Tax return preparers beware of trumped-up due diligence standards

Gregory Clifton
Metropolitan State University of Denver

Elizabeth Conner
University of Colorado Denver

Doug Laufer
Metropolitan State University of Denver

ABSTRACT

Tax preparation is conducted by various professionals who are governed by the same standards from the perspective of the Internal Revenue Service. Those standards do, however, distinguish between the clients they serve. Such distinctions complicate tax practice and create uncertainty among tax professionals.

The purpose of this paper and conference presentation is to highlight the differences in the tax preparer's scope of diligence and inquiry in preparing a federal income tax return for a small business owner who is eligible for the earned income tax credit versus one who is not. The due diligence procedures for preparing income tax returns for taxpayers that are eligible for the tax credit have arguably converted tax return preparers into de facto IRS auditors.

Keywords: tax return preparer, earned income tax credit, due diligence, Schedule C

Copyright statement: Authors retain the copyright to the manuscripts published in AABRI journals. Please see the AABRI Copyright Policy at http://www.aabri.com/copyright.html

PURPOSE

The purpose of this paper and conference presentation is to highlight the differences in the tax preparer's scope of due diligence in preparing a federal income tax return for a small business owner who is eligible for the earned income tax credit versus one who is not. The due diligence procedures for preparing income tax returns for taxpayers that are eligible for the tax credit have arguably converted tax return preparers into de facto IRS auditors.

INTRODUCTION

There are a number of different professionals engaged in tax practice. Attorneys, Certified Public Accountants, and Enrolled Agents are the most notable among them but the law does not limit tax practice to these professionals. The law also does not differentiate when it comes to the expectations placed on any paid professional that prepares a tax return for a client. There are differences, however, in the steps a return preparer must take in completing tax returns for small business clients.

The due diligence rules promulgated under IRC §6694 are largely responsible for these differences. The due diligence rules require tax preparers, regardless of their professional background, to make additional inquiries of taxpayers that claim the earned income credit while also claiming small business self-employment income on Schedule C. The IRS describes these inquires as common sense but stops short of requiring such inquires of all Schedule C filers.

PROFESSIONAL STANDARDS FOR PREPARING TAX RETURNS

Tax practitioners are governed by Treasury Department Circular 230, which lays out the rules for practicing before the IRS and authorizes the Department to penalize rule violations. Some professionals, such as CPAs and Attorneys, are simultaneously guided by codes of ethics, unique to their particular license, that also subject them to various penalties for violations. The AICPA's Statements on Standards for Tax Services are the practice standards that guide CPA's engaged in tax practice and are generally pertinent to all return preparers.

The AICPA guidelines indicate that a CPA may rely upon, without verification, information furnished by the client but also state that the CPA should make reasonable inquiries where information appears incomplete, incorrect or inconsistent. Whether or not the tax preparer is a CPA, the tax preparer should verify any claimed expenses and that only legitimate business expenses are deductible. Return preparers must exercise some diligence and counsel clients on what expenses are deductible before preparing the return.

THE DUE DILIGENCE RULES

In 2012, the Department finalized regulations under IRC §6695 to require return preparers to exercise due diligence in completing tax returns that include the earned income tax credit. These due diligence rules require, among other things, return preparers to make additional inquiries of taxpayers qualifying for the earned income credit who appear to be making inconsistent, incorrect, or incomplete claims related to self-employment income and expenses recorded on the Schedule C of their tax return. Since their inception in 2012, these requirements have been the subject of many articles mostly because of the increased – but somewhat unclear – expectations placed on preparers. The uncertainty to some extent revolves around the level and extent of inquiry expected of the return preparer.

Historically, as noted above, preparers were expected to make reasonable inquiries where information appeared incomplete, incorrect or inconsistent but otherwise they were allowed to rely on information furnished by the client. The due diligence requirements pertaining to tax returns with a Schedule C and the earned income credit state that a return preparer may not ignore the implications of information furnished to, or known by, him or her and must make reasonable inquiries where that information seems incomplete. A common example noted on the IRS website and in other literature is where the taxpayer claims to be a business owner but has no business expenses. The expectations in this situation are clear in that the return preparer should make additional inquiries to complete the Schedule C. But what if the taxpayer has some business expenses? How far must a preparer go in determining whether the extent (and amount) of those expenses is appropriate and is the scope of inquiry by the preparer required to be even deeper when the taxpayer is claiming the earned income credit?

To answer these questions, The Paid Preparer's Due Diligence Checklist (Form 8867) was created and must be filed with every tax return that claims the earned income tax credit. The Checklist and its instructions require preparers to ask sufficient questions of taxpayer clients claiming Schedule C self-employment income to confirm that the clients are actually operating a business, that they have records to support their business income and expenses, and that they have included all such income and expenses.

THE IRS AND COURT INTERPRETATIONS OF DUE DILIGENCE

In June 2000, long before enactment of the due diligence rules, the Office of Chief Counsel released CCA 200022051. In that Chief Counsel Advice, the Chief Counsel addressed the interplay between the earned income credit and the Schedule C. In addressing this interplay, the Chief Counsel analyzed Revenue Ruling 56-407, 2 C.B. 564. This revenue ruling, in summary, stated that taxpayers must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Thus, according to the Chief Counsel, this revenue ruling applies equally to the earned income credit because the net earnings from self-employment that are included in earned income for purposes of the earned income credit are defined by cross-reference to the definition of net earnings from self-employment under IRC §1402(a).

In February 2017, the US Court of Claims addressed preparer due diligence in the case of Foxx v. United States (Foxx v. US, No. 1:15-cv-01266). In Foxx, the tax preparer (Foxx) interviewed a client before filing the federal income tax return and determined that the taxpayer owned a business and that she had certain income and expenses associated with that business. The taxpayer showed Foxx a business license for her business, that she had just secured that day, and a list of the income and expense items. Because of her income level, she also qualified for the earned income tax credit. The Court's opinion did not indicate, however, what particular expenses the taxpayer claimed but just noted that some expenditures existed. Foxx completed the return and secured a $2,577 refund for the client. The IRS audited the return and identified tax deficiencies due to the earned income tax credit. The IRS then determined that the deficiencies were due to Foxx's willful and reckless conduct in preparing the return, and imposed a $5,000 penalty on Dr. Foxx that was later reduced to $2,500.

In imposing §6694 penalties on the preparer, the Court noted that Foxx did not examine bank statements, business receipts or business ledgers. The Court went on to say that Foxx's behavior did not satisfy his obligation to reasonably inquire about the client's business despite some written representations from the client about her business affairs. Even though the Court did not indicate which expenses were included on the client's list, its focus on the client's bank statements, business receipts, and business ledgers is illuminating – at least as it relates to those Schedule C filers that may be eligible for the earned income credit. The Court's admonishment of the preparer for not verifying expenses is certainly understandable but the mandate as it relates to the business's income and breadth of expenses may surprise some practitioners.

The importance of the Foxx case, when read in this light, may be that tax preparers will have to examine accounting records to meet the due diligence requirements for Schedule C filers that claim eligibility for the earned income credit. The questions related to the breadth of expenses for any particular business may be even more troubling for the tax preparer that is unfamiliar with the taxpayer's line of work or where the taxpayer has not saved the appropriate receipts because of a belief that a particular expense was not deductible. The consequences of not engaging in what amounts to an audit of the client's accounting records are elevated when coupled with the Service's ability to ignore net earnings from self-employment for purposes of the earned income credit or to disallow the earned income credit altogether. (IRC §6001; IRC §32(k))

SMALL BUSINESS TAX RETURNS WITHOUT THE EARNED INCOME CREDIT

In contrast to the due diligence requirements set forth in IRC §6695, the first page of instructions for completing a Schedule C for a tax return that does not include the earned income credit establishes some markedly different standards. First, the instructions indicate that the taxpayer may file a Schedule C-EZ if their business expenses are less than $5,000. The Schedule C-EZ is a one page form that simply requires the taxpayer or preparer to subtract total expenses from total revenue to compute net profit. Secondly, and perhaps most notably, the Schedule C instructions include a list of other forms that a preparer may have to file on behalf of a taxpayer when filing a Schedule C but noticeably absent from that list is any checklist or confirmation from the preparer as to how net profit or loss was calculated or what questions were asked of the taxpayer.

CONCLUSION

A tax preparer's professional responsibility in completing tax returns for clients depends on the income level of the client and, more specifically, on whether the client is eligible for, and claims, the earned income tax credit. For clients that claim the earned income tax credit, the tax preparer is required to essentially audit the taxpayer's business to determine not only the validity of income and expense items but also to identify other income and expense items that the taxpayer may not have considered. For clients that do not claim the credit, tax preparers can simply rely on information furnished by the client so long as it appears complete and consistent and need not keep a record of what questions were asked to make that determination.