The blame game

IRS focus on tax preparers is creating a growing conflict of interest in tax representation.

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By Jim Buttonow, CPA/CITP

You are representing your client in an IRS audit. You prepared your client’s small business return. The IRS agent says that your client underreported income and took several personal deductions to which he wasn’t entitled. The audit takes several months to complete, and your client is on edge, wondering why the IRS is so interested in him. The IRS expands the audit to the next year, finds the same errors, and proposes adjustments to the return, as well as a 20% accuracy-related penalty.

As the examination winds down, the IRS agent starts asking questions about the how the return was prepared. The agent asks to interview your client to determine what information he provided to you and what questions you asked to clarify the facts on the return. Your client finds the questions disturbing, on top of the examination and penalty. At this point, your client is in damage control, and the blame game begins.

As your client’s representative and tax preparer, you are now in an uncomfortable position—and you may even have a conflict of interest under Treasury Circular 230, Regulations Governing Practice Before the Internal Revenue Service, Section 10.29. Karen Hawkins, director of the IRS Office of Professional Responsibility, suggests that you do.

At the Carolinas Tax Forum, held from Aug. 8 to 10 in Charlotte, N.C., Hawkins explained the problem. When the IRS begins investigating preparer penalties, the tax preparer/representative is in a precarious position: Protect my client or protect myself. The preparer may be more interested in protecting his or her practice than in reducing the client’s tax liability and audit exposure to the IRS. In any event, once preparer penalties are contemplated, the preparer, according to Hawkins, is no longer objective.

The IRS focus on tax preparers

Tax preparers have become a major focus for the IRS. The IRS is increasing post-filing compliance efforts to close the $450 billion a year tax gap, lost to underreporting, underpayment, and nonfiling. Eighty-four percent of the tax gap, or $376 billion, is attributable to underreporting of income, which also includes overstating deductions and credits. In short, the big problem for the IRS is inaccurate tax returns, and it’s still figuring out a solution.

The IRS has established some new strategies to increase compliance. One key strategy is enlisting tax preparers. Professional tax preparers complete more than 60% of individual tax returns and more than 90% of business returns. In 2009, the IRS began implementing tax return regulations that included a broad plan to register all return preparers, require continuing
education, and eventually certify preparers with testing requirements. Most of this strategy will be fully implemented by the end of 2013.

**Preparer penalties**

Penalties provide an economic cost to taxpayers for noncompliance, so the IRS uses them to foster future compliance. During an examination, IRS agents and auditors are required to determine the applicability of penalties, including preparer penalties. If a substantial understatement penalty is applicable, the agent must comment on whether the preparer should also be subject to preparer penalties under Section 6694 and other applicable preparer penalty code sections.

Last year, the IRS sent 21,000 notices to tax preparers whom it profiled as having returns with the highest potential for error. This year, the IRS visited about 2,100 tax professionals to determine whether they completed their due-diligence requirements in preparing complete and accurate tax returns for their clients, and whether they met other compliance requirements under Section 6695 (failure to furnish a copy of the return, failure to sign the return, proper safeguarding of client information, Earned Income Credit due diligence, etc.).

In the past several years, Congress has increased Section 6694 preparer penalties for tax professionals who do not meet due-diligence requirements. Section 6694 provides for penalties for poor preparer conduct, including understating income or overstating deductions and credits by taking unreasonable positions or engaging in willful or reckless conduct.

In a 2010 report on correspondence audits, the Treasury Inspector General for Tax Administration (TIGTA) reminded the IRS that agents are required to investigate preparer compliance when there is a Section 6662(d) accuracy penalty assessed. The IRS has been pursuing preparer penalties in areas with high noncompliance, such as shareholder losses taken in excess of basis on S corporation returns. If the agent pursues penalties against a preparer, the agent gathers evidence from all sources, including the taxpayer.

**A conflict of interest**

Circular 230, Section 10.29, prohibits practitioners from representing clients before the IRS if the representation involves a conflict of interest. Section 10.29(a)(2) states that there is a significant risk when the representation will be materially limited by the personal interest of the practitioner.

The conflict is real. When pursuing a preparer penalty, the IRS agent is going to ask about your due diligence in preparing the return. Your client may argue that he or she relied on your expertise. This turns into a blame game, in which you have a conflict of interest and should not be representing your client under Circular 230.

Hawkins reminds practitioners that they should disclose that conflict to their clients and get a conflict of interest letter if the client wants to pursue the engagement and have the practitioner represent him or her before the IRS. Circular 230 describes the letter as “informed consent, confirmed in writing by each affected client, at the time the existence of the conflict is known by
the practitioner.” However, written consent should not trump good judgment; if there is a conflict of interest, you should withdraw from the engagement.

**Best practices**

It’s clear that the IRS cannot audit its way to more compliance. It does not have enough resources. The IRS must deputize tax preparers and use them to close the tax gap. Tax preparers who are faced with the possibility of preparer penalties when representing clients in an audit or underreporter inquiry should withdraw from the engagement to meet their requirements under Circular 230—and avoid the blame game.

The best policy is prevention. Avoid preparer penalties by completing your due diligence during tax preparation. Gather all the relevant facts, ask the right questions, take a supportable tax position, and document your due-diligence findings. Proactively keeping your clients in compliance will help ensure your continued relationship as their trusted adviser for years to come.

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