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Emerging Issues in Tax Practice Due Diligence

Circular 230 Provisions

- Due Diligence as to Accuracy (10.22)
- Due Diligence Standards for Returns and Other Submissions (10.34)
- Competence (10.35)
- Due Diligence for Written Advice (10.37)





Diligence as to Accuracy §10.22

- Must exercise Due Diligence in:
 - Preparing, approving and filing tax returns, documents, affidavits, etc. relating to IRS matters.
 - Determining correctness of oral/written representations made to the client or to Treasury personnel.
- Reliance on Another's Work Product? Only With Reasonable Care.





Due Diligence for Tax Returns

§ 10.34(a)

- May not sign a tax return with a position or advise a position on a tax return, if:
 - Lacks reasonable basis
 - Unreasonable position (6694(a)(2))
 - Willful attempt to understate liability (6694(b)(2)(A))
 - Reckless, intentional disregard of rules and regulations (6694(b)(2)(B))
- Patterns matter





Due Diligence for Documents and Other Papers §10.34(b)

- May not advise Positions that are Frivolous in submissions.
- May not advise Submissions:
 - To delay or impede tax administration
 - That are frivolous
 - Containing or omitting information that demonstrates an intentional disregard of rules or regulations





Disclosure Requirement

§ 10.34(c)

- Advised position?
- Prepared or signed return?
- Submitting docs/other papers to IRS?
- Then-
 - Must Advise Client of Potential Penalties and Avoidance through Disclosure





Reliance on Client §10.34(d)

- Reliance on Client Information in good faith, without verification, is OK, but...
 - Cannot ignore implications of other information furnished
 - Cannot ignore actual knowledge
 - Must make reasonable inquiries for apparently incorrect, inconsistent or incomplete information
- No Willful Blindness





Competence §10.35

- A practitioner must possess the necessary competence to practice before the IRS
- Requires
 - Knowledge
 - Skill
 - Thoroughness
 - Preparation
- You must know when you are NOT competent





Due Diligence for Written Advice

§10.37

- Reasonable factual and legal assumptions
- Reasonably consider all relevant facts
- Reasonable efforts to identify and ascertain the relevant facts
- No unreasonable reliance on representations, statements, findings, or agreements = know or should know based on incorrect, incomplete, inconsistent representation/assumption



§10.37 (continued)

- Apply applicable law to relevant facts
- No audit lottery positions or advice
- Reliance on advice of another? OK, if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances
 - Reliance = unreasonable, if other advisor
 - Is not reliable
 - Is incompetent
 - Has a conflict of interest (10.29)
- Applies to All “Federal tax matters”





APPENDIX

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Rental Real Estate

- A 2008 General Accounting Office Audit Report indicated that at least 53% of individuals (approximately 5 million taxpayers) who reported income from rental properties in tax year 2001 misreported that income.
- Common Errors:
 - Misreported expenses
 - Miscalculated depreciation
 - Not filing all required tax forms





Rental Real Estate (cont.)

- Important to know what qualifies as rental property under IRC § 469
 - Must be “tangible property”
 - Held for use by customers (i.e., not family, clients or personal use)
 - Minimal rental period of more than 7 days (i.e., it is not a temporary or transient accommodation)
 - The expected gross income is derived from rental activity (i.e., it’s not being held as an investment)
 - Any income received was from amounts paid for rental
- Know what to do when there is no rental income
 - Does the activity qualify as a trade or business under IRC § 162?





Rental Real Estate (cont.)

- Renting real estate is generally a passive activity (IRC § 469(c)(2); Treas. Reg. § 1.469-1T(e)(3))
- Active vs. Passive activity
 - Passive loss limitations
 - IRC § 469(c)(7) provides special rules for taxpayers in real property business
- Material Participation Rules
- Treatment of Former Passive Activities
 - Passive losses can only be offset against passive income
- Methods of Proof
 - Recordkeeping requirements and establishing participation by reasonable means. Know what is reasonable.



Like-Kind Exchanges

- Generally, individuals who sell business or investment property at a gain must pay tax on the gain at the time of sale.
- IRC Section 1031 provides an exception to the general rule – a taxpayer may postpone paying tax on the gain if the taxpayer reinvests the proceeds in similar property as part of a qualifying like-kind exchange.
 - Gain is tax-deferred, but not tax-free.
- The exchange can include like-kind property exclusively or like-kind property along with cash, liabilities, and property that is not like-kind
 - Cash, relief from debt, or property that is not like-kind may trigger some taxable gain in the year of the exchange.





Like-Kind Exchanges (cont.)

- Who qualifies for deferral?
 - Owners of investment and business property
 - Individuals
 - C corporations
 - S corporations
 - Partnerships (general or limited)
 - LLCs
 - Trusts
 - Any other taxpaying entity
- Three kinds of like-kind exchanges (“LKEs”)
 - Simultaneous
 - Deferred
 - Reverse
- All present unique diligence issues





Diligence and LKEs

- Understand and correctly apply the different structures and restrictions
- Know:
 - What property qualifies
 - Types of property excluded from IRC § 1031 treatment (e.g., inventory, stocks, bonds, notes, other securities or debt, partnership interests, and certificates of trust)
 - Applicable Time Limits
 - How to Compute Basis
 - How to report LKEs to the IRS
 - Form 8824, *Like-Kind Exchanges*





Offers-In-Compromise

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- IRC § 7122 authorizes the IRS to compromise tax liabilities.
 - Also provides rules for submission of offers-in-compromise (“OICs”) and standards for evaluation of offers
- Acceptance or rejection / agreement’s terms and conditions are at the IRS’s. Treas. Reg. 301.7122-1(a)(1) & (c)(1)
- Common basis to accept: doubts as to sufficient assets or income to satisfy the tax liability while the collection SoL is still open.



OICs (cont.)

- Prerequisites to eligibility – taxpayer:
 - Filed all required federal tax returns
 - Made all required estimated tax payments for the current year
 - Received at least one tax bill for the debt included in the offer
 - Made all required Federal tax deposits for the current quarter (if taxpayer operates a business with employees)
 - May not be in open bankruptcy proceedings (taxpayer or taxpayer’s business)



OICs (cont.)

- Application must include:
 - Form 656, *Offer in Compromise*
 - Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* (if applicable)
 - Form 433-B, *Collection Information Statement for Businesses* (if applicable)
 - \$186 application fee (unless taxpayer meets Low Income Certification), and
 - Initial offer payment (usually 20% of the offer amount, unless taxpayer meets Low Income Certification).



OICs (cont.)

- Practitioners should use the Application Checklist on the last page of the Form 656 Booklet
 - Incomplete, unsigned, and undated forms will be rejected
- Practitioners should manage clients' expectations when seeking to compromise tax debts
 - Don't make false or misleading statements
- Delaying the collection process is not a legitimate use of the OIC program (be mindful of §§ 10.23 and 10.51(a)(4) of Circular 230, as well as § 10.22)
 - Filing an application for a client you know is unqualified is a Circular 230 violation
 - Filing an incomplete application may be a Circular 230 violation





Worker Classification

- Common misperception – a small business w/ a corporate officer and no non-officer employees does not have employment-tax filing or payment obligations
- Corporate officers are employees for FICA purposes under IRC § 3121(d)(1).
 - General Rule: a corporate officer is an employee of the corporation. But there are exceptions
 - E.g., officer who does not perform any services and is not paid any remuneration
- IRC § 3401(c) and § 3306(i) have similar provisions for income tax withholding and FUTA

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Worker Classification (cont.)

- Practitioners should know:
 - Common law factors used in classifying workers
 - Behavioral
 - Financial
 - Type of relationship
 - When/what payments need to be classified as wages
 - Applicable filing requirements
 - Quarterly and annual employment tax returns
 - Information returns
- Issues with potential Circular 230 implications
 - Inconsistent treatment with no reasonable basis (e.g., year to year or workers performing similar services)
 - Lack of appropriate documentation
 - Failures to meet filing requirements





Worker Classification (cont.)

- Section 530 of the Revenue Act of 1978 (P.L. 95-600) provides employers with relief from Federal employment tax withholding and payment obligations if certain requirements are met
- Know the rules for Section 530 Relief (IRM 4.23.5.2.2)
 - Two consistency requirements
 - All federal tax returns, including information returns required to be filed with respect to the worker for the period, are timely filed and on a basis consistent with the taxpayer's treatment of the worker as not an employee.
 - The treatment of the worker is consistent with the taxpayer's (or predecessor's) treatment of all workers in similar positions.
 - Taxpayer also must have had a reasonable basis for the treatment.





Worker Classification (cont.)

- Classification Settlement Program (“CSP”) (IRM 4.23.6) – taxpayers can resolve worker classification cases as early in the administrative process as possible, reducing taxpayer burden.
 - Under the CSP, IRS examiners can offer taxpayers a settlement using a standard closing agreement.
- Consider the Voluntary Classification Settlement Program (“VCSP”)
 - Voluntary program with an opportunity to reclassify workers as employees for employment tax purposes for future tax periods with partial relief from employment taxes.
 - The VCSP allows relief for eligible taxpayers not under examination similar to that available through the CSP
 - To participate in the VCSP, a taxpayer must apply using Form 8952, *Application for Voluntary Classification Settlement Program*





Contacting OPR

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