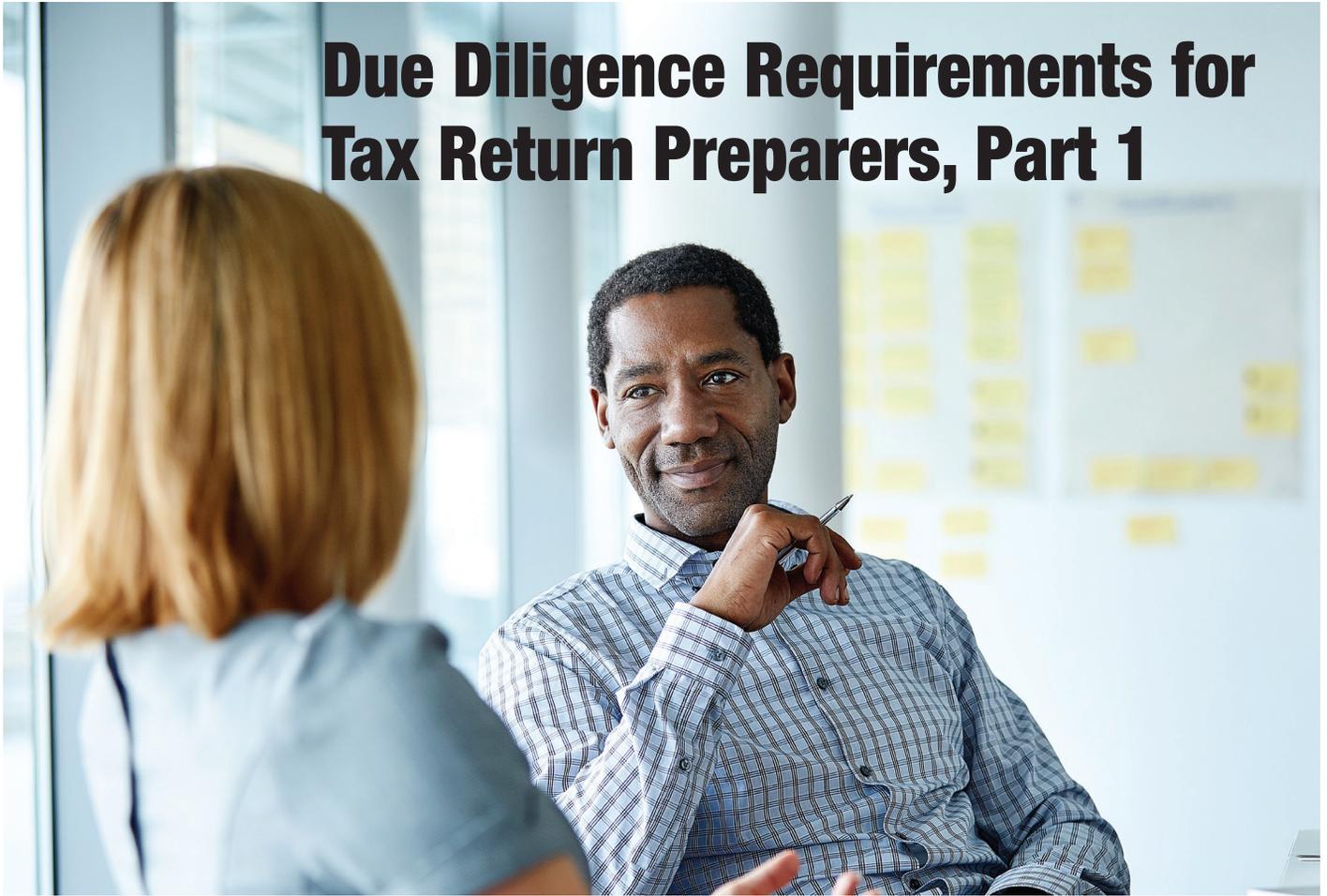


Due Diligence Requirements for Tax Return Preparers, Part 1



By Paul M. Budd, J.D., LL.M., MBA

One of the biggest challenges for a tax preparer is balancing two conflicting interests. On the one hand, a preparer is expected to carefully prepare precise and accurate returns without error. On the other hand, he/she is expected to file timely returns under strict time constraints imposed by unforgiving filing deadlines. Balancing the need for precision and timeliness forces a preparer to address a difficult question regarding each return. How much careful due diligence must be performed while also complying with filing deadlines?

This article summarizes the due diligence requirements for federal tax return preparers. It discusses diligence measures practitioners are expected to take to avoid careless mistakes. It also explains how the proper diligence measures, if taken, can help shield a preparer from penalties even when he/she makes a mistake. Finally, it illustrates the due diligence requirements with a few examples.

Preparer Penalties under the Internal Revenue Code

The Internal Revenue Code (the Code) is the primary source of rules regulating tax preparers. Code section 6694(a) imposes a penalty against tax return preparers who prepare a return or refund claim that understates a taxpayer's tax liability if the understatement is due to an "unreasonable position" taken and he/she "knew or reasonably should have known" the

position was unreasonable.¹ This penalty applies to each return or refund claim containing an understatement and is the greater of \$1,000 or 50 percent of the income the preparer derived from each erroneous return.²

In addition to the Code's penalties, a state or federal licensing board may impose further disciplinary actions against a licensed tax professional found liable for preparer penalties. Additional consequences may include anything from a public censure to revoking the professional's license to practice.

Section 6694 broadly defines a "preparer" as anyone who prepares a return for compensation.³ Anyone paid to prepare a tax return may be subject to preparer penalties, regardless of whether the person is a CPA, accountant, attorney or otherwise. Furthermore, a preparer does not have to sign a tax return to be assessed penalties. Merely advising a taxpayer may subject someone to preparer penalties.⁴

Fortunately, section 6694 is not a strict liability penalty. Penalties apply only if a preparer "knew or reasonably should have known" that a tax return position resulting in an understatement was "unreasonable."⁵ The question then becomes: When should a preparer reasonably know a position is unreasonable? Stated another way, what due diligence measures should be taken to ensure that all the positions on a taxpayer's return are objectively reasonable? While the Code provides no clear answer, it does give some guidance in the form of a due diligence exception.

The Due Diligence Exception: Good Faith and Reasonable Cause

Like most rules, the Code carves out an exception to section 6694 preparer penalties. If a preparer understates a taxpayer's liability on a return, penalties will not apply if there is a "reasonable cause for the understatement and the tax return preparer acted in *good faith*" when preparing the return.⁶ This is referred to as the "reasonable cause and good faith" exception. The exception will not apply if a preparer willfully or recklessly takes an unreasonable position that causes an understatement.⁷

Determining when an error is due to "reasonable cause" and when someone acts in "good faith" can be difficult. These somewhat ambiguous standards impose a due diligence requirement. If a practitioner acts in good faith when preparing a return by performing sufficient due diligence, but still makes an error that results in an understatement, the understatement is likely due to reasonable cause, because he/she acted in good faith by performing sufficient due diligence. If, however, a practitioner does not act in good faith by carelessly failing to perform sufficient due diligence when preparing a return, any error resulting in an understatement is likely due to negligence rather than a reasonable cause.

So what due diligence steps should be taken to ensure that any mistakes are due to reasonable cause and good faith? Code section 6694's corresponding Treasury Regulations (the Regulations) list six factors that help a preparer make that determination.

Six Factors for Reasonable Cause and Good Faith

The Regulations say that all the "facts and circumstances" should be considered to determine whether an understatement was due to reasonable cause and if a preparer acted in good faith.⁸ The Regulations list six factors to help make this facts and circumstances determination.⁹ If some or all of the factors weigh in a preparer's favor, they will strengthen his/her case against penalties under the reasonable cause and good faith exception. The following six factors provide some guidance on due diligence measures expected to avoid preparer penalties.

Nature of the Error. If the error resulted from a provision of the Code that was complex, uncommon or highly technical, and a competent tax return preparer could have made the mistake, this factor will support the reasonable cause and good faith exception.¹⁰ However, if the error would be easily apparent from a general review of the return, the reasonable cause and good faith exception will not apply.¹¹

Frequency of the Error. If the understatement is due to an isolated error, such as a mathematical or clerical mistake, the reasonable cause and good faith exception will generally apply.¹² But if the understatement is due to an isolated error that is "so obvious, flagrant or material that it should have been discovered during a review of the return . . ." the exception will not apply.¹³ If there is a pattern of errors on a return, the exception will not apply.¹⁴

Materiality of the Error. If the error resulted in a small, immaterial understatement in relation to the taxpayer's total tax liability, the reasonable cause and good faith exception will generally apply.¹⁵ But minor, immaterial errors may not qualify for the exception if they are sufficiently obvious or frequent.¹⁶

Six Factors for Reasonable Cause and Good Faith

- Nature of the Error
- Frequency of the Error
- Materiality of the Error
- Tax Return Preparer's Normal Office Practice
- Good Faith Reliance on Advice of Others
- Reliance on Generally Accepted Administrative or Industry Practice

Tax Return Preparer's Normal Office Practice. If a tax preparer has normal office procedures in place to ensure the consistent, accurate preparation of tax returns, and he/she made an error on a return despite following those normal office procedures, and the other facts and circumstances indicate the error would rarely occur, then this factor will weigh in the practitioner's favor for the reasonable cause and good faith exception. "Normal office practices" are essentially due diligence measures. The Regulations describe good normal office practices as "a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return and review procedures."¹⁷ Even if a preparer follows sufficient normal office practices, however, the reasonable cause and good faith exception will not apply if he/she makes a flagrant error, a pattern of errors or a repetitive error on numerous returns.¹⁸

Good Faith Reliance on Advice of Others. If a preparer reasonably relies in good faith on advice or information (oral or written) furnished by a taxpayer or another party, and the advice or information leads to an understatement, he/she will likely qualify for the reasonable cause and good faith exception.¹⁹ A preparer does not reasonably rely in good faith on advice or information if (1) the advice or information is unreasonable on its face; (2) he/she knew or should have known that the party providing the advice or information was not aware of all the relevant facts required to render the advice for the tax return; or (3) he/she knew or should have known, given the nature of his/her practice, at the time the return or refund claim was prepared, the advice or information was no longer reliable due to developments in the law after the advice or information was given.²⁰

Reliance on Generally Accepted Administrative or Industry Practice. If a preparer reasonably relies in good faith on generally accepted administrative or industry practices when taking an erroneous position on a return that causes an understatement, he/she may qualify for the reasonable cause and good faith exception.²¹ He/she is not considered to rely in good faith on such practices if, at the time the return or refund claim is prepared, "the tax return preparer knew or should have known (given the nature of the tax return preparer's practice) . . . the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed."²²

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Good Faith Reliance on Information or Advice

It is nearly impossible to prepare a tax return without relying on information provided by someone else, such as the taxpayer, bookkeeper, another accountant or any person who may have information regarding a taxpayer's income. Since preparers must rely on the information they are provided to prepare a return, there is always the risk that the information is incomplete, inaccurate or false. It would be unreasonable and unfair to penalize a tax preparer for relying on information that someone else created and furnished.

Fortunately, the Code and Regulations address this concern by expressly stating that preparers do not have to verify information or advice they receive, so long as their reliance without verification is reasonable and in good faith.²³ Thus, penalties will not apply when the source of an understatement is information or advice furnished, which the preparer then relied upon in good faith.²⁴ This rule encompasses a broad range of information and advice, including both oral and written information.²⁵ However, if it turns out the information or advice is erroneous, the preparer bears the burden of reproducing the erroneous information to show it was the source of the understatement.²⁶ Therefore, copies of all information received and relied upon to prepare a return should be retained, just in case the information must later be reproduced for the IRS as a defense against preparer penalties.

An important aspect of the reliance rule is that a preparer is generally not required to verify every piece of information received when preparing a tax return.²⁷ The Regulations state that a preparer may generally rely in good faith *without verification* on information furnished by the taxpayer or another third party.²⁸ This includes a taxpayer's previously filed tax returns.²⁹ This means preparers do not have to audit, examine or otherwise question their clients' tax return information.³⁰ If a preparer asks a taxpayer-client for information, he/she may generally rely on whatever the taxpayer provides without having to doubt or question the information.

There are two exceptions to this general rule of reasonable reliance without verification. First, a preparer cannot ignore the implications of information provided or information known that give the preparer reason to believe the furnished information may be incomplete or inaccurate.³¹ If a taxpayer provides records showing the taxpayer had deductible expenses, but the preparer knows the expenses were never incurred, the conflicting information cannot simply be ignored. The preparer has a duty to make reasonable inquiries to determine the validity of the information.³²

Second, there is a special exception for tax benefits that require preparers to make mandatory inquiries to substantiate the furnished information before relying upon it. These special, statutory exceptions generally apply to deductions and credits especially vulnerable to tax fraud or abuse, such as the Earned Income Credit, Child Tax Credit and American Opportunity Tax Credit. Additionally, under the recently enacted Tax Cuts and Jobs Act, Congress expanded the statutory due diligence requirement to determining a taxpayer's eligibility to file as head of a household.³³ For a detailed explanation of the specific diligence requirements, see Form 8867 and section 1.6695-2(b) of the Treasury Regulations.

Examples of Good Faith and Reasonable Cause

Examples are helpful to understand the application of these abstract

rules. The following examples illustrate how and when the good faith and reasonable cause exception may apply. The examples are based on the Regulations, case law and IRS rulings.

Example 1: Duty to Make Reasonable Inquires. A tax return preparer prepares income tax returns for both a doctor and the doctor's professional corporation. While preparing the professional corporation's returns, the preparer sees that the corporation's books show the corporation received loans from both the doctor and from a bank during the tax year. The books also show that the corporation paid for loan interest expenses, but do not show who the corporation made the interest payments to. Despite this knowledge, the preparer does not ask the doctor if the doctor received any interest income from his corporation and reports no interest income on the doctor's individual tax return. The doctor did, in fact, receive interest income during the year, so the preparer's failure to report the interest income on the return results in a substantial understatement of the doctor's tax liability.

Under these facts, the preparer is liable for preparer penalties and will not qualify for the reasonable cause and good faith exception. The preparer did not act in good faith because, despite the corporate books' implication that the doctor received interest income, the preparer did not make any reasonable inquiries into the existence of any interest income. The implication of information in the corporate books imposed a duty to make reasonable inquiries before claiming that the doctor received no interest income. The preparer could not merely rely in good faith without verification on the doctor's failure to tell him/her about any interest income. Therefore, the preparer did not exercise the requisite due diligence of asking the doctor about any interest income before claiming on the return that the doctor received no interest income. Accordingly, the understatement resulted from the unreasonable position, which the preparer should have known was unreasonable. Thus, the preparer is subject to penalties.³⁴

Example 2: Reasonable Reliance on Information in Previously Filed Tax Return. Tax Preparer 1 prepares a taxpayer's 2015 return. When preparing the return, Preparer 1 negligently overstates the taxpayer's expenses, creating a net operating loss for 2015. Next, Preparer 1 prepares amended income tax returns for the years 2012, 2013 and 2014 and claims refunds for those years based on the net operating loss carryback from 2015. Because the carryback was not exhausted in 2014, a portion of the loss was available to be carried forward to 2016.

The following year, Tax Preparer 2, a different income tax return preparer, prepares the same taxpayer's 2016 return. Preparer 2 prepares the 2016 return using information provided to Preparer 2 by the taxpayer, which includes a copy of the 2015 return prepared by Preparer 1. Preparer 2 was not aware of the negligent overstatement of expenses by Preparer 1. Preparer 2 checked the net operating loss deduction claimed in 2012, 2013 and 2014, so the taxpayer could claim what Preparer 2 believed to be the proper net operating loss deduction on the 2016 return. The net operating loss deduction constituted a substantial portion of the taxpayer's 2016 return.

Under these facts, Preparer 2 will be assessed no penalties, because he/she may reasonably rely without verification on the taxpayer's previously filed tax returns when preparing a return. However, Preparer 1 may be assessed separate penalties for each tax year return affected by the negligent or intentional overstating of expenses on the taxpayer's 2015

return. Therefore, Preparer 1 may be penalized for the 2016 return even though it was prepared by Preparer 2.³⁵

Example 3: Reasonable Reliance on Taxpayer Information. A tax preparer prepares the income tax return for a taxpayer who claims to have incurred deductible entertainment business expenses. Under the requirements of section 274(d) of the Code, the preparer asks the taxpayer if the taxpayer has records substantiating the amount, time, place, business purpose and business relationship relating to entertainment expenses. The taxpayer tells the preparer that the taxpayer has the required records. The preparer relies on this information and files the return, claiming a deduction for entertainment expenses in the amount indicated by the taxpayer.

Upon examination, the IRS disallows a portion of the claimed entertainment expense deductions, because the taxpayer does not have the records needed to substantiate the business entertainment expenses. The deductions are disallowed and the preparer understated the taxpayer's liability.

Here, the preparer is not assessed preparer penalties under the reasonable cause and good faith exception. The taxpayer told the preparer that the taxpayer had the substantiating records for the business expenses. The preparer could reasonably rely on this information without having to verify it. And the preparer acted in good faith by making appropriate inquiries on whether the taxpayer had the records needed to claim an entertainment expense deduction. Therefore, despite the understatement of liability, the preparer is not assessed preparer penalties.³⁶

Example 4: Failure to Make Appropriate Inquires. The same facts as Example 3, except it is one year later. The same preparer completes the tax return for the same taxpayer for the year following the IRS' examination and disallowance of the entertainment expense deductions for the prior year. The preparer and taxpayer go through the exact same routine: the taxpayer wants to claim an entertainment expense deduction; the preparer asks the taxpayer if the taxpayer has the substantiating records; the

taxpayer says the records exist, but does not produce them; the preparer believes the taxpayer and claims the deduction; and the IRS later audits and disallows the deduction, because the taxpayer again does not have the records.

Now, unlike the previous year in Example 3, the preparer will likely be assessed preparer penalties. Unlike Example 3, the preparer now has a reasonable basis to doubt the taxpayer's assertion that the taxpayer has the records. The preparer knows of the prior year's disallowance of the deduction since the taxpayer did not have the substantiating records. Therefore, while the preparer's inquiry about records was reasonable in Example 3, the preparer's inquiry in this example was unreasonable. Preparer's knowledge from past experience required the preparer to make further inquiries to determine whether the taxpayer actually had the required records. The preparer did not perform reasonably sufficient due diligence and therefore does not qualify for the reasonable cause and good faith exception to penalties.³⁷

Relying on Expertise and Judgment

Unfortunately, neither the Code nor the IRS provide tax preparers with a defined list of specific due diligence measures they can follow to always safeguard against preparer penalties. The Code and Regulations do, however, provide the good faith and reasonable cause exception. This exception serves as a due diligence exception to preparer penalties, giving tax preparers some insight into the level of due diligence the federal government expects from tax preparers. Ultimately, however, with due diligence, preparers should rely on their expert opinion and good judgment rather than trying to decipher the Code's ambiguous rules and standards.

As a general rule, if a preparer is unsure whether more due diligence is necessary, then more due diligence is necessary. The minimal cost of performing a little extra diligence is heavily outweighed by the potential benefit of precluding liability for costly preparer penalties. ■

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Footnotes

1. I.R.C. § 6694(a).
2. *Id.*
3. I.R.C. §§ 6694(f); 7701(a)(36).
4. See Treas. Reg. § 301.7701-15(b)(3)(i).
5. See I.R.C. § 6694(a).
6. I.R.C. § 6694(a)(3).
7. See I.R.C. § 6694(b)(2).
8. Treas. Reg. § 1.6694-2(e).
9. *Id.*
10. Treas. Reg. § 1.6694-2(e)(1).
11. *Id.*
12. Treas. Reg. § 1.6694-2(e)(2).
13. *Id.*
14. *Id.*
15. Treas. Reg. § 1.6694-2(e)(3).
16. *Id.*
17. Treas. Reg. § 1.6694-2(e)(4).
18. *Id.*
19. Treas. Reg. § 1.6694-2(e)(5).
20. *Id.*
21. Treas. Reg. § 1.6694-2(e)(6).
22. *Id.*
23. Treas. Reg. § 1.6694-1(e).
24. See *supra* Section II.A.2.b.; Treas. Reg. § 1.6694-2(e)(5); Treas. Reg. § 1.6694-1(e).
25. Treas. Reg. § 1.6694-2(e)(5).
26. *Id.*
27. Treas. Reg. § 1.6694-1(e)(1).
28. *Id.* (emphasis added).
29. Treas. Reg. § 1.6694-1(e)(2).
30. Treas. Reg. § 1.6694-1(e)(1).
31. *Id.*
32. Treas. Reg. § 1.6694-1(e)(1).
33. I.R.C. § 6695(g).
34. Example based on the facts in *Brockhouse v. United States*, 749 F.2d 1248 (7th Cir. 1984).
35. Example based on the facts in Revenue Ruling 81-171.
36. Example based on the facts in Revenue Ruling 80-266.
37. Example based on the facts in Revenue Ruling 80-266.