

EXPERT WEBINAR SERIES (2013)



Tax Practice Ethics and Quality Control

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Short Bio – E. Lynn Nichols CPA

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E. Lynn Nichols, a practicing CPA for 40+ years, provides tax consulting services to accounting firms. He has developed an intimate knowledge of tax law and regulation of tax practice.



He is the founder of Nichols Patrick CPE, Inc. and presents more than 100 CPE seminars sponsored by state societies of CPAs each year, and is also a featured speaker at major tax conferences.

Lynn serves as an advisor to CPA firms across the U.S. on matters of federal income taxation, tax practice quality control, and IRS procedures.

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Tax Practice Ethics and Quality Control

Expert Webinar Series

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“Confluence” of Regulation

- Ethical standards for tax practice include:
 - Treasury Circular 230 – Standards for all tax practitioners:
[\(Revised 8/2/2011, proposed changes on 9/14/2012\)](#)
 - IRC Sec. 6694 & Regulations – Preparer Penalties: IRS is enforcing the penalties
 - Strict rules for registration and regulation of paid preparers, including CPAs
 - AICPA - 7 Statements on Standards for Tax Services
[\(Revised 1/1/2010\)](#) 2 Interpretations [\(Revised 8/30/2011\)](#)

Ethics ?

- “The courage to say ‘No’ !” (Clement Stone)
- Doing the right thing, even if no one is watching.
(Anonymous)
- “There is no such thing as a minor lapse of integrity.” (Tom Peters)
- “I consider ethics . . . as supplements to law in the government of man.” (Thomas Jefferson)
 - What do you think Jefferson meant ?
 - Does the law not work well without “ethics” ?

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Why All the Fuss About “Ethics”?

- Return preparers must behave in a manner that not only conforms to the minimum standards established by accountancy and tax law and professional standards, but also must act within the spirit of applicable law and professional standards
 - Never forget that the purpose of laws and professional standards is to protect the public
 - Financial reporting . . . Investors and bankers
 - Income tax reporting . . . The public purse

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Your Tax Practice and The IRS

A Story of Changed
Responsibilities and Risks

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Concentration of IRS Resources

- On November 13, 2009 , IRS officials said, in a California Bar Seminar :
 - IRS is considering regulations coordinating Circular 230 sanctions and Sec. 6694 preparer penalty rules (**DONE !**)
 - From one shelter promoter case, the IRS has generated 1,500 participant audits, 1,400 settled and paid additional tax without litigation, others are losing. . . one-by-one !!!

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What is Driving Regulation of Tax Practice

- On October 26th, 2009, IRS Commissioner Shulman made these statements:
 - “. . . almost 9 of 10 individual taxpayers use a tax preparer or 3rd party software . . .”
 - “We want to make sure return preparers are part of the IRS’ overall goal of seeing that taxpayers file accurate returns and pay what they owe.”
 - “The *status quo* is not optimal.”

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What Form Will Regulation Take ?

- Chief Counsel, William J. Wilkins, said on November 19, 2009 . . .
 - “As the IRS develops its new initiative to require disclosure of information about . . . uncertain tax positions, it is interested in learning what issues are there so that resources can be devoted to issues that are important and not wasted on issues that are not important.” (That’s done in Schedule UTP)
- Section 6694 regulations were released in final form on December 15, 2008
 - Preparers have enhanced responsibility for ALL returns; income, excise, payroll, gift, wagering, claims for refund, etc.

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March 26, 2010

- REG-134235-08, 3/26/2010 . . . Proposed regulations
 - Based on survey results
 - Requires all paid preparers to register (or re-register), pay a fee, and obtain a Preparer Tax Identification number (PTIN)
- A firestorm of protest followed, but the IRS has been unyielding on the main points of its proposal.
- Employees of CPAs, EAs, and Attorneys must register and secure a number, but are excused from CPE and testing. (Notice 2011-6, 12/30/2010)

May 31, 2011

- T. D. 9527, 5/31/2011, (Effective 8/2/2011)
IRS amends Circular 230 modifying practice standards, and requiring ALL tax return preparers to secure an identifying number issued by the IRS
- Preparer's Social Security number will no longer be accepted as identifying number
- Old preparer number must be replaced
- Electronic registration is at www.irs.gov
- Form W-12 is available for print filing

Loving Litigation

- Sabina Loving et al. v. United States et al.; CA DC; No. 13-5061
 - Government has appealed decision of DC District Court enjoining IRS from full implementation of tax return preparer testing and regulation
 - I believe that decision is based on an outdated understanding of modern tax return preparation and IRS processing methods. When that is explained to the Court of Appeals, I expect it to be reversed.

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Treasury Department Regulation of Tax Practitioners

Ethical Standards for
Federal Tax Practice

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Circular 230 (As Amended)

- Who can practice before the IRS
 - Attorneys and CPAs
 - Enrolled Agents and Enrolled Actuaries
 - Qualified Appraisers
 - Qualified Retirement Plan Advisors
 - Registered Tax Return Preparers
 - Limited to preparing and signing returns or claims for refund
 - Cannot act for taxpayer
- What is “practice before the IRS?”

Practice Before the IRS Defined

“(4) Practice before the Internal Revenue Service comprehends 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, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings. “

Circular 230 (continued)

- Duties and restrictions (Subpart B)
 - Promptly provide information requested by IRS(10.20)
 - Client matters **OR** Circular 230 matters
 - Advise client promptly of error or omission in tax return and consequences of failure to correct(10.21)
 - Exercise “due diligence” as to accuracy of representations to IRS (10.22)
 - When relying on others must show reasonable care in engaging, supervising, training, and evaluating the person
 - **This has become the OPR’s principal weapon against irresponsible or deceitful practitioners**
 - Do not unreasonably delay prompt disposition of any matter before IRS(10.23)

Circular 230(continued)

- Duties and restrictions (continued):
 - No assistance from disbarred persons(10.24)
 - No assistance from former government employee on matter worked on in official capacity while employed by IRS(10.25)
 - Cannot notarize documents you will present to IRS on behalf of client(10.26)
 - Fees(10.27)
 - No unconscionable fees
 - No contingent fee for advice as to return position or return preparation

Circular 230(continued)

- Duties and restrictions (continued):
 - At request of client must promptly return all records of the client needed for tax compliance(10.28)
 - No conflicts of interest without written waiver(10.29)
 - Be alert for conflict of interest between **client and preparer** !!!
 - No false, misleading or deceptive advertising(10.30)
 - Cannot endorse or negotiate refund check(10.31)
 - Proposed changes to this section on September 14, 2012, extend the prohibition to receiving or coming into control of client refunds regardless of the medium in which the refund is made.

Circular 230 (continued)

- Duties and restrictions (continued)
 - No unauthorized practice of law(10.32)
 - Should adhere to “Best Practices” (described) (10.33)
 - Communicate clearly with client regarding terms of engagement
 - Establish the facts
 - Advise the client as to penalty exposure
 - Act fairly and with **integrity** in practice before the IRS
 - Tax advisors with responsibility for firm’s tax practice should take reasonable steps to ensure the firm’s procedures for all personnel are consistent with best practices set out in Section 10.33 (See also Section 10.36 as of 9/14/2012)

Circular 230 (continued)

- Tax returns, documents, affidavits, etc. (10.34)
 - A practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund, or advise a client to take a position on a tax return or claim for refund, that the practitioner knows or reasonably should know contains a position that –
 - Lacks a reasonable basis (that's the Sec. 6694 minimum standard)
 - Is an unreasonable position as described in IRC Sec. 6694(a)(2), or
 - Is a willful attempt to understate the liability for tax or a reckless or intentional disregard (see next slide) of rules or regulations as described in IRC Sec. 6694(b)(2) including related regulations and other guidance
 - Practitioner may generally rely on information furnished by client, but may not ignore inconsistencies or other information known to practitioner (See "Due Diligence" requirement in Sec. 10.22)

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Willfulness, Recklessness, or Intentional Disregard

- Willful = deliberate disregard of information furnished by the taxpayer in order to understate the taxpayer's tax liability.
- Reckless = little or no effort to determine the correct position, when a reasonable preparer would have made an effort.
- Intentional Disregard = taking a position that is contrary to a rule or regulation that the preparer knows of or should know of.

Circular 230(continued)

- Duties and restrictions (continued):
 - Standards for Tax shelter opinions “Old Section 10.35”
 - Defines “Covered Opinion”
 - Sets standards for other written opinions
 - Changes proposed on 9/14/2012 revoke the “covered opinion” rules in their entirety and new Section 10.35 is a simple statement;
 - “New Section 10.35 “Competence”

“(a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.”

Circular 230(continued)

- Duties and restrictions (continued):
 - Person responsible for overseeing tax practice must (10.36)
 - Take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with Circular 230, (both as to tax opinions and tax returns) and will be subject to discipline if he or she does not do that, or fails to take action to correct non-compliance of which the practitioner is, or should be, aware.
 - This section is modified by the September 14, 2012 proposed changes to require the responsible person to ensure compliance with ALL requirements of Circular 230

Circular 230(continued)

- Duties and restrictions (continued):
 - Other written advice must also meet standards (10.37)
 - Those standards are significantly expanded and clarified by the September 14th, 2012 proposed changes
 - Section 10.37 now contains the rules for ALL written opinions, requiring the practitioner to:
 - Base written advice on reasonable factual and legal assumptions
 - Reasonably consider all relevant facts
 - Use reasonable efforts to identify relevant facts
 - Not rely on any unreasonable representations or assumptions
 - Limit reliance on others
 - IRS will apply a reasonableness standard in evaluating practitioner conduct with regard to written advice

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Circular 230(continued)

- Actions for which a practitioner may be fined, censured, or suspended)(Subpart C)
 - A criminal offense under the revenue laws or any offense involving dishonesty or breach of trust
 - Willfully failing to file a tax return, evading or attempting to evade any federal tax
 - Mishandling client funds
 - Attempting to influence IRS employees by threat or favors
 - Knowingly giving false information in connection with federal tax matters
 - Soliciting employment by false or deceptive advertising

Circular 230(continued)

- Actions for which a practitioner may be disciplined (continued)
 - Being disbarred or suspended by your profession
 - Trouble with state Board of Accountancy means trouble with IRS !
 - Knowingly aiding a disbarred or suspended practitioner to practice before the IRS
 - Using abusive language, knowingly making false accusations, circulating malicious or libelous material, or engaging in “contemptuous conduct”
 - Giving a false opinion knowingly, recklessly, or through gross incompetence (modified by proposed changes to specifically address sections 10.34, 10.36. and 10.37)

Circular 230 (continued)

- Actions for which a practitioner may be disciplined (continued)[these 3 are new in 2011]
 - Following a pattern of providing incompetent opinions
 - Willfully failing to file electronically when required
 - Willfully preparing or signing a return when not possessing a valid PTIN
 - Willfully representing a taxpayer before the IRS when not authorized to do so

High Profile Suspensions

- CPA Tim W. Kaskey disbarred for failure to exercise due diligence in preparation of tax returns that understated income of client corporation and its shareholders
- CPA Shawn Washington suspended for 24 months for failure to timely file his returns and failure to pay employment taxes
- EA Humberto Collazo suspended indefinitely, permanently enjoined from preparing returns with frivolous positions
- Attorney Michael McCall suspended for 24 months for giving false opinion and failure to exercise due diligence
- CPA Edgar H. Gee, Jr. disbarred for engaging in disreputable conduct . . . Failed to pay taxes & lied to IRS !!!
- EA Marco Frausto censured for failure to exercise due diligence
- CPA James E. Davis suspended for 12 months for failure to exercise due diligence

Failure to Exercise Due Diligence ?

- What is that ?
 - Client understated income - CPA “should have known”
 - Claimed disabled access credit but expenses did not qualify or were not incurred
 - Took unsupported return positions
 - Accepted client representation in complex transaction where client did not know the law
 - Divorce/alimony/support
 - Sale of multi-use property

What About Other Actions ?

- Through September 1, 2012. . .
 - Numerous indictments
 - A conviction rate above 50%
 - Too many civil injunctions to count
 - Hundreds of undercover visits to preparers
 - More than 10,000 “visits” to preparers to warn against sloppy procedures in securing information for individual returns



Miscellaneous Penalties and Disclosure Forms

Disclosure as Required by Circular
230 and Internal Revenue Code
Protects Both CPA and Client from
Penalties

Preparer Penalties

- IRC Sec. 6694 (as of 7/14/09)
 - Greater of \$1,000 or 50% of fee for understatement due to position that did not have substantial authority, a reasonable basis (with disclosure), or was frivolous
 - Greater of \$5,000 or 50% of fee for willful understatement of liability, or reckless or intentional disregard of rules or regulations
 - Final Regs 12/15/08
 - Penalty case will be opened after audit is complete.
 - OPR is encouraging use of the penalty !

A Word About Disclosure

- Form 8275 must be used to disclose tax return position that does not have “substantial authority” (up from “realistic possibility of success”) (See Reg. Sec. 1.6664-4)
- Such a position would need to meet at least a “reasonable basis” standard
- No amount of disclosure will protect the preparer if the position is frivolous or does not meet a “reasonable basis” standard
 - The best explanation of that standard is found in AICPA Statements on Standards for Tax Services, Interpretation 1-1

Unreasonable Position

- The preparer knew or should have known of the position; and
- The position was not disclosed on a Form 8275, even though there might be a reasonable basis for the position; **or**
- No professional could reasonably believe the position could be sustained on its merits

Reasonable Cause

Penalty for understatement under IRC Sec. 6694 may be avoided upon showing reasonable cause. Consider the following:

- Nature of the error
- Frequency of errors
- Materiality of errors
- **Preparer's normal office practice**
- Reliance on advice of another preparer, who preparer believed to be competent

Permission to Use or Disclose IRC Sec. 7216

- Must have written permission in mandated format to disclose, or to use for any purpose
- Rev Proc. 2013-14 gives standard format and exact wording for 1040 client consent
 - 8 ½ X 11 paper
 - 12 point type
- Penalty for disregarding rule - \$1,000 fine plus up to 1 year in jail !
- AICPA Tax Division and some tax services have published form letters - get them and use them !

Confidentiality Privilege – IRC Sec. 7525

- Extends limited privilege of confidentiality to communications between tax practitioners and their clients related to seeking/giving tax advice
 - Does not apply to:
 - information for preparation of tax returns
 - communications relating to tax shelters
 - criminal matters
- The practice management issue is:
 - What are the client's expectations ?
 - You need an engagement letter for tax advice !

Potential Penalties

Section 6707A — Penalty for failure to include “reportable transaction” information with return as modified by Small Business Jobs Act of 2010

- Reportable or listed transaction:
 - General rule is 75% of the claimed tax reduction
 - Minimum penalty
 - \$5,000 if a natural person
 - \$10,000 if any other taxpayer
 - Maximum penalty
 - Reportable \$10,000 natural person, \$50,000 all other
 - Listed \$100,000 if natural person, \$200,000 all other

Form 8886

- Form 8886 is the only acceptable disclosure of participation in a reportable transaction
 - Listed Transaction – Notice 2009-59
 - Confidential – Keep documents secret
 - Contractual Protection – Money back guarantee
 - Loss Transaction –
 - Individual > \$5 million
 - Entity > \$10 million
 - Transaction of Interest – Notice 2009-55
- Provide as XML document when e-filing



AICPA Statements on Standards for Tax Services

Professional Standards for
All Aspects of Tax Practice

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AICPA Statements on Standards for Tax Services

- Enforceable ethical standards that govern an AICPA member's entire tax practice
 - Standards 1-7 (as of 1/1/2010)
 - Standard #1 mandates compliance with all regulations of the taxing jurisdiction
 - Standard #7 adds written opinion rules similar to Circular 230, Sec. 10.35 (Soon to be found in 10.37)
 - Standard #3 requires CPA to examine data same as Circular 230, Sec. 10.34(c)

New Standard #1

“Statement

4. A member should determine and comply with the standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position, or preparing or signing a tax return.”

I believe this obligates me to comply with IRC Sec.6694 as a matter of professional ethics.

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New Interpretations

(Adopted as of 8/30/2011)

- SSTS Interpretation No. 1-1 – “Reporting and Disclosure Standards” . . . Contains:
 - Preface explaining common tax return reporting standards and how to determine they are satisfied
 - Illustrations of “realistic possibility” and “reasonable basis”
- SSTS Interpretation No. 1-2 – “Tax Planning”
 - Contains references to non-signing preparers and clarification to illustrations regarding tax advice

Other Standards

- **Number 2** – Answers to questions on returns – all questions should be answered unless an exception applies. Forms are “questions” for this purpose and all forms must be filed.
- **Number 3** – OK to rely on client’s information UNLESS that information appears incorrect. AICPA member has duty to investigate questionable items
- **Number 4** – OK to use estimates in certain situations if properly disclosed ([This is in conflict with preamble to Sec. 6694 Regulations](#))

Other Standards

- **Number 5** – Not required to continue a position agreed to in settlement of previous exam
- **Number 6** – (Combining old #s 6 and 7) Discovery of error in filed return, or during examination, must be communicated to client together with possible exposure to penalties

New Standard #7 (Old #8)

In deciding on the form of advice provided to a taxpayer, a member should exercise professional judgment and should consider such factors as the following:

(First 7 points are essentially unchanged from old #8)

- a. Importance of the transaction and amounts involved*
- b. Specific or general nature of the taxpayer's inquiry*
- c. Time available for development and submission of the advice*
- d. Technical complexity involved*
- e. Existence of authorities and precedents*
- f. Tax sophistication of the taxpayer*
- g. Need to seek other professional advice*

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New Standard #7 (Old #8)

(Last 4 points are new and reconcile the AICPA standard with Circular 230, Part B, section 10.35)

[Remember that Section 10.35 is going to change]

- h. Type of transaction and whether it is subject to heightened reporting or disclosure requirements*
- i. Potential penalty consequences of the tax return position for which the advice is rendered*
- j. Whether any potential applicable penalties can be avoided through disclosure*
- k. Whether the member intends for the taxpayer to rely upon the advice to avoid potential penalties.*

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Is More Regulation Inevitable ?

- Whatever is subsidized by our tax dollars will grow, whether we need more of it or not !
- Practitioner misconduct has opened the door
- With an administration that is heavily anti-self regulation to start with, we tax return preparers are in a bad situation
 - More regulation, by more governmental authorities will be the norm

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The Sum of the Parts

- Taken together, the rules in . . .
 - State Accountancy Laws
 - Circular 230
 - Internal Revenue Code
 - AICPA Statements on Standards for Tax Services
- Require the contemporary tax practice to give greater attention to documentation and risk management than at any time in history.

How Will Your Tax Practice Change ?

- Engagement documentation [at least 4 parts]
 - Return preparation engagement letter [1]
 - IRC Sec. 7216, permission to use (mailing list) [2]
 - IRC Sec. 7525, privileged communication letter re: advice about tax matters [3]
 - IRC Sec. 6707A disclosure questionnaire [4]
- Client files
 - Physical control, management, and security
- Professional liability insurance may be limited

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Quality Control Document

- Does NOT need to be too complicated
- Should cover
 - Advocacy, Integrity, and Objectivity
 - Personnel Management
 - Acceptance and Continuance of Clients and Engagements
 - Engagement Performance
 - Monitoring

Free Draft Document

- E-mail lynn@npcpe.net and ask for **either**:
 - Sole Practitioner
 - Small Firm Without Tax Department
 - Firm With Tax Department
 - Multi-Office Firm With Tax Department and Internal Specialists
- These are **drafts**, developed from AICPA documents produced over a decade ago, and then forgotten (by them !). . . Not finished documents . . . But updated for all rule changes

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FOR
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