This is a follow-up article to "Due Diligence Requirements for Tax Return Preparers" published in *Today's CPA* magazine last year. This article suggests 12 good due diligence practices that tax preparers can utilize to avoid mistakes and minimize their exposure to preparer penalties.

12 Due Diligence Best Practices for Tax Return Preparers

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As a brief recap, the general rule is a tax preparer will only be assessed preparer penalties when a tax return understates the taxpayer's tax liability and the preparer "knows or should have known" that a position on the tax return was unreasonable and may result in an understatement.[1] If the tax preparer has "reasonable cause" for the understatement on the return and the preparer acted in "good faith" while preparing the return, the preparer generally will not be penalized for the understatement.[2]

A preparer will usually satisfy this "reasonable cause and good faith" exception to penalties if he/she exercised an appropriate level of due diligence when preparing the return, but nevertheless, an understatement still occurred. While there is no certain, foolproof method for satisfying this standard, implementing the following due diligence practices should strengthen a practitioner's case against preparer penalties.

1 IRC § 6694(a).
2 IRC § 6694(a)(3)

1 Establish a Diligence Checklist for Returns and Always Follow It

Establishing a checklist of due diligence measures (i.e., normal office practices) to follow while preparing a return is the most important due diligence measure a CPA can take because it establishes the foundation of the return preparation process for every return. All of the rules that regulate tax preparers point to "normal office practices" as one of the most important factors to consider when determining whether a preparer should face penalties for an error on a return.

By having a diligence checklist of normal office practices to follow for every tax return, a preparer is less likely to make a negligent error while preparing a return and if an error does occur despite following the checklist, it is more likely the IRS will view the error as an isolated anomaly. If a checklist is always followed, it is more likely that the preparer acts in good faith while preparing returns.

While a diligence checklist is important, it can serve as a double-edged sword if it is not used diligently on every return. In *Brockhouse v. United States*, a commonly cited preparer penalty case, a factor the court cited in support of assessing penalties was that Brockhouse, the tax preparer, failed to follow his own diligence procedures for the tax return at issue when he did not send a routine data questionnaire to his taxpayer-client.[3] Further hurting his case was the fact that Brockhouse wrote an article in a journal for tax practitioners in which he said: "[e]xamples of good office procedures include a system to promote accuracy and consistency in the preparation of returns. The system might include a preparation checklist, a method for obtaining the necessary information from the taxpayer, examination of prior returns and review procedures … ."[4] Thus, despite advising other practitioners to strictly adhere to a diligence checklist, Brockhouse failed to follow his own advice.

2 Document and Retain Records for Everything

This is another very important diligence measure that is repeated throughout these tips. While a diligence checklist helps prevent careless errors and protects the tax preparer if an error does occur, the primary purpose for documenting and retaining records is protection when something goes wrong. If the IRS charges a tax preparer with taking an unreasonable position on a return, he/she has the burden of showing the IRS the information or advice that was relied on for the unreasonable position. A tax preparer may rely in good faith on advice or information provided by the taxpayer or other trustworthy sources.

A tax preparer should not only keep copies of written information (receipts, prior tax returns, emails, etc.), but also document and retain copies of all oral information and advice received. This includes conversations with the client and other related parties. For example, if a client tells a tax preparer information that's relied on while preparing the return, the preparer should immediately type (or handwrite) a note or memo to the client's file. Additionally, the preparer should document in a note or memo to file any advice given.

By regularly documenting conversations and meetings with the client, there will be written records of oral advice and information exchanged, just in case some of that information leads to an understatement. If a client provided bad information that the preparer relied on, and the client later tries to shift blame to the preparer by saying "I never told the preparer that" or "the preparer never advised/warned me about that," the preparer will have some documentation to support his/her claim of reasonable reliance on the client's information or advice.

3 Make Appropriate Inquires and Refer to the Taxpayer's Prior Returns and Other Relevant Documents

This diligence tip suggests that practitioners should go above and beyond the regulations' minimal standard of making appropriate inquires whenever the practitioner "knows or should know" that further inquiries are necessary. Practitioners should always play it safe and make appropriate inquires, because the regulations' "should know" standard is such a vague, unpredictable standard.

AICPA's SSTS rules already strongly suggest CPAs should make appropriate inquires of taxpayers claiming deductions or credits requiring substantiating records. It also suggests preparers should refer to taxpayer-client's returns from prior years whenever it is feasible. Tying this suggestion back into the diligence checklist suggestion, a CPA can make reasonable inquires through a uniform questionnaire sent to every client early on during the return preparation. For due diligence purposes, it is always a good idea to ask about anything that may help the preparer compile a more accurate, complete return.

It is also important to remember that a tax preparer is not required to audit his/her client. When making reasonable inquires, all the preparer must do is ask. Once the appropriate questions have been asked, the preparer should be able to reasonably rely on any information, documents or oral answer provided by the client. The only exception to this is if the client provides information that is clearly inaccurate or that the preparer knows is inaccurate.

Preparers may generally rely on taxpayer's information and are not required to grill their client about their information, question the validity of their information or otherwise challenge his/her trustworthiness. Generally, once the appropriate inquiry has been made, the preparer has satisfied his/her professional duty. If the client responds by providing inaccurate, misleading or fraudulent information that is reasonably relied on in good faith when preparing the return, the liability falls on the client, not the tax preparer.

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3 *Brockhouse v. United States*, 577 F. Supp. 55, 58 (N.D. Ill. 1983) ("Also illustrative of Brockhouse's lack of due diligence in preparing Dr. Busch's 1978 return is his failure to follow procedures which both Goldman, Weiss as an accounting firm and he as an individual accountant recognized as necessary to obtain complete information from a taxpayer. As previously noted, Goldman, Weiss had "adopted a practice" (Stipulation, para. 10) of sending a data questionnaire to its clients as a means of collecting information, a practice not utilized in preparing Dr. Busch's 1978 return."))

4 Brockhouse v. United States, 577 F. Supp. 55, 58 (N.D. Ill. 1983).

4 Request Supporting Documents for Positions that Require It

This suggestion is similar to the previous one, but it focuses on taxpayer-clients who are claiming deductions or credits that require substantiating records. This suggestion is that practitioners should actually request the substantiating records from a taxpayer who wants to claim a deduction or credit requiring substantiating records, rather than simply asking if the taxpayer has the records.

AICPA's SSTS rules suggest that CPAs should make inquires to determine if the taxpayer actually has the necessary records, but the Code's preparer penalties do not necessarily require that. For example, in some instances, taxpayer-clients may claim a deduction or credit on their tax return that requires the taxpayer to have receipts or records substantiating the claim but does not require tax preparers to actually see those records to claim the position on the return. The following example illustrates this unusual situation:[5] A taxpayer-client tells the tax preparer to claim a business entertainment expense deduction on the taxpayer's tax return. Under the Code, a taxpayer must have receipts and other substantiating documentation to claim a business expense deduction. The preparer, however, merely has to ask the taxpayer if he/she has the necessary substantiating records. Rather than just asking the taxpayer if he/she has the records, a tax preparer should take the extra step of asking the taxpayer to produce the substantiating records.

This extra diligence measure will not only further assist the preparer in preparing the return, but will also provide protection for a messy situation if there are no records and the IRS is curious as to whether the preparer knew or should have known the taxpayer did not actually have the records. If a taxpayer wants to claim a deduction or credit that requires substantiating records, the taxpayer should be able to produce the records for the preparer. "I have them; I just can't find them right now" will not cut it with the IRS, so it should not cut it with a tax preparer who is signing his/her name and reputation on the return.

5 The Bigger the Claim, the Greater the Need for Diligence

One of the regulations' factors to consider when determining if a preparer's understatement error was due to reasonable cause and good faith is the materiality of the error.[6] If an error results in a small understatement of the tax liability when compared to the taxpayer's total tax liability, it is likely the preparer will not be assessed penalties. On the other hand, if the error results in a large understatement compared to the taxpayer's total liability, the preparer could have a difficult time avoiding penalties.

Thus, as a general rule, the bigger the claim, the greater the need for due diligence. This does not suggest only performing due diligence for large items on a tax return, but rather, it is suggesting that an alarm should go off in a practitioner's head whenever a taxpayer attempts to claim a very large deduction or credit. That alarm should tell the preparer "I need to be careful and exercise sufficient due diligence before I sign off on this claim."

6 Always Comply with the Heightened Diligence Requirements for Special Claims or Deductions

There is not really much more to say about this suggestion. If a specific deduction or claim requires a tax preparer (as opposed to just the taxpayer) to follow specific diligence steps before making the claim on a return, the preparer should carefully comply with every diligence requirement. If specific diligence requirements are not followed, the preparer will be assessed penalties regardless of whether there is an understatement on the tax return.[7] Preparers should always stay current on any requirements that may apply to a deduction or credit, as the Code, regulations and IRS rulings are constantly changing in an attempt to crack down on tax fraud and abuse.

7 Never Consider a Taxpayer's Return Information in Isolation

This suggests that outside facts and circumstances should always be considered when preparing a taxpayer's return. This most commonly applies to tax returns prepared for an individual and the individual's closely held business. In this situation, preparers should be aware how income and tax items for the individual's business affect the individual's personal tax return. Accordingly, a preparer should not consider each return in isolation or be willfully blind to any tax information affecting both returns.

The Brockhouse case provides a good example. In Brockhouse, the court upheld preparer penalties assessed against a CPA who prepared income tax returns for a doctor and the doctor's professional corporation.[8] The books the CPA used to prepare the professional corporation's return showed that the doctor and a bank loaned money to the doctor's corporation during the tax year.[9] The books also showed that the corporation paid interest expense on loans during the year, but did not say who specifically it paid interest to.[10] Furthermore, the doctor's individual tax return information made no reference to any interest income received.[11] The CPA did not claim any interest income on the doctor's individual return, which resulted in an understatement, because the doctor's corporation had paid interest on the loan to the doctor during the tax year.[12]

The court held that the CPA "should have known" to inquire about any interest income received by the doctor based on the information the CPA knew from reviewing the books for the doctor's professional corporation.[13] The CPA was assessed preparer penalties, because he considered each

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5 *Supra* Section I.A.2.c.
6 Treas. Reg. § 1.6694-2(e)(3).

7 IRC § 6695(g)
8 *Brockhouse v. United States*, 577 F. Supp. 55, 55-58 (N.D. Ill. 1983).
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.*

return in isolation and failed to make appropriate inquiries.[14] The CPA should have considered the tax information he knew about the doctor's business when preparing the doctor's individual return.

8 Never Give Out Casual Tax Advice

A tax return preparer does not need to sign a tax return for the IRS to assess section 6694 preparer penalties against the preparer. By merely offering some casual tax return advice to a client, the preparer may be subject to penalties. "Off-the-cuff" comments made by email, phone conversation or casual in-person conversations can be traps for the unwary. Preparers should never give out casual advice and should always have a strong grasp of the taxpayer's facts and circumstances before offering tax advice.

Also, whenever possible, practitioners should try to formalize their advice in a typed memo or letter. This will create a clear, written record of the advice given, which the practitioner and taxpayer can refer back to at any time. It is also important that the advice be supported with relevant, up-to-date authority and include any risks, drawbacks or other concerns associated with the advice. This leads into the next suggestion.

9 Advise Clients of the Benefits, Risks, Drawbacks and Other Considerations Associated with a Position – and Document It

The role of a tax return preparer is to prepare the return in a way that conforms to the client's wishes. The client makes the final decisions; it is the preparer's job to merely give advice on the most favorable position and make sure the client understands any alternative options that may be available. Thus, when a preparer advises on a position, he/she should make sure the client fully understands the position, along with all of the benefits, drawbacks, risks and any other concerns associated with the position.

To a lesser extent, the Circular 230 rules impose this duty on tax practitioners, requiring practitioners to advise clients of any penalties the client is reasonably likely to face as a result of a position taken on a tax return. Practitioners should do more than just warn about penalties that are reasonably likely. They should also provide advice on the benefits and drawbacks of multiple positions that may be available and make sure the advice is understood.

For example, if a client has an eligible foreign business entity and cannot decide whether to "check the box" on the tax return, the preparer should provide advice on the benefits and drawbacks of making the election as opposed to not making the election. Furthermore, a note or memo to file should be made summarizing the details of the meeting that includes details such as the advice given, whether the advice was understood and any preferences or feedback the client had regarding the advice.

By documenting the exchange, advice and discussions between the preparer and client, there will be records showing the individual was properly advised and understood all the options available. If a client makes a decision he/she later regrets and tries to claim the preparer did not properly advise him/her before making the decision, the preparer will have a record showing he/she was properly advised and understood the decision before making it. Like most of these diligence suggestions, it is not enough for preparers to merely perform the suggested due diligence; preparers must also document and retain records of their due diligence.

10 Never Assume What the Law Is

Of all the areas of law, tax laws are most unpredictable and unstable. They are constantly in flux as the federal and state governments debate ways to raise revenue and spur on economic growth, while also combating tax fraud. Despite the complexities of tax law, practitioners still have a duty to maintain their competence in the field. If a tax practitioner is unaware of any changes to a certain law, the practitioner should never assume what the law is. Preparers should always exercise due diligence by performing sufficient research to make sure a position is still supported by good authority.

As stated in the regulations, a preparer has no defense against preparer penalties if he/she takes an unreasonable position on a return and should have known the position was no longer reasonable due to changes in the law.[15]

11 Do Not Prepare a Tax Return Unless Sufficiently Competent

If a tax return preparer has prepared small, individual returns for his/her entire career, he/she should probably not attempt to prepare a *Fortune 500* company's tax return. This is an extreme case, but it illustrates the point of this suggestion. If a tax preparer is not competent to handle a return or particular tax matter, he/she should not accept the project.

Tax laws are complex and wading into unfamiliar waters is a recipe for disaster for the unprepared. A CPA should know his/her limitations and decline projects when he/she lacks the requisite experience or qualifications.

12 Terminate a Client Relationship if the Client is Unwilling to Listen to Advice or Wants to Take Unreasonable Positions

Keeping a client is never worth losing your license. If someone is asking that unreasonable positions be taken on the return or asking the preparer to cut corners by skipping essential due diligence steps, it is probably best to end the relationship. There is no preparer penalty exception for "yeah I know it was wrong, but my client told me to do it."

As professionals, practitioners are expected to know what is right and wrong in their area of expertise. If a client insists on a tax preparer taking a position the preparer knows is unreasonable or lacks due diligence, he/she should clearly explain why he/she cannot take that position. If the individual is unwilling to listen to reason, there may be no other option than terminating the relationship.

14 *See id.*

15 Treas. Reg. § 1.6694-2(e)(6).

If the individual insists on taking an unreasonable position, the preparer should write a memo or formal letter explaining why the preparer cannot take the position.

It is in these types of situations when it is most important for tax preparers to document and retain records of the advice and information exchanged with a client. If the individual insists on taking an unreasonable position, the preparer should write a memo or formal letter explaining why the preparer cannot take the position. If the preparer has a conversation with the client explaining why an unreasonable position cannot be taken, and he/she refuses to accept the advice, the preparer should draft a memo to the client's file summarizing the details of the meeting and clearly stating that he/she was advised the position was unreasonable and that the preparer would not take the position.

It is extremely important to document and retain the documents in these situations, because when a client refuses to listen to a preparer's advice regarding an unreasonable or unethical tax position, there is a high likelihood the individual will take that position regardless. If this happens and the client gets caught, the IRS may come after anyone involved in the preparation of the tainted tax return. In that situation, the preparer may need to produce records or documentation showing he/she refused to take the unreasonable position and advised against it.

Exposure to Risks

These 12 due diligence suggestions are by no means a foolproof way to avoid preparer penalties or professional discipline. Tax return preparation is an extremely challenging, highly complex profession involving high stakes for tax professionals and their clients. In an area as challenging as this, a myriad of unpredictable problems may arise.

There is no easy 12-step solution that can shield a tax practitioner from all the risks associated with the profession. Nevertheless, by carefully performing the proper due diligence on every return, a practitioner can avoid careless mistakes and limit exposure to liability for the mistakes that are bound to occasionally happen. ❖

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TABLE 1.
Due Diligence Best Practices at a Glance

1. Establish a Diligence Checklist for Returns and Always Follow It
2. Document and Retain Records for Everything
3. Make Appropriate Inquires and Refer to the Taxpayer's Prior Returns and Other Relevant Documents
4. Request Supporting Documents for Positions that Require It
5. The Bigger the Claim, the Greater the Need for Diligence
6. Always Comply with the Heightened Diligence Requirements for Special Claims or Deductions
7. Never Consider a Taxpayer's Return Information in Isolation
8. Never Give Out Casual Tax Advice
9. Advise Clients of the Benefits, Risks, Drawbacks and Other Considerations Associated with a Position – and Document It
10. Never Assume What the Law Is
11. Do Not Prepare a Tax Return Unless Sufficiently Competent
12. Terminate a Client Relationship if the Client is Unwilling to Listen to Advice or Wants to Take Unreasonable Positions