Exploring the Implications of Questions on Tax Returns
(An Ethics Case Study)

American Institute of Certified Public Accountants

http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/STANDARDSETICS/Pages/default.aspx
Today’s Agenda

• Types of questions
• Ethical requirements overview
• 2 case studies
• Lessons learned
• Tax practice quality control
• Wrap-up and take aways

Please ask questions as we go!
Two Types of Questions

Type #1
What types of questions do you need to ask your clients when gathering information to prepare the return?

Type #2
What do you need to do when completing the questions on tax forms as part of the return preparation process?
Ethical Requirements

- Internal Revenue Code
- Circular 230
- Applicable state laws, regulations
- Other Professional Standards
  - AICPA’s Statements on Standards for Tax Services
  - NAEA’s Code of Ethics & Rules of Professional Conduct

See Resource Appendix for full list of AICPA & NAEA standards.
Examples of Ethical Requirements

- Tax return reporting standard
- Confidentiality of client information
- Conflicts of interest
- Due diligence
- Knowledge of client’s error
- Contingent fees
- Written tax advice
Case #1: The Trucker

The Facts:

- Long-haul driver with significant overnight travel & meals, which are not subject to the 50% M&E limitation
- Practitioner combined all M&E and reported it as a single amount
- Client had not filed for 4 years
- All 4 returns prepared as one engagement
- Client filed all returns simultaneously
The Outcome

- IRS examined returns because meals did not appear to be subject to the 50% limitation
- Examiner assessed a 6694(b) penalty
  - Understatement due to willful or reckless conduct
  - Penalty is greater of $5,000 or 50% of income derived
- 6694(b) results in automatic OPR referral

*See Resource Appendix for full text of IRC 6694(b).*
The Implications

Questions to consider include:

• Did practitioner ask for M&E details?
• What due diligence did practitioner go through?
• Is there a similar pattern with other clients?
• What is the practitioner’s return review process?

Do you have any other concerns?
Relevant Guidance: *Why* you need to ask

- Circular 230 § 10.22, Diligence as to accuracy
- AICPA’s SSTS No. 3, Certain Procedural Aspects of Preparing Returns
- NAEA Code of Ethics #7

*See Resource Appendix for more information on cited resources.*
Case #2: The Nurse

The Facts

- Client was a full time nurse who regularly worked substantial overtime
- She lived in California and owned two rental properties in Florida
- She claimed to be a real estate professional which allowed her to:
  - Group properties into a single activity
  - Deduct rental losses
The Outcome

- IRS examined returns and disallowed the rental losses
- Client logs were deemed unreliable
- Practitioner should have inquired further because
  - Nursing income was 1.5x her salary due to additional overtime earnings
  - Hours devoted to rental seemed improbable
- 6694(b) penalty assessed with a referral to OPR
The Implications

Questions to consider include:

• Did practitioner review the documentation *before* taking the position?
• How far should practitioner dig?
• What are the practitioner’s quality control procedures?

Do you have any other concerns?
Relevant Guidance: Why you need to know

- Circular 230
  - Competency requirement (proposed)
  - §10.37 Requirements for other written advice
- AICPA’s SSTSS
  - No. 1, Tax Return Positions
  - No. 2, Answers to Questions on Returns
- NAEA Code of Ethics #3

See Resource Appendix for more information on cited resources.
Lessons Learned

• Both types of questions are important
• All questions are not of uniform importance
• Implications of questions vary widely
• 6694(b) penalties result in automatic referrals to OPR, which will lead to:
  – Questions about preparer due diligence
  – Questions about quality control

Can you think of other forms or situations may where these issues might arise?
Other Situations: Question on Forms

At any time during 2013, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions.

If “Yes,” are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), formerly TD F 90-22.1, to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements.

If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located.

During 2013, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If “Yes,” you may have to file Form 3520. See instructions on back.
Other Situations: Question on Forms

<table>
<thead>
<tr>
<th>Part</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on.</td>
</tr>
</tbody>
</table>
Other Situations: Question on Forms

**Part I** Income or Loss From Rental Real Estate and Royalties

Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

A. Did you make any payments in 2013 that would require you to file Form(s) 1099? (see instructions)

B. If “Yes,” did you or will you file required Forms 1099?

1a. Physical address of each property (street, city, state, ZIP code)

**Part II** Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See instructions.

27. Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section.

28.

(a) Name

(b) Enter “P” for partnership; “S” for S corporation

(c) Check if foreign partnership

(d) Employer identification number

(e) Check if any amount is not at risk
Other Situations: Question on Forms
Other Situations:
Questions to the client
Other Situations:
Questions to the client

Form 1099-C
Cancellation of Debt

- Date of identifiable event
- Amount of debt discharged
- Interest if included in box 2
- Creditor's name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.
- Debtor's identification number
- Debtor's name
- Street address (including apt. no.)
- City or town, state or province, country, and ZIP or foreign postal code
- Account number (see instructions)
- Identifiable event code
- Fair market value of property

File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2014 General Instructions for Certain Information Returns.
Other Situations:

Questions to the client

<table>
<thead>
<tr>
<th>Form 8941</th>
<th>Credit for Small Employer Health Insurance Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>Caution:</td>
<td>See the instructions and complete Worksheets 1 through 7 as needed.</td>
</tr>
<tr>
<td>1a</td>
<td>Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (total from Worksheet 1, column (a)).</td>
</tr>
<tr>
<td>b</td>
<td>Enter the employer identification number (EIN) used to report employment taxes for individuals included on line 1a if different from the identifying number listed above.</td>
</tr>
<tr>
<td>2</td>
<td>Enter the number of full-time equivalent employees (FTEs) you had for the tax year (from Worksheet 2, line 3). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12.</td>
</tr>
<tr>
<td>3</td>
<td>Average annual wages you paid for the tax year (from Worksheet 3, line 3). If you entered $50,000 or more, skip lines 4 through 11 and enter -0- on line 12.</td>
</tr>
<tr>
<td>4</td>
<td>Premiums you paid during the tax year for employees included on line 1a for health insurance.</td>
</tr>
</tbody>
</table>
Quality Control System

- Defines processes and standards
  - Tax practice documents (e.g., checklists)
  - Use of engagement letters
- New client acceptance process
  - Evaluate prospective clients
  - Assess if firm has appropriate capabilities and resources
- Set and communicate expectations to clients
Quality Control System

- Engagement performance
  - Preparation process & review procedures
  - Due date tracking & reporting
- Documentation standards
  - Capture client representations
  - Documentation of oral advice
- Procedures to resolve differences of opinion
- Establish client termination process
Putting It All Together

Independent Judgment

Advocate for the Client

Know when to say no!
Know when to walk away!
Thank you!
These slides have been included as supplemental information only. Speakers may reference information contained in this Appendix, but these slides will not be included in the live presentation. The Appendix includes a list of additional resources, hyperlinks and other information.
Select Circular 230 Provisions

§ 10.20 Information to be furnished
§ 10.21 Knowledge of client’s omission
§ 10.22 Diligence as to accuracy
§ 10.28 Return of client’s records
§ 10.29 Conflicting interests
§ 10.33 Best practices for tax advisors
§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers
§ 10.36 Procedures to ensure compliance
§ 10.37 Requirements for other written advice

Proposed (9/17/12) New § 10.35 General Standard of Competence
AICPA Statements on Standards for Tax Services

- SSTS No. 1, Tax Return Positions
- SSTS No. 2, Answers to Questions on Returns
- SSTS No. 3, Certain Procedural Aspects of Preparing Returns
- SSTS No. 4, Use of Estimates
- SSTS No. 5, Departure From a Position Previously Concluded
- SSTS No. 6, Knowledge of Error: Return Preparation and Administrative Proceedings
- SSTS No. 7, Form and Content of Advice to Taxpayers
1. Members and Associates will, in personal and public life, strive to enhance the status of Enrolled Agents and promote their qualifications to serve the public.

2. Members and Associates will demonstrate honesty, integrity and objectivity in all of their professional actions and relationships.

3. Members and Associates will continually strive to improve upon their competence to practice by keeping informed and educated about tax practice and representation.

4. Members and Associates will maintain the confidentiality of professional relationships.
5. Members and Associates will support efforts to advance the reputation and prestige of the EA license.

6. Members and Associates will be compliant with the most current provisions of Treasury Department Circular 230 and the NAEA Rules of Professional Conduct.

7. Members and Associates will not knowingly misrepresent or omit information in preparing or in approving and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters. If a client insists on the misrepresentation or omission, the Member or Associate should withdraw and refuse to prepare the return or other document.
Hyperlinks

• Circular 230:

• AICPA Statements on Standards for Tax Services:

• AICPA Code of Conduct:
  – http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx

• NAEA Code of Ethics and Rules of Professional Conduct:
  – http://portal.naeacentral.org/MemberPortal/About/Governance/Ethics_and_Professional_Conduct.htm
§ 6694(b) – Understatement due to willful or reckless conduct

(1) In general, any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a conduct described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of—

(A) $5,000, or

(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.
§ 6694(b), continued

(2) Conduct described in this paragraph is conduct by the tax return preparer which is—
   (A) a willful attempt in any manner to understate the liability for tax on the return or claim, or
   (B) a reckless or intentional disregard of rules or regulations.

(3) The amount of any penalty payable by any person by reason of this subsection for any return or claim for refund shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).
(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.
§ 10.22 – Due Diligence, continued

(b) *Reliance on others.* Except as provided in §§ 10.34, 10.35 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.
Circular 230 Proposed Competency Requirement

• Proposed new § 10.35, General Standard of Competence on 9/17/12
• Practitioners must exercise competence when engaged in practice before the IRS
• This means you have all of the following:
  – Knowledge
  – Skill
  – Experience
• You can hire or partner with others
(a) **Requirements.** A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues **if the practitioner** bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), **unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person,** **does not consider all relevant facts that the practitioner knows or should know,** or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved...
§ 10.37 – Requirements for other written advice, continued

…through settlement if raised. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining whether a practitioner has failed to comply with this section. In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment…
plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner’s lack of knowledge of the taxpayer’s particular circumstances.
AICPA SSTS No. 1
Tax Return Positions

• A tax return position is:
  – A position reflected on a tax return on which a member has specifically advised a taxpayer
  – A position about which a member has knowledge of all material facts and, on the basis of those facts, has concluded whether the position is appropriate

• Must advise client of disclosure responsibilities and potential penalties

• Must have a good-faith belief that position has a realistic possibility of being sustained if challenged
AICPA SST No. 2
Answers to Questions on Returns

- Must make a reasonable effort to obtain information to answer all questions
- All questions are not equal
- Recognizes that some questions may not apply to a particular taxpayer
- Specifically addresses standards for signing a return with *unanswered* questions
SSTS No. 2 – Question Types

Three considerations to consider:

a) A question may be of importance in determining taxable income or loss, or the tax liability shown on the return, in which circumstance an omission may detract from the quality of the return.

b) A request for information may require a disclosure necessary for a complete return or to avoid penalties.

c) A member often must sign a preparer’s declaration stating that the return is true, correct, and complete.
SSTS No. 2 – Omitting Answers

Reasonable grounds for omission may exist:

a) The information is not readily available and the answer is not significant in terms of taxable income or loss, or the tax liability shown on the return

b) Genuine uncertainty exists regarding the meaning of the question in relation to the particular return

c) The answer to the question is voluminous; in such cases, a statement should be made on the return that the data will be supplied upon examination
SSTS No. 2 – Implication of Omissions

• May not omit an answer just because it might prove disadvantageous to a taxpayer
• Need to consider whether the omission may cause the return to be deemed incomplete or result in penalties
• If reasonable grounds exist to omit an answer, an explanation of the reason for the omission is not required
AICPA SSTS No. 3
Certain Procedural Aspects of Preparing Returns

• Discusses standards for examining or verifying documents and to consider information

• Practitioner may rely on 3rd party information
  – Cannot ignore implications of information furnished
  – Must inquire if information is incorrect, incomplete or inconsistent with other known facts

• Must inquire if client can meet documentation and substantiation requirements (e.g., contributions)

• Must resolve all concerns or questions
Tax Practice Quality Control System - Defined

- Purpose is to provide reasonable assurance of compliance with applicable statutory, regulatory, and professional requirements
- Consists of organizational structure, policies and procedures
- Evidenced by Tax Practice Quality Control document
Elements of a Quality Control System

• Leadership responsibilities
• Ethical requirements
• Acceptance of client relationships
• Human resources function
• Engagement performance
• Monitoring of QC system
Factors that Influence Quality Control System

- Size of practice
- Number of offices
- Degree of authority granted
- Knowledge and experience
- Nature of practice
- Specialties
- Cost-benefit considerations
Tax Procedures Manual

- Manual contents - checklists, tax return review procedures, tracking procedures, etc.
- Promotes quality products and services
- Builds consistency
- Streamlines the administrative aspects of practice