

Tax Preparers

AND

Preparer Penalties

Tax return preparer penalty enforcement

Presented by S. Mark Klecka Esq.
P O Box 9287 Huntsville, TX 77340
(936) 400-7170

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IRS Has a Problem!

- For the past decade, the IRS has seen an increase in the number of returns filed as well as a decrease in resources available for examination. For example, in Fiscal Year 2010 the IRS received 230.4 million returns and employed 13,879 revenue agents, compared to 253.0 million returns and 8,526 revenue agents in Fiscal Year 2019, and 262.8 million returns and 8,566 revenue agents in Fiscal Year 2022. (1)
- Budget cuts have decimated the ability of the IRS to perform its job. From exams to collections, the IRS has insufficient resources to work cases and perform customer service. Nevertheless, Congress expects the IRS to collect revenue. It's no wonder that voluntary compliance is down and the tax gap has increased. (2)
- Despite recent budget increases, the system still primarily relies on information submitted by taxpayers and their tax professionals.

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IRS Solution? Force Tax Preparers and those Practicing before the IRS To Police Their Clients!

- By attempting to hold preparers responsible for the pre-existing actions of their clients, the IRS can use the specter of preparer penalties and ethical charges against professionals to cause preparers to perform basic IRS audit tasks. (2)
- Preparer penalties constitute a powerful and coercive tool to force preparers to police their own clients. (2)
- In my opinion, it is never a defense to say the client is solely responsible for the entries on the tax return. If that were the case, both signing and non-signing return preparers would be irrelevant to the tax return preparation process.
- To hold preparers liable for the information presented by their client that appears to be accurate and reasonable that after the fact are shown as not being correct would cause the tax preparer and those practicing before the IRS to question and interrogate clients and their representations and conduct an examination of underlying documents to determine accuracy of information during the tax return preparation process. This would all need to be documented in writing by the tax preparer to support the work performed. This would be considered similar to doctors doing additional tests to protect against malpractice claims.
- The returns selected for audit are based on an IRS algorithm, not actual return inspection to determine if the tax return preferences are accurately computed/determined. Thus, it is possible for paid preparers to be assessed Due Diligence Penalties on returns that were accurate and prepared correctly but did not take all the appropriate actions when preparing the tax return. (3)
- The Due Diligence average penalty assessment amount per case against paid preparers increased from \$60,622 in FY 2021 to \$70,654 in FY 2022. The no change audit rate for Due Diligence penalties inspections in FY 2021 was 2.2% and FY 2022 3.8%. (3)

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Preparer Penalties

- Increases the penalty to the greater of:
- IRC Sec 6694- Understatement of taxpayer's liability by tax return preparer.
- IRC Sec 6694 (a)- Understatement due to unreasonable positions. The penalty is the greater of \$1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
- IRC Sec 6694 (b)- Understatement due to willful or reckless conduct. The penalty is the greater of \$5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
- IRC Sec 6695 (g)- Tax Return Preparer penalty of \$635 (2024-indexed for inflation) per violation for failure to make and document inquiries and retention of supporting documents for refundable credits and Head of Household filing status.
- The IRS can use the specter of preparer penalties and ethical charges against professionals to cause preparers to perform basic IRS audit tasks. (2)
- Many paid preparers are unaware of the material impact of the Due Diligence audit process and the potential large penalty assessments resulting from such audits, and other paid preparers have indicated they will not prepare returns with these issues to avoid possibly being penalized. (3)
- By aggressive use of "due diligence" requirements, the IRS is attempting to use the preparer penalty provisions to coerce tax preparers and tax professionals to perform audit work for the IRS against the interests of the client paying the professional fees.

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Internal Revenue Regulations and AICPA Tax Engagement Requirements

- IRS Reg. Sec. 1.6694-1(e)-The tax return preparer generally can rely in good faith without verification upon information furnished by the taxpayer, another advisor or another return tax preparer. However, the tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.
- AICPA Statements on Standards for Tax Services-TS Section 300.02- In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. However, a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.
- The “interpretation” of “due diligence” by the IRS and Office of Professional Responsibility appear to be in conflict with the positions outlined above.

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What is “Due Diligence” anyway?

- The term is not specifically defined in the regulations. (4)
- The concept of due diligence-
 - Entered legal lexicon as a term of art with its inclusion in the Securities Act of 1933. A “safe harbor” defense for broker-dealers accused of making inadequate disclosures to investors with respect to a purchase of securities required the broker-dealer to demonstrate they exercised “due diligence” in the investigation of a particular security to be sold. (4)
 - The concept of “know your client” as adopted in the US banking regulations, including the FATCA provisions, is based on this expectation of the professional’s “due diligence”. (4)
- “Due Diligence” concepts in the tax arena
 - An element of “due diligence” that is unique to tax professionals appears in Circular 230, Section 10.22 (a) (2), “ensuring” that oral and written representations made to the IRS are correct. (4)
 - Due diligence requires the professional to educate the client on the importance of accuracy in the tax return and to “tease out” the correct facts/data to “ensure” that the professional (and the client) is signing an accurate return. (4)

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What is “Due Diligence” anyway? (Cont’d)

- The definition of “ensure” ---
 - To “Guarantee” or “Make Sure or Certain”
 - Thus the responsibility of the tax return preparer under the IRS interpretation is to – “Guarantee that the tax preparer and client are signing an accurate return”. Tax return preparers as “guarantors” of the accuracy of tax return information presented!
- This level of “assurance” exceeds the assurance provided on a 10-K or 10-Q report provided by a CPA and also exceeds the level of assurance provided by a CPA on audited financial statements– “Present fairly in all material respects”.
- The only way for a tax preparer to “guarantee” the tax return is accurate is to perform an audit of the underlying documentation of each transaction and obtain information from the client by interrogation, teasing out the facts/data, and documenting responses in the workpapers.

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Highlights-Frequently Asked Questions about Due Diligence (Recent IRS Presentation January 10, 2024)

- The firm along with the employee preparer can each be assessed a penalty for failure to meet the due diligence requirements.
- The preparer must ask all the right questions and prepare a “contemporaneous” document for questions and taxpayer responses.
- Documentation on paper or electronically must be kept by the preparer for 3 years.
- Completing Form 8867 and filing it with the tax return is NOT due diligence.
- Letters and “knock and talk” meetings or phone calls are connected with failure to attach Form 8867 or IRS has noted compliance issues with tax returns filed by the preparer (note PTIN now required on Form 8867)
- The IRS can issue Letter 6222 for a correspondence due diligence examination with a Revenue Agent providing the preparer a list of documents to be provided.
- Form 5816-Report of Tax Return Preparer penalties assessed-30 days for the preparer to file an appeal.
- Due Diligence is not just checking a box on a form-Ask all the right questions, compute the credit based on the facts, complete and submit Form 8867 and KEEP RECORDS.
- The preparer must perform due diligence EVERY YEAR for all required returns.

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Recent Due Diligence Requirements

- Form 8867
 - Did you make reasonable inquiries?
 - Did you document your inquiries?
 - In essence, you are auditing your client to determine if the claiming of the credit(s) and head of household filing status (if applicable) are “accurate” according to IRS rules and regulations.
- Recent Due Diligence Preparer Penalties assessed
 - \$75,000, \$100,000 and \$125,000 assessments.
 - Recent case- 122 violations and \$63,000 assessment.
 - Even if not fully assessed on appeal, how much time you will spend in defending the assessment + legal representation costs.
- The New Tax Cuts and Jobs Act
 - Adds “Head of Household” Filing Status qualifications to the list of items requiring “Due Diligence”.

Polling Question

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Current Enforcement Actions

- There was little enforcement in 2018 due to the government shutdown and impact on the IRS.
- However, in 2019 the enforcement visits started. Documented visit on 12/23/19.
- 2023 and beyond. Who knows when enforcement by the IRS will resume. But do you want to take the chance? Note the recent program presentation by the IRS on January 10th. With increases in the IRS budget, examinations most likely than not will resume.
- Review page 2 of Form 8867. Ensure you are meeting all the requirements at the bottom of the second page.

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Current Enforcement Actions (Continued)

Comments of Revenue Agent in Recent Examinations

- Return preparer failed to prove the relationship requirement. There was no birth certificates to prove the two dependents were related to the taxpayer. Return Preparer failed the residence requirement. No documentation was maintained to prove the two dependents lived with the taxpayer. The Return Preparer failed to document the whereabouts of the mother of the two dependent children and why the mother failed to claim the two children. The Return Preparer failed to maintain copies of the school records of the dependents. Return Preparer did not maintain the Client Profile worksheet as explained in the interview. Return Preparer failed to address or show inquiry as to anyone else who would be able to claim the dependents. The dependent children are of the ages 4 and 6 in the Return Preparers records. Who takes care of the dependents while the taxpayer is working?
- Return Preparer has made notes to the client file since the last appointment on December 23, 20xx. The agent explained in the initial appointment the items/notes/documentation needed for the Due Diligence audit. The agent was able to verify notes were added into the tax software because the notes are date stamped. The agent will not rely on the notes added into the tax software after December 23, 20xx. The Return Preparer has failed the relationship and residency requirement. The Return Preparer failed to maintain copies of the birth certificates to prove the relationship requirement. The Return Preparer failed to maintain client school records or statements to prove the dependent children lived with the taxpayers. The Return Preparer failed to document the whereabouts of the father of the dependent children and why the father failed to claim the dependent children. The Return Preparer failed to document the Schedule C business. There were no notes or supporting documentation to prove the business existed. The Schedule C business allowed the taxpayer to claim the maximum EITC.

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Current Enforcement Actions (Continued)

Comments of Revenue Agent in Recent Examinations

- Return Preparer has made notes to the client file since the last appointment on December 23, 20xx. The agent explained in the initial appointment the items/notes/documentation needed for the Due Diligence audit. The agent was able to verify notes were added into the tax software because the notes are date stamped. The agent will not rely on the notes added into the tax software after December 23, 20xx. The Return Preparer has failed the relationship and residency requirement. The Return Preparer failed to maintain copies of the birth certificates to prove the relationship requirement. The Return Preparer failed to maintain client school records or statements to prove the dependent grandchildren lived with the taxpayers. The Return Preparer failed to document the whereabouts of the parents of the dependent children and why the parents failed to claim the two children. The Return Preparer failed to meet the recordkeeping requirement. The Return Preparer failed to maintain copies of the taxpayer provided records. Records include three W-2 forms and two 1099-SSA forms.

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Consider Fees for Due Diligence Requirements Form 8867!

- A proper due diligence package requires significant time and effort to compile documents, perform an interview, and complete the necessary forms.
- You must retain this information for 3 years upon request.
- The IRS can come to your offices or require a correspondence audit to review compliance. Who will pay you for the time and efforts connected with the examination? Will you be billing your client additional fees for the IRS review of the due diligence documentation in your office or via the mail? Who will ensure the documentation is kept for 3 years?
- See the attached Form 8867 Part VI for the Eligibility Certification requirements.
- Consider charging your clients an additional fee for the "Due Diligence Package". I charged \$300 for my due diligence package when I was preparing returns and lost only one client as a result.
- Explain the situation to your client and the need to charge additional fees for the work.
 - Mr. and Mrs. Smith, I see you have 2 children living with you that may qualify you for the Child Tax Credit of \$x,xxx per child. However, I am required by the IRS and Congress to perform Due Diligence work to support this credit.
 - I must perform the additional work, retain the supporting documents in my files for 3 years, and then are subject to IRS review of my compliance with the requirements to see if I should be assessed a fine for non-compliance.
 - The fine is \$635 per violation. Therefore, I must do additional work to avoid this fine.
 - As a result, my fee for the Due Diligence Package is \$XXX. If you agree with this additional fee to be added to your invoice, please sign the engagement letter agreeing to the additional charge.

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Example of Due Diligence Package

- **See the attached pdf files**
 - Important! All pages signed by both the preparer and the taxpayers!
 - Cover letter
 - Interview form-Can conduct via telephone
 - Schedule C form
 - Head of Household Form
 - Qualifying Child Form
- **Must attach the supporting documents!**
 - Tuition- Form 1098-T and paid tuition/fee invoices
 - Children- Birth Certificate and Proof of Residency (School or Medical Records)
 - Calculation forms for the credits claimed
 - Schedule C supporting documentation reviewed (Bank Statements & Other Documents)

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Potential New Areas for Due Diligence

- Reasonable Compensation for Corporate Officers of S Corporations.
 - However, when the client returns for the following year for tax preparation, the compensation income taken was too low. (2)
 - First and foremost, the obligation of the preparer is to accurately report the events that already occurred. Second, the tax year is closed. Fixing the problem would require the preparer to convince the client to recognize more salary, and amend quarterly employment returns, causing the incurrence of large penalties. When confronted with this, and similar scenarios, the IRS is looking to preparers to “fix the problem”. (2)
- Compliance with filing of employment tax returns and payment of all payroll taxes, including amounts considered trust funds for the IRS.
 - Already included in the Form 990 form.
 - Questions regarding filing of Form 1099-MISC on Schedule C and corporate/partnership returns already exists.
 - Big issue with IRS concerning collection of these taxes-Easy to extend the burden to the tax return preparer by adding “check boxes”.

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Potential New Areas for Due Diligence

- Schedule C due diligence requirements?
 - Ask the similar questions that are on Form 8867 now to determine the questions you asked, whom you asked, when you asked, the information that was provided, and the impact the information had on your preparation of the return.
 - In effect you will need to “audit” business tax return information to satisfy these types of requirements.

Polling Question

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Form 8275 and 8275-R-The Preparer's Way to CYA (Cover Your Assets)

- Controversy over a tax return position on the tax return, where the tax preparer may have concerns over imposed preparer penalties.
- Preparation of Form 8275 with supporting documentation showing the tax position arguments and basis for the treatment.
 - If disclosed on Form 8275, the standard is reasonable basis (20% or more).
 - If not disclosed on Form 8275, the standard is substantial authority (40% or more).
 - Penalties may not be assessed against the tax return preparer with Form 8275 included, but the return has a high likelihood of being audited.
- With the growing assessment of return preparer penalties from the IRS—
 - **Why are YOU leading the charge on this?**
 - If the client objects to the inclusion of the disclosure, you might consider whether the position really is sustainable.
 - No longer “don’t ask, don’t tell”. If you don’t think the position can meet the criteria, need to consider disengagement.
 - Be sure to get client’s written informed consent for the disclosure, to avoid malpractice claims.

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Conflict of Interest

- Due diligence is a concept that results from the tax professional’s dual responsibilities to clients and to the system of tax administration. (4)
- Conflict of Interest? Acting in best interest of client or system of tax administration?
 - AICPA Code of Professional Conduct-
 - » Sec. 1.110.101.06- The nature of the relevant interests and relationships and the services may change during the course of the engagement. This is particularly true when a member is asked to conduct an engagement for a client in a situation that may become adversarial with respect to the member or member’s firm.
 - » Sec 1.110.101.12- When a conflict of interest exists, the member should disclose the nature of the conflict of interest to clients and obtain their consent to perform the professional services.
 - » Sec. 1.110.101.13- General disclosure to clients where the member does not provide services exclusively for any one client. Such disclosure might be made in a member’s standard terms and conditions for the engagement (in the engagement letter)
 - ABA Model Rules of Professional Conduct-
 - » Rule 1.7- A lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if (2) There is a significant risk that the representation of the client will be materially limited by a personal interest of the lawyer. (b)(2) A lawyer may represent the client if each affected client gives informed consent, confirmed in writing.

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Conflict of Interest (Continued)

- Tax return engagements
 - Have you gotten “informed consent” from your clients informing them that-
 - » The tax return preparer is performing additional investigative work and interrogation to “tease out” answers from the client?
 - » That the notes of the interrogation and the workpapers and documentation in the member’s files is not subject to privilege and can be used against your client if a summons or subpoena is issued to produce the workpapers?
 - Are you performing the engagement in the best interests of the client, or is the engagement being performed to protect the tax preparer from IRS tax preparer penalties?
- IRS Tax Audit engagements
 - Whose interests are you representing? Your client’s interest or your interest to avoid preparer penalties? Have you gotten informed consent from the client concerning the conflict of interest during the audit representation? See Circular 230-Section 10.29
 - You are being examined for potential preparer penalties during the audit examination. See the next slide for the IRM covering this issue.
 - Consider not representing clients in an IRS examination engagement if you were the preparer of the tax returns under examination.

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Preparer Penalties Resulting from Representation of a Client during an Audit

- **IRM 4.11.51.5 (09-23-2016)**
 - **Preparer Penalties Overview**
1. By pursuing preparer penalties when warranted, preparers will be educated on proper tax preparation techniques and procedures. Addressing a tax return preparer’s noncompliant behavior will have an impact on the tax returns they prepare. Correcting an unlawful tax return preparer can have an exponential impact on the tax compliance of many tax returns.
 2. During an examination of the client taxpayer’s return, **do not** disclose a preparer penalty decision to the taxpayer or preparer.
 3. The examination case of the related client should be closed prior to establishing the preparer penalty case.
 4. Consideration of tax return preparer penalties under IRC 6694 and IRC 6695 is required on **all examinations**.

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Preparer Penalties Resulting from Due Diligence Examinations

- **IRM 20.1.6.5.7.2 (8/25/2020)**

5. Visits with tax return preparers to determine compliance with the due diligence requirements for the EIC, the CTC, the ACTC, the ODC and/or the AOTC are not third party contacts that require advance notification.

Penalties imposed for due diligence penalties under IRC 6695 (g) can be appealed to the IRS Appeals Division. If the appeal is denied or settlement not reached, the penalty assessment must be paid IN FULL, a request filed for refund and the refund denied before action can be taken to file action with the US Federal District Court.

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I Don't Prepare Tax Returns- Why Should I Care?

- Any representation or tax document presented to the IRS is practice before the IRS and subjects the attorney, CPA, or enrolled agent to the provisions for practice under Treasury Section 230.
- Have you performed "due diligence" to "ensure" the accuracy of the documents you present and documented the evidence you performed such an examination?-
 - Offer In Compromise Forms and supporting documents (including Forms 433A and 433B)?
 - Installment Agreement Requests
 - Penalty Abatement Requests
 - Other IRS documents where the member is signing as the "preparer".

Polling Question

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The Future of Tax Preparation and IRS Representation

- **Significant increases** in fees connected with tax return preparation and representation to clients to meet the IRS due diligence standards of practice.
- Increasing number of disengagement letters and termination of engagements due to disputes over client fees and disclosures to the IRS.
- Increasing number of returns prepared by unenrolled and/or dishonest persons, or self-preparation of tax returns by taxpayers who lack the necessary education, background and experience to prepare an accurate return.
- Growth of the “tax gap” as fewer tax return engagements are performed by persons eligible to practice before the IRS, and/or taxpayers fail to file tax returns at all.
- Exit of qualified practitioners from the tax preparation business due the increased risks of penalty assessment vs. income derived from the business or paid preparers declining to prepare returns with potential Due Diligence penalty risk. More focus on taxpayer audit examination engagements “after the fact”.
- What can you do about it?
 - Bring forward your concerns in contacts with IRS roundtables, forums, etc.
 - Have professional organizations (AICPA, AAA/CPA) contact IRS and Congress about this problem.
 - Contact your Congressman for a Congressional Referral regarding these changes and your concerns.

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Need Help?

Have you been assessed tax return preparer penalties?

For assistance/representation in tax return preparer penalty matters, contact:

S Mark Klecka Esq.

S Mark Klecka PC

(936) 400-7170

kleckalaw@smarkcpa.com

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End Notes

- (1) Source - IRS Data Book 2019, 2022
- (2) Source-Tax Preparers Plan for Shrinking IRS Budgets and Growing Penalties by Eric L. Green-CCH Tax and Accounting Learning Magazine. Used with permission.
- (3) Source- November, 2023 Internal Revenue Service Advisory Council Public Report.
- (4) Source- Ethics-How Much Diligence is "Due"? By Karen L. Hawkins-December 2015-January 2016 Journal of Tax Practice & Procedure-Used with permission.

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