - 31 USC § 330 (1884)
  - Circular 230 (Rev. 6/2014)
- Investigates allegations of misconduct by practitioners in their practice before the IRS and impose disciplinary sanctions if warranted; and
- Supports the IRS's strategy to enhance enforcement of the Internal Revenue Code by ensuring that tax practitioners adhere to professional standards and follow the law.

# Definition

*due dil-i-gence*

*— reasonable steps taken by a person in order to satisfy a legal requirement*

# Due Diligence – Circular 230

Section 10.22(a), Diligence as to accuracy

- A practitioner must exercise due diligence –
  - In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters;
  - In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
  - In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS.

# Due Diligence – Circular 230 (Cont.)

Section 10.34(d), Relying on information furnished by clients

- A practitioner:
  - Generally may rely in good faith without verification upon information furnished by the client.
  - Can not ignore the implications of information furnished to or actually known by the practitioner.
  - Must make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent with other facts or assumptions.
    - Willful blindness violates a practitioner's due diligence duties under Circular 230.

# Due Diligence – Internal Revenue Code

Title 26 (IRC) provisions regarding record retention and production:

- Broad requirements of record retention and production on a taxpayer and, by extension, on a practitioner representing the taxpayer before the IRS (IRC § 6001, Treas. Reg. § 1.6001-1).
- IRS has authority to examine and to request documents, records, and other information from a taxpayer or representative (IRC §§ 7602, 7603, 7605).

# Due Diligence – Internal Revenue Code (Cont.)

Besides the general record-keeping responsibilities under the Code, certain provisions have specific record-keeping responsibilities. For example:

- IRC § 162: Allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.
- IRC § 274: Imparts strict record-keeping requirements for expenditures for travel, entertainment, gifts, and specific "listed property."

# Practitioner & Taxpayer Due Diligence

# Practitioner Due Diligence

- Tax practitioners who practice before the IRS have a dual responsibility with the IRS to ensure the fair and correct administration of the tax laws.
- Practitioners must exercise due diligence when preparing or approving for submission to the IRS, or filing anything that relates to an IRS matter -- returns, tax forms, documents, affidavits, protests, etc.

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# Practitioner Due Diligence (Cont.)

To ensure accurate and complete information is received from your clients, these best practices should be followed:

- Use an engagement agreement with provisions that set forth the mutual responsibilities of the client and tax practitioner.
- Obtain copies of a new client's prior years IRS-filed tax returns -- at a minimum, obtain the most recent IRS-filed tax return, if possible.
- Tailored client tax information organizers are a valuable tax return information collection tool.
  - General or off-the-shelf tax information organizers not tailored to specific client's tax situation can lead to incorrect or incomplete information gathering.

# Practitioner Due Diligence (Cont.)

To ensure accurate and complete information is received from your clients, these best practices should be followed (Cont.):

- Ask questions of the client.
- Make reasonable inquiries if the information you're being given appears to be incorrect or inconsistent or incomplete.
- Contemporaneously document questions and taxpayer responses.
- Confirm that the taxpayer has maintained appropriate books and records or substantiation to support deductions or tax treatments.
- Obtain appropriate and sufficient information to determine the correct reporting of items on the return (e.g., income, deductions, credits, etc.) and compliance with the tax laws.

# Practitioner Due Diligence (Cont.)

- Practitioners must meet specific due diligence requirements regarding determining a taxpayer's eligibility for, and the amount of, tax credits, and filing status.
  - Earned Income Credit (EIC)
  - Child Tax Credit (CTC)
  - Additional Child Tax Credit (ACTC)
  - Credit for other dependents (ODC)
  - American Opportunity Tax Credit (AOTC)
  - Head of Household (HOH) filing status

# Taxpayer Due Diligence

- Pursuant to Treasury Regulation § 1.6001-1, in filing tax returns or other documents with the IRS, taxpayers must keep and maintain books and records that will substantiate the accuracy of their filed documents.
  - Maintain all supporting documents!
    - Err on the side of over substantiating!
- A failure to adhere to this duty can result in the loss of favorable tax treatment, disallowance of deductions, tax deficiencies, and, often, penalties.

# Taxpayer Due Diligence (Cont.)

- Business records are needed to:
  - Identify gross receipts and source of receipts
  - Track inventory
  - Substantiate expenses, including travel, transportation, entertainment, and gifts
  - Establish basis, placed into service, class life and depreciation of property
  - Determine gain/loss, character, and recapture
  - Authenticate non-taxability of a transfer or transaction (351, like-kind exchange)
- Personal records are needed to:
  - Establish the basis of an asset or interest
  - Determine gain/loss and holding periods
  - Define the character of an asset (business vs. personal)
  - Value charitable contributions
  - Substantiate non-taxability of a transfer or transaction (e.g., gift, inheritance, division of assets pursuant to a separation or divorce)

# Taxpayer Due Diligence (Cont.)

- A taxpayer should maintain records suited to their respective business that clearly shows income and expenses.
  - Use an accounting method that clearly shows income.
  - Use a complete and separate set of records for each business.
  - Summary of business transactions.
  - Gross income, deductions, and credits.

# Record Retention Due Diligence

How long to keep records:

- Generally, keep records supporting an item of income or deduction on a return until the period of limitations for that particular return expires.
  - Period of limitations is the time in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax.
- For employment taxes, keep all employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later.

# Record Retention Due Diligence (Cont.)

How long to keep records (cont.):

- Keep records relating to property until the period of limitations expires for the year in which the property is disposed of in a taxable disposition.
  - To figure any depreciation, amortization, or depletion deductions, and the basis for computing gain or loss when the property is sold or otherwise disposed of.
- Be mindful of record-keeping retention timeframes for nontax purpose, which may or may not coincide with tax retention periods (e.g., legal obligations, insurance-related intents, creditor purposes, etc.)

# Due Diligence when Missing Records

# Client Missing Records

Clients may not have pertinent tax records for a variety of reasons:

- Poor record-keeping or misunderstanding regarding what records are necessary
- Computer or network failures
- Accidental destruction of records
- Sale of a business
- Abrupt change of leadership or accounting personnel
- Divorce and other separations
- Mental incapacity or death

# Due Diligence in Making Estimates

- When common sense dictates the taxpayer had some expense (or credit), but strict compliance with documentation standards may not be possible, estimates *may be used*.
  - Practitioner's due diligence obligations require the preparer to have a *reasonable basis* for the estimate.
- Practitioners must use their professional judgment as to when, if ever, estimates may be relied upon in an original return for reporting purposes and what, if any, added disclosures are necessary.

# "Reasonable Basis"

- A record reconstruction through other documentation can be a *reasonable basis* to support a reasonable estimate of the taxpayer's income or expense.
  – "Reasonable basis" means there is a greater than 25% possibility of success the position taken on the return would be sustained if challenged; AND
  – The position on the return is disclosed.
    - A preparer should consider disclosing the use of an estimate on a return by filing a Form 8275, *Disclosure Statement*.

# Due Diligence in Reconstructing Records

- If it is necessary to reconstruct records for a client:
  - Determine precisely what has been lost;
  - Determine if it is the only copy of an item;
  - For those items that are the only copy, rank the relative importance of the lost items, starting with those of highest importance; and
  - List items that warrant the time and expense of reconstruction.
- The reconstruction will demonstrate that the tax professional exercised due diligence and (hopefully) educate the client on proper record-keeping.

# Due Diligence in Reconstructing Records (Cont.)

A record reconstruction can be through:

- Calendars and appointment books
- Client lists
- Social media postings
- Government and industry standards
- Financial records (e.g., bank and credit card statements)
- Prior year tax records (including sales tax), returns and transcripts
- Online mapping programs
- Phone records and computer logs
- Public records
- Third-party records and affidavits

# Penalties and Sanctions

- Maintaining a record by the preparer regarding how the estimate was determined is critical to substantiate the position on the return and as a defense to penalties and sanctions.
- Practitioners can face sanctions and penalties for improperly using estimates.
  - Penalties: §§ 6694, 6695, 7407
  - Sanctions: disbarment, censure, suspension, monetary penalties (§10.50)

# Penalties and Sanctions (Cont.)

Best practices to avoid penalties when using estimates:

- Document advice to the client in writing.
- Establish a system of checklists for advice, and use it.
- Think "substantial authority" or "reasonable basis" with disclosure (i.e., Form 8275).
- Don't take unnecessary risks or be cute; the loss of your livelihood and damage to your reputation and integrity is not worth it.

# Due Diligence in Protecting Records

# Protecting Client Records

Tax professionals:

- Must take appropriate steps to protect their clients' data.
- Should use IRS Publication 4557, *Safeguarding Taxpayer Data, and Small Business Information Security*, as a guide for reviewing security measures and for creating or updating a security plan.
- Ought to create an action plan to outline the steps to take in the event of data theft (saves valuable time should the worst happen).

# Protecting Client Records (Cont.)

Suggested best practices for keeping records safe and secure:

- Secure physical client files, records, and work papers in the office.
- Safely secure client files in workspaces/desks, especially when meeting with clients.
- Have employee training programs and written office procedures on records management, and implement and adhere to these policies.
- Create a Due Diligence checklist policy.
- Carry adequate professional liability insurance to include Internet/cyber coverage.

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# Security Software

- It is critical that tax professionals assess their current software security and address any weaknesses.
- Install anti-malware/anti-virus security software on all devices (i.e., laptops, desktops, routers, tablets, and phones) and keep software set to update automatically.
- Use robust security software for all computers and devices, and routinely perform deep scans often to identify any malware/virus infections.

# Passwords

- Use strong passwords that include special and alphanumeric characters or phrases to access computers, routers, tablets, phones, etc.
- Use different passwords for each account.
- Password protect all computers and wireless devices.
- Consider a password manager program.

# Phishing

- Learn to recognize phishing emails, especially those pretending to be from the IRS, e-Services, a tax software provider, or cloud storage provider.
- Never open an embedded link or any attachment from a suspicious email.

# Internal Controls

- Limit access to taxpayer data to individuals who need to know.
- Encrypt all sensitive files, emails, and attachments to emails.
- Back-up sensitive data to a safe and secure external source not connected full-time to a network.
- Wipe clean or destroy old computer hard drives, printers, copiers, and fax machines.
- Check IRS e-Services account weekly for the number of returns filed with EFIN.
- Report any data theft or data loss to the appropriate IRS Stakeholder Liaison.
- Stay connected on the latest news and update through subscriptions to the IRS's e-News for Tax Professionals, QuickAlerts, and social media.

# CONTACT INFORMATION & RESOURCES

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# Contacting OPR

- Questions? Contact OPR at:
  - Efax: (855) 814-1722
  - Office of Professional Responsibility
    1111 Constitution Ave., NW
    SE:OPR Rm. 7238
    Washington, DC 20224
- For more info on OPR and Circular 230 visit http://www.irs.gov/
  Search: "Circular 230 Tax Professionals"

# Resources and Guidance

- IRS Pub. 334, *Tax Guide for Small Business*
- IRS Pub. 463, *Travel, Gift and Car Expenses*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 583, *Starting a Business and Keeping Records*
- IRS Pub. 4557, *Safeguarding Taxpayer Data: A Guide for Your Business*

# Resources and Guidance (Cont.)

- Rev. Proc. 92-71, 1992-2 C.B. 437, 1992-35 I.R.B. 17 (July 1, 1992)
- IRS Form 8275, *Disclosure Statement*
- IRS Form 8867, *Paid Preparer's Due Diligence Checklist*
- Treasury Department Circular No. 230 (Rev. 6-2014)
- The OPR Website
- News & Updates from the Office of Professional Responsibility