THE ELITE QUARTERLY – Ethics for Enrolled Agents
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What's Inside This Issue

INSTRUCTIONS – Read the content on pages 1-9, the quiz questions on pages 10-11, and the quiz instructions on page 12. Select the best answer for each quiz question and record the answers either on the answer sheet on page 12 or on-line at www.cpelite.com.

COURSE COMPONENTS, CONTENT LEVEL, AND LEARNING OBJECTIVES – The components of this newsletter are divided into three parts – an analysis of the Code provisions which allow a District Court to enjoin a tax preparer from preparing tax returns, and a District Court decision permitting a disbarred attorney to prepare tax returns (Part I), a review of the updated due diligence requirements for various refundable credits (Part II), and selected Circular 230 provisions (Part III). The learning objectives for Part I are: (1) differentiate among three Code provisions which allow a District Court to enjoin tax preparers from preparing tax returns; (2) know the actions for which a tax preparer can be enjoined under Sections 7407, and 7408; and, (3) determine whether the Office of Professional Responsibility has oversight over a disbarred attorney who prepares income tax returns. The learning objective for Part II is to know the Section 6695(g) due diligence requirements for claiming certain credits. The learning objective for Part III is to know the requirements and limitations provided in Sections 10.22, 10.31, and 10.35-37 of Circular 230. There are no prerequisites or additional materials needed nor is advance preparation required for this Special Edition.

Key Terms in This Issue of THE ELITE QUARTERLY

[Item 1] Enjoin: Prohibit from performing an action by an injunction.

[Item 1] Reportable transactions: Defined by Treasury Regulation Section 1.6011-4, and include six broad categories, three of which are: (1) confidential transactions; (2) loss transactions; and, (3) listed transactions. These transactions must be disclosed on Form 8886 or be subject to penalty.

[Item 3] Office of Professional Responsibility (OPR): OPR is the governing body responsible for interpreting and applying the regulations governing practice before the IRS (Circular 230).

[Item 3] Practice before the IRS: Practice during an investigation, adversarial hearing, or other adjudicative proceeding before the IRS.

[Item 5] Section 6695(g) due diligence requirements: Preparer requirements (when taxpayers claim certain credits) that must be met to avoid the penalty under Section 6695(g).

[Item 5] Section 6695(g) knowledge requirement: One of the requirements imposed on the preparer to make reasonable inquiries, when necessary, to ensure taxpayer eligibility and correct computation of the earned income tax credit, child tax credit, additional child tax credit, and American Opportunity Tax Credit.

[Item 6] Federal tax matter: Any matter concerning the application or interpretation of a Section 6110(i)(1)(B) revenue provision, any provision of the law that impacts a person's obligations under the Code and Treasury regulations, and any other law or regulation that the IRS administers.

PART I
PROHIBITING TAX RETURN PREPARERS FROM PREPARING TAX RETURNS

Part I of this year's Special Edition first summarizes three Code Sections which may be used to prohibit a tax return preparer from preparing federal income tax returns and then provides two recent court cases that deal with this issue.

[ITEM 1] CODE SECTIONS WHICH ENJOIN TAX RETURN PREPARERS

Section 7407 authorizes the IRS to prohibit a tax preparer from preparing federal tax returns if certain

actions are committed by the tax return preparer and injunctive relief is appropriate to prevent the recurrence of the conduct. Any IRS action under this section shall be brought in the District Court of the United States for the district in which the tax return preparer resides or has his principal place of business, or in which the taxpayer with respect to whose tax return the action is brought resides. There are four actions committal of which may result in the tax preparer bing enjoined. First, the tax return preparer has engaged in any conduct subject to penalty under Section 6694 or 6695, or subject to any criminal penalty under the Code. Section 6694(a) was covered in depth in our 2016 Special Edition. In summary, a tax return preparer may be subject to a penalty under this section if a tax understatement is due to an unreasonable position under one of the following three scenarios: (1) the position lacks substantial authority and it is not disclosed in the return; (2) the position is disclosed in accordance with Section 6662(d)(2)(B)(ii) but the position lacks a reasonable basis; and, (3) the position is taken with respect to a tax shelter or a reportable transaction. Irrespective of these three scenarios of an unreasonable position, a penalty will not be imposed if it is shown that there is a "reasonable cause" for the understatement and the tax return preparer acted in good faith. For more information about Section 6694, please see our 2016 Special Edition. Second, a tax preparer may be enjoined if he misrepresents his eligibility to practice before the IRS, or otherwise misrepresents his experience or education as a tax return preparer. Third, a preparer may be enjoined if he guarantees the payment of any tax refund or the allowance of any tax credit. Fourth, the preparer may be enjoined if he engages in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws. If a tax return preparer has continually or repeatedly engaged in one of the above actions, the District Court may enjoin a preparer from further engaging in such conduct if it finds that it is the only remedy to prevent the taxpayer from violating the law again.

Section 7408 applies to actions to enjoin specified conduct related to tax shelters and reportable transactions. Specific actions under this provision deal with any action, or failure to take action, which is either (1) subject to penalty under Sections 6700, 6701, 6707, or 6708, or (2) in violation of any requirement under regulations issued under Section 330 of Title 31, USC. The applicable Code sections deal with: (1) promoting abusive tax shelters; (2) penalties for aiding and abetting understatement of tax liability; (3) failure to furnish information regarding reportable transactions; and, (4) failure to maintain lists of advisees with respect to reportable transactions. Section 330 deals with practicing before the Treasury and IRS.

Section 7402(a) provides that U.S. District Courts have jurisdiction to (1) make and issue in civil actions writs and orders of injunction and other orders and processes, and (2) render judgments and decrees as may be necessary or appropriate for the enforcement of the Internal Revenue laws.

[ITEM 2] DISTRICT COURT GRANTS PERMANENT INJUNCTION AGAINST TAX RETURN PREPARER

In Stinson [3/6/17], the taxpayer became an owner of twelve stores in a tax franchise during 2011 and 2012. During this time, the taxpayer prepared hundreds of tax returns. In 2013, he downsized his operations to ten stores in five states and began doing business under a new name rather than the franchise name. He no longer prepared tax returns in 2013 and left the tax preparation to his employees. According to the taxpayer, his tax preparation stores targeted "underprivileged, undereducated poor people" and earned income tax credit claims. His practice did not charge a fee for each tax return upfront, but rather extracted the fee from the taxpayer customer's refund amount. Therefore, a larger refund was better for the client and for the company. Often the charge was in excess of $600 per return, sometimes as much as $999, oftentimes without informing the taxpayer of the amount. The goal was to get the maximum refund to make the customer happy and deduct a larger fee from the refund. The IRS claimed that the taxpayer, by way of his tax preparation stores, had repeatedly engaged in the following fraudulent practices: (1) falsifying deductions on Form 1040 Schedule A to reduce a customer's taxable income by reporting personal expenses as business expenses and falsifying unreimbursed employee expenses and charitable contributions; (2) falsifying Form 1040 Schedule C deductions by fabricating businesses and reporting profits or losses from a false business or inflating profits and losses from an actual business; (3) claiming false education credits; (4) falsifying a customer's earned income tax credit; (5) failing to conduct proper due diligence; and, (6) failing to disclose fees and provide customers complete copies of their tax returns. The IRS argued that the taxpayer should be enjoined under Sections 7402(a), 7407, and 7408. While any one of these provisions prohibit a taxpayer from preparing tax returns, different actions can be demanded by the court depending on the provision. For example, under Section 7402(a), the court may order the taxpayer to provide a list of all taxpayers for whom he or his employees have prepared income tax returns. Another difference is the type and amount of penalties under Sections 7407 and 7408. Apparently because of these differences, the District Court ruled on each section whether to enjoin the taxpayer even though it was fairly clear from the facts that the IRS would prevail under any of the three provisions.

Before discussing the court's ruling, some of the evidence gathered by the IRS is provided next to illustrate the types of action by a tax preparer that could lead to an injunction. Many of the tax returns prepared by the tax preparer and his employees claimed deductions for business mileage that were actually nondeductible commuting miles. In many cases, the miles claimed were tens of thousands more miles than the client actually drove for work. Education credits were claimed on a number of tax returns where the client never attended school. Schedule C's were prepared with made-up businesses and expenses to generate loss deductions without the

knowledge of the client. Form 8867 "Paid Preparer's Earned Income Credit Checklist" was completed by the taxpayer or his employees without actually receiving documentation from the clients. Another due diligence violation was the fact that a number of clients either never received copies of their tax returns or received copies with missing pages. The IRS also noted that many of the store managers and tax preparers had no experience preparing tax returns prior to their involvement with the taxpayer, and the taxpayer's so-called training focused on the company's policies, managing employees, and marketing efforts. The limited training in preparing tax returns involved figuring out how to maximize refunds.

With respect to the court's ruling, it found that Section 7407 was satisfied as there was clear evidence that the taxpayer violated Section 6694 because he negligently and willfully prepared tax returns with the same types of false and improper claims that served to wrongfully reduce the taxpayer's liability. The court indicated that the IRS presented evidence of numerous tax returns containing an understatement of liability due to completely fabricated expenses, wrongfully claimed dependents or head of household filing status, wrongfully claimed charitable contributions, and fabricated businesses. It also noted that once the IRS establishes any of the violations enumerated in Section 7407, it need only demonstrate that "injunctive relief is appropriate to prevent recurrence of such conduct." Factors for determining whether a tax preparer is likely to violate the law again include the following: (1) the gravity of the harm caused by the offense; (2) the extent of the tax preparer's participation; (3) the tax preparer's degree of scienter (knowledge of intent to deceive); (4) the isolated or recurrent nature of the infraction; (5) the tax preparer's recognition (or non-recognition) of his own culpability; and, (6) the likelihood that the tax preparer's occupation would place him in a position where future violations could be anticipated. For the first factor, the court concluded that the tax preparer took advantage of the taxpayers' lack of knowledge to cause great harm to his low-income customers who have been audited and now owe relatively significant sums to the IRS. With respect to the second and third factors, the court noted that the tax preparer was well aware that his employees were improperly preparing tax returns given the pattern of false claims made on numerous tax returns. Even if he did not instruct his preparers to wrongfully claim these amounts on their customers' returns, he played an integral role by failing to oversee his own employees and correcting this practice. Given the sheer number of falsely-prepared returns, the taxpayer's lack of remorse, and his refusal to recognize the harm he caused his clients, the court concluded that factors 4-6 also weighed against the taxpayer. As a result, it concluded that an injunction under Section 7407 preventing the tax preparer from acting as an income tax return preparer is appropriate and necessary to prevent future interference with the Internal Revenue laws.

Based mainly on the same evidence, the District Court also ruled that an injunction under Section 7408 was warranted primarily because Section 6701 (aiding and abetting understatement of tax liability) was satisfied. Under Section 7402(a), in seeking a permanent injunction the IRS must demonstrate the following traditional equitable principles: (1) the IRS has suffered an irreparable injury; (2) remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) considering the balance of hardships between the IRS and tax preparer, a remedy in equity is warranted; and, (4) the public interest would not be disserved by a permanent injunction. For the first principle, the court noted that the Treasury suffered irreparable harm with the loss of millions of dollars of lost tax revenue and the IRS's customers have suffered irreparable harm because they now owe additional taxes and penalties that they may not be able to afford. For the second principle, the District Court ruled that there is no adequate remedy at law because the tax preparer's continued operation would cause irreparable harm to his customers and the public at large and there is no way of stopping him from fraudulently preparing taxes absent an injunction. On the third principle, the court noted that the tax preparer owned rental property from which he could make a living and that the balance of hardships favors the IRS. It also concluded that the fourth principle favored the IRS as, by defrauding the IRS, a tax preparer is defrauding every law-abiding taxpayer who pays their taxes. It therefore concluded that injunction under Section 7402(a) was warranted and that the tax preparer was required to pay a remedy of disgorgement award (give up illegally gained profits) of nearly $950,000. **Note:** In addition to enjoining the tax preparer from acting as a federal tax return preparer, the court ordered several actions to be completed by the taxpayer and issued further limitations on the taxpayer. Some of these actions and limitations are: (1) closing all of the tax return preparation stores; (2) prohibiting the tax preparer from selling, transferring, or assigning his tax practice to another tax return preparation business; (3) barring the tax preparer from selling a list of his clients; (4) providing a list of all personnel who were involved in his tax preparation businesses; and, (5) providing a list of all clients whose tax returns were prepared by his tax preparation businesses.

[ITEM 3] DISTRICT COURT CONSIDERS WHETHER A DISBARRED ATTORNEY MAY BE A TAX PREPARER

Circular 230 regulates practice before the Treasury and IRS as authorized by Congress under Section 330 of Title 31. Section 10.3 of Circular 230 limits those who may practice before the IRS to attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, and other persons representing taxpayers before the IRS. In Sexton [3/17/17], the plaintiff pleaded guilty to four counts of mail fraud and one count of money laundering in 2005. He was subsequently disbarred in South Carolina, and in 2008 the Office of Professional Responsibility (OPR) suspended him from practicing before the IRS. Although he has not challenged the suspension prior to and during his suspension, he has offered professional tax services as president of an

LLC. He assists with the preparation of tax returns for individual clients of the LLC. Also, he performs various other duties within the scope of his employment with the LLC, including management, marketing, and client relations. In September 2012, the OPR received a complaint from a former client of the LLC. The client found out about the plaintiff's disbarment, and fired him by an email sent on September 12, 2012. Following her complaint, the OPR initiated an investigation of whether the plaintiff was violating his suspension from practicing before the IRS. During February 2013, the OPR sent a request to the plaintiff for information related to an investigation of alleged unauthorized practice by him during his suspension. In response, the plaintiff filed a Complaint against the OPR to determine whether the OPR has jurisdiction or authority over him. The plaintiff cited Loving in his defense that he is not a practitioner as defined by federal law. Before Loving was affirmed in 2014 by the D.C. Circuit Court, very few legal scholars would have given the current plaintiff much of a chance to win this case. After all, he committed two felonies and was disbarred by South Carolina. However, after Loving, the regulatory authority of the OPR has diminished significantly. As we have reported in several of our past newsletters, the taxpayers in Loving were unregistered tax preparers who argued that the Treasury overstepped its authority to require all tax professionals to pass a competency test and earn annual CPE. The D.C. Circuit Court agreed with a lower court which ruled that the regulations in Circular 230 applied only to individuals who were able to "practice" before the IRS and that the preparation and signing of tax returns did not constitute such practice. In the current case, the OPR made two broad claims. First, it claimed that Circular 230 extends to tax professionals who are not authorized to practice before the IRS because they are suspended from practice due to misconduct, yet offer services within the scope of the statute and its regulations. Within this claim, it offered several arguments, all of which were turned down by the District Court. The court noted that it is unaware of any binding authority or federal case law holding that a disbarred lawyer is the equivalent of a suspended representative under Section 330. In rejecting the OPR's argument that Congress intended for oversight to continue after suspension, the court countered that an indefinite and undefined oversight by the IRS based upon suspension would result in suspension becoming potentially a more severe penalty than disbarment. It also argued that the OPR has no authority to regulate tax preparers unless they have the authority to represent a taxpayer before the IRS. The second broad claim made by the OPR is that its authority extends to tax professionals who offer written tax advice regardless of whether they represent clients in a typical tax controversy before the IRS. The District Court rejected the OPR's expansive reading of the regulations. In support, it cited Loving, which ruled that to practice before a court or agency ordinarily refers to "practice during an investigation, adversarial hearing, or other adjudicative proceeding" before the IRS and that this does not encompass the work of tax preparers. The District Court ruled that the plaintiff is not currently a practitioner as defined in Circular 230 and that the OPR and its agents are permanently enjoined from seeking to assert authority or jurisdiction over the plaintiff and his tax preparation activities.

REVIEW QUESTIONS AND SOLUTIONS

1. Regarding the three Code sections dealing with enjoining a tax preparer, **which one** of the following statements **is false**?

   a. Penalties related to tax shelters and reportable transactions are covered in Section 7408.

   b. A tax preparer who misrepresents his eligibility to practice before the IRS may be enjoined under Section 7407.

   c. The Tax Court may issue orders of injunction under Section 7402(a).

2. In a District Court case dealing with enjoining a tax preparer with ten tax preparation stores, **which one** of the following statements **is true**?

   a. The tax preparer was required to close all of his tax preparation stores.

   b. Most of his clients were highly sophisticated.

   c. For clients who claimed the earned income tax credits, qualification for this credit was properly documented by the tax preparer or his employees.

3. Based on a District Court case involving a disbarred attorney, **which one** of the following statements **is false**?

   a. The Loving case ruled that the preparation of tax returns did not constitute "practice" before the IRS.

   b. Because he was disbarred, the court ruled that he may no longer prepare income tax returns.

   c. Attorneys are specifically mentioned in Section 10.3 as professionals who may practice before the IRS.

Solutions

1. **"C" is the correct response**. Only a District Court may issue orders of injunction under Section 7402(a).

   "A" is an incorrect response. Section 7408 deals with four Code sections that cover penalties with respect to tax shelters and/or reportable transactions.

   "B" is an incorrect response. Section 7407 provides four actions for which a tax preparer may be enjoined from practice. Tax preparer

misrepresentations about his eligibility to practice before the IRS is the second action. *Sections 7402, 7407, and 7408.*

2. **"A" is the correct response**. In addition to having to close all of his stores, he was prohibited from selling, transferring, or assigning his tax practice to another tax return preparation business

   "B" is an incorrect response. To the contrary, his tax preparation stores targeted "underprivileged, undereducated poor people."

   "C" is an incorrect response. Form 8867 was completed by the taxpayer or his employees without actually receiving documentation from the clients. *Stinson.*

3. **"B" is the correct response**. Because the taxpayer was disbarred, the court concluded he no longer was under the oversight of the OPR. Since under the Loving decision tax preparers generally are not practicing before the IRS, he could continue preparing income tax returns.

   "A" is an incorrect response. The decision in Loving ruled that to practice before a court or agency ordinarily refers to "practice during an investigation, adversarial hearing, or other adjudicative proceeding" before the IRS and that this does not encompass the work of tax preparers.

   "C" is an incorrect response. Attorneys, certified public accountants, enrolled agents, and enrolled retirement plan agents are specifically listed in Section 10.3. *Sexton.*

PART II
TAX PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN TAX CREDITS

[ITEM 4] HISTORICAL BACKGROUND OF THE SECTION 6695(g) DUE DILIGENCE REQUIREMENTS

The "Taxpayer Relief Act of 1997," effective for taxable years that began after December 31, 1996, included Section 6695(g), that originally imposed a $100 penalty on an income tax return preparer who failed to meet the earned income tax credit (EITC) due diligence requirements set forth in the Treasury regulations. Section 6695(g) was added to the Code because Congress believed more thorough efforts by tax return preparers were important to improving EITC compliance. However, the number of erroneous EITC claims continued to rise. As a result, the EITC over the last ten years has received a lot of attention from Congress, the Treasury, and the IRS. In 2006, income tax preparers claiming the EITC for their clients were required to file Form 8867, "Paid Preparer's Earned Income Credit Checklist." The "Small Business and Work Opportunity Tax Act of 2007" amended the penalty to apply to all tax return preparers, not just income tax preparers. A 2011 study by the Treasury Inspector General for Tax Administration estimated that the EITC error rate may be as high as 28% which translates to an annual revenue loss of between $11 and $13 billion. In the same year of the study, 2011 tax legislation increased the Section 6695(g) penalty to $500 (indexed for inflation beginning in 2015). **Note:** The Section 6695(g) penalty is $510 for each due diligence failure in 2016 and 2017. As recently as 2016, the IRS estimates that between 21% to 26% of EITC claims are paid in error. While some of the errors are believed to be unintentional caused by the complexity of the law, many EITC claims are an intentional disregard of the law. For many years, the EITC was the only refundable credit, making it a target for the filing of fraudulent tax returns. As illustrated in the Stinson case reported above, unscrupulous tax preparers and even taxpayers, may have been incentivized by the refundable nature of the EITC to manipulate income and deductions in order to claim erroneous or overstated EITCs. Over the last 10-15 years, the number of refundable individual income tax credits has increased to four. Because these credits phase out over various income levels, the majority of the taxpayers who claim these credits are low income to middle income taxpayers who claim one or more children as dependents. To help mitigate the erroneous claims of these credits, the "Protecting Americans from Tax Hikes Act of 2015" (the PATH Act) expanded the scope of the Section 6695(g) due diligence requirements to include the child tax credit (CTC), the additional child tax credit (ACTC), and the American Opportunity Tax Credit (AOTC). This expansion is effective for tax years that begin after December 31, 2015. In 2016, Form 8867 was changed in three significant ways. First along with its name change to "Paid Preparers Due Diligence Checklist," the form must be completed if one or more of the following credits are claimed: (1) Earned Income Credit (EITC); (2) Child Tax Credit (CTC); (3) Additional Child Tax Credit (ACTC); and, (4) the American Opportunity Tax Credit (AOTC). Second, the due diligence requirements checklist, which appeared in Part IV of page 3 now appears on page 1. This checklist apples to all four credits and there are three separate yes/no boxes – the CTC and ACTC are answered together. Third, page two provides additional due diligence requirements unique to each credit.

[ITEM 5] TREASURY EXPANDS SCOPE OF DUE DILIGENCE REGULATIONS TO THREE ADDITIONAL TAX CREDITS

Treasury Decision 9799 [12/2/16], contains final and temporary IRS regulations affecting tax return preparers that reflect the PATH Act's expansion of the Section 6695(g) due diligence penalty to the CTC, the ACTC, and the AOTC. The 2016 regulations state that, as a result of the PATH Act's expansion of the due diligence requirements, one return or refund claim may contain claims for more than one credit that are subject to the due diligence requirements. Each failure to comply with the due diligence requirements will result in a penalty, since the Section 6695(g) due

diligence requirements apply to each credit that is claimed. So more than one penalty could apply to a single return or refund claim. Form 8867 is a single checklist that is to be used for all of the applicable credits (EITC, CTC, ACTC, and AOTC) now subject to the Section 6695(g) due diligence requirements. Form 8867 is to be filed with every paper return or e-filed return on which an EITC, CTC, ACTC, or AOTC is claimed. Copies of Form 8867 and the various required worksheets are to be completed and kept. The worksheets include: the EITC and CTC worksheets in the Form 1040 instructions, the EITC worksheet in the Form 1040 EZ instructions, and the AOTC worksheet in the Form 8863 instructions. The regulations clarify that the completion of Form 8867 is to be based on information that is provided by the taxpayer to the preparer, or otherwise reasonably obtained or previously known by the preparer.

The due diligence requirements imposed on the tax return preparer for the four credits in the regulations are fourfold. First, the tax preparer must truthfully and accurately complete the actions described on Form 8867 for each credit claimed. Second, Form 8867 must be submitted in the manner required (see the next paragraph). Third, the tax preparer must satisfy the knowledge requirement by interviewing the taxpayer. The preparer must ask adequate questions, and contemporaneously document the questions and the taxpayer responses. He also must review adequate information to determine if the taxpayer is eligible to claim the credit(s) and in what amounts. Fourth, the tax preparer must retain for three years from the applicable date the following documents: (1) copies of the Form 8867; (2) Worksheets (or alternative records) for each credit; (3) copies of any documents provided by the taxpayer on which the preparer relied to determine eligibility for, and the amount of, the credit(s); and, (4) a record of how, when, and from whom the information used to prepare Form 8867 and the worksheet(s) was obtained. This includes a copy of any document relied on by the preparer.

A tax preparer is required to submit Form 8867 to the IRS when the preparer electronically files the tax return. If the taxpayer's return is mailed, the tax return preparer must mail Form 8867 with the tax return. If the preparer of Form 8867 is not the signing return preparer, the preparer satisfies the submission requirement by providing a copy of the completed Form 8867 to the signing return preparer. If the preparer of Form 8867 is the signing return preparer and the taxpayer is not electronically filing the return, the preparer must provide a copy of completed Form 8867 to the taxpayer to be attached to the return that is being filed with the IRS.

To comply with the knowledge requirement in the regulations, the preparer may not ignore the implications of information furnished to, or known by, the preparer. He must make reasonable inquiries if the information furnished to him appears to be incorrect, inconsistent, or incomplete. The knowledge requirement is consistent with the verification requirement that is imposed on all tax return preparers with respect to any tax return or refund claim under the Section 6662 accuracy-related standards, for example the negligence penalty and the penalty for substantial understatement of income tax.

A firm that employs a return preparer subject to penalty under Section 6695(g) also is subject to a penalty if certain conditions apply. A firm will be subject to a penalty if at least one of three conditions apply. First, one or more members of principal management (or principal officers) of the firm or branch participated in, or prior to the time the return was filed, knew of the failure to comply with the Section 6695(g) due diligence requirements. Second, the firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements. Third, through willfulness, recklessness, or gross indifference the firm disregarded its own reasonable and appropriate compliance procedures. This includes ignoring facts that would lead a person of reasonable prudence and competence to investigate further or ascertain more information. The regulations state that a firm that is subject to the Section 6695(g) penalty if any of these three conditions apply is not eligible for the penalty exception in the regulations. The penalty exception provides that the Section 6695(g) penalty will not apply if the return preparer can demonstrate to the IRS's satisfaction that, considering all of the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements, and the failure to meet the due diligence requirements with respect to the particular tax return or refund claim was isolated and inadvertent.

Updated and new examples in the regulations provide more insight into when a preparer has satisfied the due diligence knowledge requirement, including for purposes of the CTC and the AOTC. The examples illustrate that the knowledge requirement for purposes of due diligence can be satisfied in conjunction with a preparer's information-gathering activities done for the purpose of accurately completing other aspects of a tax return or refund claim. They illustrate that in certain circumstances a preparer may satisfy the knowledge requirement based on existing knowledge without having to make additional reasonable inquiries. Here are some new and revised examples in the 2016 Treasury regulations.

Example 1: In 2018, 22-year-old taxpayer Tina engages tax preparer Phillip to prepare her 2017 federal income tax return. Tina completes Phillip's standard intake questionnaire and states that she never has been married, and has two sons, ages 10 and 11. Based on the intake sheet and other information that Tina provides, including information that shows that the two boys lived with Tina throughout 2017, Phillip believes that Tina may be eligible to claim each boy as a qualifying child for purposes of the EITC and the CTC. However Tina

provides no information to Phillip, and Phillip does not have any information from other sources, to verify the relationship between Tina and the boys. To meet the knowledge requirement in the regulations, Phillip must make reasonable inquiries to determine whether each boy is a qualifying child of Tina for purposes of the EITC and the CTC, including reasonable inquires to verify Tina's relationship to the boys. Phillip must contemporaneously document these inquiries and the responses.

Example 2: The facts are the same as in Example 1. Also, as part of preparing Tina's 2017 federal income tax return, Phillip makes sufficient reasonable inquiries to verify that the boys were Tina's legally adopted children. In 2019, Tina engages Phillip to prepare her 2018 federal income tax return. When preparing Tina's 2018 federal income tax return, Phillip is not required to make additional inquiries to determine the boys' relationship to Tina for purposes of the knowledge requirement under the Section 6695(g) due diligence provision in the IRS's regulations.

Example 3: In 2018, Tonya, an 18 year-old taxpayer, engages Paul to prepare her 2017 federal income tax return. Tonya completes Paul's standard intake questionnaire and states that she has never been married and has one infant child. Tonya tells Paul that her infant child and she lived with her parents during part of the 2017 tax year. Tonya also provides Paul with a Form W-2 showing that she earned $10,000 during 2017. Tonya provides no other documents or information showing that she earned any other income during the tax year. Based on the intake sheet and other information that Tonya provides, Paul believes that Tonya may be eligible to claim the infant as a qualifying child for purposes of the EITC and the CTC. To meet the Section 6695(g) knowledge requirement under the regulations, Paul must make reasonable inquiries to determine whether Tonya is eligible to claim these credits, including reasonable inquiries to verify that Tonya is not a qualifying child of her parents (which would make her ineligible to claim the EITC) or a dependent of her parents (which would make her ineligible to claim the CTC). Paul must contemporaneously document these inquiries and the responses.

Example 4: Tommy, who is 32 years old, engages Patty to prepare his federal income tax return. Tommy completes Patty's standard intake questionnaire and states that he has never been married. As part of Patty's client intake process, Tommy provides Patty with a copy of the Form 1098-T that Tommy received showing that University M billed him $4,000 of qualified tuition and related expenses for his enrollment or attendance at the university, and that Tommy was at least a half-time undergraduate student. Patty believes that Tommy may be eligible for the AOTC. To meet the Section 6695(g) knowledge requirements, Patty must make reasonable inquiries to determine whether Tommy is eligible for the AOTC, as Form 1098-T does not contain all the information needed to determine eligibility for the AOTC or to calculate the amount of the credit if Tommy is eligible. Patty also must contemporaneously document these inquiries and the responses.

Reminders: Records should be kept for three years from the later of the due date of the return, the date on which the return was e-filed, the date the client signed the return, or the date that the preparer gave the part of the return he or she prepared to the signing preparer. Employers should regularly review current office procedures or develop new procedures with respect to the four credits, as applicable, ensure that employees are familiar with the procedures, and as necessary conduct due diligence checks.

REVIEW QUESTIONS AND SOLUTIONS

4. Regarding Section 6695(g), **which one** of the following responses **is true**?

   a. A preparer who prepares a 2017 return on which the child tax credit and the earned income tax credit are claimed, and who fails to comply with the Section 6695(g) due diligence requirements, would be subject to a $1,000 penalty.

   b. For 2017, each Section 6695(g) due diligence failure on a taxpayer's return subjects the preparer to a penalty of $510.

   c. The due diligence requirements checklist for the four credits are on page 3 of revised Form 8867.

5. For the 2016 Treasury regulations dealing with the Section 6695(g) due diligence penalty, **which one** of the following responses **is false**?

   a. Form 8867 is to be filed with every paper return or e-filed return which claims at least one of the applicable tax credits.

   b. It is possible for the preparer to satisfy the knowledge requirement for a taxpayer's current return based on information gathered from doing the taxpayer's prior return.

   c. There is a separate Form 8867 provided for each credit subject to the Section 6695(g) due diligence requirements.

Solutions

4. **"B" is the correct response**. The original $500 penalty has been inflation-adjusted, and is $510 per failure for 2016 and 2017.

   "A" is an incorrect response. The penalty is $1,020 ($510 per failure x two failures).

   "C" is an incorrect response. The due diligence requirements checklist for the four credits are on page 1. *Part II, "Historical Background of the Section 6695(g) Due Diligence Requirements."*

5. **"C" is the correct response**. Form 8867 is a single checklist to be used for all of the applicable credits (EITC, CTC, ACTC, and AOTC).

   "A" is an incorrect response. Form 8867 is to be filed with every paper return or e-filed return on which an EITC, CTC, ACTC, or AOTC is claimed.

   "B" is an incorrect response. In certain circumstances a preparer may satisfy the knowledge requirement based on existing knowledge without having to make additional reasonable inquires (see Example 2 in the writeup on the Section 6695(g) regulations). *Part II, Treasury Decision 9799.*

PART III
CIRCULAR 230 PROVISIONS

Part III covers five Sections of Circular 230 that have been revised within the last three years and have not been reviewed in either of our last two Special Editions.

[ITEM 6] SECTIONS 10.22, 10.31 AND 10.35-37 OF CIRCULAR 230

Section 10.22 Diligence as to accuracy

A practitioner must exercise due diligence in the following activities: (1) preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters; (2) determining the correctness of oral or written representations made by the practitioner to the Treasury; and, (3) determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS. Generally, a practitioner may rely on the work product of another person. But, the practitioner must use reasonable care in engaging, supervising, training, and evaluating that other person. In exercising reasonable care, the practitioner must take proper account of the nature of the relationship the practitioner has with the other person.

Section 10.31 Negotiation of taxpayer checks

This provision applies to all individuals who represent the taxpayer before the IRS, not just practitioners who are tax return preparers. Any practitioner may not endorse or negotiate any check issued to a client by the government in respect of a federal tax liability. Negotiation includes directing or accepting payment by any means, electronic or otherwise, into an account that the practitioner owns or controls, or any firm or other entity with whom the practitioner is associated. Section 10.31 does not apply to an individual who is acting solely in the capacity of a trustee of a trust, nor to the administrator / executor of an estate.

Section 10.35 Competence

The IRS requires that the practitioner have the appropriate level of knowledge, skill, thoroughness, and preparation that is necessary for the matter for which he or she is engaged. The practitioner may become competent for the matter for which he or she has been engaged through various methods, for example consulting with experts in the relevant area and studying the relevant law. The IRS states that whether consultation and / or research are adequate to make the practitioner competent in a particular situation depends on the facts and circumstances of the particular situation. The IRS recognizes that a practitioner who is highly experienced in a particular matter may require less preparation than a practitioner who is handling the same matter for the first time. Even though there are various practitioners subject to Circular 230, for example attorneys, CPAs, and enrolled agents, there is only one competency standard. The IRS does not provide examples that show practitioner competence, though it says there are several sources that are "generally informative" on Circular 230's standard of competency: Rule 1.1 of the Model Rules of Professional Conduct, State Bar opinions that address the competence standard, and the AICPA's competency standard.

10.36 Procedures to ensure compliance

Section 10.36 requires a firm to take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees to ensure that it complies with Circular 230. Circular 230 places responsibility for procedures to ensure compliance on persons who may not have principal authority and responsibility for overseeing a firm's practice, but who are practitioners under Circular 230. In the absence of persons identified by the firm as having principal authority and responsibility, the IRS may identify one or more individuals in the firm who are subject to Circular 230 who will be held responsible for taking reasonable steps to ensure that the firm has adequate procedures in effect for all firm members for purposes of complying with Circular 230. While the firm is limited in its responsibility for personal tax filings and payment obligations of any member, associate, or employee, the regulations specify that firm management should not ignore noncompliance with those obligations by any practitioner associated with the firm when the noncompliance is known or should be known to the firm.

Section 10.37 Requirements for Written Advice

In giving written advice on a federal tax matter, the practitioner must adhere to six principles. *First*, he must base the written advice on reasonable factual and legal assumptions. The IRS states that all forms of advice, written or oral, should be based on reasonable assumptions. *Second*, he must reasonably consider all relevant facts and circumstances that he knows or reasonably should know. *Third*, he must use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter. *Fourth*, he may not rely on representations, statements, findings, or agreements of the taxpayer or any other person if reliance on them would be unreasonable. The IRS provides that reliance on representations, statements,

findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent. *Fifth*, he must relate the applicable law and authorities to the facts. *Sixth*, in evaluating a federal tax matter, he must not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. Audit risk should not be considered by practitioners in the course of advising a client on a federal tax matter, regardless of the form in which the advice is given.

Generally, the practitioner may rely on the advice of another person if the advice was reasonable and the reliance is in good faith, considering all the facts and circumstances. Practitioner reliance on another includes reliance on any other person, whether the person is one defined as a practitioner under Circular 230 or not.

"Federal tax matter" generally is any matter concerning the application or interpretation of a Section 6110(i)(1)(B) revenue provision, any provision of the law that impacts a person's obligations under the Internal Revenue Code and Treasury regulations, and any other law or regulation that the IRS administers. This definition of a federal tax matter reflects the broad nature of advice that federal tax practitioners render in today's practice environment. There are two items the IRS states specifically are not written advice on a federal tax matter. One is government submissions on matters of general policy. The other is continuing education presentations provided to an audience solely for the purpose of enhancing practitioners' professional knowledge on federal tax matters. Including contact information on a continuing education presentation does not convert an educational presentation into an item of written tax advice governed by the regulations. Presentations marketing or promoting transactions are not continuing education presentations.

****REVIEW QUESTION AND SOLUTION****

6. Concerning the Circular 230 provisions summarized in this Special Edition, **which one** of the following statements **is false**?

   a. Written advice includes continuing education presentations to tax practitioners who are attending to enhance their tax knowledge.

   b. A practitioner may not endorse a client's federal income tax refund check.

   c. The practitioner may become competent for a matter for which she has been engaged through consulting with experts.

Solution

6. **"A" is the correct response**. The IRS specifies two items which are not written advice on a federal tax matter. One is CE presentations provided to an audience solely for the purpose of enhancing practitioners' professional knowledge on federal tax matters.

   "B" is an incorrect response. Section 10.31 provides that any practitioner may not endorse or negotiate any check issued to a client by the government in respect of a federal tax liability.

   "C" is an incorrect response. Consulting with experts is one of the methods provided in Section 10.35 to gain tax competence. *Sections 10.31, 10.35, and 10.37 of Circular 230.*

INDEX

***** QUIZ QUESTIONS *****

*Place your answers to the following 10 Multiple Choice Questions on the enclosed answer sheet (**page 12**).*

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1. **Which one** of the following **is not** a Code section which may be used to prohibit a tax return preparer from preparing federal income tax returns?

   a. Section 6694.

   b. Section 7402.

   c. Section 7407.

2. Under Section 7407, there are four actions for which a tax preparer may be enjoined. **Which one** of the following **is** such an action?

   a. The tax preparer is subject to a penalty for promoting an abusive tax shelter.

   b. The tax preparer violates Section 330.

   c. The tax preparer guarantees the allowance of a tax credit.

3. In a District Court case which granted an injunction to prevent the tax preparer from acting as an income preparer, **which one** of the following statements **is false**?

   a. Many of the tax returns prepared by the tax preparer and his employees claimed commuting miles as business mileage.

   b. The employees of the tax preparer's tax preparation stores were adequately trained.

   c. The District Court ruled that the IRS suffered irreparable harm from the actions of the tax preparer and his employees.

4. Based on a District Court case involving a disbarred attorney, **which one** of the following statements **is true**?

   a. Even though the attorney was disbarred after committing mail fraud and money laundering, the court ruled that he could continue with his tax preparation business.

   b. The Office of Professional Responsibility (OPR) has oversight over an attorney who is suspended from practice before the IRS.

   c. The OPR's authority extends to tax professionals who offer written tax advice regardless of whether they represent clients in a typical tax controversy before the IRS.

5. For 2017, **which one** of the following credits **is not** subject to the Section 6695(g) due diligence requirements?

   a. Child and dependent care credit.

   b. Earned income tax credit.

   c. American Opportunity Tax Credit.

6. Regarding recent IRS regulations on the expansion of the Section 6695(g) due diligence penalty, **which one** of the following responses **is false**?

   a. More than one penalty under Section 6695(g) could apply to a return.

   b. Form 8867 is a single checklist that is to be used for all of the credits subject to the Section 6695(g) due diligence requirements.

   c. While a copy of a completed Form 8867 must be kept by the preparer, it is **not** necessary to retain a copy of any Section 6695(g) credit worksheets.

7. Timothy engages Peyton to prepare his 2017 federal income tax return. As part of Peyton's information gathering process, Timothy provides Peyton with Form 1098-T, showing that State University billed Timothy $8,000 of qualified tuition and related expenses for his enrollment at State during 2017. Based only on these facts and the Section 6695(g) IRS regulations, **which one** of the following **is not** an action that Peyton should take?

   a. Make reasonable inquiries to determine if Timothy is eligible for the American Opportunity Tax Credit.

   b. Compute Timothy's American Opportunity Tax Credit without further action.

   c. Contemporaneously document any inquiries that Peyton makes of Timothy and Timothy's response to those inquiries.

8. **Which one** of the following statements dealing with either Section 10.22 or Section 10.31 in Circular 230 **is false**?

   a. A practitioner may not rely on the work product of another person.

   b. Section 10.31 does not apply to an individual who is acting solely in the capacity of a trustee of a trust.

   c. Diligence as to accuracy also applies to a practitioner's written representations to the Treasury.

9. **Which one** of the following statements dealing with either Section 10.35 or Section 10.36 in Circular 230 **is true**?

   a. The competency standard for CPAs is different than the competency standard for enrolled agents.

   b. The managing director of the firm is responsible for establishing procedures to ensure compliance with Circular 230, even if the director is not considered a practitioner under Circular 230.

   c. A practitioner who is more experienced in a matter than another practitioner may not require the same amount of preparation as the other practitioner.

10. **Which one** of the following **is not** one of the six principles to which the practitioner must adhere in giving written advice on a federal tax matter?

    a. Use reasonable factual and legal assumptions.

    b. Never rely on representations or statements of another person.

    c. Not take into account the possibility that a tax return will not be audited with respect to the federal tax matter the practitioner is evaluating.

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QUIZ INSTRUCTIONS AND ANSWER SHEET – 2017 SPECIAL EDITION – ETHICS
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You must score 70% to receive continuing professional education credit for the newsletter. After you successfully complete the quiz, your quiz results, a complete set of solutions, and a certificate of completion will be mailed to you within 10 working days of our receipt of your answer sheet. If a score of less than 70% is achieved, you may retake the quiz without additional cost. The **completion date** that you specify on your answer sheet below **will be** the date placed on your certificate. We appreciate your business and hope that you are satisfied with the newsletter.

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A DESCRIPTION OF CPElite's[T.M.] CPE MATERIALS

The recommended CPE hours for our newsletters are based on length of written material, level of difficulty, and input from reviewers and pilot testers. Each hour of credit specified below is based on a 50-minute hour per CPE hour. The content level of materials is an update [U] for our newsletters and basic [B] for each course. **Notes:** There are no prerequisites nor is advanced preparation required for our products. The learning objectives of each CPE product are provided below and on page 15. All our materials are available for download and on-line testing.

NEWSLETTERS

[1] THE ELITE QUARTERLY – Recommended CPE Credit – 4 Hours per issue [U]

To make practitioners aware of recent tax developments in legislation, the IRS, judicial decisions, and the Treasury. The four issues typically are available on-line, by email, or mail by the following dates: May 1, July 15, September 15, and November 30. Each issue costs $40. An annual subscription to all four issues costs $135. The 2-hour ethics issue for enrolled agents is included in the subscription.

[2] ETHICS FOR ENROLLED AGENTS – Recommended CPE Credit – 2 Hours per issue [U]

To provide recent developments affecting tax professionals which satisfy the ethics and professional conduct component required for enrolled agents only. The 2017 issue costs $20 and is **free to annual subscribers** to *The Elite Quarterly* and Option 5 orders.

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COURSES – Field of Study: Federal Tax

[1] INCOME ITEMS AND PROPERTY TRANSACTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) selected income items affecting individual income taxpayers, including social security income, alimony, and scholarships, and (2) common property transactions involving individual income taxpayers, such as capital gains, sale of personal residence, and like-kind exchanges.

[2] ABOVE-THE-LINE DEDUCTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) expenses commonly deducted by Schedule C taxpayers, including travel, transportation, and home office deductions, and (2) and common above-the-line deductions.

[3] ITEMIZED DEDUCTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of medical expenses, taxes, residence interest, charitable contributions, nonbusiness casualty and theft losses, miscellaneous itemized deductions, and the standard deduction.

[4] RATES, CREDITS AGAINST TAX, AND SPECIAL ISSUES. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of the tax rate structure, selected credits (including the earned income tax credit and the education credits), estimated tax payments, and selected special issues (including filing status and exemptions).

[5] PARTNERSHIP TAXATION – PART I. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) the tax implications of formation, including gain or loss, basis of partnership interest, and basis of partnership assets after formation and (2) general reporting procedures of partnership items.

[6] PARTNERSHIP TAXATION – PART II. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of the special topics involving partnership operations and the tax implications of sales of partnership interests, partnership distributions, and redemptions of a partner's interest.

[7] S CORPORATION TAXATION – PART I. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) considerations in being an S Corporation, (2) requirements and election to be an S Corporation, (3) elections and operations, (4) shareholder basis issues, and (5) reporting and compliance.

[8] S CORPORATION TAXATION – PART II. Recommended CPE Credit: 6 HRS [B]

To provide detailed coverage of S Corporation shareholder basis issues, and an explanation of loss limitation issues, distributions made by an S Corporation to its owners, and S Corporation shareholder changes and income taxes.