



# Liability Issues for Tax Professionals

December 3, 2021

- Who Are Considered Tax Preparers and Who are Not?
- Current and Proposed Regulation of Tax Preparers.
- IRS Enforcement and Penalties.
- Criminal Liability.
- Pennsylvania State Board of Accountancy/ Disciplinary Board of the Supreme Court of Pennsylvania
- Civil Liability.

# Who Are Considered Tax Preparers and Who Are Not?

# Who are Considered Tax Preparers?

- Individuals who prepare a tax return or refund claim for compensation or who hire others to prepare returns for compensation are tax return preparers.
- Preparation of a "substantial portion" of a return or claim for refund is treated as preparation of that return or claim for refund.
- Professional designation, education, nationality, or residence are not considered.

## Who are Considered Tax Preparers? (con't)

- Full return preparation is not required. Preparation of a schedule, such as a depreciation calculation or allocation of income or expenses, could potentially "qualify" an individual as a tax preparer.
- Tax preparers include preparers of all returns, not just income tax returns.

# Who are Considered Tax Preparers? (con't)

- Tax return preparers can be signing or nonsigning preparers.
- Nonsigning preparers are tax return preparers who do not sign returns but who prepare all or a substantial portion of a return or claim for refund.
  - They include individuals who provide advice (oral or written) to either the taxpayer or another tax adviser that led to a position that constitutes a substantial portion of the return.

# Who are Not Considered Tax Preparers?

- IRS employees performing official duties;
- Individuals working under the IRS's Volunteer Income Tax Assistance (VITA) program;
- Volunteers in a Low-Income Taxpayer Clinic;
- Individuals who provide typing, copying, or printing assistance;
- Individuals who prepare a return or refund claim of the employer (or of an officer or employee of the employer) for whom they are regularly and continuously employed; and
- Preparers of fiduciary returns or refund claims when the preparer is either a fiduciary or an officer, general partner, or employee of the fiduciary.

# Current and Proposed Regulation of Tax Preparers.



# Current Regulation of Tax Preparers

- Preparer Tax Identification Number (PTIN)
  - Paid preparers must register and obtain a PTIN.
- Annual Filing Season Program
  - Program is voluntary.
  - Those that take the required continuing education, pass an exam and subject themselves to portions of Circular 230, receive a "Record of Completion."
  - IRS lists participating preparers in its online "Directory of Federal Tax Preparers."
  - IRS Commissioner has stated the program allows participants to stand out from the competition by giving them a recognizable item they can show clients.

# Proposed Regulation of Tax Preparers

- **Taxpayer Protection and Preparer Proficiency Act**
  - Would allow IRS to regulate tax preparers and mandate minimum competency standards.
  - Bill has support from the AICPA, the National Association of Enrolled Agents, and National Association of Tax Professionals.
  - Would require tax preparers to demonstrate competency in preparing returns, claims for refund, and associated documents.
  - Also would require preparers to complete continuing education requirements.
  - Proponents cite to the fact that the IRS receives tens of thousands of complaints per year about insufficient services.

# Proposed Regulation of Tax Preparers (con't)

- **American Families Plan**
  - All tax preparers in the U.S. would be subject to registration, testing, and regular attendance of courses that would continue their education in accounting.
  - Would give the IRS more authority to regulate the tax industry.
  - Stiffer penalties for any unethical tax preparation practices.
- **AICPA Consumer-Protection Measure**
  - AICPA continues to pursue a measure about advertising.
  - Seeks to require that unlicensed PTIN holders who represent themselves as a registered tax return preparer display a statement directing taxpayers to the IRS website where the differences between the types of preparers are explained.

# IRS Enforcement and Penalties Against Tax Preparers.

# Issues Leading to Claims Against Tax Preparer with IRS

- Failing to inform clients before filing their Form 1040;
- Altering client tax return documents;
- Using an improper filing status;
- Reporting an inaccurate amount of income;
- Using the wrong Preparer Tax Identification Number;
- Forgetting to sign the client's tax return;
- Refusing to provide clients a copy of their tax return;
- Refusing to release client records until they pay for your services; and
- Misrepresenting your qualifications.

# Potential Penalties From IRS

- The first preparer penalties were enacted by the Treasury Department in 1921 and could be amended or modified without notice to the public.
- Since 2007, penalties can apply to both signing and non signing individuals, as well as individuals who never see the taxpayer's return.
- Sec. 6694 delineates penalties for paid preparers who take unreasonable positions on tax returns or refund claims that result in an understatement of a taxpayer's liability. Also includes details about who has responsibility for a position on a return, what is considered an unreasonable position, information verification requirements, and the basis for penalty assessment.
- Sec. 6695 provides for further assessable penalties when a preparer fails to complete specific responsibilities such as failing to retain a copy of the return, to sign the return, or to furnish a copy to the taxpayer.

# Unreasonable Positions.

- Unreasonable positions are those that lack substantial authority.
- This standard is less stringent than the more likely than not standard (a greater than 50% likelihood of being upheld) but more stringent than the reasonable basis standard.
- A 1999 Joint Committee on Taxation Staff Report describes substantial authority as at least a 40% likelihood of success if challenged, which it described as "a general consensus of scholars and practitioners based on a survey of the literature." This same report describes reasonable basis as at least a 20% likelihood of success if challenged.

# Unreasonable Positions (con't)

- In the case of a tax shelter or reportable transaction, the position must meet the "more likely than not" (MLTN) standard (a greater than 50% possibility that the position would be sustainable if examined by the tax authorities) to avoid penalties.
- The possibility a return will not be audited, or an item will not be raised on audit, is not relevant in determining whether a standard is met.
- A preparer can take a position on a tax return and avoid preparer penalties when the position meets the reasonable basis standard but does not have substantial authority, as long as there is adequate and appropriate disclosure. The reasonable basis standard is not applicable to tax shelters and reportable transactions, which must meet the more likely than not standard.



# Potential Penalties From IRS from Client's Claims

- Monetary penalties – Depending on the issue, monetary penalties can range between \$50 up to \$100,000.
- Temporary suspension – For a serious error, you may receive a court-mandated injunction, barring you from preparing taxes for a certain amount of time.
- Reopening old tax returns – To make sure you have not repeatedly made the same mistake in the past, you may also have to re-open every “like and non-like” return that the statute of limitations permits.

# Who is Subject to Penalties?

- Preparation of a "substantial portion" of a return or claim for refund is treated as preparation of that return or claim for refund.
- Preparation of a schedule, such as a depreciation calculation or allocation of income or expenses, could potentially "qualify" an individual as a tax preparer.
- Advice provided by a nonsigning tax preparer before the transaction that leads to the position on the return is not necessarily subject to preparer penalties.
  - Do not confuse preparer penalties for IRS purposes with potential professional liability or civil claims.

# Who is Subject to Penalties?

- No preparer penalties apply if, after the transaction occurs, less than 5% of the aggregate tax advisory time on the transaction is provided by the nonsigning preparer.
- For nonsigning preparers only, two de minimis rules apply in determining whether a portion of the return is a substantial portion of the return.
- If the gross income, deduction, or basis for a credit is less than \$10,000; or less than \$400,000 and also less than 20% of the gross income on the return (or adjusted gross income (AGI) in the case of an individual), a nonsigning preparer will not be considered potentially liable for penalties under Sec. 6694.
- If portion of return prepared by the nonsigning preparer consists of more than one schedule, entry, or other portion, all of these are aggregated in applying the rules.

# Due Diligence Obligations

- Regs. Sec. 1.6694-1(e) provides guidelines regarding responsibility to verify information furnished by taxpayers or other parties.
- Entitled to good faith reliance on information furnished by the taxpayer, other advisers, and other preparers.
- Not required to audit, review, examine, or verify information beyond reasonable inquiries of facts and circumstances unless conflicting facts are known.
- If using information from a previously filed return, you are not required to verify unless there is reason to believe the information is incorrect or incomplete.
- Standards of reasonableness and professional judgment apply for all information used to prepare a return.

Criminal Liability.

# U.S. v. Amaefuna, April 27, 2021

- Defendant Amaefuna was indicted with 29 counts related to the preparation of false income tax returns.
- Defendant owned American Financial Stewardship (AFS), a tax preparation business in Northeast Philadelphia.
- Defendant allegedly prepared false and fraudulent tax returns for clients from 2014 through 2016.
- Defendant added attachments to the 1040 Forms that claimed false or inflated employee business expenses, inflated state and local taxes, false or inflated miscellaneous deductions, and losses that were entirely fictitious or falsely inflated.
- These falsities resulted in the filing of income tax returns claiming refunds which the clients were not entitled to receive.

Pennsylvania State Board of Accountancy/  
Disciplinary Board of the Supreme Court of  
Pennsylvania.

# Pennsylvania State Board of Accountancy

- July 2020 – Not a lot of detail, but tax preparer was ordered to pay a civil penalty in the amount of \$1,000 and an assessment fee of \$321.06 towards costs of investigation; and a public reprimand was placed on his permanent disciplinary record with the Board, because he violated the law in that he engaged in unprofessional conduct.
- Nov 2020 -- Tax preparer repeatedly provided false tax returns for Client to submit to lenders on which Preparer inflated Client's income by hundreds of thousands of dollars, when Preparer knew that the lenders were going to be relying upon the inflated income figures in approving Client's loan requests.
- Other States – CA, NJ, NY – Monitor and send out tag-a-long letters for any regulatory activity.



# Disciplinary Board of the Supreme Court of Pennsylvania

- Board has authority to regulate attorney conduct.
- Recent case involving estate administration involved typical fact pattern.
  - Failure to communicate with clients.
  - Failure to prepare estate returns and resulting loss of refunds.
- Attorney suspended for one-year due to multiple instances.

Civil Liability.

- Professionals have a duty to exercise a level of care, skill and diligence commonly associated with that of other members of their profession under similar circumstances.
- For a plaintiff to prevail in a malpractice action against a tax professional, the plaintiff must prove: (1) the tax preparer owed a duty to the taxpayer, (2) there was a breach of that duty, (3) the plaintiff suffered injuries, and (4) there was a proximate cause between the injury suffered and the duty.

# Civil Litigation (con't)

- The first element is typically found in an engagement letter that outlines the scope of the accountant's duties and responsibilities to the taxpayer
  - Alternatively, could be a verbal agreement.
- The second element arises when preparer makes an error or omits information that results in an incorrect return or flawed tax advice.
- The third element, includes damages that stem from the failure to fulfill duties and responsibilities.
- The fourth element draws a causal connection between the error and damages.

## Civil Litigation (con't)

- Not all mistakes necessarily constitute malpractice.
- You are not civilly liable if incorrect advice is a result of a mere error in judgment concerning a doubtful or unsettled area of the law. The law does not require tax practitioners to guarantee particular outcomes.
- Examples of mistakes that do create liability include those when preparers fail to file returns or file them late, are negligent in return preparation, or render incorrect tax planning advice.

- Taxes owed are generally not a recoverable damage component where a mistake results in an understatement of tax.
- But, you could be held liable for taxes overpaid if the taxes can no longer be recovered from the government by filing an amended return.
- Penalties are generally recoverable as damages.

# Civil Litigation – Damages (con't)

- Interest may be recoverable to the extent a taxpayer has suffered actual damages from the interest charged.
  - Some courts have held that interest is not a recoverable damage component. They have theorized that while interest accrued, the taxpayer had use of the unpaid tax dollars and thus suffered no economic harm.
  - Several courts have adopted an intermediate position of allowing as recoverable damages the amount of the interest owed to the government over the return the taxpayer was able to achieve while the tax dollars remained unpaid.
- Pennsylvania leaves it up to the jury to decide if Plaintiff has met their burden of proving a recoverable loss based on the facts and circumstances of the case.

# Civil Litigation - Hypothetical

- A business client needs an extension of time to file its tax returns. The accounting firm prepares the Form 7004 Application for Automatic Extension and forwards it to the client for review. However, due to a breakdown in communication, neither the client nor the accountant files the extension.
- Months later, the accountant and client execute an engagement letter for preparation of the tax returns. The standard engagement letter contains a provision limiting the accounting firm's liability to the fee paid.
- The final tax returns seek a tax benefit for prior net operating losses. The IRS rejects the returns as untimely and denies the tax benefit sought. The client then sues the accounting firm, who claims that the engagement letter limits the firm's liability to the fee paid for the tax preparation.



## Civil Litigation – Hypothetical (con't)

- At least one Court presented with this scenario has found that the engagement letter did not limit liability because:
  - it was executed five months after the failure to file the extension; and
  - the scope of work referenced only the preparation of the tax returns, not the extension request.
- The Court went on to hold that the engagement letter did not provide for releases or limitations of liability for services beyond the scope of the engagement letter or for conduct that already occurred.
- Instead of facing a claim for several thousand dollars, the accounting firm found itself defending a multi-million-dollar claim.

# Use Engagement Letters to Mitigate Risk

- Tax Preparers can mitigate their risk of liability in this scenario by:
  - requiring that engagement letters are executed before commencement of any new services, even if those services are seemingly administrative, like filing an application for automatic extension to file taxes;
  - reviewing engagement letters to ensure that any related services (like preparation and filing of an application for extension) are specifically included in the scope of the engagement letter, and that the releases and limitations of liability provisions apply to conduct that has already occurred; and
  - communicating with clients in a clear manner the party responsible to prepare, review and file documents.

# How to Contact Me



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Thank you.

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