Practice

In a Tax Practice, Everything Is Fine, Until It's Not!

By Charles P. Rettig

Although often struggling with deadlines and sometimes recalcitrant clients, your tax practice can be an enjoyable, rewarding experience. Tax practitioners provide their clients with an objective, knowledgeable review of financial information that is ultimately presented to the government in the form of a tax or information return. If the client has provided timely, complete responses requests for information, the process should be fairly smooth and straightforward. Unfortunately, there is a reason many people become clients, and it is not because they routinely coordinate all relevant information necessary to the preparation of a return nor do they routinely provide such information in a timely manner.

Possibly more than in any other profession, tax practitioners are required to participate in extensive, ongoing training and education to keep pace with highly complex, ever-changing statutory and case authorities. Tax practitioners often devote untold personal hours being educated on new tax provisions, software updates, policies and procedures. Cases issued in the morning might impact positions in returns filed later that afternoon. Since a purpose in proposing and assessing penalties is to encourage accountability, affect behavior and increase voluntary compliance, examiners are now generally required to comment on preparer penalties as a material part of the examination process.

Preparer penalty issues will most often arise during or at the conclusion of an examination of the taxpayers return when some or all of an undisclosed or improperly disclosed position has been disallowed. Is it reasonable to believe that an examining agent, having disallowed a questionable position, will be convinced there was the requisite "substantial authority" for the undisclosed position? Is it reasonable to believe that an examining agent, having disallowed a questionable position, will be convinced there was a "reasonable basis" for the disclosed position? Also, most return positions are comprised of several sub-positions. If each sub-position has a 40-percent chance of success on the merits, the primary position might not have a similar overall 40-percent chance of success on the merits (40 percent of 40 percent of 40 percent is not 40 percent overall).

Client interactions can be the best—or worst—part of any tax practice. Clients believe they have fully and timely responded to every inquiry from you. If you are their return preparer, clients often believe that if more information was required,

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you would have asked, and the fact you sign their return, everything must be satisfactory. When the possibility of penalties arises during an examination, clients often believe it must somehow be the responsibility of the preparer. Following many years of practice handling tax disputes with the IRS while interacting with sometimes difficult clients and others, various suggested "practice tips" include:

- **Be prepared, not paranoid.** Learn to expect the unexpected. Are you adequately prepared to handle the issues presented when preparing the return or handling an examination of a return prepared by you or by others? Lack of diligence in representation, before and during the examination of a return, may adversely affect the outcome of any examination. Failure to inquire about additional facts, to discover contrary legal authorities, to review large, unusual or questionable items in the return, to review prior year returns and potentially applicable IRS Audit Technique Guidelines (ATGs) or to identify sensitive issues or "patterns" over multiple years can be the difference between a reasonable resolution and someone going to "Club Fed" (*i.e.,* prison).
- **Competency.** Are you competent to prepare the return or handle the representation? Being an effective practitioner does not mean you can be all things to all people. Know your limitations, do not inadvertently exceed the scope of your license or experience, and consult your colleagues when you are unsure of any issue. When providing tax advice, preparing tax returns, preparing for an IRS examination and when preparing a client for an interview with the government, be familiar with the ATGs issued by the IRS. Often, it may be beneficial to review relevant ATGs earlier in the process … perhaps while preparing the return. Preparers representing clients in an industry or having issues covered by an ATG should consider thoroughly reviewing the ATG with the client, before the return is filed. Do not exceed the scope of your competency for any issue or matter.
- **Phone a colleague.** Tax practice is a profession, and professionals help other professionals. If struggling with a tax issue, ask an experienced colleague for advice. If asked by a colleague for advice, take the time to listen and provide whatever meaningful assistance you can and remember, someday you may be the person placing that call for assistance—respect those who reach out for assistance and pity those who are embarrassed to do so.
- **Be sensitive to nontax issues.** Tax people need to be sensitive to nontax issues. Otherwise, resolution of a tax dispute might inadvertently set up a securities case, a money-laundering structuring case, *etc.*, against one's client. A practitioner cannot know everything that one's client will expect the practitioner to know. However, a practitioner should be able to "issue spot" matters within their field of expertise and, to a lesser extent, matters outside their field of expertise. There is a tremendous amount of information available on the internet, use it.
- **Limit the nature and scope of services to be provided in the engagement letter.** Do not exceed the scope of an engagement letter without another engagement. Engagement letters for tax-related matters should specify the scope and terms of the engagement. If additional services are to be provided, additional engagement letters should be obtained. If a client relationship is terminated for any reason, written confirmation of the termination should be promptly provided to the client and the opposition. If the government has been involved, the government should also be clearly advised of the termination of the client relationship.
- **Conflicts.** In California, three out of every two marriages end in a divorce. There are many potential conflicts of interest that can arise during return preparation or the examination process. The practitioner is often unaware a spouse may be considering a divorce or a business relationship may be falling apart. Conflicts can often be avoided by receipt of a timely, knowing and intelligent waiver. However, if things get tough, someone is likely to contest the "knowing" and "intelligent" waiver. Was counsel involved in the waiver process? Did one party feel economically compelled to sign the waiver?
- **Control client expectations.** Some clients are aggressive and somewhat unwilling to consider an objective view of the facts in a manner that could compromise the professional relationship between the client and the practitioner. There must be an objective analysis of relevant facts leading to any position set forth in a return or provided to the government during an examination. Are you able to communicate effectively and control the expectations of your client?
- **Public School 101.** Tax return positions should be appropriately analyzed and discussed with the client, including a discussion re any possible penalties that may be assessed. Such discussions should avoid technical terms that may be easily misunderstood by the client or others.
- **There are no hypothetical client questions.** Do not respond unless you are confident you have received and understood all relevant facts. Responses should be limited to the facts presented.

- **When appropriate, request supporting data.** Although the return preparer is not required to independently examine or verify all supporting information, make sure to inquire as to whether such data have been satisfactorily maintained. Encourage the client to maintain proper information supporting the positions set forth within the return. Best practice suggests retaining documentation resulting from any tax-related research (including authorities both for and against the tax position), the reasoning behind the conclusion and relevant authorities supporting the conclusion. Be prepared to demonstrate an appropriate degree of good-faith reliance on information provided by the client or others.
- **Establish a system of checklists—and follow the system.** Best practices in the office strongly suggest a system for promoting accuracy and consistency in the preparation of returns or claims and should generally include—in the case of a signing preparer—checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return and possibly all related returns, and internal review procedures.
- **Preparer judgment.** The judgment of the preparer and other tax advisors, not the client, should be the determining factor regarding positions set forth on the return. If the client refuses to comply with the recommendations, the significance of each recommendation in relation to the return may be the deciding factor regarding whether to withdraw from representation. Maintain timely, clear communications with the examining agent and the client—confirm statements in writing.
- **Remain professional.** Act fairly and with integrity in dealings with the government. Respond to requests by an examiner in a timely manner, attempt to fully cooperate as reasonably required, inquire when faced with uncertainty and push back when appropriate. An audit need not be adversarial, and the practitioner must maintain appearance of reasonableness throughout the entire process. The examination should not be prolonged simply because the taxpayer is unable to satisfy any resulting deficiency. Practitioners can be subjected to discipline for unreasonably delaying the examination process. When representing clients in a tax dispute, maintain the appearance of cooperation and reasonableness at all times.
- **Think disclosure.** Take the time to analyze relevant facts and authorities before making the determination to disclose, or not. Appropriate disclosures within the return can generally avoid most penalties, for the client and the preparer. All disclosures should be in writing. Review Rev. Proc. 2016-13[1] regarding the possibility of making a disclosure within a taxpayer's return and the appropriate form of disclosure. Otherwise, consider using IRS Forms 8275 or 8275-R, as appropriate, to be filed with the return. An appropriate disclosure represents an opportunity to explain, in single-syllable words, why a potentially questionable return position is not questionable. Disclosures must be adequate and easily understood by anyone reviewing the return. They should not be subject to being interpreted as misleading or incomplete.
- **Privileges are only important … when needed the most.** Practitioners should have a general awareness of all potentially applicable privileges and avoid the inadvertent waivers of any potential privileges. When in doubt, ask a colleague for advice. Although Code Sec. 7525 extended common-law protections of confidentiality to tax advice rendered between a taxpayer and a federally authorized tax practitioner (nonlawyers, *etc.,* to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), this statutory privilege only applies to noncriminal tax matters before the IRS and noncriminal tax proceedings in federal court. Unfortunately, this statutory privilege is not available when it is truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in certain state-related tax proceedings or nontax civil litigation. In appropriate situations, consider a *L. Kovel* [2] engagement of the nonlawyer practitioner by counsel.
- **Be careful with remote client relationships.** Does the client understand the reason, nature and scope of your request for information and supporting documentation? Remote relationships with clients are difficult, at best. A client's interpretation of your question may well differ from yours. Communicating by phone or electronically sometimes precludes the knowledge gained by looking someone in the eyes when asking direct, important questions.
- **Taxpayer interviews.** Examining agents often seek testimonial evidence through interviews of the taxpayer, the return preparer and third parties. A taxpayer has the right to resist an examining agent's request for an interview. Pursuant to Code Sec. 7521(c), the taxpayer's representative may represent the taxpayer before the examining agent and is not required to produce the taxpayer for questioning, *unless* an administrative summons is served on the taxpayer. Code Sec. 7602(a) provides the authority to the IRS to summons a taxpayer for an interview. Is an

interview of the taxpayer or return preparer necessary and unavoidable? Interviews of the taxpayer or return preparer by an examiner can create awkward moments during an examination, especially if there has been a lack of preparation. If the interview is necessary, thoroughly discuss the parameters with the client and the examining agent, in advance.

- **Inadequate internal office supervision.** Enough said.
- **Tax advice is sufficient for Code Sec. 6694 penalties to apply.** It is not necessary to see the return to be the "preparer" of a specific position set forth within a tax return. A person who renders advice, which is directly relevant to the determination of the existence, characterization or amount of an entry on a return or claim for refund, may be regarded as having prepared that entry. Whether a schedule, entry or other portion of a return or claim for refund is a substantial portion is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole. There can be more than one preparer for each return.
- **Office of Professional Responsibility (OPR) referrals.** Be aware that IRS employees are generally required to make a referral to the OPR if there is a "pattern" of certain conduct and a Code Sec. 6694 preparer penalty is sustained. OPR has exclusive responsibility for practitioner conduct and discipline, including instituting disciplinary proceedings and pursuing sanctions, functioning independently of the Title 26 enforcement components of the IRS. OPR has the authority to impose suspension, disbarment and/or significant monetary fines on federally-authorized tax practitioners, firms and other entities. In addition, as part of any OPR investigation, they may contact current and former clients. Although not required to make the referral to OPR in the event of a single violation, some within the IRS may feel compelled to make the OPR referral for a single violation.
- **Requirements to notify state licensing authorities.** Many states have requirements for a licensee to notify the state licensing authority[3] in the event of a preparer penalty. Failure to provide timely notification could be a separate violation.
- **Fight, Fight, Fight … if facing a potential preparer penalty.** The primary issue is often the reasonableness of the preparer's belief and good faith in the reported position. Although the economic penalty under Code Sec. 6694 may not be significant when compared to the effort involved to dispute it, any related investigations by OPR and the state licensing authorities may destroy the preparer's practice (and reputation). Anticipate that potential malpractice claims will routinely include allegations of a failure to comply with federal tax standard of care and Circular 230. Anticipate the government may contact the current and former clients and that they may require the preparer to also disclose the violations to their clients with a full explanation. Your reputation is at issue—protect it!
- **Unauthorized disclosures of client information.** Return preparers who "knowingly or recklessly" make "unauthorized disclosures or use" of "information furnished in connection with the preparation of an income tax return" are subject to criminal sanctions (*i.e.*, imprisonment!). "Preparers" include those engaged in preparing or assisting in preparing tax returns, including those who provide auxiliary services such as developing software to prepare or e-file a return. "Tax Return Information" basically includes everything received to prepare the return plus computations, worksheets and printouts created by the preparer. Code Sec. 7216 was implemented for a purpose—do not let that purpose be you.
- **Terminating the client (relationship).** Terminating your relationship with a difficult or nonresponsive client can be a rewarding experience. Since 98 percent of the problems in practice come from two percent of the clients, the ability to identify the "two-percenters" is critical to a successful, enjoyable practice. If the client is unwilling to accept and follow your advice, strongly consider terminating the engagement. Life is short, and the headaches of trying to convince someone to do the right thing may simply not be worth your effort. When terminating a client relationship, consider returning all client records and remember to notify the government that any outstanding authorizations to receive client information or represent the client have been terminated. Arguing over the return of client records to receive payment for delinquent fees might be rewarded with an unwarranted claim for malpractice. Your other clients deserve your attention, and a redirection of your efforts to such clients will be more rewarding over time. Cut your losses and move on … or consider referring the difficult client to your business competitors.
- **Emails have a life of their own.** "Delete" merely takes the email off your screen. Experienced investigators will locate deleted emails. Only render such advice that you reasonably believe is accurate and appropriately supported by relevant facts and authorities.

- **If you feel the need of a friend, get a dog!** "Off-the-cuff" advice and quick email responses may, in certain circumstances, be sufficient for penalties or Circular 230 sanctions to apply. Establish relevant facts, evaluate reasonableness of any assumptions or representations and apply the relevant legal authorities in arriving at a conclusion supported by the law and the facts. Your client is not your friend—trust, but verify since your reputation (and more) is associated with every document passing through your firm.

The practitioner's duty of representation to the client must be balanced with the effort to reasonably cooperate with the return filing and examination process. You cannot be all things to all people, regardless of the effort and personal sacrifice. Be prepared, exercise your best judgment and document your recommendations. Clients who refuse to comply with your valued recommendations should be encouraged to seek other representation. In a tax practice, everything is fine, until it's not!

ENDNOTES

1 Rev. Proc. 2016-13, IRB 2016-4, 290.

2 *L. Kovel*, CA-2, 62-1 USTC ¶9111, 296 F2d 918. In civil tax audits that include potentially sensitive issues, taxpayers often engage a team of representatives, including counsel and a forensic accountant. Engagement of the accountant by counsel should extend the attorney-client privilege to advice rendered by the accountant pursuant to the engagement. If the accountant is appropriately engaged by counsel, the common law attorney-client privilege should apply to all communications rendered in furtherance of the legal services being provided to the client, both during the investigative stages of the audit and, if necessary, during any subsequent civil or criminal litigation. This privilege does not extend to the actual return preparation.

3 An example of a state statute requiring notification of the state licensing authority is the requirement in California Business & Professions Code § 5063 for California Certified Public Accountants to notify the state Board of Accountancy of a practitioner penalty. In part, California Business & Professions Code § 5063 provides:

> California Business & Professions Code § 5063.
> (a) A licensee shall report to the board in writing of the occurrence of any of the following events occurring on or after January 1, 1997, within 30 days of the date the licensee has knowledge of these events: … (3) The cancellation, revocation, or suspension of the right to practice as a certified public accountant or a public accountant before any governmental body or agency.
> (c) A licensee shall report to the board in writing, within 30 days of the entry of the judgment, any judgment entered on or after January 1, 2003, against the licensee in any civil action alleging any of the following: … (5) Any actionable conduct by the licensee in the practice of public accountancy, the performance of bookkeeping operations, or other professional practice.
> (d) The report required by subdivisions (a), (b), and (c) shall be signed by the licensee and set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.
> (f) Nothing in this section shall impose a duty upon any licensee to report to the board the occurrence of any of the events set forth in subdivision (a), (b), or (c) either by or against any other licensee.

