Return Preparer Due Diligence and The IRS: The Looming Battle

By Kip Dellinger

Kip Dellinger is a CPA in Santa Monica, Calif. He is a former Chair of the American Institute of Certified Public Accountants Tax Division Practice Responsibilities Committee and writes and teaches in the areas of tax practice, quality control, and tax practice conduct standards and ethics.

In this article, Dellinger discusses IRS due diligence expectations for tax return preparers and suggests that the IRS approach the matter realistically and judiciously.

Section 6662 assesses a taxpayer accuracy-related penalty and holds the taxpayer responsible for items on a tax return (and items omitted from a tax return) when determining if the erroneous treatment (or omission) of an item on a return will result in a penalty assessment. Section 6694 imposes a penalty on a return preparer in some circumstances for tax positions in a return of which the preparer has knowledge. The distinction between item and tax position is a distinction with a difference, and the “has knowledge” requirement is of great importance. Taxpayers are responsible for their information, representations, and returns. They may seek the advice of a preparer (or tax professional) concerning the treatment of an item on the return, but absent that, these two sections don’t require the preparer or adviser to verify the taxpayer’s information.

There are exceptions to this rule as mandated by statute (for example, preparer duties regarding earned income tax credit claims), and other obvious due diligence requirements have evolved — for example, when preparers see section 274 expenditures or listed property use under section 280, they should ascertain whether the taxpayer has maintained adequate records to support the claimed deductions. This also applies regarding charitable contribution recordkeeping and verification requirements. However, the preparer is not required to independently verify or examine the information.

For an eternity (as tax law is measured), the regulations under section 6694, Circular 230 (see section 10.34) and the respective standards or rules of professional bodies such as the American Institute of Certified Public Accountants and the American and leading state bar associations have consistently recognized that the tax professional is under no obligation to verify the client’s assertions. The rules inform the tax professional that he cannot ignore the implications of the information submitted or other information that he may possess or acquire independently. But that is very different from a mandate to verify, challenge, or examine the client’s tax data or representations.

Recently, however, there has been evidence that seems to confirm that we practitioners will have a battle with the IRS over what is considered adequate due diligence regarding return preparation. This looming battle may not be pleasant, and tax practitioners likely will be displeased with the outcome.

Telltale Signs

There’s plenty of evidence, anecdotal and otherwise:

• More than a year ago, Treasury and IRS representatives, encouraged by repeated comments from former Office of Professional Responsibility (OPR) Director Michael Chessman, asserted that Circular 230 practitioners had a duty not just to ask their clients if they had signature authority over a foreign bank account, but to have a specific conversation with every taxpayer client concerning the foreign account reporting requirements — even if there was no evidence the client had an account and even when the client had indicated “no” or “none” by checking a box in a tax organizer submitted for return preparation. The unpleasantness of questioning a client’s veracity aside, this requirement (which to date is still awaiting clarification) imposed onerous time burdens on the tax practitioner.

• The national taxpayer advocate’s annual report to Congress1 for 2009 discussed the possibility, if not the likelihood, of imposing additional due diligence requirements on preparers (this was of course framed as a consumer protection issue). Although the report has not always carried great weight with Congress, Treasury, or the IRS, one can safely assume that when it comes to using the return preparer as an enforcement tool, it will receive the Service’s full attention.

• In January the IRS sent letters to 10,000 return preparers explaining a variety of due diligence responsibilities regarding return preparation, and in nearly all cases, the letter was followed by a meeting between an IRS agent and the preparer at the preparer’s office that often lasted about three hours. The letter, and often the visiting IRS agents, misrepresented the due diligence requirements imposed on practitioners — by, for example, asserting that a preparer had a duty to verify client-submitted information for trade or business (Schedule C) income

1For the report, see Doc 2010-174 or 2010 TNT 4-19.
and to review bank statements to verify reported gross receipts. The AICPA brought the misinformation about verification 2 to the attention of the IRS, which promptly published a clarifying FAQ on the Web page describing the project.

- As a tax professional who defends other tax professionals and teaches professional standards, I have seen a fair amount of evidence across the country that IRS examiners are asserting preparer penalties in instances when the preparer isn’t required to verify the specific items and appears to have properly counseled the taxpayer about the rules and recordkeeping requirements for claiming the items on the returns. Return preparer penalty assessments have also been proposed in situations when the client understated business income gross receipts for the information provided to the return preparer — again, when it appears the return preparer had little reason to question or challenge the client’s provision of gross receipts on a tax organizer information sheet.

Return Preparers

No doubt the IRS would dearly love to deputize return practitioners and make them responsible for verifying those taxpayer items.3 This, of course, infuriates many return preparers who seemingly see their duties either as scrivener for the taxpayer or as adviser in the submission of a first offer of tax liability to the government. Taxpayers generally expect a preparer to be something more than a messenger of their data to the government and rightfully seek assistance to get their liability right, while our self-assessment system expects honesty from the taxpayer and the return preparer.

Regarding the latter, practitioners should acknowledge some increased duties. Too many preparers turn a blind eye to indications that something may not be all there. Arguably, that is a small minority of preparers in the federally authorized tax practitioner category (that is, CPA and enrolled agents who prepare income tax returns). Nonetheless, there is sufficient lack of due diligence to warrant concern and justify increased standards.

The IRS

For the IRS, the due diligence requirements or expectations should not be so intrusive that they require confrontation with the taxpayer or impose excessive financial burdens in the form of professional fees on the taxpayer. The overwhelming majority of taxpayers try to be compliant, and they should not be forced to bear a significant increase in the fee burden so that practitioners can discourage a very small number of miscreants.

Nor should practitioners face onerous obligations that will unnecessarily put them at risk of having contentious relationships with clients. This shouldn’t be a “gotcha” game, and still too many IRS examiners play it that way. The mind-set among those agents is that if the taxpayer has misstated something, it must have been with the knowledge and approval of the practitioner (or the practitioner should have audited the client’s information).

Also, the concept of due diligence as it affects the entire scope of tax practice in America is hardly one-size-fits-all, which is too often the bureaucratic approach. Very large firms of tax professionals will have valid concerns about economic substance and reportable transactions (and Notice 2010-9); in many cases they will justifiably depend on their clients to provide them with information about these items. The IRS must recognize that.

Small firms rely on their clients for assertions about trusts and estate, listed property, gross receipts reporting, and all variety of items. To require them to delve deeply into the client’s summary information, or to examine underlying items, is to create a contentious atmosphere between client and return preparer in many situations when it is unwarranted. It may also impose additional preparation costs on millions of compliant taxpayers to catch the few who aren’t.

If the IRS is going to challenge and attempt to punish tax professionals for failing to exercise due diligence, then it must spell out in dozens of concrete examples what it believes is expected of them. And it darn well owes it to American taxpayers, as well as their professionals,5 to begin properly training its own employees about how to apply penalty assessments and properly assess practitioner conduct before sending those employees on an audit mission with a quiver full of penalties.

One finds that practitioners — the overwhelming majority of whom are trying to do a professional and honest job — are appalled at the apparent lack of examiner training and the reluctance of group managers to provide adult supervision, which too often is accompanied by an attitude that every taxpayer is a bad guy. This mind-set and approach is what led to the IRS Restructuring and Reform Act of 1998, which impeded the IRS’s enforcement for years.

However, in dealing with the IRS at a national level, I am impressed with the rational and judicious approach to many practitioner-related issues. One can cite any number of IRS responses to practitioners that indicate that National Office management is trying to “get this right” for taxpayers, practitioners, and the government — and that it welcomes practitioner input to ensure that outcome. At the National Office level, the IRS has responded favorably, and sometimes generously, to input from the tax professional community.

So we appear to have a disconnect: The field isn’t getting the message from the National Office, or it’s

---

3Without, of course, receiving liberal healthcare, annual leave, and retirement benefits.


5This is, after all, the employer of every employee of the IRS and Treasury.
getting distorted as it travels down through the bureaucracy. If the system is to function effectively, that disconnect must be eliminated. Agents in the field need to understand that the tax practitioner is not their enemy and should not be treated as such except when clearly justified. They need to be reminded that they are required to use the enormous power they have fairly and judiciously.6

I have had some success in my efforts to get tax practitioners to understand the world from the IRS’s perspective and to accept that the irritating or even infuriating IRS agent and the absent or disinterested group manager are the exception and not the rule. IRS agents too often live in an insular environment in which they have never seen the return preparation world through a practitioner’s eyes. A good start might be for IRS management to arrange for knowledgeable tax practitioners to make presentations to IRS personnel regarding the various professional standards imposed on preparers and to discuss tax professionals’ views of their duties under Circular 230 — similar to the continuing education requirements for return preparers under the new preparer registration regime to be administered by OPR.7

A Modest Recommendation
Both the IRS and the return preparer community should, and surely do, want a relationship that works for taxpayers, professionals, and the administrator. Return preparers want reasonable requirements for, and limitations to, their duties in verifying taxpayer-provided information and taxpayer representations. Onerous, expansive, and intrusive due diligence requirements will likely have an adverse effect on preparer-taxpayer relationships that could in turn have an adverse effect on the tax administration.

Here’s a suggestion for the IRS: Approach this issue respectfully, thoroughly, and seriously. The tax professional community will also do so and will respond in kind. Each side should carefully consider the objectives of the other and recognize that neither has a monopoly on nefarious motives and that there is virtue on both sides. This is an issue of potential disconnects, disagreement, and dispute that we need to get it right to ensure the effective and efficient administration of the tax law.

6A significant part of the disconnect appears to originate from the fact that National Office management at the IRS, understandably, believes that return preparers should have a duty to educate taxpayers about their reporting and disclosure obligations in some areas, or to ensure those obligations are fulfilled, or in some instances to do both. However, these requirements do not necessarily require actual examination of the taxpayer’s records or third-party verification of the taxpayer’s assertions or representations, which is what examiners too often assert.

7This is different than meetings between local IRS management and local practitioner groups that are taking place with increasing frequency. Those meetings generally involve “management,” but rarely include group managers and examiners.