Professional Education Services, LP

Quality education offered by PES...

Ethics and Professional Responsibility for Enrolled Agents

Course #4525F

Course Material

Professional Education Services, LP

The Professional's Choice for CPE.

8303 Sierra College Blvd. • Suite 150 • Roseville, CA 95661

To Order: 1-800-998-5024 • Customer Service: 1-800-990-2731 • Fax: 916-791-4099

www.mypescpe.com • www.pescpe.com • www.pesqascpe.com • www.eacpe.com

ETHICS AND PROFESSIONAL RESPONSIBILITY FOR ENROLLED AGENTS (COURSE #4525F)

TABLE OF CONTENTS

CHAPTER 1: IRS CIRCULAR 230

Objectives: After completing this chapter, you will be able to:

- Discuss the Internal Revenue Service Requirements as outlined in Circular 230.
- Explain the applicable NAEA guidance on tax practice.
- Apply the NAEA Rules of Professional Conduct and the IRS rules to common ethical dilemmas faced by EAs in tax practice.

Introduction

The tax preparation and tax consulting industry has historically enjoyed less government regulation than the practice of accountancy. In most states (California being a notable exception), no professional license is required to prepare income taxes. One simply hangs out a shingle and begins business. There are currently no federal registration requirements for tax preparers. In 1995, the IRS proposed studying the concept of tax preparer registration in order to combat rising fraud in the earned income credit program. This proposal was dropped because of widespread industry opposition. Instead, the IRS increased the scrutiny applied to firms applying to file tax returns electronically.

The tax practice field has had less ethical guidance because of the unique relationship between the CPA and client. In a tax engagement the EA is an "advocate of the taxpayer." The courts have held that there is nothing illegal or sinister in a taxpayer arranging one's affairs so as to pay the lowest tax legally available.

Nevertheless, EAs in tax practice do have two sets of ethical and legal guidance which governs their tax practice. Circular 230 governs practice before the Internal Revenue Service. The National Association of Enrolled Agents (NAEA) has issued rules of professional conduct. We will examine both of these items, pointing out the differences wherever relevant.

Circular 230

The Office of Professional Responsibility (OPR) is the IRS organization that interprets and applies Title 31, Code of Federal Regulations Subtitle A, Part 10, "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Appraisers, and others before the Internal Revenue Service." These regulations are generally known as "Treasury Department Circular 230," or simply "Circular 230." Circular 230 describes expectations, rights, and obligations of those who represent taxpayers before the IRS. Circular 230 has been amended several times recently, and more changes are proposed. This course reprints and discusses most, but not all, of Circular 230.

Explanations of Provisions

Tax advisors play an increasingly important role in the federal tax system, which is founded on principles of voluntary compliance. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice. To restore, promote, and maintain the public's confidence in those individuals and firms, Circular 230 sets forth regulations and best practices applicable to all tax advisors. Circular 230 regulations are limited to practice before the IRS and do not alter or supplant other ethical standards applicable to practitioners.

What is not considered "practice before the IRS"

Section 10.7 of Circular 230 provides a long list of exceptions and exclusions to Circular 230. The following persons and situations are not considered "practicing before the IRS" and therefore are exempt from the rules we will discuss later in this course.

A. Representing oneself – individuals may always appear on their own behalf before the IRS.
B. Participating in rulemaking – individuals may participate in rule making.
C. Limited practice – in a number of circumstances an individual who is not a practitioner can represent a taxpayer on a limited basis:

    i. An individual may represent a member of his or her immediate family.
    ii. A regular full-time employee of an individual employer may represent the employer
    iii. A general partner or regular full-time employee of a partnership may represent the partnership
    iv. A bona fide officer or a regular full-time employee of a corporation may represent the corporation
    v. A trustee, receiver, guardian, personal representative, administrator, executor, or regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate
    vi. An individual may represent any individual or entity before personnel of the Internal Revenue Service who are outside of the United States
    vii. An individual who prepares and signs a taxpayer's return as the preparer, or who prepares a return but is not required (by the instructions to the return or regulations) to sign the return, may represent the taxpayer before officers and employees of the Examination Division of the Internal Revenue Service with respect to the tax liability of the taxpayer for the taxable year or period covered by that return.

D. Preparing tax returns and furnishing information. Perhaps the most important exception applies to preparing tax returns. <u>Any individual may prepare a tax return</u>, appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Service or any of its officers or employees. This is not considered practicing before the IRS.

It should be noted that signing a tax return does entail certain responsibilities as discussed later. However, preparing a tax return does not rise to the level of practicing before the IRS.

OBSERVATION*: None of the items above in A-D are considered to be practicing before the IRS.*

A EA who is practicing before the IRS and does not fall into one of the exception categories above is subject to subpart B of Circular 230 – Duties and Restrictions relating to practice before the IRS. It is reproduced below and should be read in its entirety.

CIRCULAR 230: SUBPART B -- DUTIES AND RESTRICTIONS RELATING TO PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Table of Contents (this subpart)

Section

SUBPART C -- SANCTIONS FOR VIOLATION OF THE REGULATIONS

SECTION 10.20 Information to be furnished.

(a) To the Internal Revenue Service.

(1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of

the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

OBSERVATION: *The paragraph above should be read in light of the recently enacted accountant-client privilege.*

OBSERVATION: *Section 10.20 requires a practitioner to respond promptly to a proper and lawful request for records and information, unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.*

(b) To the Director of the Office of Professional Responsibility.

When a proper and lawful request is made by the Director of the Office of Professional Responsibility, a practitioner must provide the Director of the Office of Professional Responsibility with any information the practitioner has concerning an inquiry by the Director of the Office of Professional Responsibility into an alleged violation of the regulations in this part by any person, and to testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

Observation: *Sometimes referred to as "snitch laws" these provisions require the cooperation of those practicing before the IRS. Failure to cooperate could result in the loss of the right to practice before the IRS.*

NAEA Rule 1

Members and Associates will adhere to all laws and regulations that provide equal opportunity for all clients and employees regardless of race, color, religion, gender, national origin, age, handicap, sexual orientation and/or any other legally protected class.

(c) Interference with a proper and lawful request for records or information.

A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, or the Director of the Office of Professional Responsibility, or his or her employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

SECTION 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.

NAEA Rule 15

Members and Associates will advise a client, preferably in writing if they suspect the client may not have complied with the revenue laws or (may) have made an error in, or omission from a return, document, affidavit, or paper which the client is required by law to execute concerning the matter, and also advise the client of the consequences of the noncompliance, error or omission.

OBSERVATION: *When you sign a tax return as a paid preparer, your signature is based not only on what is presented in the return but any item that you have knowledge of.*

SECTION 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 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.

NAEA Rule 16

Members and Associates will not knowingly misrepresent or omit material facts in preparation of tax returns. Should a client insist, the Member and Associate will withdraw and refuse to prepare the return.

(c) Effective/applicability date. This section is applicable on September 26, 2007.

SECTION 10.23 Prompt disposition of pending matters.

A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

OBSERVATION: *The following two sections seek to ensure that all persons will be treated equally by the IRS and that none will receive preferential treatment.*

SECTION 10.24 Assistance from disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

(b) Accept assistance from any former government employee where the provisions of §10.25 or any federal law would be violated.

NAEA Rule 8
Members and Associates will not knowingly, directly or indirectly, employ, form an association or partnership with, be employed by, accept assistance of, or share fees with, a person, associate, correspondent or subagent who has been disbarred or suspended.

SECTION 10.25 Practice by former government employees, their partners and their associates.

(a) Definitions.

For purposes of this section:

(1) Assist means to act in such a way as to advise, furnish information to, or otherwise aid another person, directly or indirectly.

(2) Government employee is an officer or employee of the United States or any agency of the United States, including a special government employee as defined in 18 U.S.C. 202(a), or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) Member of a firm is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

(4) Particular matter involving specific parties is defined at 5 CFR 2637.201(c), or superseding post-employment regulations issued by the U.S. Office of Government Ethics.

(5) Rule includes Treasury regulations, whether issued or under preparation for issuance as notices of proposed rulemaking or as Treasury decisions, revenue rulings, and revenue procedures published in the Internal Revenue Bulletin (see 26 CFR 601.601(d)(2)(ii)(b)).

(b) General rules

(1) No former Government employee may, subsequent to Government employment, represent anyone in any matter administered by the Internal Revenue Service if the representation would violate 18 U.S.C. 207 or any other laws of the United States.

(2) No former Government employee who personally and substantially participated in a particular matter involving specific parties may, subsequent to Government employment, represent or knowingly assist, in that particular matter, any person who is or was a specific party to that particular matter.

(3) A former Government employee who within a period of one year prior to the termination of Government employment had official responsibility for a particular matter involving specific parties may not, within two years after Government employment is ended, represent in that particular matter any person who is or was a specific party to that particular matter.

(4) No former Government employee may, within one year after Government employment is ended, communicate with or appear before, with the intent to influence, any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule the development of which the former Government employee participated in, or for which, within a period of one year prior to the termination of Government employment, the former government employee had official responsibility. This paragraph (b)(4) does not, however, preclude any former employee from appearing on one's own behalf or from representing a taxpayer before the Internal Revenue Service in connection with a particular matter involving specific parties involving the application or interpretation of a rule with respect to that particular matter, provided that the representation is otherwise consistent with the other provisions of this section and the former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

(c) Firm representation.

(1) No member of a firm of which a former Government employee is a member may represent or knowingly assist a person who was or is a specific party in any particular matter with respect to which the restrictions of paragraph (b)(2) of this section apply to the former Government employee, in that particular matter, unless the firm isolates the former Government employee in such a way to ensure that the former Government employee cannot assist in the representation.

(2) When isolation of a former Government employee is required under paragraph (c)(1) of this section, a statement affirming the fact of such isolation must be executed under oath by the former Government employee and by another member of the firm acting on behalf of the firm. The statement must clearly identify the firm, the former Government employee, and the particular matter(s) requiring isolation. The statement must be retained by the firm and, upon request, provided to the Director of the Office of Professional Responsibility.

(d) Pending representation. The provisions of this regulation will govern practice by former Government employees, their partners and associates with respect to representation in particular matters involving specific parties where actual representation commenced before the effective date of this regulation.

(e) Effective/applicability date. This section is applicable on September 26, 2007.

OBSERVATION: *This section reflects changes to federal statutes governing post-employment restrictions applicable to former government employees.*

OBSERVATION: The section above may impose obligations on the firms of former government employees that exceed the obligations of other practitioners.

SECTION 10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

OBSERVATION: *Obviously, a notary may not be a party to the transaction, benefit from the transaction, or have a conflict of interest.*

SECTION 10.27 Fees.

(a) In general.

A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.

OBSERVATION: *A practitioner may charge different rates depending upon the complexity of the issue.*

(b) Contingent fees.

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to—

(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return

OBSERVATION: *Contrary to AICPA standards, a contingent fee may not be charged on an original return even when the practitioner reasonably anticipates that the return position will be substantively reviewed by the IRS prior to filing of the return.*

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the

determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

(c) Definitions. For purposes of this section—

(1) Contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) Matter before the Internal Revenue Service includes tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

(d) Effective/applicability date. This section is applicable for fee arrangements entered into after March 26, 2008.

NAEA Rule 21

Tax preparation services will not be offered or rendered under any arrangement except as authorized by the most current provisions of Circular 230.

Note: *The IRS is considering rules that would further restrict the use of contingent fee arrangements.*

SECTION 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.

OBSERVATION: *The records that must be returned are limited to those records necessary for the client to comply with his or her federal tax obligations. This rule does not apply to other records the practitioner may have.*

(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.

OBSERVATION: *A practitioner may withhold the client's current year completed tax return pending payment of fees.*

NAEA Rule 20

Members and Associates will furnish to clients or former clients, upon request and reasonable notice, any accounting or other records obtained from the client.

SECTION 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;

(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 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.

Practice Pointer: Consents must be in writing and must be retained for at least 36 months after the conclusion of the engagement.

NAEA Rule 5

Members and Associates will not represent conflicting interests without express written consent of all parties after full disclosure.

NAEA Rule 10

Members and Associates who are engaged simultaneously in another occupation will conduct themselves in such a manner so as not to create a conflict of interest in rendering professional tax service or professional advice. No Member or Associate will accept or pay a commission for the sale or referral of products or services unless properly licensed, and those facts are fully disclosed in writing, to the client. No Member or Associate will pay a commission or referral fee to an employee for referring a client for products or services unless such employee is properly licensed.

SECTION 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 or enrolled retirement plan agents, in describing their professional designation, may not utilize the term of art "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.”

NAEA Rule 14

Members and Associates will not suggest, state, promise, or give the impression that they are able to obtain special consideration from governmental agencies or their representatives, including making reference to previous I.R.S. employment.

NAEA Rule 11

Members and Associates will not solicit clients by advertising or other forms of solicitation in a manner that presents a false, misleading, or deceptive appearance. Members will not solicit clients in any manner prohibited by the most current provisions of Circular 230.

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates federal or state law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) Fee information.

(1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information:

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

Practice Pointer: When practitioners send their clients annual income tax organizers, it is appropriate to include an engagement letter. The engagement letter should specify the responsibilities of both the practitioner and client as well as the responsibility for fees and 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, 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.

Practice Pointer: Practitioners must keep a copy of all mailers for at least 36 months.

(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 on September 26, 2007.

SECTION 10.31 Negotiation of taxpayer checks.

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a federal tax liability.

Practice Pointer: By completing Form 2848 “Power of Attorney and Declaration of Representative,” a taxpayer may authorize their CPA to receive refund checks. However, even the power of attorney specifically forbids the CPA from endorsing refund checks.

SECTION 10.32 Practice of law.

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

SECTION 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, and 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.

SECTION 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) [Reserved].

(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) [Reserved].

(f) Effective/applicability date. Section 10.34 is applicable to tax returns, documents, affidavits and other papers filed on or after September 26, 2007.

NAEA Rule 7

Members and Associates will take a position on a tax return favorable to their clients only if there is a realistic possibility that the position will be sustained on its merits, unless the position is disclosed on the return. Members and Associates have the absolute duty to explain in writing the probable effects of various alternatives to their clients who must make the final decision as to the position to be taken when the applicable law is unsettled or the application of law to the facts in a given situation is uncertain.

Tax Return Standards

As you can see from the sections above titled “reserved,” the IRS intends to update this section to implement the tax return preparer penalty provisions of the Small Business and Work Opportunity Tax Act of 2007 “The Act.” IRS Notice 2008-13 provides some guidance as follows:

The Act amended several provisions of the Code to extend the application of the income tax return preparer penalties to all tax return preparers, alter the standards of conduct that must be met to avoid imposition of the section 6694(a) penalty for preparing a return which reflects an understatement of liability, and increase applicable penalties under section 6694(a) and (b). The amendments made by the Act to section 6694 were effective for tax returns and claims for refund prepared after May 25, 2007 but were subsequently retroactively repealed by The Emergency Economic Stabilization Act of 2008.

As amended by the Act, section 7701(a)(36) now defines *tax return preparer* as any person that prepares for compensation a tax return or claim for refund, or a substantial portion of a tax return or claim for refund, and is no longer limited to persons who prepare income tax returns.

Section 301.7701-15 of the current Procedure and Administration Regulations defines the term *income tax preparer* to include any person who prepares for compensation all or a substantial portion of a tax return or claim for refund under Subtitle A of the Code. Operation of the current regulations brings into the preparer penalty regime a wide range of activities performed by persons who do not sign the tax return or claim for refund, who may have no knowledge of how their work is ultimately reported on the tax return or claim for refund, or who may have no knowledge of the size or complexity of the schedule, entry, or other portion of a tax return or claim for refund relative to the entire tax return.

The Act also amended section 6694(a) by raising the standards of conduct for tax return preparers. For *undisclosed positions*, the Act replaced the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits. For *disclosed positions*, the Act replaced the nonfrivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

SECTION 10.35 Requirements for covered opinions.

(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions

For purposes of this subpart –

(1) A practitioner includes any individual described in Sec. 10.2(a)(5).

(2) Covered opinion –

(i) In general

A covered opinion is written advice (including electronic communications) by a practitioner concerning one or more federal tax issues arising from:

(A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011-4(b)(2);

(B) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or

(C) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice –

(1) Is a reliance opinion;
(2) Is a marketed opinion;
(3) Is subject to conditions of confidentiality; or
(4) Is subject to contractual protection.

(ii) Excluded advice

A covered opinion does not include –

(A) Written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section;

(B) Written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(ii)(B) of this section (concerning the principal purpose of avoidance or evasion) that –

(1) Concerns the qualification of a qualified plan;
(2) Is a state or local bond opinion; or
(3) Is included in documents required to be filed with the Securities and Exchange Commission;

(C) Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction. The preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits not reported on previously filed return) filed after the date on which the advice is provided to the taxpayer;

(D) Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer; or

(E) Written advice that does not resolve a federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. If written advice concerns more than one federal tax issue, the advice must comply with the requirements of paragraph (c) of this section with respect to any federal tax issue not described in the preceding sentence.

(3) A federal tax issue is a question concerning the federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes. For purposes of this subpart, a federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstances, on the overall federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Reliance opinion

Written advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant federal tax issues would be resolved in the taxpayer's favor.

For purposes of this section, written advice, other than advice described in paragraph (b)(2)(1)(A) of this section (concerning listed transactions) or paragraph (b)(2)(1)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Marketed opinion

(i) Written advice is a marketed opinion if the practitioner knows or has reason to know that the written advice 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 a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a marketed opinion if the practitioner prominently discloses in the written advice that –

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(6) Conditions of confidentiality

Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner's tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

(7) Contractual protection

Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the matters addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation.

(8) Prominently disclosed

An item is prominently disclosed if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed, an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

(9) State or local bond opinion

A state or local bond opinion is written advice with respect to a federal tax issue included in any materials delivered to a purchaser of a state or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a state or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a state or local bond, the status of a state or local bond as a qualified tax-exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a state or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

(10) The principal purpose

For purposes of this section, the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose. The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10).

(c) Requirements for covered opinions.

A practitioner providing a covered opinion must comply with each of the following requirements.

(1) Factual matters

(i) The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

(iii) The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a taxpayer's factual representation that a transaction has a business purpose if the representation fails to include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate law to facts

(i) The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any significant federal tax issue except as provided in paragraphs (c)(3)(v) and (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(iii) The opinion must not contain internally inconsistent legal analyses or conclusions.

(3) Evaluation of significant federal tax issues

(i) In general

The opinion must consider all significant federal tax issues except as provided in paragraphs (c)(3)(v) and (d) of this section.

(ii) Conclusion as to each significant federal tax issue

The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion. If the practitioner is unable to reach a conclusion with respect to one or more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues. If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant federal tax issues considered, the opinion must include the appropriate disclosure(s) required under paragraph (e) of this section.

(iii) Evaluation based on chances of success on the merits

In evaluating the significant federal tax issues addressed in the opinion, the practitioner must not take 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 through settlement if raised.

(iv) Marketed opinions

In the case of a marketed opinion, the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant federal tax issue. If the practitioner is unable to reach a more likely than not conclusion with respect to each significant federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(5)(ii) of this section.

(v) Limited scope opinions

(A) The practitioner may provide an opinion that considers less than all of the significant federal tax issues if –

(1) The practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer are limited to the federal tax issue(s) addressed in the opinion;

(2) The opinion is not advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions), paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion) or paragraph (b)(5) of this section (a marketed opinion); and

(3) The opinion includes the appropriate disclosure(s) required under paragraph (e) of this section.

(B) A practitioner may make reasonable assumptions regarding the favorable resolution of a federal tax issue (an assumed issue) for purposes of providing an opinion on less than all of the significant federal tax issues as provided in this paragraph (c)(3)(v). The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.

(4) Overall conclusion

(i) The opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

(ii) In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not.

(d) Competence to provide opinion; reliance on opinions of others

(1) The practitioner must be knowledgeable in all of the aspects of federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant federal tax issues, unless the practitioner knows or should know that such opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner must identify the other opinion and set forth the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

(e) Required disclosures

A covered opinion must contain all of the following disclosures that apply -

(1) Relationship between promoter and practitioner. An opinion must prominently disclose the existence of -

(i) Any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing, or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

(2) Marketed opinions

A marketed opinion must prominently disclose that -

(i) The opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion; and

(ii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(3) Limited scope opinions

A limited scope opinion must prominently disclose that -

(I) The opinion is limited to the one or more federal tax issues addressed in the opinion;

(ii) Additional issues may exist that could affect the federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and

(iii) With respect to any significant federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(4) Opinions that fail to reach a more likely than not conclusion

An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant federal tax issue must prominently disclose that -

(i) The opinion does not reach a conclusion at a confidence level of at least more likely than not that with respect to one or more material federal tax issues addressed by the opinion; and

(ii) With respect to those significant federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Advice regarding required disclosures

In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(f) Effect of opinion that meets these standards

(1) In general

An opinion that meets the requirements of this section satisfies the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.

(2) Standards for other written advice

A practitioner who provides written advice that is not a covered opinion for purposes of this section is subject to the requirements of Sec. 10.37.

(g) Effective date

This section applies to written advice that is rendered after June 20, 2005.

SECTION 10.36 Procedures to ensure compliance.

(a) Requirements for covered opinions

Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of providing advice concerning federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with Sec. 10.35. Any such practitioner will be subject to discipline for failing to comply with the requirements of this paragraph if –

(1) The practitioner through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with Sec. 10.35, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with Sec. 10.35; or

(2) The practitioner knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with the firm, that does not comply with Sec. 10.35 and the practitioner, through willfulness, recklessness, or gross incompetence, fails to take prompt action to correct the noncompliance.

(b) Effective date

This section is applicable after June 20, 2005.

SECTION 10.37 Requirements for other written advice.

(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 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.

(b) Effective date.

This section applies to written advice that is rendered after June 20, 2005.

SECTION 10.38 Establishment of Advisory Committees.

(a) Advisory committees

To promote and maintain the public’s confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures prescribed by the Director, an advisory committee may review and make recommendations regarding professional standards or best practices for tax advisors, or more particularly, whether a practitioner may have violated Sec. 10.35 or 10.36.

(b) Effective date

This section applies after December 20, 2004.

SUBPART C -- SANCTIONS FOR VIOLATION OF THE REGULATIONS

SECTION 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 Sec. 10.51), fails to comply with any regulation in this part (under the prohibited conduct standards of Sec. 10.52), or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

OBSERVATION: *The new regulations add “censure” as a possible sanction.*

(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 Director of the Office of Professional Responsibility 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) Sanctions to be imposed. The sanctions imposed by this section shall take into account all relevant facts and circumstances.

(e) Effective/applicability date. This section is applicable to conduct occurring on or after September 26, 2007, except paragraph (c) which applies to prohibited conduct that occurs after October 22, 2004.

SECTION 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.

> ***Observation:*** *In an article published in the NAEA Journal, OPR Director Brien Downing stated that the service actively pursues cases of EA non filing.*

(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.

NAEA Rule 12

Members and Associates will undertake only those tax matters which the Member or Associate, or the Member's or Associate's firm, can reasonably expect to complete with professional competence. Members and Associates will obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to the task.

NAEA Rule 13

Members and Associates will be considerate and courteous in dealing with representatives of governmental agencies. In practice, the Member and Associate is under a duty to provide all information required by a statute or regulations, and formally requested by the authorized governmental agency. The defense of the client must be exercised within the bounds of the law and without resorting to deception.

(14) Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by the 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.

(b) Effective/applicability date. This section is applicable to conduct occurring on or after September 26, 2007.

Case Study

Disreputable Conduct

While employed by CPA firm, CPA prepared 17 income tax returns for clients who were not clients of the CPA firm. CPA used the employer's tax return preparation software and computer equipment to prepare these tax returns. CPA did not remove the employer's name from the paid preparer section of the tax returns prior to issuing these tax returns to clients. CPA billed the clients using invoices with CPA's name only and kept the fees received for these services.

CPA believed that these clients knew the CPA firm was not responsible for the tax returns even though the employer's name was displayed in the paid preparer section of the tax return.

Revised Regulations on Releasing Taxpayer Information

In early 2008, the IRS released revised regulations concerning taxpayer privacy and the release of taxpayer information with an effective date of January 1, 2009. Among the new rules:

- Generally, preparers must obtain taxpayer consent, either by paper or electronically depending on how the return is being filed, before tax return information can be disclosed to any third party or used for any purpose other than filing the return.
- If the taxpayer consents to the disclosure and use of his information, the consent must identify the intended purpose of the disclosure, identify the recipients, and describe the particular authorized disclosure or use of the information.
- Mandatory language informs individual taxpayers that they are not required to sign the consent. If they sign the consent, they can set a time period for the duration of that consent. If taxpayers fail to set a time period, the consent is valid for a maximum of one year.
- To prevent consent requests from individual taxpayers from being buried in fine print, the rules require the paper consent documents to be in 12-point type on 8½ by 11 inch paper and require electronic consent requests to be in the same type as the Web site's standard text.
- Mandatory consent from taxpayers also is required if the tax information is going to be disclosed to a tax preparer located outside the United States. This provision is intended to ensure taxpayers are informed if their tax information is being sent off-shore for return preparation. The individual taxpayer's Social Security Number also must be redacted.

Many of these provisions are similar to recently enacted state laws.

SECTION 10.52 Violation subject to sanction.

(a) A practitioner may be sanctioned under Sec. 10.50 if the practitioner

(1) Willfully violates any of the regulations (other than §10.33) contained in this part; or

(2) Recklessly or through gross incompetence (within the meaning of §10.51(a)(13)) violates §§10.34, 10.35, 10.36 or 10.37.

(b) Effective/applicability date. This section is applicable to conduct occurring on or after September 26, 2007.

SECTION 10.53 Receipt of information concerning practitioner.

(a) Officer or employee of the Internal Revenue Service.

If an officer or employee of the Internal Revenue Service has reason to believe that a practitioner has violated any provision of this part, the officer or employee will promptly make a written report to the Director of the Office of Professional Responsibility of the suspected violation. The report will explain the facts and reasons upon which the officer's or employee's belief rests.

Practice Pointer: Be very careful what you say and do when meeting with IRS personnel. As detailed above, IRS employees are required to report any violation by a practitioner.

(b) Other persons.

Any person other than an officer or employee of the Internal Revenue Service having information of a violation of any provision of this part may make an oral or written report of the alleged violation to the Director of the Office of Professional Responsibility or any officer or employee of the Internal Revenue Service. If the report is made to an officer or employee of the Internal Revenue Service, the officer or employee will make a written report of the suspected violation to the Director of the Office of Professional Responsibility.

(c) Destruction of report.

No report made under paragraph (a) or (b) of this section shall be maintained by the Director of the Office of Professional Responsibility unless retention of such record is permissible under the applicable records control schedule as approved by the National Archives and Records Administration and designated in the Internal Revenue Manual.

The Director of the Office of Professional Responsibility must destroy such reports as soon as permissible under the applicable records control schedule.

(d) Effect on proceedings under subpart D.

The destruction of any report will not bar any proceeding under subpart D of this part, but precludes the Director of the Office of Professional Responsibility's use of a copy of such report in a proceeding under subpart D of this part.

(e) Effective/applicability date. This section is applicable on September 26, 2007.

SUMMARY OF 2005-2008 CIRCULAR 230 CHANGES

Best Practices

To ensure the integrity of the tax system, tax professionals should adhere to best practices when providing advice or assisting their clients in the preparation of a submission to the IRS. Section 10.33 describes the best practices to be observed by all tax advisors in providing clients with the highest quality representation. These best practices include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) advising the client regarding the import of the conclusions reached; and (4) acting fairly and with integrity in practice before the IRS.

Standards for Covered Opinions

Section 10.35 prescribes requirements for practitioners who provide covered opinions. Covered opinions include written advice that concerns one or more federal tax issues arising from a listed transaction, any plan or arrangement which the principal purpose is the avoidance or evasion of any tax, or any plan or arrangement with the significant purpose of avoidance or evasion of tax if the written advice is a reliance opinion, a marketed opinion, subject to conditions of confidentiality, or subject to contractual protection.

Requirements for Covered Opinions

A practitioner providing a covered opinion, including a marketed opinion, must not assume that a transaction has a business purpose or is potentially profitable apart from tax benefits, or make an assumption with respect to a material valuation issue.

Required Disclosures

Section 10.35(e) provides disclosures that are required to be made in the beginning of marketed opinions, limited scope opinions, and opinions that fail to reach a conclusion at a confidence level of at least more likely than not. In addition, certain relationships between the practitioner and a person promoting or marketing an opinion must be disclosed. A practitioner may be required to make more than one of the disclosures described below.

1. Relationship Between Practitioner and Promoter

Under §10.35(e)(1), a practitioner must disclose if the practitioner has a compensation arrangement with any person (other than the client for whom the opinion is prepared) with respect to the promoting, marketing or recommending of the entity, plan, or arrangement that is the subject of the opinion. A practitioner also must disclose if there is any referral agreement between the practitioner and any person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing, or recommending of the entity, plan, or arrangement that is the subject of the opinion.

2. Marketed Opinions

Under §10.35(e)(2), a practitioner must disclose that the opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion. The practitioner also must state that taxpayers should seek advice from their own tax advisors.

3. Limited Scope Opinion

Under §10.35(e)(3), a practitioner must disclose in a limited scope opinion that additional issue(s) may exist that could affect the federal tax treatment of the tax issues addressed in the opinion, that the opinion does not consider or reach a conclusion with respect to those additional issues and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the taxpayer.

4. Opinions That Fail to Reach a Conclusion at a Confidence Level of at Least More Likely Than Not

Under §10.35(e)(4), a practitioner must disclose that the opinion fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material federal tax issue(s) addressed by the opinion and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the taxpayer.

5. Advice Regarding Required Disclosures

Under §10.35(e)(5), the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

Procedures to Ensure Compliance

Section 10.36 provides that tax advisors with responsibility for overseeing a firm's practice before the IRS should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described in §10.35.

Requirement for Other Written Advice

Under Section 10.37, a practitioner must not give written advice concerning one or more federal tax issues if the practitioner bases the advice on unreasonable factual or legal assumptions, 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.

Disclaimers

The new regulations virtually require tax practitioners to include a disclaimer in most written communications to clients to the effect that any tax advice provided in such communication may not be relied upon by the taxpayer to avoid tax penalties. An example of a typical disclaimer follows:

> **IRS Circular 230 Disclaimer:** To ensure compliance with IRS Circular 230, any U.S. federal tax advice provided in this communication is not intended or written to be used, and it cannot be used by the recipient or any other taxpayer (i) for the purpose of avoiding tax penalties that may be imposed on the recipient or any other taxpayer, or (ii) in promoting, marketing, or recommending to another party a partnership or other entity, investment plan, arrangement or other transaction addressed herein.

The new regulations pose greater potential malpractice liability for any Circular 230 non-compliance.

Who May Practice

A new designation was created. The “enrolled retirement plan agent” is limited to representing taxpayers with regard to retirement plans.

Contingent Fees

Allows a contingent fee for representing a taxpayer with an IRS examination. Contingent fees will also be allowed for interest and penalty reviews because there is no exploitation of the audit lottery in these situations as they are generally completed on a post-examination basis. Practitioners may also charge a contingent fee in connection with any judicial proceeding arising under the Internal Revenue Code.

Conflicts

A practitioner is required to obtain written consent from each client in order to represent clients with conflicting interests.

Future Revisions to Circular 230

The IRS will likely continue to revise Circular 230 in order to better enforce the Internal Revenue Code.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following is considered practicing before the IRS:

    a) preparing one's own tax return
    b) preparing, at no charge, a tax return for a friend
    c) preparing simple tax returns for $100 each
    d) none of the above

2. Circular 230 Section 10.22 requires a practitioner to be diligent as to accuracy in most situations. In which of the following is diligence as to accuracy <u>not</u> required:

    a) preparing tax returns
    b) year-end tax planning
    c) preparing letters to the IRS regarding a taxpayer under audit
    d) preparing amended tax returns

3. Under Circular 230 Section 10.27, a practitioner is prohibited from charging certain fees. Which of the following fees is prohibited:

    a) fees in excess of $300 per hour
    b) contingent fees
    c) an unconscionable fee
    d) fees based on the number of forms and schedules contained in a tax return

4. Which of the following is true regarding when a contingent fee is permitted by the IRS:

    a) contingent fees are permitted as long as AICPA standards are followed
    b) contingent fees are allowed on original tax returns
    c) contingent fees are allowed when representing a client under audit
    d) contingent fees are never allowed

5. Under Circular 230 Section 10.28, a practitioner must return certain client records under various circumstances. Which of the following is true under section 10.28 regarding returning client records:

    a) a practitioner may withhold the client's current year completed tax return pending payment of fees
    b) a practitioner may withhold all client records pending payment of fees
    c) a practitioner must return all client records upon request
    d) federal law gives a practitioner the right to place a lien on client records

6. Circular 230 Section 10.30 imposes numerous restrictions on solicitation and advertising. Which of the following is true:

    a) hourly fee information must be included in all ads
    b) although ads may include a fee schedule, rates can be changed at any time
    c) a copy of all direct mail advertisements must be retained for at least 36 months
    d) when accepting a new client, the practitioner must give the client a good faith estimate of the cost of the services contemplated

7. Circular 230 Section 10.51 outlines items that may constitute incompetence or disreputable conduct. Which of the following would <u>not</u> be considered disreputable conduct:

    a) using abusive language with an IRS auditor in order to get the auditor to delete an item from the audit report
    b) having one’s CPA license revoked for cause
    c) being subject to a preparer penalty for negligence in the preparation of a state tax return by that state’s tax authority
    d) conviction of a crime relating to the filing of a state tax return

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A taxpayer may always prepare their own tax return.

   B: Incorrect. Simply preparing tax returns is not practicing before the IRS.

   C: Incorrect. Although the paid preparer must sign the tax return as preparer, simply preparing tax returns is not practicing before the IRS.

   D: Correct. Practice usually entails representing clients during an examination.

   (See page 1-2 of the course material.)

2. A: Incorrect. Although a practitioner must exercise due diligence when preparing tax returns, tax planning alone does not entail filing anything with the IRS and is not covered under Section 10.22.

   B: Correct. Since nothing is being filed with the IRS, due diligence is not expressly required. Section 10.22 relates to items provided to the IRS.

   C: Incorrect. Although a practitioner must exercise due diligence when preparing letters to the IRS, tax planning alone does not entail filing anything with the IRS. Section 10.22 relates to items provided to the IRS.

   D: Incorrect. Although a practitioner must exercise due diligence when preparing any federal tax return, tax planning alone does not entail filing anything with the IRS. Section 10.22 relates to items provided to the IRS.

   (See Section 10.22 of Circular 230 in the course material.)

3. A: Incorrect. There is no limit on the hourly rate charged as long as the fee is not unconscionably high.

   B: Incorrect. There are significant restrictions on contingent fees, but they are not prohibited in all circumstances.

   C: Correct. Although subject to interpretation, an unconscionably high fee is prohibited.

   D: Incorrect. Generally, the more schedules required in a tax return, the more time and effort required by the practitioner. Accordingly, charging a greater fee for a more detailed return is not prohibited.

   (See Section 10.27 of Circular 230 in the course material.)

4. A: Incorrect. The AICPA and IRS have vastly different rules relating to contingent fees. CPAs will generally be bound by more than one set of rules and must adhere to the strictest rule that applies to any given situation

   B: Incorrect. Contingent fees for preparing original tax returns are never permitted by the IRS.

   C: Correct. When representing a client under audit, there is little incentive for the practitioner to misstate income and play the “audit lottery.”

   D: Incorrect. The IRS prohibits contingent fees on original tax returns and most amended tax returns while permitting contingent fee arrangements in many other situations.

   (See Section 10.27 of Circular 230 in the course material.)

5. **A: Correct.** A completed tax return is the practitioner’s work product and is not a client record.

   B: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Section 10.28 does not expressly require the return of other client records allowing practitioners to consider remedies under state law.

   C: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Some states permit the practitioner to withhold records that are not required to compute federal tax liability.

   D: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Some states permit the practitioner to withhold records that are not required to compute federal tax liability. Federal law does not afford that option.

   (See Section 10.28 of Circular 230 in the course material.)

6. A: Incorrect. Ads may include a schedule of fees, but publishing the fee schedule is not mandatory.

   B: Incorrect. Rates may not be increased for at least 30 days after the last date the fee schedule was published.

   C: Correct. In addition, a list or description of the intended recipients must also be retained for 36 months. This also applies to e-mail solicitations.

   D: Incorrect. Although sound business practices suggest the use of an engagement letter that includes fee information, Circular 230 does not require giving the client a fee estimate.

   (See Section 10.30 of Circular 230 in the course material.)

7. A: Incorrect. Using abusive language with an IRS agent is unprofessional and may subject you to disciplinary action.

   B: Incorrect. Having one's CPA license revoked is considered disreputable conduct.

   C: Correct. Section 10.51 is primarily concerned with the preparation of federal tax forms. Being assessed of a preparer penalty is not a crime, and is not considered disreputable conduct.

   D: Incorrect. Section 10.51 is primarily concerned with the preparation of federal tax forms. However, conviction of a state tax crime would be disreputable.

   (See Section 10.51 of Circular 230 in the course material.)

CHAPTER 2: NAEA CODE OF ETHICS AND RULES OF PROFESSIONAL CONDUCT

Objectives: After completing this section, you will be able to:

- Describe the ethical framework applicable to EAs
- Apply the NAEA Rules of Professional Conduct to your tax practice

The National Association of Enrolled Agents (NAEA) has issued two sets of ethical guidance for Enrolled Agents. The Code of Ethics is a broad conceptual framework of ethical concepts. The Rules of Professional Conduct are more specific in that each rule tends to relate to a specific action. The rules follow closely and expand upon the legal requirements of Circular 230.

Code of Ethics

1. Members and Associates will, in personal and public life, strive to enhance the status of the profession and promote its qualifications to serve the public.

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

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

4. Members and Associates will maintain confidentiality of professional relationships.

5. Members and Associates will support all efforts to advance the reputation and prestige of the EA license.

6. Members and Associates will so conduct themselves and their practices that they remain in compliance with the most current provisions of Treasury Department Circular 230 and the NAEA Rules of Professional Conduct.

Rules of Professional Conduct

1. Members and Associates will adhere to all laws and regulations that provide equal opportunity for all clients and employees regardless of race, color, religion, gender, national origin, age, handicap, sexual orientation and/or any other legally protected class.

2. Members and Associates will maintain a confidential relationship between themselves and their clients, or former clients, disclosing confidential information only when authorized or legally obligated to do so. Members and Associates will instruct employees that information acquired in their duties is confidential and will ensure that confidentiality is maintained.

3. Members and associates will promptly submit requested information to the I.R.S. unless the member or associate believes, in good faith and on reasonable grounds, that the information is privileged. Similarly, members and associates must not interfere with lawful efforts by the I.R.S. to obtain any record of information unless the member or associate believes in good faith and on reasonable grounds that the information is privileged.

4. Only Members may designate themselves as “Members(s) of the National Association of Enrolled Agents”; only Associates may designate themselves as “Associate(s) of the National Association of Enrolled Agents.”

5. Members and Associates will not represent conflicting interests without express written consent of all parties after full disclosure.

6. Members and Associates will not allow their related business interests to affect representation of a client. If the propriety of a Member’s and Associate’s own conduct in a transaction is in question, it may be difficult or impossible for the Member and Associate to offer detached advice. Members and Associates will advise all appropriate parties of potential conflicts. Members and Associates must immediately disclose their interests when referring a client to another firm or enterprise for services. Members and Associates will refuse any gift, favor or hospitality that would influence or appear to influence their actions.

7. Members and Associates will take a position on a tax return favorable to their clients only if there is a realistic possibility that the position will be sustained on its merits, unless the position is disclosed on the return. Members and Associates have the absolute duty to explain in writing the probable effects of various alternatives to their clients who must make the final decision as to the position to be taken when the applicable law is unsettled or the application of law to the facts in a given situation is uncertain.

8. Members and Associates will not knowingly, directly or indirectly, employ, form an association or partnership with, be employed by, accept assistance of, or share fees with, a person, associate, correspondent or subagent who has been disbarred or suspended.

9. Members and Associates will avoid any appearance of impropriety when paying or accepting a commission to obtain a client, or to refer products or services. It will not be inappropriate to purchase a tax practice, to make retirement payments to persons formerly engaged in a tax practice, or to make payments to their heirs or estates.

10. Members and Associates who are engaged simultaneously in another occupation will conduct themselves in such a manner so as not to create a conflict of interest in rendering professional tax service or professional advice. No Member or Associate will accept or pay a commission for the sale or referral of products or services unless properly licensed, and those facts are fully disclosed in writing, to the client. No Member or Associate will pay a commission or referral fee to an employee for referring a client for products or services unless such employee is properly licensed.

11. Members and Associates will not solicit clients by advertising or other forms of solicitation in a manner that presents a false, misleading, or deceptive appearance. Members will not solicit clients in any manner prohibited by the most current provisions of Circular 230.

12. Members and Associates will undertake only those tax matters which the Member or Associate, or the Member's or Associate's firm, can reasonably expect to complete with professional competence. Members and Associates will obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to the task.

13. Members and Associates will be considerate and courteous in dealing with representatives of governmental agencies. In practice, the Member and Associate is under a duty to provide all information required by a statute or regulations, and formally requested by the authorized governmental agency. The defense of the client must be exercised within the bounds of the law and without resorting to deception.

14. Members and Associates will not suggest, state, promise, or give the impression that they are able to obtain special consideration from governmental agencies or their representatives, including making reference to previous I.R.S. employment.

15. Members and Associates will advise a client, preferably in writing, if they suspect the client may not have complied with the revenue laws or (may) have made an error in, or omission from a return, document, affidavit, or paper which the client is required by law to execute concerning the matter, and also advise the client of the consequences of the noncompliance, error or omission.

16. Members and Associates will not knowingly misrepresent or omit material facts in preparation of tax returns. Should a client insist, the Member and Associate will withdraw and refuse to prepare the return.

17. Members and Associates will not represent a client, or where representation has commenced, will withdraw from representation of the client if:
    a. the representation will result in violation of the rules of professional conduct or the law,
    b. the Member's or Associate's physical or mental condition materially impairs his/her ability to represent the client,
    c. the client persists in a course of action involving the Member's or Associate's services that the member or Associate believes is criminal or fraudulent,
    d. the client has used the Member's or Associate's services to perpetrate a crime or fraud, or
    e. the Member or Associate is discharged.

18. Members and Associates may withdraw from representing a client if:
    a. the client insists on pursing an objective that the Member or Associate considers imprudent,
    b. the client fails substantially to fulfill an obligation to the Member or Associate regarding the Member's or Associate's services and has been given reasonable warning that the Member or Associate will withdraw unless the obligation is fulfilled,
    c. the representation will result in an unreasonable financial burden on the Member or Associate or has been rendered unreasonably difficult by the client, or
    d. other good cause for withdrawal exists.

19. Upon termination of representation, a Member or Associate will make reasonable steps to protect the client's interests, providing reasonable notice, allowing time for employment of another practitioner, surrendering papers and property to which the client is entitled, and refunding advance fees that have not been earned. The Member or Associate must retain papers relating to the client to the extent required by law.

20. Members and Associates will furnish to clients or former clients, upon request and reasonable notice, any accounting or other records obtained from the client.

21. Tax preparation services will not be offered or rendered under any arrangement except as authorized by the most current provisions of Circular 230.

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. In preparing the tax return for Nash Plumbing, Inc., you notice a large deduction for "consulting services." You ask your client to explain this deduction and he explains it represents gifts he purchased for his wife to make up for him being on call and having to work at odd hours. You know that no 1099 or W-2 is issued for these "services" nor is any of this income reflected on your client's personal tax return. Your client states that "everyone" in this industry does this. The deduction is equivalent to 20% of net income. What action should you take according to NAEA Rule 7:

   a) sign the return since NAEA Rule 7 states your primary duty is to your client
   b) notify the IRS immediately
   c) sign the return and recommend that the client file an amended return after tax season
   d) not sign the return unless the client agrees not to claim the frivolous deduction

2. Assume the same facts as Question 1 above except that the questionable deduction was in a prior year return prepared by the prior preparer. What responsibilities do you have under NAEA Rule 15:

   a) you have no responsibility to do anything since you did not prepare the return in question
   b) you have no responsibility since the deduction in question was insignificant
   c) you should simply notify the client of the error
   d) you should notify the client of the error and advise the client of the consequences of the error

<u>CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES</u>

1. A: Incorrect. NAEA Rule 7 applies to tax return positions.

   B: Incorrect. A practitioner may not notify the IRS under any circumstances.

   C: Incorrect. A practitioner may not sign a false return even if he believes an amended return will later be filed.

   D: Correct. A practitioner may not sign a return containing a frivolous deduction.

   (See NAEA Rule 7 in the course material.)

2. A: Incorrect. NAEA Rule 15 specifies the practitioner's duties when an error on a prior year return is discovered.

   B: Incorrect. NAEA Rule 15 does not contain any references to materiality.

   C: Incorrect. Simply notifying the client of the error does not provide the client with an adequate course of action.

   D: Correct. Under NAEA Rule 15, you must both notify the client of the error <u>and</u> advise the client of the consequences of the error filed.

   (See NAEA Rule 15 in the course material.)

CHAPTER 3: IRS PRACTICE ISSUES

Objectives: After completing this section, you will be able to:

- Identify types of conduct that may result in discipline under Circular 230
- Recognize abusive tax shelters and abusive trusts

IRS Sanctions

The Internal Revenue Code and Regulations contain a number of provisions that impose criminal, civil, and regulatory sanctions on tax practitioners.

Of the approximately 150 penalty provisions a tax professional could run afoul of, one of the most relevant is section 6694. Section 6694 provides for a penalty against the preparer for each return involving an understatement of tax liability due to certain positions taken on a return.

The Treasury Department and the Internal Revenue Service issued Notice 2008-13 that implements a May 2007 law that expanded the tax return preparer penalty and heightened the standards of conduct that must be met by tax return preparers in order to avoid that penalty.

"The plan to take a fresh look at the preparer penalty regulations will be a top priority for us in 2008," said IRS Chief Counsel Don Korb. "Our goal is to complete our work on the overhaul of these rules by the end of 2008," he said.

For undisclosed positions on a tax return, the new law replaced the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits. In cases in which the taxpayer discloses the position on the tax return, the notice implements the new law that states there must be a reasonable basis for the tax treatment of the position taken on the tax return.

The Emergency Economic Stabilization Act of 2008 returned us to the possibility standards. Notice 2009-5 provides guidance on the realistic possibility standard.

Practitioners who violate the rules of Circular 230 are referred to the Director of Practice for disciplinary action. The sanctions for violating the rules under Circular 230 can be severe, including suspension or disbarment from practice before the Service. The Office of the Director of Practice recently published scenarios of conduct that may result in discipline under Circular 230. The scenarios represent composites of actual fact patterns that were brought to the attention of the Director of Practice.

Scenario No. 1: Taking Unwarranted Deductions

The practitioner was engaged to prepare a doctor's tax return. The doctor indicated he hoped substantial deductions could be taken for the use of his car in his practice. Without investigating further, the practitioner prepared the return with deductions for various automobile expenses. Upon audit, the doctor's "business use" of the automobile turned out to be nothing more than commuting between his home and office.

The practitioner was charged with violating Circular 230 section 10.22(a) (lack of due diligence in preparing tax returns) and section 10.51(b) (giving false information to the IRS). The practitioner argued that he was entitled to rely in good faith on client information but was unable to cite any authority for deduction of commuting expenses. Consequently, he was found guilty of giving false information under section 10.51(b).

Scenario No. 2: Contemptuous Conduct

In this scenario, the practitioner discussed his client's case with a revenue officer over the phone. Upon being advised that his client could still expect enforcement action, the practitioner said, "How about my coming down there and jerking you around for a while?" The practitioner also said he "would not mind kicking down the door." He called back later that day to apologize.

His actions were found to violate the section 10.51(i) rule against contemptuous conduct, including use of abusive language. However, since this was an isolated incident after many years of IRS practice, the practitioner was simply reprimanded and given a warning regarding future conduct.

Scenario No. 3: Lack of Due Diligence

The practitioner reviewed and signed a client return prepared by an employee. The employee had accepted without question that several client trips had been for business and had therefore deducted the related expenses. In fact, the client had no substantiation of any business purpose. The practitioner stated the employee had failed to follow office policy which required obtaining substantiation for claimed business trips.

The Director of Practice considered whether the practitioner had violated the section 10.22(a) due diligence rule and the section 10.51(b) rule against giving false information to the IRS. Since the office had a policy requiring client substantiation for business trips and since the practitioner did not have a history of preparing inaccurate returns, the Director concluded he did not knowingly submit false information. However, he was found to have failed to exercise "due diligence."

Scenario No. 4: Knowledge of Client Mistake

Based on a conversation, the practitioner understood the client to be legally separated and thus prepared a return using single filing status. Later, the practitioner learned that while the client and spouse had come to terms on a separation agreement, they were not actually legally separated under a decree of divorce or separate maintenance. In other words, they were still married for federal income tax purposes. The client had declined to file an amended return in a prior year, so the practitioner felt he would decline to do so in this situation as well. Therefore, the practitioner did not inform the client that his filing status was incorrect and that an amended return was in order.

This was found to be a violation of section 10.21 of Circular 230, which requires advising the client of the problem when the practitioner becomes aware of an error or omission in a return. It's unclear if the practitioner was actually suspended or disbarred or just reprimanded as a result of this incident.

Earned Income Credit Due Diligence

The IRS has instituted a due diligence requirement on preparers of tax returns where the taxpayer is claiming the Earned Income Credit (EIC). The preparer must either (1) complete the newly created Earned Income Credit checklist, or (2) otherwise record in the preparer's paper or electronic files the information that would be necessary to complete the checklist. The preparer must also complete the EIC worksheet included in the form 1040 instructions or a similar worksheet. In addition the preparer must retain the above items for three years after the June 30th following completion of the return. Most commercial tax preparation programs collect and retain this information.

Abusive Tax Shelters / Abusive Trusts

There has been a lot of talk lately regarding abusive tax shelters. The IRS has announced time and again that they are cracking down on abusive tax shelters and abusive trusts. As a CPA, you need to know the facts since some of your clients will be approached. Following are materials put out by the IRS on abusive tax shelters and abusive trusts.

Definition of an Abusive Tax Shelter Arrangement

While there is no hard and fast definition of abusive tax shelter arrangements, typically they are promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. The promised benefits may include reduction or elimination of income subject to tax; deductions for personal expenses paid by the trust or other entity; depreciation deductions of an owner's personal residence and furnishings; a stepped-up basis for property transferred to the trust or other entity; the reduction or elimination of self-employment taxes; and the reduction or elimination of gift and estate taxes. These promised benefits are inconsistent with the tax rules.

Frequently Asked Trust Questions

Q. What is a trust?

A. A trust is a legal entity created under state or common law, whereby a "trustee" holds property for the benefit of some other person called a "beneficiary." If a trustee attempts to hold property for his own benefit, the transfer is generally treated as a fraudulent conveyance under state law and is not recognized for federal income tax purposes.

Q. What is a grantor of a trust?

A. The term "grantor" refers to an individual who establishes or funds the trust (with property, money, or any other asset). Common synonyms are settlor, creator and trustor.

Q. What laws control trust taxation?

A. For all trusts, the Internal Revenue Code controls federal income tax consequences. Whether a trust is valid or invalid under state law, the common law, or any other law generally does not impact federal income taxation.

Q. I have been told that trusts are a legal method of paying personal expenses with "before-tax" dollars, reducing personal tax liability, or avoiding income or employment taxes. Is this true?

A. No. Many recent trust arrangements have been held by the courts to be shams with no economic substance. The income and expenses of such arrangements are attributed to the actual earner of the income, typically the individual grantor or other individual on whom the trust depends for the production of income or the providing of services.

Q. I have been told that I can assign income to a trust and I will not be taxed on that income. Is this true?

A. No. Contrary to the claims of the promoters who sell such arrangements, trusts are not a legal method of paying personal expenses with "before-tax" dollars, reducing one's personal tax liability, or avoiding income or employment taxes. Rather, ALL income is taxable unless there is a specific statutory provision excluding it; there is no such provision in the trust area. The Internal Revenue Service is presently auditing numerous trust arrangements to determine whether they reflect economic reality and comply with the requirements of the Internal Revenue Code.

Since the IRS does not give legal advice, we suggest that you seek competent, independent legal assistance in determining exactly how your income should be reported and your taxes paid.

Q. Do pure trusts or contract trusts have a requirement to file federal income tax returns?

A. The terms of "Pure Trust" or "Contract Trust" are not used in the Internal Revenue Code, and entities under such names will be classified as an entity recognized under the Internal Revenue Code. In any event, all trusts have the same responsibility to report income and pay tax on it. The filing requirements vary with the type of trust.

Q. Do foreign trusts have a United States reporting requirement?

A. Many entities called "foreign trusts" are not considered to be "foreign" under the law. If a trust has one or more United States persons having the authority to control substantial decisions of the trust or if a United States court can exercise jurisdiction over the administration of the trust, it will be considered a "domestic" trust and treated under normal rules of taxation. If the trust is truly a "foreign" entity with all of its actual assets outside of the United States, it must file a Form 1040NR and Form 3520.

Q. What is a business trust?

A. Most trusts are used for the protection or conservation of property (e.g., decedent's estate, trust for minor children, bankruptcy estate, etc.). However, sometimes an actual business is operated in the form of a trust, rather than as a partnership, corporation or sole proprietorship.

Q. How is a business trust taxed?

A. Business trusts are taxed according to the economic reality of the business. If the trust is a sham or façade with no economic reality, it will be ignored and the tax liability will be placed directly on the individual who formed the trust. If the trust has only one individual who funded it and operates it, it will generally be treated as a sole proprietorship. If it has two or more individuals who control it (i.e., if it resembles a partnership), it will generally be treated as a partnership. If the trust is registered as a corporation under state or federal statutes, it will be treated as a corporation.

Q. Will the use of a business trust avoid Estate Taxes?

A. If the trust is a sham or façade with no economic reality, it will be ignored and the tax liability will be placed directly on the individual who formed the trust. This includes Estate Taxes.

Q. What are the federal income tax reporting requirements for business trusts?

A. They depend on the economic reality of the arrangement, not on what the business is called.

If the trust actually operates as a sole proprietorship, the income and expenses should be reported on the Schedule C of the Form 1040 of the individual who actually owns and operates it.

If the trust actually operates as a partnership, the income and expenses should be reported of on a Form 1065, U.S. Partnership Income Tax Return, and passed through to the partners on the Schedule K-1.

If the trust has been granted a corporate charter under any state or federal law, then it should report its income and expenses on a Form 1120, U.S. Corporation Income Tax Return or a Form 1120S, U.S. Small Business Corporation Income Tax Return.

If it is actually operated as a "Trust" pursuant to the requirements of the Internal Revenue Code, then it should file a Form 1041, U.S. Fiduciary Income Tax Return.

Q. How does a trust compute its income tax liability?

A. A trust computes its income tax liability in much the same way that an individual does and is allowed most of the credits and deductions that an individual is allowed. Similarly, DEDUCTIONS NOT ALLOWED TO INDIVIDUALS ARE NOT ALLOWED TO TRUSTS. For example, personal living expenses such as food, utilities, recreational expenses, children's education, depreciation of one's personal residence, etc. are not allowed as a trust deduction any more than as an individual deduction.

Trusts are also required to prepare a Schedule K-1 for their beneficiaries, showing them the amounts distributed by the trust to them. These amounts must be reported on the beneficiaries' individual returns. More information about trust taxation can be found in the IRS Instructions for the Form 1041.

Q. Are monetary contributions to a charitable trust deductible?

A. To be deductible, a contribution must be made for "charitable" purposes and made to an entity recognized as a charitable entity by the Internal Revenue Service. Thus, amounts paid for tuition at a church school would not be deductible because they are for an educational purpose, not a charitable purpose. Similarly, amounts paid by an individual to a charity established by that individual are likely not deductible because the entity has not been registered as a charitable organization with the Internal Revenue Service.

Q. What is a Grantor Trust?

A. "Grantor Trust" is a term used in the Internal Revenue Code to describe any trust over which the Grantor or other owner retains the power to control or direct the trust's income or assets. If a Grantor retains certain powers over or benefits in a trust, the income of the trust will be taxed to the grantor rather than to the trust.

Q. How is a revocable trust taxed?

A. A revocable trust may be revoked and is considered a Grantor Trust thus the revocable trust is taxed to the grantor rather than to the trust.

What Do the Courts Say About Abusive Trusts?

Assignment of Income in General

In 1930, the United States Supreme Court said that income that has been assigned to another entity is taxable to the one who assigns it. In this case, a married attorney assigned half of his salary and fees to his wife, so as to split his income and qualify for a lower tax bracket. The IRS of that era taxed all income to him at the higher rate. The Supreme Court upheld the Government's position, stating that the "tax could not be escaped by anticipatory arrangements and contracts however skillfully devised."

Lucas v. Earl, 281 U.S. 111 (1930)

Trust Income Taxable to the Individual Controlling the Trust

In this 1940 case, the Supreme Court determined that trust income is taxable to the person who actually controls that trust. In this case, an individual made a formal transfer of assets into certain trusts, thus splitting his income and qualifying for a lower tax rate. The IRS taxed all income to him, inasmuch as he retained control over the trust assets. The Supreme Court held that the Treasury could tax income to the original owner even though he had made a “formal” transfer into a trust, since the tax law was concerned with the substance of the transaction, rather than its form.

Clifford v. Helvering, 309 U.S. 331 (1940)

Business and Home Transferred to a Trust

This 1980 case holds that a trust set up by individuals to avoid taxes was devoid of economic reality and was to be treated as a nullity for federal income tax purposes. In this case, the taxpayers transferred all of their business and personal assets, including husband’s dental equipment, his lifetime services, and all remuneration therefrom, to a family trust established under the Educational Scientific Publishers (ESP) promotion, under which they were the only trustees. Petitioners continued to use their home and personal assets, and husband continued to use his office and dental equipment in his practice. Husband continued to receive all of the gross income from his dental practice and deposited it in his personal account. Petitioners then paid 80 percent of the gross income from the dental practice to the trust as a “fee.” The Tax Court held that the trust was devoid of economic reality and is to be treated as a nullity for Federal income tax purposes.

Markosian v. Commissioner, 73 T.C. 1235 (1980)

Transfers to Foreign Trusts

This case holds that foreign trusts set up by taxpayers to avoid taxes on income from properties in the United States were invalid for tax purposes. The Zmudas formed several trusts under the American Law Association promotion and transferred US real personal property (including real estate sales contracts) into those trusts, in return for units of beneficial interest. Since the ultimate ostensible holders of the property were foreign trusts, the individuals claimed that they had no gross income and, thus, no tax liability. The Tax Court held that the trusts were shams, inasmuch as the Zmudas had simply restructured the form in which they held their property, without giving up control over that property. The Tax Court determined the ostensible trust income was actually the individuals’ income, claimed deductions for creating the trusts were disallowed for lack of business purpose, and penalties were imposed. The Ninth Circuit affirmed.

Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984), aff’g 79 T.C. 714 (1982)

Use of Multiple Trusts Including a *Charitable Trust*

This case held that trusts created by the taxpayers should be disregarded because they were shams. The taxpayers established a multi-trust scheme promoted by the Heritage Assurance Group/Bartoli, transferred their business and services into the trusts, and used the trusts to pay personal expenses while reporting no income because the excess amounts went into a *charitable trust* under the scheme. Petitioners, who were represented by Joe Izen in the trial, controlled all entities. The Tax Court held that the scheme lacked economic substance, taxed the income to the individuals, and imposed accuracy-related penalties.

Muhich v. Commissioner, T.C. Memo. 1999-192

Promoter of Trust Scheme That Included Deducting Personal Living Expenses

In this case, an injunction issued against a trust promoter. Tax shelter promoter Henkel (Estate Preservation Services) made numerous false statements in connection with supposed tax benefits of trusts he sold, including stepped-up basis without recognition of gain, deductibility of personal living expenses, etc. District Court issued injunction against him and company; Ninth Circuit affirmed.

Estate Preservation Services, United States v., 38 F. Supp. 2d 846 (E.D. Ca 1998), aff'd, 202 F.3d 1093 (9^{th} Cir. 2000)

Promoter Convicted of Conspiracy to Defraud the United States

Noske and related defendants were convicted of conspiracy to defraud the United States and conspiracy to evade income taxes in a scheme involving the use of bogus trusts and "tax-exempt" corporations to fragment and hide income and assets. As well as affirming the convictions, the Eighth Circuit held that the imposition of criminal penalties in addition to the civil fine (of $490, 174 under I.R.C. § 6700 for promoting abusive tax shelters) did not constitute double jeopardy; thus, the defendants were subject to both the civil and criminal penalties, as well as any income taxes due.

United States v. Noske, 117 F.3d 1053 (8^{th} Cir. 1997)

Summary

Abusive Tax Shelters

If the promotion you are considering sounds too good to be true it may be an <u>abusive tax shelter</u>. Look to see if any of the following ***red flags*** exist.

- <u>Never pay taxes again</u>
- <u>Deduct the cost of your personal residence</u>
- <u>Deduct the cost of your child's education</u>
- <u>The IRS doesn't want you to know about this</u>
- <u>This is so new, your tax professional doesn't know about it yet</u>

- <u>Multiple trusts, partnerships or other entities are involved</u>

- <u>Some of the entities involved are foreign</u>

If one or more of these ***red flags*** exist, you should consult a tax professional not involved in promoting the investment or contact the IRS to determine how it will treat such a promotion. It's worth your time to learn more about the legal/tax consequences of the promotion you are considering investing in. The penalties, interest, and legal costs associated with an abusive tax promotion are significant (and these are in addition to the tax due and fees you paid for the promotion).

As of January 2008, the IRS reported that its tax shelter compliance efforts have reaped disclosures from more than 1,500 taxpayers. The IRS is using those disclosures to identify tax shelter promoters. The disclosures from promoters are being used to identify additional taxpayers.

IRS Names Four New Frivolous Claims to Avoid

IR-2008-8, January 14, 2008

WASHINGTON – The Internal Revenue Service today issued a notice that lists four additional erroneous legal positions that taxpayers should refrain from using as an excuse to avoid paying their taxes.

An individual or group may not avoid paying their fair share of taxes by making "frivolous" legal arguments such as those listed in this notice. The IRS publicizes these frivolous claims to help taxpayers understand the law and avoid penalties.

Notice 2008-14 lists positions identified as frivolous for purposes of the penalty under section 6702 of the federal tax code for filing a frivolous tax return or submitting to the IRS a frivolous request for a collection due process hearing or application for an installment agreement, offer-in-compromise, or Taxpayer Assistance Order.

Taxpayers who file a tax return or make a submission based on a position listed in this notice are subject to a $5,000 penalty.

The four new frivolous claims pertain to the following:

- Misinterpretation of the 9th Amendment to the U.S. Constitution regarding objections to military spending.
- Erroneous claims that taxes are owed only by persons with a fiduciary relationship to the United States or the IRS.
- A nonexistent "Mariner's Tax Deduction" (or the like) related to invalid deductions for meals.
- Certain instances of misuse or excessive use of the section 6421 fuels credit.

In 2006, Congress increased the penalty for frivolous tax returns from $500 to $5,000. The increased penalty amount applies when a person submits a tax return or other specified submission, and any portion of the submission is based on a position the IRS identifies as frivolous.

Notice 2008-14 along with additional information providing the truth about frivolous arguments can be found on IRS.gov.

Return Preparer Enforcement Program

The IRS Criminal Investigation Return Preparer Program (RPP) was implemented in 1996, and established procedures to foster compliance by identifying, investigating and prosecuting abuse return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or incompetent return preparers. This is a significant problem for both the IRS and our taxpayers. Abusive return preparers frequently prepare bad returns for large numbers of taxpayers who, at best, are stuck with paying additional taxes and interest and at worse, depending on culpability, are subject to penalties and maybe even criminal prosecution. In fiscal year 2007, the program had 127 convictions of unscrupulous preparers with an average of 19 months incarceration.

Examples of Abusive Return Preparer Investigations for 2009

The following examples of abusive return preparer fraud investigations are excerpts from public record documents on file in the court records in the judicial district in which the cases were prosecuted.

Tax Preparer Sentenced to Federal Prison for Preparing Fraudulent Tax Returns

On January 29, 2009, in Kansas City, Kan., Gene Franklin, a tax preparation business owner, was sentenced to 30 months in prison following his March 2008 conviction for preparing false tax returns. He owned Franklin & Company, Inc., an income tax preparation business with offices in Kansas City, Butler, Mo., and Overland Park, Kan. Evidence presented at trial showed Franklin advised clients and prepared tax returns fraudulently reporting business expenses in a manner promoted by Renaissance, The Tax People in literature, sales presentations and videos. Franklin joined Renaissance as an “Independent Marketing Associate,” drawing revenue by bringing other members into the network. Additionally, Franklin was an “Affiliated Tax Professional” with Renaissance, which enabled him to promote his tax preparation business at Renaissance meetings. Through the affiliation with Renaissance, the gross receipts for Franklin & Company increased almost 50 percent due to the large number of new clients. Renaissance, The Tax People founder, Michael Craig Cooper, was convicted in February 2008 on more than 70 counts of mail fraud, wire fraud, money laundering and conspiracy.

Four Employees of Independent Tax Service Sentenced for Tax Fraud

On January 7, 2009, in Wilmington, N.C., four defendants were sentenced for their roles in a tax fraud scheme. Sentences were up to 15 months in prison. According to court documents, from January 2004 to April 15, 2004, the defendants, while employees of Independent Tax Service located in Rocky Mount, North Carolina, conspired to make, and did make, false claims for refunds from the Internal Revenue Service (IRS) by filing or causing others to file false 2003 federal income tax returns. The defendants inflated wages and/or withholdings and listed false dependants and/or false dependant information to qualify clients for the earned income credit. In addition, the defendants sold fraudulent dependent information to some clients so they would qualify for a larger refund and claimed education credits their clients were not entitled to claim.

Former Tax Preparer Is Sentenced for Fraud

On January 6, 2009, in Tulsa, Okla., Cynthia J. Williams, a former tax preparer, was sentenced to 12 months and one day in prison to be followed by one year of supervised release for preparing a false federal income tax return while she operated a tax preparation business in Sapulpa, Okla. U.S. District Judge Terence Kern also ordered her to pay $45,877 in restitution to the IRS and a special monetary assessment of $100. Williams pleaded guilty to the charge in August 2008. According to court documents, Williams owned a tax preparation business, Tax and Accounting Solutions, Inc. Williams would prepare one version of an income tax return using clients' information while they were in her office. Unbeknownst to her clients, she would electronically file a different version of the same return with the Internal Revenue Service with increased itemized deductions or expenses listed on Schedules A and/or C of the return that falsely inflated the refund amounts. In addition, without the knowledge or permission of her clients, Williams would apply for a Refund Anticipation Loan (RAL) in the name of her clients. This would cause the improperly inflated refund amount to be paid into a RAL bank account to which only Williams had access. Williams would only pass on the original (smaller) refund to her clients and keep the remainder of the false refund for herself.

Section 7216 Updated Rules for Tax Preparers (Updated 12/18/2008)

New regulations under Internal Revenue Code Section 7216, Disclosure or Use of Tax Information by Preparers of Returns, became effective January 1, 2009. The new regulations update regulations that have been substantially unchanged since the 1970s, and give taxpayers greater control over their personal tax return information. The statute limits tax return preparers' use and disclosure of information obtained during the return preparation process to activities directly related to the preparation of the return. The regulations describe how preparers, with the informed written consent of taxpayers, may use or disclose return information for other purposes. The regulations also describe specific and limited exceptions that allow a preparer to use or disclose return information without the consent of taxpayers.

Revenue Procedure 2008-35 supplements the regulations, and provides specific form and content guidance to tax return preparers for obtaining consents to disclose and consents to use taxpayer data in both the paper and electronic environments. Generally, tax preparers must obtain the signed consent of the taxpayer on paper or electronically before they can disclose taxpayer return information to anyone or use it for any purpose other than in the context of preparing and filing the return. Separate consents are required for disclosure(s) and use(s). Consents must:

- Identify the intended purpose of the disclosure or use;
- Identify the recipient(s) and describe the particular authorized information to be disclosed or used;
- Include the name of the tax return preparer and the name of the taxpayer;
- Include the applicable mandatory language set forth in section 4.04(a)-(c) of Revenue Procedure 2008-35 that informs the taxpayer that he is not required to sign the consent; and if he signs the consent, he can set a time period for the duration of that consent;
- Include the mandatory language set forth in section 4.04(d) of Revenue Procedure 2008-35 that refers the taxpayer to the Treasury Inspector General for Tax Administration if he believes that his tax return information has been disclosed or used improperly;
- Where applicable, include the appropriate mandatory statement set forth in section 4.04(e) of Revenue Procedure 2008-35 that informs the taxpayer that his tax return information may be disclosed to a tax return preparer located outside the U.S.;
- Be in 12-point type on 8½ x 11 inch paper. Electronic consents must be in the same type as the website's standard text;
- Contain the taxpayer's affirmative consent (as opposed to an "opt-out" clause); and
- Be signed and dated by the taxpayer.

The updated regulations apply to paid preparers, software developers, Electronic Return Originators, and other persons or entities engaged in tax return preparation services or services that are auxiliary to return preparation. They also apply to most volunteer tax preparers, for example, Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) volunteers and employees and contractors employed by tax preparation companies in a support role.

Violations could result in imprisonment for up to one year, a fine of not more than $1,000, or both, for each violation.

CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following is <u>not</u> true regarding abusive tax shelter arrangements:

   a) they are typically promoted by the promise of tax benefits
   b) promised benefits may include reduction or elimination of income subject to tax
   c) abusive tax shelter arrangements are specifically defined by the IRS
   d) the promised benefits of abusive tax shelters are inconsistent with the tax rules

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The promised tax benefits have no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets.

   B: Incorrect. The promised benefits may also include deductions for personal expenses paid by the trust or other entity and the reduction or elimination of self-employment taxes or gift and estate taxes.

   C: Correct. There is no hard and fast definition of abusive tax shelter arrangements.

   D: Incorrect. The promised benefits of an abusive tax shelter arrangement are in contrast to the tax rules.

   (See page 3-3 of the course material.)

GLOSSARY OF ETHICS TERMS

The terms included in this glossary are related to the ethics area in general, but may not be specifically used in this material. They are provided for greater clarification and educational purpose.

TERM	DEFINITION
Alternative Practice Structures (APS)	A nontraditional structure for the practice of public accounting in which a traditional CPA firm engaged in auditing and other attestation services might be closely aligned with another organization, public or private, that performs other professional services (e.g., tax and consulting).
American Institute of Certified Public Accountants (AICPA)	The national professional organization for all certified public accountants (CPAs).
Client's records	Any accounting or other records belonging to the client that were given to the member by, or on behalf of, the client.
Close relative	Close relatives are the member's nondependent children (including grandchildren and stepchildren), brothers and sisters, grandparents, parents, and parents-in-law. Spouses of any of the above are also close relatives. The SEC definition of close relatives expands the above to include a spouse's brothers and sisters and their spouses.
Code of Professional Conduct (the Code)	The Code was adopted by the membership of the AICPA to provide guidance and rules to all members on various ethics requirements. The Code consists of: 1) Principles, 2) Rules, 3) Interpretations, and 4) Ethics Rulings.
Conflict of interest	A conflict of interest may occur if a member performs a professional service for a client or employer, and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity.
Consulting process	The analytical approach applied in performing a consulting service. The process typically involved some combination of the following: • Determining the client's objective • Fact-finding • Defining problems or opportunities • Evaluating alternatives • Formulating proposed actions • Communicating results • Implementing • Following up

Consulting services	Professional services that use the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process.
Contingent fee	A fee for performing any service in which the amount of the fee (or whether a fee will be paid) depends on the results of the service.
Direct financial interest	A direct financial interest is created when a member invests in a client entity.
Disqualifying services	Term used to refer to the following services, which when performed for a client prohibit the member from accepting a contingent fee or commission: a. An audit or a review of a financial statement. b. An examination of prospective financial information. c. A compilation of a financial statement expected to be used by third parties except when the compilation report discloses a lack of independence.
Ethics Rulings	Part of the Code of Professional Conduct. Rulings summarize the application of rules and interpretations to a particular set of factual circumstances.
Firm	A form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof.
Former practitioner	A proprietor, partner, shareholder or equivalent of a firm, who leaves by resignation, termination, retirement, or sale of all or part of the practice.
Holding out as a CPA	Includes any action initiated by a member, whether or not in public practice, that informs others of his or her status as a CPA.
Independence in appearance	If there are circumstances that a reasonable person might believe are likely to impair independence, the CPA is not independent in appearance. To be recognized as independent, the auditor must be free from any obligation to or interest in the client, its management, or its owners.
Independence in fact	To be independent in fact (mental independence), the CPA must have integrity and objectivity. If there is evidence that independence is actually lacking, the auditor is not independent in fact.
Indirect financial interest	An indirect financial interest is created when a member invests in a nonclient entity that has a financial interest in a client.
Integrity	An element of character fundamental to professional recognition. It is the quality from which public trust derives and the benchmark against which a member must ultimately test all decisions.

Internal audit outsourcing	Internal audit outsourcing involves performing audit procedures that are generally of the type considered to be extensions of audit scope applied in the audit of financial statements. Examples of such procedures might include confirming receivables, analyzing fluctuations in account balances, and testing and evaluating the effectiveness of controls.
Interpretations of rules of conduct	Part of the Code of Professional Conduct. Interpretations are pronouncements issued by the AICPA's Division of Professional Ethics to provide guidelines concerning the scope and application of the rules of conduct.
Joint closely held business investment	An investment that is subject to control by the member, or the member's firm, client or its officers, directors, or principal stockholders, or any combination of the above.
Joint Ethics Enforcement Program (JEEP)	The AICPA and most state societies cooperate in the Joint Ethics Enforcement Program (JEEP) in bringing enforcement actions against their members.
Member	In its broadest sense, "member" is a term used to describe a member, associate member, or international associate of the AICPA. All members must adhere to the AICPA's Code of Professional Conduct. For the purposes of applying the independence rules, the term "member" identifies the people in a CPA firm and their spouses, dependents, and cohabitants who are subject to the independence requirements.
Multidisciplinary practices (MDP)	Arrangements in which CPAs share fees with attorneys or other professionals.
National Association of State Boards of Accountancy (NASBA)	A voluntary organization composed of the state boards of accountancy. It promotes communication, coordination, and uniformity among state boards.
Objectivity	The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Objectivity is a state of mind, a quality that lends value to a member's services.
Period of professional engagement	The period of engagement starts when the member begins the service requiring independence and ends upon termination of the relationship (by the member or the client) or, if later, when the report is issued. The period does not stop when the report is issued and restart with the beginning of the next engagement. The period of engagement typically covers many periods.

Practice of public accounting	According to the Code of Professional Conduct, the practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPAs, of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements on Standards for Tax Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements. However, a member or member's firm, while holding out as CPAs, is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph.
Principles	Positive statements of responsibility in the Code of Professional Conduct that provide the framework for the rules, which govern performance.
Professional services	Includes all services performed by a member while holding out as a CPA.
Rules	Broad but specific descriptions of conduct that would violate the responsibilities stated in the principles in the Code of Professional Conduct.
Securities and Exchange Commission (SEC)	A federal government regulatory agency with responsibility for administering the federal securities laws.
State boards of accountancy	State government regulatory organizations. Each state government issues a license to practice within the particular state under that state's accountancy statute.
State societies of CPAs	Voluntary organizations of CPAs within each individual state.
Statements on Standards for Tax Services (SSTS)	SSTS superseded and replaced the AICPA's Statements on Responsibilities in Tax Practice (SRTP). They are enforceable standards of conduct for tax practice under the Code of Professional Conduct.
Unpaid fees	Fees for: 1) audit, and 2) other professional services that relate to certain prior periods that are delinquent as of the date the current year's audit engagement begins, if the client is an SEC registrant, or the date the audit report is issued for non-SEC clients (i.e., AICPA rule).
Yellow Book	Governmental Auditing Standards issued by the Government Accountability Office.

INDEX