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Notice
This information is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Because tax laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research before acting on the information contained in this document.
Chapter 1: Rules Governing Authority to Practice

Introduction

Internal Revenue Service Circular 230 (IRS Circular 230) contains rules governing the practice before the Internal Revenue Service, as well as the requirements and expectations of the different types of professionals in this field. There are five categories of professionals that can practice before the Internal Revenue Service (IRS): attorneys, certified public accountants (CPA), enrolled agents (EA), enrolled retirement plan agents (ERPA), and other unenrolled professionals. Though attorney’s, CPA’s EA’s, and ERPA’s will have more privileges to represent taxpayers before the IRS, an unenrolled tax professional may have just enough rights to represent their client on less complicated tax issues just to get the job done. IRS Circular 230 contains all the rules for practicing, the duties, the requirements, and the responsibilities. This is organized into five Subparts:

- **Subpart A** — Rules Governing Authority to Practice
- **Subpart B** — Duties and Restrictions Relating to Practice Before the Internal Revenue Service
- **Subpart C** — Sanctions for Violation of the Regulations
- **Subpart D** — Rules Applicable to Disciplinary Proceedings
- **Subpart E** — General Provisions

- **Subpart A** describes the rules governing authority to practice before the IRS, it explains who is entitled to practice before the IRS, and how someone applies to become enrolled. It also discusses limited practice before the IRS covering tax professionals who are not enrolled.
- **Subpart B** discusses the duties and restrictions relating to practice before the IRS including requirements to disclose information to the IRS, diligence as to accuracy, fee and solicitation restrictions, conflict of interest issues and standards for advising with respect to tax return positions. It also addresses practice of law issues and tax shelter opinions.
- **Subpart C** provides sanctions for violations of Circular 230.
- **Subpart D** sets forth detailed rules for the conduct of disciplinary actions and proceedings in connection with violations of Circular 230.
- **Subpart E** contains miscellaneous procedural rules.

This course does not focus on all subparts, however it will discuss various rules throughout Circular 230 that are expected and what ethics a tax professional should maintain on a day to day basis. The course revolves heavily and points out many sections within IRS Circular 230. Additional information in this study course that is not described in IRS Circular 230, such as Penalty amounts and Earned Income Tax Credit (EITC), are derived from various IRS Publications. Tax professionals play an important role in today's tax system which was founded on principles of voluntary compliance. The tax system works best when the public has confidence in the honesty and integrity of both the IRS employees and the tax professionals providing tax services. As a tax professional, providing the highest level of honesty and lawful tax services to your clients sets a foundation for long term growth and success.

**Who May Practice Before the IRS**

Representing taxpayers in connection with federal tax matters is considered practice before the IRS and is governed by the rules and standards set forth in Treasury Department Circular 230, Regulations Governing Practice before the Internal Revenue Service. Practice before the IRS includes the following:

- Communicating with the IRS on behalf of a taxpayer regarding his rights, privileges, or liabilities under laws and regulations administered by the IRS
- Representing a taxpayer at conferences, hearings, or meetings with the IRS
- Preparing and filing documents, including tax returns, for the IRS
- Corresponding and communicating with the IRS for a taxpayer
• Providing a client with written advice that has a potential for tax avoidance or evasion

**Example:** Sara is a CPA. Her client, Glenn, has a large tax debt. Glenn does not wish to communicate directly with the IRS, but he wants to set up an installment agreement. Sara has Glenn sign Form 2848 giving her power of attorney and then she calls the IRS on his behalf and sets up the installment agreement for him. This action is considered "Practice before the IRS."

**Note:** IRS Circular 230 does not state that anyone wishing to practice before the IRS is required to be a U.S Citizen.

The following individuals who are not currently under suspension or disbarment may represent taxpayers before the IRS. There are also some other individuals who may practice before the IRS because of a "special relationship" with the taxpayer.

**Quick Definitions:**
- **Disbarment from practice before the IRS:** An individual who is disbarred is not eligible to represent taxpayers before the IRS. Also, as a result of a suspension or disbarment, the professional may have his PTIN revoked.
- **Suspension from practice before the IRS:** An individual who is suspended is not eligible to represent taxpayers before the IRS during the term of the suspension.

**Attorneys:** Any attorney who is a member in good standing of the bar and currently not under suspension may practice before the IRS in all fifty states.

**Certified Public Accountants:** Any CPA who is duly qualified may practice before the IRS in all fifty states.

**Enrolled Agents:** Any enrolled agent in active status may practice before the IRS. An enrolled agent is a federally authorized tax professional licensed by the U.S. Department of Treasury’s Internal Revenue Service to represent taxpayers before the IRS. Enrolled agent status is the highest credentials awarded by the IRS and has earned the privilege of representing taxpayers before the IRS in all fifty states. Similar to attorneys and CPAs, EAs are unrestricted as to which taxpayers they can represent, what types of tax matters they can handle, and which IRS offices they can represent clients before.

**Note:** EAs are allowed to represent taxpayers in the U.S. Tax Court only if they have passed the U.S. Tax Court exam.

**Enrolled Actuaries (Limited Practice):** Any individual who is enrolled as an actuary may practice before the IRS. The practice of enrolled actuaries is limited to certain Internal Revenue Code sections that relate to their area of expertise, principally those sections governing employee retirement plans.

**Enrolled Retirement Plan Agents (Limited Practice):** An enrolled retirement plan agent (ERPA) is allowed to practice before the IRS. However, an ERPA’s practice is limited to certain Internal Revenue Code sections that relate to their area of expertise, principally those sections governing employee retirement plans.

**Unenrolled professional, or unenrolled individual:** An unenrolled individual who signs a return as its preparer may act as the taxpayer's representative if accompanied by the taxpayer, or by filing a written authorization from the taxpayer as provided. Such representation is limited to practice before examining officers of the Examination Division in the offices of District Directors and in the Office of International Operations, and may only encompass matters concerning the tax liability of the taxpayer for the taxable year covered by that return, subject to the limitations herein prescribed.

Privilege of limited practice before the Internal Revenue Service is limited to any person who is not under disbarment or suspension from practice before the Internal Revenue Service or form practice of the person's profession by any other authority (in the case of attorneys, certified public accountants, public accountants, or actuaries).
The following acts on behalf of the taxpayer are beyond the scope of authority permitted an unenrolled preparer:
(a) Executing claims for refund;
(b) Receiving checks in payment of any refund of Internal Revenue taxes, penalties, or interest;
(c) Executing consents to extend the statutory period for assessment or collection of a tax;
(d) Executing closing agreements with respect to a tax liability or specific matter; and
(e) Executing waivers of restriction on assessment or collection of a deficiency in tax

Information regarding Annual Filing Season Program Record of Completion from the IRS’s Publication 947:

Beginning January 1, 2016, only unenrolled return preparers who hold a record of completion for BOTH the tax return year (2015 or thereafter) under examination and the year the examination is conducted may represent under the following conditions: Unenrolled return preparers may represent taxpayers only before revenue agents, customer service representatives, or similar officers and employees of the Internal Revenue Service (including the Taxpayer Advocate Service) and only during an examination of the taxable year or period covered by the tax returns they prepared and signed. Unenrolled return preparers may not represent taxpayers, regardless of the circumstances requiring representation, before appeals officers, revenue officers, counsel or similar officers or employees of the Internal Revenue Service or the Department of Treasury. Unenrolled return preparers may not execute closing agreements, extend the statutory period for tax assessments or collection of tax, execute waivers, or sign any document on behalf of a taxpayer.

If an unenrolled return preparer does not meet the requirements for limited representation, you may authorize the unenrolled return preparer to inspect and/or request your tax information by filing Form 8821. Completing Form 8821 will not authorize the unenrolled return preparer to represent you before any IRS personnel.

An individual (self-representation): Any individual may always represent himself before the IRS, provided he has appropriate identification (such as a driver's license or a passport). Even a disbarred individual may represent himself before the IRS.

Example: Jacob was a tax attorney who was disbarred because of a felony conviction in 2011. An individual who is disbarred is not eligible to represent taxpayers before the IRS. Jacob was audited by the IRS in 2012. Despite being disbarred, Jacob may still represent himself before the IRS during the examination of his own return.

Disbarment and Suspension

When the final decision in a judicial proceeding is for disbarment, the tax professional will not be allowed to practice in any capacity before the IRS (except to represent himself). A disbarred professional may not:

- Prepare or file documents, including tax returns, or other correspondence with the IRS. The restriction applies regardless of whether the individual signs the document and regardless of whether the individual personally files or directs another person to file, documents with the IRS.
- Render written advice with respect to any entity, transaction, plan or arrangement having a potential for tax avoidance or evasion (tax shelter advice).
- Represent a client at conferences, hearings, and meetings.
- Execute waivers, consents, or closing agreements; receive a taxpayer’s refund check; or sign a tax return on behalf of a taxpayer.
- File powers of attorney with the IRS.
- Accept assistance from another person (or request assistance) or assist another person (or offer assistance) if the assistance relates to a matter constituting practice before the IRS, or enlist another person for the purpose of practicing before the IRS.
- State or imply that he is eligible to practice before the IRS.

A suspended or disbarred individual is still allowed to:
• Represent himself in any matter.
• Appear before the IRS as a trustee, receiver, guardian, administrator, executor, or other fiduciary if duly qualified/authorized under the law of the relevant jurisdiction.
• Appear as a witness for the taxpayer.
• Furnish information at the request of the IRS or any of its officers or employees.

A family member: An individual family member may represent members of his immediate family. Family members include a spouse, child, parent, brother, or sister of the individual.

An officer: A bona fide officer of a corporation (including parents, subsidiaries, or affiliated corporations) may represent the organization he is an officer of before the IRS.

A partner: A general partner may represent the partnership before the IRS. Limited partners in a partnership are considered merely investors and may not represent a partnership before the IRS.

Example: Robert's mother is being audited by the IRS. Even though Robert is not enrolled to practice before the IRS, he is allowed to represent his mother because of the family relationship.

Example: Marcy is an accounting student who is not an enrolled professional. The IRS is auditing her brother. Marcy is allowed to represent her brother before the IRS, meaning she can practice before the IRS in this limited circumstance. Because of the family relationship, Marcy's brother is not required to be present during the examination.

An employee: A regular full-time employee can represent his employer. An employer can be an individual, partnership, corporation (including parents, subsidiaries, or affiliated corporations), association, trust, receivership, guardianship, estate, organized group, governmental unit, agency, or authority.

Example: Cheryl is a full-time staff accountant for her employer. She is not an enrolled preparer. During the year, the IRS sent her employer a notice regarding some unfiled payroll tax returns. Cheryl may file a Form 2848 and speak with the IRS on her employer's behalf because of the employee-employer relationship.

A fiduciary: A trustee, receiver, guardian, personal representative, administrator, or executor can represent the trust, receivership, guardianship, or estate. In the eyes of the IRS, a fiduciary is considered to be the taxpayer and not a representative of the taxpayer.

Example: Vince was named the executor of his mother's estate after she passed away. He is not an enrolled preparer, but he is allowed to represent his mother's estate before the IRS. Vince is considered the fiduciary for the estate.

"Practice before the IRS" does NOT include:
• Representation of taxpayers before the U.S. Tax Court. The Tax Court has its own rules of practice and its own rules regarding admission to practice.
• Appearing as a witness for the taxpayer is not practice before the IRS. In general, individuals who are not "enrolled professionals" may appear before the IRS as witnesses—but they may not advocate for that taxpayer during that session.

Section 10.7 discusses representatives who are not considered practicing before the IRS. This includes representing oneself, participating in rulemaking, limited practice, and special appearances. There are some exceptions to the general rule regarding enrolled professionals (CPAs, EAs, and attorneys). Because of a "special relationship" with the taxpayer, certain individuals may represent some taxpayers before the IRS.

A taxpayer may always represent himself before the IRS, especially a disbarred professional, and does not require a representative, unless a language translator is needed. All that is required is to provide appropriate identification such as a driver's license or a passport.

Supervised Preparers
Supervised preparers are individuals who do not sign tax returns as paid return preparers but are employed by a law firm, EA office, or CPA practice, and are supervised by an attorney, CPA, EA, ERPA, or enrolled actuary who signs the returns prepared by the supervised preparer as the paid tax return preparer.

Supervised preparers may NOT sign any tax return they prepare or assist in preparing, Represent taxpayers before the IRS in any capacity, or identify themselves as a Circular 230 professional.

Persons Who Are Not Considered Tax Preparers

- A person who gives an opinion about events that have not happened, such as tax advice for a business that hasn’t been created.
- A person who prepares a return for his employer (an officer of employee of the employer) by whom the person is regularly and continuously employed
- A fiduciary who prepares a tax return for a trust or estate
- A volunteer who provides tax assistance under the VITA program
- An unpaid volunteer who provides tax assistance in the Tax Counseling for the Elderly program
- An employee of the IRS who is performing official duties by preparing a tax return for a taxpayer who requests it

Example: Bill is a retired tax professional. He does not have a PTIN. Bill volunteers during the tax filing season at a VITA site, where he prepares individual tax returns for lower-income individuals for free. Bill is not a "tax return preparer" and he is not required to have a PTIN.

Preparation of tax returns outside the U.S. is included in these rules. Tax preparers who work on U.S. tax returns overseas are still subject to Circular 230 regulations.

Example: Nelson is an EA who has a PTIN. He employs an administrative assistant, Sara, who performs data entry during tax filing season. At times, clients call and provide Sara with information, which she records in the system. Using the data she has entered, Nelson meets with his clients and provides tax advice as needed. He then prepares and signs their returns. Sara is not a "tax return preparer" and is not required to have a PTIN.

Employer of a Tax Preparer office

If an enrolled agent owns a franchise that employs additional tax preparers, the enrolled agent, as the owner of the business, is the one who is primarily liable for any preparer penalties.

When a person employs tax return preparers for their business, they are required to retain records detailing the name, identifying number, and principal place of work of each income tax return preparer employed. The records of these employees must be made available upon request to the IRS. They must be retained and available for inspection for at least three years following the close of period for each tax return. The "return period" means the 12-month period beginning July 1 each year.

Summary of Tax Return Preparer Requirements

<table>
<thead>
<tr>
<th>Type of Preparer</th>
<th>PTIN</th>
<th>IRS Test</th>
<th>Continuing Education</th>
<th>Practice Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrolled Agent (EA)</td>
<td>Yes</td>
<td>Yes (EA Exam)</td>
<td>72 hours every 3 years (16 hours Tax and 2 hours Ethics per year)</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Certified Public Accountant (CPA)</td>
<td>Yes</td>
<td>No</td>
<td>Varies by State</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Attorney</td>
<td>Yes</td>
<td>No</td>
<td>Varies by State</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Supervised Preparer</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Limited</td>
</tr>
</tbody>
</table>
Chapter 1 Review Questions

1. Matthew is a full-time employee for Parkway Partnership. He is not an EA, attorney, or CPA. Parkway requests that Matthew represent the partnership in connection with an IRS audit. Which of the following statements is true?

   A. Matthew is allowed to represent the partnership before the IRS.
   B. Matthew is not allowed to represent the partnership before the IRS.
   C. Matthew is only allowed to represent individual partners before the IRS.
   D. None of the above.

   The answer is A. Matthew is a full-time employee for Parkway Partnership, so in that capacity he may represent his employer before the IRS. A regular full-time employee of an individual employer may represent the employer (Circular 230, §10.7).

2. Which of the following is considered a "tax professional" under the Circular 230 regulations?

   A. A full-time bookkeeper working for an employer who prepares payroll tax returns.
   B. A retired attorney who prepares tax returns under the VITA program.
   C. A person who merely furnishes typing, reproducing, or mechanical assistance.
   D. A full-time secretary who also prepares tax returns for pay part-time from home during tax season.

   The answer is D. A person who prepares tax returns for compensation is a tax professional, even if the activity is only part-time. A person who prepares and signs a tax return WITHOUT compensation (such as for a family member or as a volunteer) is not considered a tax return preparer for the purposes of the preparer penalties. An employee who prepares a tax return for his employer or for another employee is not a "preparer" under Circular 230. The employer (or the individual with supervisory responsibility) has the responsibility for accuracy of the return.

3. In order to practice before the IRS, attorneys and CPAs licensed to practice in a particular state must _____.

   A. Be in good standing in that state and may practice before the IRS only in that state.
   B. Be in good standing in that state and may practice before the IRS in any state.
   C. Take the EA exam in order to practice outside the state in which they are licensed.
   D. None of the above.

   The answer is B. Any attorney or certified public accountant who is not currently under suspension or disbarment from practice before the IRS and who is licensed in good standing in any state, possession, territory, commonwealth, or the District of Columbia may practice before the IRS. Enrolled agents may practice in any state.
Chapter 2: Duties and Restrictions Relating to Practice Before the IRS

Knowledge of Client’s Omission

Section 10.21 discusses knowledge of client’s omission. A professional 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 professional must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

**Example:** Jacob is an EA with a new client, Sara, who has self-prepared her own returns in the past. Jacob notices that Sara has been claiming head of household on her tax returns, but she does not qualify for this status, because she does not have a qualifying person. Jacob is required to promptly notify Sara of the error and tell her the consequences of not correcting the error. However, Jacob is not required to amend Sara's prior year tax returns to correct the error. Nor is he required to notify the IRS of Sara's claim of incorrect status.

A professional who knows that his client has not complied with the revenue laws or who has made an error or omission on his tax return has the responsibility to advise the client promptly of the noncompliance, error, or omission, as well as the consequences of the error. Under the rules of Circular 230 §10.21, the tax professional is not responsible for fixing the noncompliance once he has notified the client of the issue. The tax professional is also not responsible for notifying the IRS of noncompliance by a client.

**Example:** Vicki is an EA who takes over another tax preparer's practice. She discovers that the previous preparer has been taking Section 179 depreciation on assets that do not qualify for this bonus depreciation treatment. Vicki must notify her clients of the error and the consequences of not correcting the error. She is not required to correct the error.

The obligations are not limited to professionals preparing returns, so the discovery of an error or omission in the course of a tax consulting or advisory engagement will also trigger its requirements.

Accuracy of Preparation

As required within Circular 230 section 10.22, in general, a practitioner must exercise due diligence in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters. Determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury and to clients with reference to any matter administered by the Internal Revenue Service must be performed at all times.

Also, 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.

Professional Fees

The IRS prohibits professionals from charging unconscionable fees. Though that term has not been defined, it is generally believed to be when the fees are so grossly unethical that the courts would consider them as such.
A professional may not charge a contingent fee (percentage of the refund) for preparing an original tax return, amended tax return, or claim for refund or credit. A contingent fee also includes a fee that is based on a percentage of the taxes saved or one that depends on a specific result.

Additionally, a contingent fee includes any fee arrangement in which the professional agrees to 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 not successful. The OPR says it will aggressively seek out and sanction tax preparers who are collecting unauthorized contingent fees.

The IRS does allow a professional to charge a contingent fee in some limited circumstances, including:

- Representation during the examination of an original tax return; 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 examination; or a written challenge to the original tax return.
- Services rendered in connection with a refund claim or credit or refund filed in conjunction with a penalty or interest charge.
- Services rendered in connection with any litigation or judicial proceeding arising under the Internal Revenue Code.

A professional may publish and advertise a fee schedule. A professional must adhere to the published fee schedule for at least 30 calendar days after it is published.

Fee information may be published in newspapers, telephone directories, mailings, websites, e-mail, or by any other method. A professional may include fees based on the following:

- Fixed fees for specific routine services
- Hourly fee rates
- A range of fees for particular services
- A fee charged for an initial consultation

In advertising fees on radio or television, the broadcast must be recorded, and the professional must retain a record of the recording for at least 36 months (three years) from the date of the last transmission or use.

**Example:** Tari is an EA who publishes an advertisement in her local newspaper. The ad includes a published fee schedule for preparing certain tax return forms at a deeply discounted rate. Tari is inundated with calls and decides that the ad was a mistake. Regardless, she must adhere to the published fee schedule for at least 30 days after it was published.

**Example:** Travis is an EA who pays for a radio commercial about his services. It plays for four months during tax season. Travis is required to keep a copy of the radio commercial for at least 36 months from the last date that the commercial aired.

**Conflicts of Interest**

A conflict of interest exists if the representation of one client will be directly adverse to another client; or if there is a significant risk that the representation of one or more clients will be materially limited by the tax professional's responsibilities to another client, a former client, a third person or by a personal interest of the tax professional.

For example, tax professionals commonly prepare joint tax returns for married couples. However, when tax professionals prepare tax returns or act as the representative for divorced or divorcing clients, a potential conflict of interest may exist or arise. The event that causes a conflict of interest for these clients is their change in marital circumstances, which sometimes places their tax professional in a situation where a tax position or financial advice that benefits one client may harm the other client.

However, the practitioner may represent a client where a conflict of interest exists, if:
The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

The representation is not prohibited by law;

Each affected client gives informed consent, confirmed in writing, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable amount of time after the informed consent, but no later than 30 days after the informed consent.

If the practitioner believes or finds that the representation would be prohibited by law, the conflict of interest cannot be waived by the client. Representation of the client by the practitioner should be declined and the documents should be returned to the client.

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.

In other situations, there is no easy answer as to when a practitioner should decline to represent a client. Some factors to consider include:

- Whether the taxpayer is willing to provide documentation or substantiation for items in question
- Whether the taxpayer is willing to pursue resolution through the administrative process
- Whether the taxpayer is hostile and uncooperative
- Whether the taxpayer is a tax protestor
- Whether the taxpayer agrees and understands the fee arrangement and limitations on representation, and
- Whether the taxpayer previously had multiple representatives on the same tax matter

Note: In any case where a practitioner declines representation, the client should be referred to another practitioner.

Best Practices

As noted in IRS Circular 230 section 10.33 all 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:

- 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.
- Establishing the facts, determining which facts are relevant, 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.
- 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.
- Acting fairly and with integrity in practice before the Internal Revenue Service.

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 the above paragraph.
Negotiation of taxpayer checks

A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability.

Return of Client Records

A tax professional is required to return a client's records whether or not fees have been paid. Client records are defined as any original records belonging to the client, including any work product that the client has already paid for, such as a completed copy of a tax return.

The professional must, at the request of a client, promptly return any and all records that are necessary for the client to comply with his federal tax obligations. The professional must also allow the client reasonable access to review and copy any additional records retained by the professional that are necessary for the client to comply with his federal tax obligations. The professional may retain copies of the records returned to a client.

A fee dispute does not relieve the professional of his responsibility to return client records. The professional must provide the client with reasonable access to review and copy any additional records retained by the professional under state law that are necessary for the client to comply with his federal tax obligations.

Client records do not include the tax professional's work product. "Records of the client" include: All documents provided to the professional that pre-existed the retention of the professional by the client. Any materials that were prepared by the client or a third party at any time and provided to the professional relating to the subject matter of the representation. Any document prepared by the professional that was presented to the client relating to a prior representation if such document is necessary for the taxpayer to comply with his current federal tax obligations.

Any records of the client does not include any return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the professional if he is withholding these documents pending the client's payment of fees.

Example: Greg, an EA, has a client, Annie, who becomes very upset after he tells her she owes substantial penalties to the IRS in the current year. Annie wants to get a second opinion, and she does not want to pay Greg for his time. Greg is required to hand over Annie's tax records, including copies of her W-2 forms and any other information she brought to his office. Greg returns her original records, but he does not give her a copy of the tax return he prepared, since she did not pay for the return. A professional is not required to give a client any tax return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the professional if he is withholding the documents because of a fee dispute.

Statute of Limitations for Records Retention

For Tax Preparers

Tax preparers are required to keep a copy (or a list) of all returns they have prepared for at least three years. Alternatively, preparers may also keep copies of the actual returns. If the preparer does not keep copies of the actual returns, he is required to keep a list or card file of clients and tax returns prepared. At a minimum, the list must contain the taxpayer's name, identification number, tax year, and the type of return prepared.

Note: If electronic copies are the primary choice to retain copies of tax returns, it is good practice to have backup copies. An example is having multiple encrypted USB Flash Drives, or storing online through a secure online data storage service.

For Taxpayers
A taxpayer should keep all relevant records until the statute of limitations for his tax return expires. For assessment of tax owed, this period is generally three years from the date the return was filed or the return was due, whichever is later. For filing a claim for credit or refund, the period to make the claim generally is three years from the date the original return was filed or two years from the date the tax was paid, whichever is later.

Records relating to the basis of property should be retained as long as they may be material to any tax return involving the property. The basis of property is material until the statute of limitations expires for the tax year an asset is sold or disposed of. A taxpayer must keep these records to figure any depreciation, amortization, or depletion deductions, and to figure the asset's basis.

There are longer record retention periods in some cases. If a taxpayer files a claim from a loss of worthless securities, then the period to retain records related to the transaction is seven years. If a taxpayer fails to report income that exceeds more than 25% of the gross income shown on his return, the statute of limitations is six years from when the return is filed. There is no statute of limitations to assess tax when a return is fraudulent or when no return is filed.

<table>
<thead>
<tr>
<th>Statute of Limitations</th>
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<tbody>
<tr>
<td>Type of Record/Return</td>
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<tr>
<td>Normal tax return</td>
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<tr>
<td>Omitted income that exceeds 25% of the gross income shown on the return</td>
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<tr>
<td>A fraudulent return</td>
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<tr>
<td>No return filed</td>
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<tr>
<td>A claim for credit or amended return</td>
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<tr>
<td>A claim for a loss from worthless securities</td>
</tr>
<tr>
<td>Employment and payroll tax records</td>
</tr>
<tr>
<td>Fixed assets, Real estate</td>
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</tbody>
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**Note:** A taxpayer must keep records as long as they are needed for the administration of any provision of the IRC. Taxpayers must keep records that support an item of income or deduction on a tax return until the period of limitations for that return runs out. If a tax return is not filed, there is no time limit.

**PTIN Requirements**

Under the rules of Circular 230, tax preparers who prepares tax returns for a fee are required to obtain a Preparer Tax Identification Number (PTIN) from the IRS. This can be done by going onto the IRS’s website [www.irs.gov](http://www.irs.gov) and navigating to the Tax Professionals section.

**Exception for Supervised Preparers**
Supervised preparers are individuals who do not sign tax returns as paid return preparers but are:

- Employed by a law firm, EA office, or CPA practice, and
- Are directly supervised by an attorney, CPA, EA, ERPA, or enrolled actuary who signs the returns prepared by the supervised preparer as the paid tax return preparer.

Supervised preparers may NOT:

- Sign any tax return they prepare or assist in preparing
- Represent taxpayers before the IRS in any capacity
- Identify themselves as a Circular 230 professional
- When applying for or renewing a PTIN, supervised preparers must provide the PTIN of their supervisor.

The PTIN is a nine-digit number that preparers must use when they prepare and sign a tax return or claim for refund. Previously, PTIN use was optional in place of the preparer's Social Security Number. Multiple individuals cannot share one PTIN. A PTIN is assigned to a single preparer to identify that he or she is the preparer of a particular return. Any preparer who is compensated for the preparation of (or assists in the preparation of) a tax return must apply for a PTIN. This includes attorneys, CPAs, and EAs. Failure to obtain a PTIN could result in the imposition of Internal Revenue Code Section §6695 monetary penalties, injunction, and/or disciplinary action. All tax preparers with existing PTINs are required to renew their PTINs online each year and pay a fee to do so.

Tax professionals must include their PTIN on every return filed with the IRS. The IRS has a list of the penalties that may be assessed when it comes to the preparation of tax returns for other persons such as:

- Failure to furnish a copy of a return or claim to a taxpayer
- Failure to sign a return or claim for refund
- Failure to furnish an identifying number (PTIN) on a return
- Failure to retain a copy or list of a return or claim
- Failure to file correct information returns

The penalty is steeper for a preparer who endorses, cashes, or deposits a taxpayer's refund check. Also a $500 penalty for each failure to comply with Earned Income Credit due diligence requirements.
Chapter 2 Review Questions

1. If an EA knows that a client has filed an erroneous tax return, the practitioner is legally required to __________.
   
   A. Correct the error.
   B. Advise the client about the error and the consequences for not correcting the error.
   C. Do nothing if the practitioner was not the one who prepared the erroneous return.
   D. Disengage from any further business with the client if the client does not agree to correct the error.

   The answer is B. If an EA knows that a client has filed an erroneous tax return, he must advise the client to correct the error. The EA is not required to amend the return, but he must advise the client about the error and the consequences for not correcting the error. He is not required to notify the IRS about his client's error.

2. All of the following statements are correct except:

   A. If no other provisions apply, the statute of limitations for an IRS examination of a return is three years after the return was filed or the return was due, whichever is later.
   B. If more than 25% of gross income has been omitted from the tax return, the statute of limitations is six years after the return was filed.
   C. If a fraudulent return is filed, the statute of limitations is seven years.
   D. If a tax return is not filed at all, there is no statute of limitations.

   The answer is C. If a fraudulent tax return is filed, there is NO statute of limitations for collection. Under federal law, a tax return is "fraudulent" if the taxpayer files it knowing that the return either omits taxable income or claims one or more deductions that are not allowable.
Chapter 3: Taxpayer Obligations, Fraud, and Penalty

Incompetence and Disreputable Conduct

Additional IRS examples regarding incompetent and disreputable conduct from individuals subject to Circular 230 may be suspended or disbarred from practice before the IRS, or censured. A monetary penalty may also be imposed, in addition to other disciplinary actions, on individuals as well as their firms. The following list contains examples of conduct that is considered disreputable. Further examples are shown in Circular 230, Sec. 10.51(a).

- Being convicted of any criminal offense under the revenue laws or of any offense involving dishonesty or breach of trust.
- Knowingly giving false or misleading information in connection with federal tax matters, or participating in such activity.
- Soliciting employment by prohibited means as discussed in section 10.30 of Circular 230.
- Willfully failing to file a federal tax return, evading or attempting to evade any federal tax or payment, or participating in such actions.
- Misappropriating, or failing to properly and promptly remit, funds received from clients for payment of taxes or other obligations due the United States.
- Directly or indirectly attempting to influence the official action of IRS employees by the use of threats, false accusations, duress, or coercion, or by offering gifts, favors, or any special inducements.
- Being disbarred or suspended from practice as an attorney, CPA, public accountant, or actuary, by the District of Columbia or any state, possession, territory, commonwealth, or any federal court, or any federal agency, body, or board.
- Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility of that other person.
- Using abusive language, making false accusations and statements knowing them to be false, circulating or publishing malicious or libelous matter, or engaging in any contemptuous conduct in connection with practice before the IRS.

Giving a false opinion knowingly, recklessly, or through gross incompetence; or following a pattern of providing incompetent opinions in questions arising under the federal tax laws.

Penalties Imposed Upon Taxpayers

For individual taxpayers, the IRS can assess a penalty for those who fail to file, fail to pay, or both. The failure-to-file penalty is generally greater than the failure-to-pay penalty. If someone is unable to pay all the taxes he owes, he is better off filing on time and paying as much as he can. The IRS will explore payment options with individual taxpayers.

Failure-to-file Penalty

If a taxpayer does not file a tax return by the due date of the return (including extensions), a failure-to-file penalty may be assessed. The penalty is based on the tax not paid by the due date (without regard to extensions). The penalty is generally 5% for each month or part of a month that a return is late, but not more than 25%. If the taxpayer's failure to file is found to be due to fraud, the penalty is increased to 15% for each month or part of a month that the return is late, up to a maximum of 75%.

If the return is filed more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $205 (adjusted for inflation) or 100% of the unpaid tax.

Note: The taxpayer does not have to pay the penalty if the taxpayer can show that the failure to file on time was because of reasonable cause and not because of willful neglect.
### Failure-to-pay Penalty

The taxpayer will have to pay a failure-to-pay penalty of 0.5% of the unpaid taxes for each month or part of a month after the due date that the tax is not paid. This penalty cannot be more than 25% of the unpaid tax. This penalty does not apply during the automatic 6-month extension of time to file period if the taxpayer paid at least 90% of the actual tax liability on or before the due date of the return and the balance was paid when the return was filed.

The monthly rate of the failure-to-pay penalty is half the usual rate (0.25% instead of 0.50%) if an installment agreement is in effect for that month. The taxpayer must have filed the return by the due date (including extensions) to qualify for this reduced penalty.

If a notice of intent to levy is issued, the rate will increase to 1% at the start of the first month beginning at least 10 days after the day that the notice is issued. If a notice and demand for immediate payment is issued, the rate will increase to 1% at the start of the first month, beginning after the day that the notice and demand is issued.

Note: The taxpayer will not have to pay the penalty if he can show that there was a reasonable cause for not paying the tax on time.

### Combined Penalties

If both the failure-to-file and the failure-to-pay penalties apply in any month, the 5% (or 15%) failure-to-file penalty is reduced by the failure-to-pay penalty, so that the combined penalties do not exceed 5% (or 15%). However, if the taxpayer files the return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $205 (adjusted for inflation) or 100% of the unpaid tax.

Note: The calculations for penalties are performed by the IRS and a notice will be sent to the taxpayer with any amounts due. It is not an IRS requirement to remember these numbers, however it is a good idea have a general idea of these amounts in order to express urgency to tax payers for filing on time and paying on time.

### Client Fraud

It is recommended for tax preparers to look for client fraud. Sometimes, the taxpayer can be negligent or careless, or sometimes there may have an honest difference of opinion regarding the deductibility of an expense. There are some common areas within tax filings that fraud can be hidden within. Examples include:

- Understating income or improper deductions
- Personal items deducted for business expenses
- Overstating deductions or taking improper credits
- Making false entries in documents or destroying records
- Not cooperating with the IRS or avoiding IRS contact
- Concealing or transferring assets
- Engaging in illegal activity
- Poor recordkeeping
- All-cash businesses

Some of these actions taken by themselves do not necessarily constitute fraud. However, consistent abuses or multiple red flags may be a reason to suspect taxpayer fraud. Any assistance in guiding a tax payer to filing a fraudulent tax return will lead to fines and/or imprisonment, for the tax payer or tax professional or both.

### Tax Professional Fraud

Tax professionals are sometimes guilty of preparer fraud. Preparer fraud generally involves the preparation and filing of false income tax returns with inflated personal or business expenses, false deductions, unallowable credits, or excessive exemptions on returns prepared for their clients. Preparers may also manipulate income figures to obtain fraudulent tax
credits, such as the Earned Income Tax Credit (EITC). The preparers’ clients may or may not know about the false expenses, deductions, exemptions and/or credits shown on their tax returns. Fraudulent preparers gain financially by:

- Diverting a portion of the refund for their own benefit;
- Increasing their clientele by developing a reputation for obtaining large refunds; and/or
- Charging inflated fees for the return preparation.

Important Note: When the IRS detects a false return, the taxpayer (not the return preparer), must pay the additional taxes and interest and may be subject to penalties. However filing a fraudulent tax return knowingly and willing, with or without the knowledge of the tax payer, would lead to fines and/or imprisonment for the tax professional.

Below are some helpful IRS guidelines to keep in mind when tax payers are shopping for a tax preparer:

- Be cautious of tax preparers who claim they can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the amount of the refund.
- Use a reputable tax professional who signs your tax return and provides you with a copy for your records.
- Consider whether the individual or firm will be around to answer questions about the preparation of your tax return months, or even years, after the return has been filed.
- Review your return before you sign it and ask questions on entries you don’t understand.
- No matter who prepares your tax return, you, the taxpayer, are ultimately responsible for all of the information on your tax return. Therefore, never sign a blank tax form.
- Find out the person’s credentials. Only attorneys, certified public accountants (CPAs) and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection and appeals. Other return preparers may only represent taxpayers for audits of returns they actually prepared.
- Find out if the preparer is affiliated with a professional organization that provides its members with continuing education and resources and holds them to a code of ethics.

Reputable preparers will ask to see your receipts and will ask you multiple questions to determine your qualifications for expenses, deductions and other items. By doing so, they are trying to help you avoid penalties, interest or additional taxes that could result from an IRS examination.

Penalties for Understatement of Taxpayer Liability

There are two specific penalties when an income tax preparer understates a taxpayer’s liability. If there is an understatement on a tax return due to an unrealistic position, the penalty is the greater of:

- $1,000 per tax return, or
- 50% of the additional income upon which the penalty was imposed.

This applies when a preparer knows, or reasonably should have known, that the position was unrealistic. However, if the position is adequately disclosed on a tax return, this penalty may not apply. In the case of a patently frivolous position (such as a tax protester position), the penalty will apply whether or not it is disclosed. If a tax preparer shows negligent or willful disregard of IRS rules and regulations, and makes a willful or reckless attempt to understate tax liability, the penalty is the greater of:

- $5,000 per tax return, or
- 50% of the additional income upon which the penalty was imposed.

Tax Avoidance versus Tax Evasion

The term tax avoidance is not defined by the IRS, but it is commonly used to describe the legal reduction of taxable income. Most taxpayers use at least a few methods of tax avoidance in order to reduce their taxable income and therefore lower their tax liability.
Example: Nate contributes to his employer-sponsored retirement plans with pretax funds. He also uses an employer-based Flexible Spending Account for his medical expenses, which reduces his taxable income by making all of his medical expenses pretax. Nate is using legal tax avoidance in order to reduce his taxable income.

Tax evasion, on the other hand, is an illegal practice in which individuals or businesses intentionally avoid paying their true tax liability. All citizens must comply with tax law. Although most Americans recognize their civic duty and comply with their tax obligations, the U.S. government estimates that approximately 3% of taxpayers do not file tax returns at all. Those caught evading taxes are subject to criminal charges and substantial penalties.

For each year a taxpayer does not file a return, the penalty can include a fine of up to $25,000 and a prison sentence of up to one year. If it can be demonstrated that the taxpayer deliberately did not file in an attempt to evade taxation, the IRS can pursue a felony conviction, which could include a fine of up to $100,000 and a maximum prison sentence of five years.

Trust Fund Recovery Penalty (TFRP)

The trust fund recovery penalty is most commonly exacted on employers. Also known as the "100% penalty" because the IRS will assess a tax of 100% of the amount due. This penalty involves the income and Social Security taxes an employer withholds from the wages of employees. These taxes are called "trust fund" taxes because they are held in trust for the government.

They have been withheld from an employee's paycheck, so the employer is required to remit them to the IRS. Sometimes, when business owners have financial trouble, they neglect to remit these taxes to the IRS. The trust fund recovery penalty can be assessed against anyone who is considered a responsible person in the business. This includes corporate officers, directors, stockholders, and even rank-and-file employees. The IRS has assessed the penalty against accountants, bookkeepers, or even clerical staff, particularly if they have authority to sign checks.

A person must be both "responsible" and "willful" to be liable for an employer's failure to collect or pay trust fund taxes to the United States. This means that he knew (or should have known) that the payroll taxes were not being remitted to the IRS, and that he also had the power to correct the problem. Usually, this means that the individual had check-signing authority, but each case is evaluated by the IRS.

Note: The trust fund recovery penalty may be assessed in addition to any other penalties, including the failure-to-file, failure-to-pay, or fraud penalties.

Example: Cheryl works for Speedy Dry Cleaners as a full-time bookkeeper and processes all the payroll tax forms. She also has check-signing authority, so she can pay the bills when her boss is working off-site. In 2012, her boss has a heart attack, and his wife, Dorothy, takes over the business in his absence. Dorothy can't manage the business properly and Speedy Dry Cleaners soon falls into debt. Dorothy tells Cheryl to pay vendors first. The business continues to withhold payroll taxes from employee paychecks, but does not remit the amounts to the IRS. Eventually, the business goes under and Dorothy disappears. Cheryl is contacted by the IRS shortly thereafter. Even though Cheryl was "just an employee," the IRS can assess the trust fund recovery penalty against her because (1) she had check-signing authority, and (2) she knew that the business was not lawfully remitting payroll taxes to the IRS as required.
Chapter 3 Review Questions

1. Which of the following statements is true?

   A. Tax avoidance and tax evasion are always illegal.
   B. Taxpayers who commit fraud are subject to civil penalties only.
   C. The IRS will assess a failure-to-file penalty or a failure-to-pay penalty but never both.
   D. A felony conviction against a taxpayer who deliberately failed to file taxes could mean a fine of up to $100,000 and a prison sentence of up to five years.

   The answer is D. It is correct that this is the maximum penalty and prison sentence in a tax evasion case. The other statements are false—tax avoidance is not illegal; taxpayers who commit fraud are subject to criminal penalties in addition to civil ones; and the IRS may assess both failure-to-file and failure-to-pay penalties.

2. Under IRS rules, which penalty is worse: failure-to-file or failure-to-pay?

   A. The failure-to-file penalty.
   B. The failure-to-pay penalty.
   C. Both have the same penalties.
   D. None of the above.

   The answer is A. The penalty for filing late is usually 5% of the unpaid taxes for each month that a return is late. The penalty for not paying taxes by the due date is less ½ of 1% (0.5%). The IRS advises that if someone is unable to pay all the taxes he owes, he is better off filing on time and paying as much as he can.

3. All of the following statements about the trust fund recovery penalty are correct except:

   A. This is also referred to as the "100% penalty."
   B. The IRS targets employees for this penalty.
   C. This penalty involves payroll taxes withheld from the wages of employees.
   D. The penalty can be assessed against anyone who is considered a "responsible person" and has failed to collect or pay trust fund taxes to the U.S. government.

   The answer is B. This penalty is generally levied against employers, not employees, who have failed to pay the appropriate payroll taxes to the U.S. government.
Chapter 4: Ethics of Earned Income Tax Credit

Ethics of Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable federal income tax credit for low to moderate income working individuals and families. When the EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit. The number of individuals claiming the earned income tax credit is high as well as the number of mistakes made when claiming the credit. That is why the due diligence rules for tax preparers are more stringent on EITC returns.

Items that are not earned income for purposes of the earned income tax credit (EITC) include interest and dividends, pensions and annuities, social security and railroad retirement benefits, alimony and child support, welfare benefits, workers' compensation benefits, unemployment compensation (insurance), nontaxable foster care payments, nontaxable employee compensation, scholarship or fellowship grants not reportable on Form W-2, and veterans' benefits, including VA rehabilitation payments.

Income earned for work performed while an inmate is not earned income for purposes of EITC, regardless of who the inmate works for (state or private), or where the work is performed (on or off jail grounds). This includes amount earned as part of a work release program or while living in a halfway house.

According to IRS Publication 596, there are 7 rules that a taxpayer must meet in order to qualify for the earned income tax credit:

- Rule 1: The taxpayer's adjusted gross income must not surpass a certain threshold
- Rule 2: The taxpayer must have a valid social security number
- Rule 3: The taxpayer's filing status cannot be "Married Filing Separately"
- Rule 4: The taxpayer must be a U.S. Citizen or a Resident Alien all year
- Rule 5: The taxpayer cannot file Form 2555 or Form 2555-EZ
- Rule 6: The taxpayer's Investment Income must be $3,400 or less
- Rule 7: The taxpayer must have earned income

Assuming a tax payer meets the requirements for the 7 rules listed above, the tax professional has 4 Due Diligence requirements in verifying that information provided is true and accurate when completing a tax return. Due diligence promotes accurate claims for EITC, and incorrectly filing a tax return or failure to comply with certain requirements can affect the client, or the tax professional. The four requirements focus on accurately determining a taxpayer’s eligibility for EITC and computing the credit.

The four due diligence requirements for preparers related to the EITC are as follows:

1) **Complete and submit the Eligibility Checklist.** A preparer must complete Form 8867, Tax professional's Earned Income Credit Checklist, to make sure he considers all EITC eligibility criteria for each return prepared. He must complete the checklist based on information provided by his clients. The form must be submitted either electronically or on paper, along with any returns or claims for refund.

2) **Compute the credit.** Under the knowledge requirement, a tax professional must not know, or have reason to know that any information used to determine the taxpayer's eligibility for, and the amount of, the EITC is incorrect, inconsistent or incomplete.
A tax professional cannot ignore the implications of information furnished to or known by the tax professional. In other words, a tax professional must take into account what the taxpayer says and what the tax professional knows about the taxpayer. A tax professional must make reasonable inquiries if the information furnished or known appears to be incorrect, inconsistent, or incomplete.

At the time the tax professional makes these inquiries, the tax professional must document in his or her files the inquiries the tax professional made and the responses the taxpayer provided. The documentation should happen contemporaneously (at the same time) as the questions are asked and answered.

A tax professional may have a reason to know the taxpayer is not being truthful if the information being relayed by the taxpayer would not make sense to a reasonable tax preparer. A common example of this is when a taxpayer has income that seems too low to support the number of children the taxpayer is claiming on the return or if the taxpayer does not provide consistent answers when going through the questions contained in Form 8867.

3) Knowledge. A preparer must not know (or have reason to know) that the information used to determine eligibility for the EITC is incorrect. A preparer must ask his client additional questions if the information furnished seems incorrect or incomplete.

4) Keeping records. A preparer must keep a copy of Form 8867 and the EITC worksheet, as well as any additional question/answers during the client interview. He also must keep copies of any documents the client gives to help determine eligibility for, or the amount of the EITC. In addition, a preparer must verify the identity of the person giving him the return information and keep a record of it. All records may be kept for at least three years in either paper or electronic format, and they must be presented if the IRS were to ask for them. The three-year retention requirement runs from the later of:
- the due date of the return without regard to any filing extension,
- the date the return or claim for refund was filed (if the return was electronically filed),
- the date the return or claim for refund was presented to the taxpayer for signature (if the return is not electronically filed), or
- the date the preparer submitted the part of the return you prepared to the signing preparer (if prepared by a nonsigning preparer).

Example: A client states that she is separated from her spouse. Her child lives with her and she wants to claim the EITC as head of household. In reviewing the client's records it is apparent she earns a minimal income, which appears insufficient to support a household: pay rent/mortgage, utilities, food, clothing, school supplies, etc. The return preparer should ask appropriate questions to determine the client's correct filing status and determine how long the child lived with each parent during the year and probe for any additional sources of income.

Mentioned in IRS Publication 4687, the IRS has provided some guidelines regarding the knowledge requirement. To meet the knowledge requirement, you should:
- Apply a common sense standard to the information provided by your client
- Evaluate whether the information is complete and gather any missing facts
- Determine if the information is consistent; recognize contradictory statements and statements you know not to be true
- Conduct a thorough, in-depth interview with every client, every year
- Ask enough questions to reasonably know the return is correct and complete
- Document in the file any questions you asked and your client’s responses, as it happens

IRS Example: An 18 year-old client with an infant has $3,000 in earned income and states she lives with her parents. She wants to claim the infant as a qualifying child for EITC. Due Diligence requirement: This information seems incomplete and inconsistent because the 18 year old lives with her parents and earns very little income. You must ask additional questions to determine if the 18 year old is the qualifying child of her parents. If she is the qualifying child of her parents, she is not eligible to claim EITC.
**Example:** A client tells a preparer she has no Form 1099, she was self-employed cleaning houses, she earned $12,000, and she had no expenses related to the cleaning business. The BEST course of action for the preparer in this case would be to ask probing questions and ask for proof of income. In some cases, the client may say she had no expenses when it is not reasonable to conduct the business without incurring expenses, or the expenses may seem unreasonably high. Asking these questions to a taxpayer would be fulfilling your role with due diligence requirements.

**Common EITC Errors to Avoid**

The IRS is always looking for abusive EITC claims. The three issues that account for more a large percent of all EITC errors are:

- Claiming a child who does not meet the age, relationship, or residency requirement.
- Filing as single or head of household when married.
- Incorrectly reporting income or expenses.

There are other possible reason for EITC errors that a tax professional can demonstrate whether it being accidental or deliberately, but some tax professional may just not have the knowledge of EITC tax law, therefore causing unintentional preparer mistakes. Others include disregard due diligence requirements assuming a tax professional knows the client on a personal level and makes the assumption they feel is best for the client. Whatever the action taken during the tax preparation process of the client, if Due Diligence is not taken carefully, a return that is signed and submitted to the IRS will have a high likelihood of being selected for examination and/or audit.

**Example:** Tari is an EA. A new 28-year-old client wants to claim two sons, ages 14 and 15, as qualifying children for the Earned Income Tax Credit. Tari is concerned about the age of the children, since the age of the client seems inconsistent with the ages of the children claimed as sons. Tari discovers that the two boys are both adopted, which explains the age inconsistency. Tari has fulfilled her due diligence requirement and fulfilled the knowledge standard by asking probing questions to confirm the accuracy of the client's information.

**Example:** Joe is single and wants to claim his daughter, Cherry, for the Earned Income Tax Credit. Joe earned $14,500 and had no other income. Cherry is 35 years old and unmarried, and Joe says she is disabled and lived with him for the full year. Cherry's mother is deceased. Both Joe and Cherry have valid Social Security numbers. Cherry worked for part of the year and earned $5,200. Joe states that Cherry had an accident last May and sustained a disability from the injuries. Her doctor says she is totally and permanently disabled, not able to work, and the doctor does not expect Cherry to recover. Joe can claim the EITC using Cherry as his qualifying child because her doctor determined Cherry cannot work because of her disability and because her disability will last longer than a year.

**Penalties for Incorrect EITC Returns**

The penalties for failing to exercise due diligence with EITC claims can be severe. Incorrect EITC returns affect both the preparer and the client. If the IRS examines a client's return and denies all or part of the EITC, the client:

- Must pay back the amount in error with interest;
- May need to file Form 8862, Information to Claim Earned Income Credit after Disallowance;
- Cannot claim the EITC for the next two years if the IRS determines the error is because of reckless or intentional disregard of the rules; or
- Cannot claim the EITC for the next ten years if the IRS determines the error is because of fraud.

If the IRS examines an EITC claim that was prepared by a tax professional and it is determined that the professional did not meet all four due diligence requirements, the preparer can be subject to a preparer penalty with amounts covered in IRC Section 6695(g). Any of the following examples would cause a preparer to incur fines:

- Failure to comply with EITC due diligence requirements.
• A professional prepares a client return and the IRS finds any part of the amount of taxes owed is due to an unreasonable position.
• If a professional prepares a client return and the IRS finds any part of the amount of taxes owed is due to reckless or intentional disregard of rules or regulations.

**Disallowance of EITC**

If the IRS denies a taxpayer’s EITC claim and determines that the claim was improper, future EITC restrictions may be imposed on the taxpayer. The disallowance period is:

• Two years in cases of reckless or intentional disregard
• Ten years in cases of fraud.

During the disallowance period, also known as the “EITC ban,” the taxpayer is prohibited from claiming the credit. After the disallowance period ends, the taxpayer must be able to demonstrate, to the satisfaction of the IRS, that he or she is eligible to claim the EITC. The taxpayer must complete and submit Form 8862, Information to Claim Earned Income Credit After Disallowance, in order to do so.

**Note:** The EITC Ban would be received in the form of U.S. Mail from the IRS and would be written on Notice CP75C. The letter will state the following:

> You were banned from claiming the Earned Income Credit (EIC) in a prior tax year due to your intentional disregard of the rules or a fraudulent claim. Since your ban is still in effect, we disallowed the EIC for your current tax year.

A mere denial of an EITC claim does not mean the IRS has imposed this prohibition. The IRS must issue a final determination that the taxpayer acted with reckless/intentional disregard or has committed fraud with respect to the credit. The disallowance period begins in the tax year following the tax year for which the final determination is made.

In general, a determination of reckless or international disregard may be made if, given facts and circumstances, it is found that the taxpayer claimed the EITC without considering the rules and regulations for making the claim.

**Example:** On her timely filed tax return for 2015, Barbara claims the EITC for two young boys who lived with her for the last few months of the year and who were put in her care by their mother, a distant cousin of Barbara’s. The boys are not Barbara’s qualifying children for the EITC (or for any other purpose) because they do not meet the residency or relationship tests with respect to Barbara. The IRS denies Barbara’s claim and, in September of 2016, further determines that Barbara has recklessly disregarded the EITC rules for tax year 2015. Barbara is prohibited from claiming the EITC for 2016 and for 2017.

**Note:** During the disallowance period the taxpayer cannot claim the EITC even if the taxpayer has a qualifying child during this period.

**Example:** In 2017, Barbara goes to family court and obtains legal custody of one of the boys, making this child Barbara’s eligible foster child. Although the child is now Barbara’s qualifying child, she cannot claim the EITC for him until 2018 when the EITC ban is over. She will need to complete Form 8862 at that point to claim the EITC for the child.

**Social Security Number Requirements for EITC Returns**

A valid Social Security Number is required for EITC claims. If a primary taxpayer, spouse, (or both) have ITINs, they are ineligible to receive the Earned Income Tax Credit (EITC), even if their dependents have valid SSNs. If a taxpayer and spouse (if filing jointly) have valid SSNs, only dependents with valid SSNs will qualify to receive EITC. In the case of a
taxpayer who files a return using an ATIN (Adoption Taxpayer Identification Number), the EITC will be similarly disallowed for that dependent.

**Note:** Taxpayers are allowed to amend their original returns in order to claim the EITC, if they receive valid SSNs at a later date, as long as the taxpayer otherwise qualified for the EIC at the time the original return was filed.

**Summary of EITC Due Diligence Requirements for Tax professionals**

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<th>Requirement</th>
<th>Description</th>
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| Completion of Eligibility checklist | • Make additional inquiries if a reasonable and well-informed tax return preparer would know the information is incomplete, inconsistent, or incorrect.  
• Document any additional questions the preparer asks and the client's answers at the time of the interview. The practitioner should also ask probing questions to determine correct eligibility. |
| Computation of the Credit        | • Keep the EIC worksheet that demonstrates how the EIC was computed. Preparers must complete and attach Form 8867, Tax professional's Earned Income Credit Checklist, and submit the form with all EIC refund claims.  
• The worksheet must show what is included in the computation: self-employment income, total earned income, investment income, and adjusted gross income. Most tax software includes the computation worksheet. |
| Knowledge Standard               | • The preparer must know the law and use knowledge of the law to ensure he is asking the client the right questions to get all relevant facts.  
• He must take into account what the client says and what he knows about his client.  
• He must not know (or have reason to know) any information used to determine the client's eligibility for the EIC is incorrect, inconsistent, or incomplete. |
| Record Retention                 | • Retain Form 8867 and EIC worksheet.  
• Maintain records of how and when the information used to complete these forms was obtained.  
• Verify the identity of the person furnishing the information.  
• Retain all records for three years. |
Chapter 4 Review Questions

1. What is the penalty for preparers who fail to comply with due diligence requirements for the EIC?

   A. A penalty of $500 for each failure.
   B. A penalty of $1,000 for each failure.
   C. There is no preparer penalty, but there is a taxpayer penalty for fraud.
   D. A formal reprimand by the OPR, but there is no monetary penalty.

   The answer is A. Any tax return preparer who fails to comply with due diligence requirements for the EIC can be liable for a penalty of $500 for each failure.

2. A client tells a tax preparer:
   - She has no Form 1099.
   - She was self-employed cleaning houses.
   - She earned $12,000.
   - She had no expenses related to the cleaning business.

   What is the BEST course of action for the preparer in this case?

   A. Refuse to prepare the return based on the client's information.
   B. Ask probing questions to determine the correct facts and ask for proof of income or any expenses.
   C. Accept the taxpayer's word so long as she fills out a legal liability release form.
   D. Make the client swear to the truthfulness of her statements before an IRS officer.

   The answer is B. The best course of action would be to ask probing questions and ask for proof of income. In some cases, the client may say she had no expenses when it is not reasonable to conduct the business without incurring expenses, or the expenses may seem unreasonably high. Again, the preparer may need to ask probing questions to determine the correct facts.

3. All of the following are EITC due diligence requirements except:

   A. To evaluate the information received from the client.
   B. To apply a consistency and reasonableness standard to the information.
   C. To verify the taxpayer's information with the appropriate third parties.
   D. To make additional reasonable inquiries when the information appears to be incorrect, inconsistent, or incomplete.

   The answer is C. A tax professional is not required to verify a taxpayer's answers with third parties. The EITC due diligence requires a tax professional to:
   - Evaluate the information received from the client,
   - Apply a consistency and reasonableness standard to the information,
   - Make additional reasonable inquiries when the information appears to be incorrect, inconsistent, or incomplete, and
   - Document additional inquiries and the client's response.
Final Exam

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account at www.CESelfStudy.com and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. Which of the following is correct regarding the returning of client records:
   - A. A practitioner may withhold a 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

2. Circular 230 places numerous restrictions on solicitation and advertising. Which of the following is correct:
   - A. Hourly fee information must be included in all advertisements
   - 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

3. Under Circular 230 Section 10.27, a practitioner is prohibited from charging certain fees. Which of the following fees is prohibited:
   - A. Fixed fees for specific routine services (e.g., $300 for a Form 1040A)
   - B. A flat percentage fee based on the amount of refund on a Form 1040
   - C. Hourly rates
   - D. A range of fees for particular services with a higher fee charged for more complex situations

4. Under which of the following circumstances may a practitioner endorse or otherwise negotiate a client’s federal income tax refund check:
   - A. With the client’s oral permission
   - B. When the client owes the practitioner fees for preparing the return
   - C. When the client owes the practitioner fees for preparing the return and the client was notified that the practitioner intended to negotiate the refund check
   - D. None of the above; a practitioner may not endorse client refund checks

5. When must a tax preparer complete a client checklist for the EITC?
   - A. Every year.
   - B. With every new client.
   - C. Every six months.
   - D. The client interview is recommended, but not required.
6. In preparing the tax return for Speedy Plumbing, Inc., you notice a large deduction for “consulting services.” You ask your client to explain this deduction, and he explains it represents tuition paid for his son to attend college. You know that no 1099 or W-2 was issued for these services nor is any of this income reflected on your client’s personal tax return or his son’s. Your client states that everyone in this industry does this.

This deduction is equivalent to 20% of the net income. Which of the following is correct regarding your ability to sign the tax return for Nash Plumbing, Inc. per Circular 230:

A. You may sign the return since the return meets the “nonfrivolous standard”
B. The client’s assertion that the deduction is industry practice is frivolous. Accordingly, the position does not meet IRS Circular 230 standards and you may not sign the return
C. You may sign the return only if the deduction is clearly identified on the return as “consulting expense paid to son” or some similar disclosure
D. You may sign the return since everything on the return is the representation of the client

7. Bob Jones, Inc. is a new small business client that has asked you to prepare its current year tax return. Upon interviewing the client, you determine that the client has not filed several prior year tax returns. According to Circular 230, what should you do:

A. Notify the IRS of this failure
B. Advise the client promptly of the fact of noncompliance and notify the IRS if the client refuses to file
C. Advise the client promptly of the fact of noncompliance
D. Ignore the fact of non-filing provided the current year return is filed timely

8. Which is not one of the four due diligence requirements preparers are expected to follow for EITC claims?

A. Maintaining records for two years.
B. Completing the eligibility checklist.
C. Computation of the credit.
D. The knowledge standard.

9. Phil, who was an enrolled agent, was convicted of a felony and disbarred in 2014. He was audited by the IRS in 2015 on his personal tax return. Though he is disbarred for representing taxpayers, who can represent Phil before the IRS?

A. A CPA who is in good standing with the IRS
B. An Enrolled Agent who is in good standing with the IRS
C. Himself
D. All of the above

10. How long must a tax professional retain records relating to clients who have offered their consent for representation in conflict-of-interest cases?

A. One year from the date representation ends.
B. Two years from the date representation ends.
C. Three years from the date representation ends.
D. Five years from the date representation ends.