

University of Minnesota CCAPS - Ethics 2022

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Reference Materials

1. Smith, Caleb, “But I’ve Always Done It That Way, Procedurally Taxing Blog, January 11, 2022
2. Nakamura, Karen CPA, “Kovel agreement basics for you and your client,” Journal of Accountancy, July 1, 2022
3. Nelson, Christine “Gather client experience data through effective Interviews,” MN CPA Footnote, 2022
4. Rood, Deborah K. CPA, “Unresponsive clients pose a professional liability risk,” Journal of Accountancy, Feb 1, 2022
5. Gusick, Kristy, “5 tips to help you prune toxic clients,” MN CPA Footnote, August/September 2022
6. Pitonyak, Lauren, “Insurance Claims that Can Ruin You Tax Preparation Business,” NAEA EA Journal, July/August 2022
7. Ference, Sarah Beckett, “Understanding the professional liability claims process,” Journal of Accountancy, May 2022
8. Atkinson-Flowers, Nadine C., “7 tips to handle those ‘just one question’ potential clients,” Mind Your Business, May 25, 2022
9. IRS Field Attorney Advice 20223301F (8/19/22)
10. *U.S.A., Plaintiff – Appellee v. Nikia Tull*, Defendant – Appellant (Fourth Circuit, 21-4196, July 6, 2022) unpublished opinion affirming an unreported DC Va. Opinion
11. *U.S.A., Plaintiff v. William Doonan and William Doonan and Associates Inc., doing business as William Doonan, Esq., Defendants* (U.S. District Court, S.D. New York; 19 Civ.9578(JPC), March 30, 2022

An updated Resource Materials list will be posted to the UMN CCAPS site at the end of the class sessions (January 2023)

26 CFR § 301.7701-15 - Tax return preparer.

§ 301.7701-15 Tax return preparer.

(a) *In general.* A *tax return preparer* is any [person](#) who prepares for compensation, or who employs one or more [persons](#) to prepare for compensation, all or a substantial portion of any return of [tax](#) or any claim for refund of [tax](#) under the [Internal Revenue Code](#) (Code).

(b) *Definitions* -

(1) *Signing tax return preparer.* A *signing tax return preparer* is the individual [tax return preparer](#) who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund.

(2) *Nonsigning tax return preparer* -

(i) *In general.* A *nonsigning tax return preparer* is any [tax return preparer](#) who is not a signing [tax return preparer](#) but who prepares all or a substantial portion of a return or claim for refund within the meaning of [paragraph \(b\)\(3\)](#) of this section with respect to events that have occurred at the time the advice is rendered. In determining whether an individual is a nonsigning [tax return preparer](#), time spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement shall not be taken into [account](#). Notwithstanding the preceding sentence, time spent on advice before the events have occurred will be taken into [account](#) if all facts and circumstances show that the position(s) giving rise to the understatement is primarily attributable to the advice, the advice was substantially given before events occurred primarily to avoid treating the [person](#) giving the advice as a [tax return preparer](#), and the advice given before events occurred was confirmed after events had occurred for [purposes](#) of preparing a [tax](#) return. [Examples](#) of nonsigning [tax return preparers](#) are [tax return preparers](#) who provide advice (written or oral) to a [taxpayer](#) (or to another [tax](#) return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return within the meaning of [paragraph \(b\)\(3\)](#) of this section.

(ii) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1.

Attorney A, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding a completed corporate transaction. The advice

provided by A is directly relevant to the determination of an entry on the taxpayer's return, and this advice leads to a position(s) or entry that constitutes a substantial portion of the return. A, however, does not prepare any other portion of the taxpayer's return and is not the signing tax return preparer of this return. A is considered a nonsigning tax return preparer.

Example 2.

Attorney B, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding the tax consequences of a proposed corporate transaction. Based upon this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from B with respect to the transaction. B did not provide advice with respect to events that have occurred and is not considered a tax return preparer.

Example 3.

The facts are the same as Example 2, except that Attorney B provides supplemental advice to the corporate taxpayer on a phone call after the transaction is completed. Attorney B did not provide advice before the corporate transaction occurred with the primary intent to avoid being treated as a tax return preparer. The time incurred on this supplemental advice by B represented less than 5 percent of the aggregate amount of time spent by B providing tax advice on the position. B is not considered a tax return preparer.

(3) Substantial portion.

(i) Only a [person](#) who prepares all or a substantial portion of a return or claim for refund shall be considered to be a [tax return preparer](#) of the return or claim for refund. A [person](#) who renders [tax](#) advice on a position that is directly relevant to the [determination](#) of the existence, characterization, or amount of an entry on a return or claim for refund will 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 based upon whether the [person](#) knows or reasonably should know that the [tax](#) attributable to the schedule, entry, or other portion of a return or claim for refund is a substantial portion of the [tax](#) required to be shown on the return or claim for refund. A single [tax](#) entry may constitute a substantial portion of the [tax](#) required to be shown on a return. Factors to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion include but are not limited to -

(A) the size and complexity of the item relative to the [taxpayer's](#) [gross income](#); and

(B) the size of the understatement attributable to the item compared to the [taxpayer's](#) reported [tax](#) liability.

(ii)

(A) For [purposes](#) of applying the rules of [paragraph \(b\)\(3\)\(i\)](#) of this section to a nonsigning [tax return preparer](#) within the meaning of [paragraph \(b\)\(2\)](#) of this section only, the schedule or other portion is not considered to be a substantial portion if the schedule, entry, or other portion of the return or claim for refund involves amounts of [gross income](#), amounts of deductions, or amounts on the basis of which [credits](#) are determined that are -

(1) Less than \$10,000; or

(2) Less than \$400,000 and also less than 20 percent of the [gross income](#) as shown on the return or claim for refund (or, for an individual, the individual's adjusted gross income).

(B) If more than one schedule, entry or other portion is involved, all schedules, entries or other portions shall be aggregated in applying the de minimis rule in [paragraph \(b\)\(3\)\(ii\)\(A\)](#) of this section.

(C) The de minimis rule in [paragraph \(b\)\(3\)\(ii\)\(A\)](#) of this section shall not apply to a signing [tax return preparer](#) within the meaning of [paragraph \(b\)\(1\)](#) of this section.

(iii) A [tax return preparer](#) with respect to one return is not considered to be a [tax return preparer](#) of another return merely because an entry or entries reported on the first return may affect an entry reported on the other return, unless the entry or entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return. For [example](#), the sole preparer of a [partnership](#) return of income or small business corporation income [tax](#) return is considered a [tax return preparer](#) of a partner's or a shareholder's return if the entry or entries on the [partnership](#) or small business corporation return reportable on the partner's or shareholder's return constitute a substantial portion of the partner's or shareholder's return.

(iv) **Examples.** The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1.

Accountant C prepares a Form 8886, "Reportable Transaction Disclosure Statement", that is used to disclose reportable transactions. C does not prepare the tax return or advise the taxpayer regarding the tax return reporting position of the transaction to which the Form 8886 relates. The preparation of the Form 8886 is not directly relevant to the determination of the existence, characterization, or amount of an entry on a tax return or claim for refund. Rather, the Form 8886 is prepared by C to disclose a

reportable transaction. C has not prepared a substantial portion of the tax return and is not considered a tax return preparer under section 6694.

Example 2.

Accountant D prepares a schedule for an individual taxpayer's Form 1040, "U.S. Individual Income Tax Return", reporting \$4,000 in dividend income and gives oral or written advice about Schedule A, which results in a claim of a medical expense deduction totaling \$5,000, but does not sign the tax return. D is not a nonsigning tax return preparer because the total aggregate amount of the deductions is less than \$10,000.

(4) Return and claim for refund -

(i) Return. For [purposes](#) of this section, a return of [tax](#) is a return (including an amended or adjusted return) filed by or on behalf of a [taxpayer](#) reporting the liability of the [taxpayer](#) for [tax](#) under the Code, if the type of return is identified in published guidance in the Internal Revenue Bulletin. A return of [tax](#) also includes any information return or other document identified in published guidance in the Internal Revenue Bulletin and that reports information that is or may be reported on another [taxpayer's](#) return under the Code if the information reported on the information return or other document constitutes a substantial portion of the [taxpayer's](#) return within the meaning of [paragraph \(b\)\(3\)](#) of this section.

(ii) Claim for refund. For [purposes](#) of this section, a claim for refund of [tax](#) includes a claim for credit against any [tax](#) that is included in published guidance in the Internal Revenue Bulletin. A claim for refund also includes a claim for [payment](#) under section 6420, 6421, or 6427.

(c) Mechanical or clerical assistance. A [person](#) who furnishes to a [taxpayer](#) or other [tax return preparer](#) sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered a [tax return preparer](#), even though that [person](#) does not actually place or review placement of information on the return or claim for refund. See also [paragraph \(b\)\(3\)](#) of this section.

(d) Qualifications. A [person](#) may be a [tax return preparer](#) without regard to educational qualifications and professional status requirements.

(e) Outside the United States. A [person](#) who prepares a return or claim for refund outside the United [States](#) is a [tax return preparer](#), regardless of the [person's](#) nationality, residence, or the location of the [person's](#) place of business, if the [person](#) otherwise satisfies the definition of *tax return preparer*. Notwithstanding the provisions of [§ 301.6109-1\(g\)](#), the [person](#) shall secure an employer identification number if the [person](#) is an employer of another [tax return preparer](#), is a [partnership](#) in which one or more of the general partners is a [tax return preparer](#), is a firm in which

one or more of the equity holders is a [tax return preparer](#), or is an individual not employed by another [tax return preparer](#).

(f) *Persons who are not tax return preparers.*

(1) The following [persons](#) are not [tax](#) return preparers:

- (i)** An official or employee of the Internal Revenue Service (IRS) performing official duties.
- (ii)** Any individual who provides [tax](#) assistance under a Volunteer Income [Tax](#) Assistance (VITA) program established by the IRS, but only with respect to those returns prepared as part of the VITA program.
- (iii)** Any organization sponsoring or administering a VITA program established by the IRS, but only with respect to that sponsorship or administration.
- (iv)** Any individual who provides [tax](#) counseling for the elderly under a program established pursuant to section 163 of the [Revenue Act of 1978](#), but only with respect to those returns prepared as part of that program.
- (v)** Any organization sponsoring or administering a program to provide [tax](#) counseling for the elderly established pursuant to section 163 of the [Revenue Act of 1978](#), but only with respect to that sponsorship or administration.
- (vi)** Any individual who provides [tax](#) assistance as part of a qualified Low-Income [Taxpayer](#) Clinic (LITC), as defined by section 7526, subject to the requirements of paragraphs (f)(2) and (3) of this section, but only with respect to those returns and claims for refund prepared as part of the LITC program.
- (vii)** Any organization that is a qualified LITC, as defined by section 7526, subject to the requirements of paragraphs (f)(2) and (3) of this section.
- (viii)** An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund.
- (ix)** An individual preparing a return or claim for refund of a [taxpayer](#), or an officer, a general partner, member, shareholder, or employee of a [taxpayer](#), by whom the individual is regularly and continuously employed or compensated or in which the individual is a general partner.
- (x)** An individual preparing a return or claim for refund for a trust, estate, or other [entity](#) of which the individual either is a [fiduciary](#) or is an officer, general partner, or employee of the [fiduciary](#).

(xi) An individual preparing a claim for refund for a [taxpayer](#) in response to -

(A) A [notice](#) of deficiency issued to the [taxpayer](#); or

(B) A waiver of restriction on assessment after initiation of an audit of the [taxpayer](#) or another [taxpayer](#) if a [determination](#) in the audit of the other [taxpayer](#) affects, directly or indirectly, the liability of the [taxpayer](#) for [tax](#).

(xii) A [person](#) who prepares a return or claim for refund for a [taxpayer](#) with no explicit or implicit agreement for compensation, even if the [person](#) receives an insubstantial gift, return service, or favor.

(2) Paragraphs (f)(1)(vi) and (vii) of this section apply only if any assistance with a return of [tax](#) or claim for refund is directly related to a controversy with the IRS for which the qualified LITC is providing assistance or is an ancillary part of an LITC program to inform individuals for whom English is a second language about their rights and responsibilities under the Code.

(3) Notwithstanding [paragraph \(f\)\(2\)](#) of this section, paragraphs (f)(1)(vi) and (f)(1)(vii) of this section do not apply if an LITC charges a separate fee or varies a fee based on whether the LITC provides assistance with a return of [tax](#) or claim for refund under the Code or if the LITC charges more than a nominal fee for its services.

(4) For [purposes](#) of [paragraph \(f\)\(1\)\(ix\)](#) of this section, the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well.

(5) For [purposes](#) of [paragraph \(f\)\(1\)\(x\)](#) of this section, an estate, guardianship, conservatorship, committee, or any similar arrangement for a [taxpayer](#) under a legal disability (such as a minor, an incompetent, or an infirm individual) is considered a trust or estate.

(6) **Examples.** The mechanical assistance exception described in [paragraph \(f\)\(1\)\(viii\)](#) of this section is illustrated by the following examples:

Example 1.

A reporting agent received employment tax information from a client from the client's business records. The reporting agent did not render any tax advice to the client or exercise any discretion or independent judgment on the client's underlying tax positions. The reporting agent processed the client's information, signed the return as authorized by the client pursuant to

Form 8655, Reporting Agent Authorization, and filed the client's return using the information supplied by the client. The reporting agent is not a tax return preparer.

Example 2.

A reporting agent rendered tax advice to a client on determining whether its workers are employees or independent contractors for Federal tax purposes. For compensation, the reporting agent received employment tax information from the client, processed the client's information and filed the client's return using the information supplied by the client. The reporting agent is a tax return preparer.

(g) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, [73 FR 78463](#), Dec. 22, 2008, as amended by T.D. 9436, [74 FR 5107](#), Jan. 29, 2009]

“But I’ve Always Done It That Way!” Practitioner Considerations on Subsequent Year Exams

January 11, 2022 by Caleb Smith (Procedurally Taxing Blog)

Stop me if you’ve heard this one. A taxpayer and a tax attorney walk into a room. The taxpayer pulls out an IRS examination letter and says, “I’ve always filed my returns this way, and the IRS has never cared in the other years. Why is the IRS suddenly out to get me?” The tax attorney looks at the return and the letter. “Ah. The answer is simple: You’ve always filed your returns wrong. This is just the first time the IRS has noticed”

And everyone in the room shares a good laugh.

Or, more likely, the tax attorney begins shifting uncomfortably in their seat the moment they see the problem -specifically, that there are a lot of erroneous returns filed by your client that have not been caught and may realistically never be. The obligation (or lack thereof) to file an amended return to fix errors has previously been covered by Keith (co-author: Calvin Johnson) in an article [here](#). In a different context, I have written about when you do or do not have an obligation to correct IRS mistakes [here](#) and [here](#).

In this post I’d like to take the conversation in a slightly different direction. Specifically, I want to wrestle with the issue of advising clients on exposure to future audits -a thorny topic in the tax community.

In my most recent [post](#) I covered a [TIGTA report](#) suggesting improvements to correspondence examinations, prompting my own suggestions to focus more on high-income earners and non-filers. That same TIGTA report included a raft of recommendations for examining taxpayers that appear to have the same tax issue over multiple years (“subsequent year exams”). Those recommendations are what caught my eye and inspired this post.

TIGTA’s concerns were that the IRS didn’t appear to be initiating as many subsequent year exams as it should, and the IRS could increase efficiency by considering subsequent year returns as part of the already open exam. In a nutshell, TIGTA’s recommendations hinged on the idea that if a taxpayer erroneously claimed a deduction/took a credit in one year, there is a good chance that the same deduction/credit is erroneous in the next year as well. And I’d say that is a fair assumption. But it carries some interesting considerations that I believe tax practitioners should be aware of.

The recommendations put forth by TIGTA were more narrowly focused than just increasing audits on those that have been audited already. For one, it pertained only to subsequent returns with the same issue identified as in the year audited (the same “project code”). Second, it focused on taxpayers that actually resulted in an increased assessment of tax, thereby filtering out those who were selected for exam but ultimately demonstrated that their return was correct. Third, and importantly, TIGTA particularly keyed-in on subsequent returns where the taxpayer defaulted - that is, where they never responded to the exam in the open year and had similar identified issues in subsequent years.

“Silence is Violence”

A key takeaway from this may be that when the IRS selects you for examination, generally the worst thing you can do is to do nothing at all. The TIGTA recommendation (which IRS management agreed with) is to “change the subsequent return process to address *only subsequent year returns in which the taxpayer did not respond* to the [Initial Contact Letter] for the current examination.” Page 12 of the TIGTA Report (emphasis added).

In other words, if you don’t do anything (or don’t respond to the very first letter) it may carry worse consequences than if you respond with a full concession owning up to your error. Apart from just doing the “right thing,” it may be in your self-interest to proactively agree with the IRS rather than just letting things run its course.

Note also that the IRS also has internal policies against “repetitive” audits. They are a bit narrow (I covered an unsuccessful attempt to raise the policy in court [here](#)) and don’t apply to Schedule C returns (even though the prohibition is explicitly mentioned on the IRS Publication for Schedule C Filers: [Pub. 334](#), page 45). However, whatever protections the policy does offer is more likely to apply when the taxpayer actually responds to the audit. See [IRM 4.10.2.13.2](#).

All of this taken together, I think, should factor into any advice that is given to a client. I think it is important to impart the wisdom you’ve gleaned as a practitioner on the black-box of audit: “if you don’t respond to the IRS letter, there may be a heightened possibility that you will be audited on subsequent years.” If I was the average taxpayer that is definitely something I’d want to know and take into consideration.

The Audit Lottery

And now, the backlash.

“You can’t advise your client on the likelihood of audit!” Chants of “audit lottery!” and “Circular 230!” drum in the background as the torches are lit. My demise (the stripping of my ability to practice before the Service) is nigh.

Or so it would seem. But only based on a misunderstanding of what prohibited advice about audit likelihood actually entails. When I talk to (or test) my students about the “audit lottery” some take that it mean you cannot talk to a client about audit risks. Period. In this understanding, when a tax lawyer reads the (publicly available) [IRS Stat Book](#) and sees the (abysmal) exam rate, that knowledge is forbidden fruit. One must never utter a word of it to the innocent, untainted client.

This misunderstanding of the audit lottery is not limited to students. There is, in fact, enough confusion about the topic that Professors Michael Lang and Jay Soled wrote a helpful article in the Virginia Tax Review on it [here](#).

To be clear, there is no blanket prohibition on telling clients about audit rates and general likelihoods of audit. Consider the absurdity and inability to effectively counsel or communicate,

while meeting the requirements of the MPRC (specifically [MRPC 1.4](#)) if such a blanket prohibition did apply. As an example:

I frequently have clients where the problem is that their ex claimed a child of theirs. The client is the custodial parent and has the right to claim their child under [IRC § 152](#). However, the ex was first in the race to the e-file button. Because of this, any subsequent attempt to claim the child (generally through a paper return) will very likely trigger an exam. I know this both from experience as a tax practitioner and because of my familiarity with “whipsaw” and “correlative US Taxpayer” procedures. See [IRM 4.10.13.5](#).

Am I not allowed to tell my client that if they do file a paper return claiming the child they are at a high risk of audit?

Believe it or not, audit exposure is something that matters to clients even when they are 100% substantively right on the return position. Some of my clients simply would rather not deal with the IRS or, importantly, the ire of their ex. Similarly, I know of few people that claim a smaller charitable deduction than they actually are entitled to solely because of their (inflated, inaccurate) fear of audit. It is wholly within these taxpayers’ right to make that determination, since they are not legally *required* to claim the child or the charitable contribution, but only have the right to do so. For a discussion on that point, see the law review article, [“No Thanks, Uncle Sam, You Can Keep Your Tax Break.”](#)

So in advising the client with a previously claimed child, what must I do? As a lawyer and as a counselor, I would go so far as to say under the Model Rules I *must* disclose the risk of audit to the client in that situation, rather than keep it stored away as secret knowledge. To me, a lawyer in that situation should advise the client that on the information they have: the client is entitled to claim their child if they wish, but they are at a heightened risk if they do so. The lawyer should then calm the client down and explain what an audit would actually look like in these circumstances (a few letters back and forth), so that they can make an *informed decision* about what they’d like to do. To me, getting the client to a more-fully informed decision considering the myriad legal and non-legal issues at hand is the bedrock of being a counselor. See [MRPC 2.1](#).

All of this is to say that one does not “play” the audit lottery simply by speaking of or considering audit likelihood. The prohibition is on advising individuals to take a return position based on the likelihood that it might be “caught” in audit. You play a lottery hoping you win, not simply for the fun of playing. Winning, in the prohibited sense, is having a questionable (or crazy) return position pass by the IRS because of their low audit rates rather than the merits. And you cannot let your knowledge of the odds of success (in this case, the perversely high chance of winning the lottery) color your responsibilities towards the IRS. See, e.g. [Circ. 230 § 10.22](#), 10.34 and 10.37.

Now, rant completed, let’s bring this back to advising someone as to whether they should respond to an IRS letter *after* an audit has been initiated. In this case you are not counseling them on prospectively taking a return position at all. If they’ve made that same mistake year-over-year, the position has already been taken before they even came to you. What you are doing is simply letting them know that failing to respond to an IRS audit might make future audits more

likely. If that is true (and there is reason to believe it is), it is unclear to me how keeping that important information to yourself doesn't run afoul of your many responsibilities to the client under the MPRC (loyalty and communication, foremost among them).

I want to close with a note to those feeling squeamish about the preceding paragraphs: I feel your pain. If someone has previously taken an incorrect tax position I counsel them to change it. I want them, genuinely, to change it, because I believe we all have an obligation to pay the correct amount of tax. However, I cannot tell them that they *must* change it, because that would be my imposing my own personal morality on a legal question that has different considerations. (Note that this all changes if and when there is an actual controversy for that tax year before the IRS.)

But there is more to this than just hand wringing and pleading that someone do the right thing while acknowledging they don't technically have to. Once the taxpayer *knows* (through the counseling of their tax attorney) their position is untenable they cannot freely take that position in as-yet unfiled tax years. Now, your advice changes: "Look, you *should* fix the back years, but you don't technically have to. However, now that you *know* those positions are wrong, you cannot take them moving forwards and if you do there could be criminal exposure."

Thus, the tax attorney sleeps at night.

About Caleb Smith

Caleb Smith is Visiting Associate Clinical Professor and the Director of the Ronald M. Mankoff Tax Clinic at the University of Minnesota Law School. Caleb has worked at Low-Income Taxpayer Clinics on both coasts and the Midwest, most recently completing a fellowship at Harvard Law School's Federal Tax Clinic. Prior to law school Caleb was the Tax Program Manager at Minnesota's largest Volunteer Income Tax Assistance organization, where he continues to remain engaged as an instructor and volunteer today.

About the Blog

Procedurally Taxing considers developments in issues relating to tax procedure and tax administration. We describe and give context to developments that are of interest to practitioners and academics. In addition, we act as a filter for readers, who in today's world, often receive more information than any one person can manage or digest. For those interested in the world of tax procedure, our blog is one way to stay current, educated and informed, and to think about issues in a new way.

Les Book, Keith Fogg and Stephen Olsen

20.1.1.3.3.4.3 (11-21-2017)

Advice From a Tax Advisor

1. Reliance on the advice of a tax advisor generally relates to the reasonable cause exception in IRC 6664(c) for the accuracy-related penalty under IRC 6662. See IRM 20.1.5.7.4, Reliance on Advice, and Treas. Reg. 1.6664-4(c).
2. However, in very limited instances, reliance on the advice of a tax advisor may provide relief from other penalties when the tax advisor provides advice on a substantive tax issue.

Example:

The employer researched all available IRS publications on the subject of contract labor, provided clear and convincing documentation as to the duties of the workers to the tax advisor, and requested an opinion from the tax advisor as to whether the workers were "contract labor" or "employees." As a result, the tax advisor advised the employer that the workers were "contract labor." However, the IRS later determined that the workers were "employees" and not "contract labor."

3. Penalty relief based on reliance on the advice of a tax advisor is limited to issues generally considered technical or complicated. **The taxpayer's responsibility to file, pay, or deposit taxes generally cannot be excused by reliance on the advice of a tax advisor.**
4. Because the IRC and treasury regulations sections that provide penalty relief criteria for erroneous advice from a tax advisor are generally limited to the accuracy-related penalty, relief from other penalties must meet the reasonable cause standards. See *IRM 20.1.1.3.2*, Reasonable Cause.

20.1.5.7.4 (08-31-2021)

Reliance on Advice

1. Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable. For example, the taxpayer must supply the advisor with all the necessary information to assess the tax matter. Similarly, if the advisor suffers from a conflict of interest or lack of expertise that the taxpayer knew or should have known about, the taxpayer might not have acted reasonably in relying on that advisor. The advice also must be based on all pertinent facts, circumstances, and the law as it relates to those facts and circumstances.
2. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on

the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based on a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Similarly, the advice must not be based on an assumption that the transaction has a business purpose other than tax avoidance.

3. "Advice" is defined as any communication, including the opinion of a professional tax advisor, setting forth an analysis or conclusion by a person other than the taxpayer and on which the taxpayer relied in preparing the return. Advice does not have to be in any particular form.
4. Whether a taxpayer reasonably relied on an opinion or advice cannot be determined without reviewing the opinion(s). At times, a taxpayer may refuse to turn over an opinion the taxpayer claims to have relied on or the taxpayer may assert a privilege claim. If the taxpayer refuses to provide the opinion, disallow the taxpayer's position as not being verifiable.
5. Whenever the penalty is not asserted because the taxpayer has met the "advice" standard under the reasonable cause exception, contact the professional tax advisor to confirm that the advice was provided and that the standard under the reasonable cause exception is available. This is **mandatory** before the case is closed from the group. This contact is authorized by IRC 6103(k)(6), Disclosure by Certain Officers and Employees for Investigative Purposes. The examiner should be mindful that a preparer of the return may not be the professional tax advisor or person who prepared or provided the advice. Contact with both may be necessary.

Note:

See IRM 11.3.21.3, Requirements for Investigative Disclosures, for additional guidance and cautions when requesting information from others.

6. Whenever a return preparer's conduct becomes an issue, the examiner should consider the applicability of the return preparer penalties under IRC 6694, Understatement of Taxpayer's Liability by Tax Return Preparer, and IRC 6695, Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons, and contact the preparer, if necessary. See IRM 20.1.6, Preparer, Promoter, Material Advisor Penalties.
7. Examiners should be mindful of the third party contact requirements discussed in IRM 25.27, Third Party Contacts.

Kovel agreement basics for you and your client

By Karen Nakamura, CPA

July 1, 2022

Consider this scenario. You're introduced to a potential client. While you are speaking with the prospect, the individual mentions that he has certain financial accounts held in foreign financial institutions and that he recently heard about the Report of Foreign Bank and Financial Accounts filing requirements. He's concerned that he may have an outstanding filing obligation and has received an IRS notice about the IRS's streamlined filing compliance procedures (SFCP). Because he's never worked with a tax adviser and is unsure what the SFCP entails, he would like your help. What's your next thought? It should be, "Stop. Our conversation is not privileged. You should engage counsel."

Occasionally, clients may need more than a CPA can offer. For example, taxpayers required to comply with complex IRS programs, such as the SFCP, or who want to protect themselves from disclosure of communications and documentation addressing certain tax positions, may be better served by engaging counsel to provide legal advice at the outset. Similarly, taxpayers facing potential litigation due to significant underreported income or other fraud indicators may need legal representation. Nevertheless, while counsel is qualified to provide legal advice and/or litigation services, they may not have enough of an understanding of complex accounting or tax rules to successfully service the client. Enter the *Kovel* agreement.

WHY USE KOVEL AGREEMENTS?

A *Kovel* agreement is an arrangement whereby a client engages counsel to provide legal services, and counsel, in turn, engages specialists, such as CPAs, to support its services to the client. The CPA interprets technical accounting, financial, and tax concepts into more easily understandable language for the client and counsel. When a *Kovel* agreement is properly drafted and executed, protections that are typically limited to the client's interactions with counsel — namely, attorney-client privilege and attorney work product privilege — are extended to specialists engaged by counsel on the client's behalf. The result? A wider scope of communications and documents receive protection from disclosure to third parties.

RELEVANT PRIVILEGES EXPLAINED

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Attorney-client privilege is a legal concept that protects confidential communications between attorneys and clients that are made for the purpose of obtaining or giving legal advice. The privilege, which is owned by the client, allows a client to refuse to disclose and prevent others from disclosing confidential communications (see *Black's Law Dictionary* (11th ed. 2019)). It is intended to encourage full and candid communications between attorneys and their clients without the fear that such communications will be disclosed to a third party. The privilege does not apply to communications made in the commission or furtherance of criminal activities, such as fraud or tax evasion.

The attorney work product privilege permits attorneys to withhold from production "documents and other tangible things" that contain the attorney's impressions and insights and that were prepared by counsel "in anticipation of litigation or for trial" (Fed. R. Civ. P. 26(b)(3)). It also can extend to materials prepared by other parties, such as CPAs, engaged by counsel on a client's behalf.

SEC. 7525 MAY NOT PROVIDE SUFFICIENT PROTECTION

While tax practitioner-client privilege under Internal Revenue Code Sec. 7525 is similar to attorney-client privilege in providing protections for communications between a taxpayer and a tax practitioner, this privilege has significant shortcomings. For example, it applies solely to tax advice and not to tax compliance or business advice. It is also limited to noncriminal matters before the IRS or in federal courts in matters involving the IRS and does not apply to private civil actions, tax shelters, state and local tax advice, or matters before the SEC. In addition, it only applies to communications between the practitioner and the taxpayer. Finally, the privilege is not available upon the commencement of a criminal investigation or prosecution. Accordingly, no party should place significant reliance on this privilege.

KOVEL AGREEMENTS: WHAT TO KNOW

Similar to a CPA firm's engagement letter with its client, a *Kovel* agreement between counsel and the CPA governs the services between the parties. Counsel takes the lead in drafting the agreement. Before signing the agreement, the CPA should review the document with their own counsel and consider the following:

- The scope of services in a *Kovel* agreement generally states that counsel is engaging the CPA to assist in providing legal services to the counsel's client and will often specify the client and the matter at issue.

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- A *Kovel* agreement should state that it is counsel's responsibility to direct the CPA's services, and the CPA takes instruction from counsel for all aspects of the engagement.
 - A *Kovel* agreement typically states that the workpapers created by the CPA firm belong to the attorney in order to maintain privilege. However, the CPA firm should be able to retain its own copies.
 - As the CPA is working solely at the direction and supervision of counsel, counsel should be primarily responsible for liability and/or indemnity claims made by the client or third parties if the matter is not resolved to the client's satisfaction.
 - A *Kovel* agreement should identify the party responsible for the payment of the CPA's fees, which, in most cases, is the client.
 - A *Kovel* agreement may be signed by the client, in addition to counsel and the CPA, especially if the client is responsible for payment of the CPA's fees.

IMPORTANT CONSIDERATIONS WHEN WORKING WITH COUNSEL UNDER A KOVEL AGREEMENT

CPAs engaged pursuant to a *Kovel* agreement should receive instructions from counsel on how to conduct the engagement, including instructions related to the CPA firm's use of subcontractors. The instructions should include guidance on how to protect available privileges as well as caveats regarding the types of actions that may waive privileges.

Counsel should instruct the CPA how to address communications to counsel and/or the client and what type of banner to include on emails and documents prepared at counsel's direction, such as "Confidential/Prepared at the direction of Counsel."

To mitigate the risk of inadvertent disclosure, access to the CPA's engagement files should be limited solely to those individuals who are members of the engagement team.

POTENTIAL PITFALLS

A client may be uncomfortable engaging counsel to provide legal services and pressure counsel to include the client's current CPA on the engagement team. However, including the current CPA might not be the best idea. Prior knowledge of an issue is not protected by the *Kovel* agreement and may cause the CPA to inadvertently waive one or more privileges. Generally speaking,

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communications between the CPA and the client are not protected. Prior communications may come back to haunt the client and the CPA if a tax authority investigates the client and compels the CPA to produce documents or provide testimony.

CPAs should exercise caution to protect the privileges noted above. A CPA's failure to abide by the privilege requirements, such as the intentional or inadvertent communication or sharing of documents with any third party, can result in a waiver of privilege for all communications and documents, a situation that may damage the client's case.

Absent counsel's specific approval, none of the communications or documents prepared pursuant to the *Kovel* agreement should be repurposed for any engagement, such as in the preparation of tax returns. Otherwise, a tax authority may assert that the communications and/or documents created by the CPA at counsel's direction served a purpose other than furtherance of counsel's legal services.

Did you know?

Kovel agreements take their name from a 1961 appellate court decision, *Kovel*, 296 F.2d 918 (2d Cir. 1961).

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Gather client experience data through effective interviews

By Christine Nelson, Ingenuity Marketing Group, LLC

Ask enough people about their expectations, and you can identify some universal themes about why they choose you. However, surveys can only do so much.

Your client experience strategy should include interviews. Shoot for 15 to 20 clients, or contact several clients in each practice area. Ask more clients than you expect will agree to interviews. Not everyone will have time.

With an interview, you can ask deeper questions based on each person's individual preferences and concerns. Here are some interviewing techniques that can help you get beyond general satisfaction ratings.

Ask a question and be quiet

Wait patiently for the person to elaborate. Silence will feel uncomfortable, but don't rush to fill it. Give the other person time to think, and their answers will be more detailed. If they become quiet, ask if there is anything else that comes to mind and be quiet again.

Ask for examples

You may have some prepared questions to ask about client experiences, the level of quality you deliver or how people feel about your team. The best interview transcripts also include real examples of how great service showed up.

If someone says that the programs or services you deliver are "high quality" or "informative," ask them for an example. Specific examples will help you identify actual results while defining what "quality" and "informative" actually mean.

Repeat what you heard

Show that you are listening. Paraphrase what you heard the person say to get them to reinforce or clarify with additional details. *"What I'm hearing is ... is that right?"*

Make it a conversation

People can get nervous and short with their answers if you keep asking questions and don't participate in the conversation. You are creating an experience during the interview, and it's a great technique to share a story of your own that relates to what the person just said.

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A conversation puts your clients at ease and they are more likely to open up and be honest about their experiences. When they are honest, tell them how much you appreciate it — whether the feedback is good or bad. It is all constructive feedback to help you improve your service delivery.

Tell them what's next.

Make sure to tell people what you will do with their responses. They want to know that they are helping you and that their input will result in something good.

If you are collecting testimonials as part of the interview, let them know that you will follow up soon to have them review some comments. Tell them that their feedback will be analyzed for improving service delivery. Let them participate in the future success of your team.

As a final tip, interviews can seem like an intrusion, but an email script can help you invite people to participate at a time that is convenient to them. Let them know how long the interview will be and offer to send questions ahead of time. More clients will say yes to interviews, and you will collect more good data to support your experience strategy and service standards.

Unresponsive clients pose a professional liability risk

By Deborah K. Rood, CPA

February 1, 2022

A CPA's job would be so much easier if clients would just respond in a timely manner. In addition to creating unnecessary stress for CPAs, clients who fail to respond timely increase a CPA firm's professional liability risk. Let's walk through some of the ways CPAs have addressed unresponsive clients, the risks associated with those actions, and what may be a better path.

The client is too busy to respond to questions in a timely manner

In an effort to complete the tax return in a timely and cost-effective manner, the CPA makes decisions related to positions taken on the return without the client's involvement or authorization.

The risk: The CPA's decision may not be the best option for the client in light of all information. For example, a CPA prepared a newly married couple's tax return using the married-filing-jointly tax status. Several years later, the wife's application for student loan forgiveness was denied because her tax returns reported too much income. A claim was made against the CPA for the unforgiven loans because, if the wife had filed a separate return using married-filing-separately status and only her income had been reported on her return, the loans would have been forgiven.

While damages were not astronomical in this case, they may be significant when the CPA makes decisions about elections or the tax treatment of significant items.

A better response: First, be alert for situations where a significant decision requiring the client's input may need to be made. Many CPAs make these decisions without realizing their potential adverse impact. Ask how the decision contemplated could be detrimental to the client.

Once the situation is identified, include the client in the decision-making process. Explain the options to the client, including the benefits and risks of each option. Document the client's decision in writing, including their rationale, if known. If applicable, an email confirming a discussion would suffice. Clients' memories are short, and, if questions arise later, contemporaneous documentation serves as evidence of the client's decision.

Client documentation is received piecemeal and/or close to the filing deadline

To help avoid inefficiency, CPAs may wait until all of the client's information is received before starting to prepare and/or review the tax return.

The risk: There may be insufficient time to thoroughly review the tax return prior to filing, leading to an unidentified error. In other situations, additional information needed from the client is identified but may not be available before the due date of the tax return.

A better response: Proactively work with clients, especially those known to be perennial procrastinators, to receive information well before due dates. Include the date information must be received by the CPA from the client in the engagement letter. Consider using software that automatically sends text messages or emails to remind clients about missing information. Some clients may be incentivized to be more timely if they are presented with an early bird discount on fees.

When information is received, review it as soon as possible to identify missing information, and communicate this to the client in writing. Include a date when the additional information is needed. Follow up in writing if the information is not timely received.

Despite the CPA's best efforts, it is likely some clients will be unable to provide all information in a timely manner. For instance, a hedge fund's Schedule K-1 may not be received until close to the deadline. To reduce the risk of an error on the tax return in this circumstance, prepare and review the return after most information is received. The partially prepared tax return can be reviewed before the stress and exhaustion of an approaching deadline is at its zenith and mistakes are more likely. When the final information is received, the CPA can focus on the new information rather than the entire return.

The client's books are messy, and the client lacks the time, inclination, or skills to 'clean them up'

The CPA reconciles bank accounts and performs other bookkeeping services without the client's authorization.

The risk: In addition to risking uncollectible fees for additional services not approved by the client, CPAs may face claims of failing to detect a theft or fraud at the client organization. Why? If a theft or fraud later is detected at the client's business, the client may assert that the CPA, when reviewing the client's bank statements, should have spotted unusual transactions or pointed out

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other red flags to the client. The CPA's actions related to the bank statements, especially when combined with the lack of an engagement letter describing the limitations of the services, can be detrimental in defense of a subsequent claim.

A better response: Obtain a detailed engagement letter specifically identifying the scope of the services to be provided and the limitations of such services. Specifically state in the engagement letter that the CPA has no responsibility to detect theft or fraud and that any ancillary bookkeeping services provided are solely for the purposes of tax return preparation. Don't forget to include the firm's billing terms in the engagement letter, including that additional fees may be necessary if the client's books and records are not complete.

Despite numerous attempts by the CPA to make contact, a prior-year client has not contacted the CPA about their current-year tax return

Faced with an AWOL client but wanting to ensure the client doesn't face a late-filing penalty, some CPAs may file a zero extension for the client.

The risk: If the client has not contacted the CPA, has the CPA been engaged to prepare the current-year tax return? Arguably, the answer is "no."

By filing an extension without client authorization, the CPA may take away the taxpayer's reasonable-cause defense for penalty abatement. In one situation, the CPA extended the tax return for a perpetually unresponsive client. This proved problematic when a successor CPA requested penalty abatement for reasonable cause because the client did not understand a tax return was required. The IRS argued that the initial extension indicated that the client understood there was a filing requirement, and the Service rejected the abatement request.

Finally, the CPA may be subject to an Internal Revenue Code Sec. 7216 penalty for the unauthorized disclosure or use of taxpayer information. This penalty can be up to a \$1,000 fine or up to one year of imprisonment, or both, for each violation.

A better response: Document your attempts to contact the missing-in-action client, especially for clients with filing obligations related to foreign investments, as the penalties can be severe. If the client does not respond, do not extend the tax return. Even for current clients and clients who have historically filed an extension, do not do so until you receive the client's written permission.

FINAL THOUGHTS

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If a client is chronically unresponsive and it appears that the CPA cares more about filing a timely tax return than the client, it might be better to part ways. For tips on how to do so, read "Professional Liability Spotlight: Take a Hike: Ending Client Relationships (</issues/2017/feb/end-client-relationships.html>)," JofA, Feb. 2017. CPAs have options — they can manage their clients or let their clients manage them.

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5 tips to help you prune toxic clients

By Kristy Gusick, Align Marketing Group

When we hear “pruning,” we often think of gardening. Pruning is selectively removing branches or buds from a tree or plant. The goal is to improve the plant’s structure and direct new, healthy growth. The same is true for pruning your clients. Removing toxic clients can free you and your firm to experience the joys of healthier client and staff relationships and increased profits.

What are the signs of a toxic client? Here are four quick ways to identify if you need to prune clients.

1. Staff is burning out and/or you are experiencing high staff turnover.
2. Net profits are decreasing and/or your firm is not growing.
3. Excessive time is being spent on clients that are not profitable.
4. Firm success! Yes — believe it or not, often when a firm is successful, it leads to too many relationships, clients or direct reports, and, in the end, the work quality suffers.

What prevents pruning?

If you think you have clients that need to be pruned, you’re not alone. Dealing with difficult clients is very common, and so is holding on to the relationship for too long. Sometimes we are stuck with a toxic client for reasons that are genuinely outside of our control. But more times than we realize, we are not executing an ending because of internal factors, not external ones.

Neuroscience research shows that your mind develops something akin to hardwiring and has adapted to accept some sort of “stuck reality.” It has become normal to be stuck with bad clients and put up with a situation that awaits a necessary ending. Here are some of the most common reasons we don’t prune toxic clients.

- You have a fear of losing money.
- You’re avoiding conflict — or you’re simply afraid to have the conversation.
- You feel a huge amount of responsibility to *all* your clients.
- It feels too “mean” to fire a client.
- You’re concerned no one else will be able to or want to help your client.
- You have a false sense of hope that the client will improve or will change.
- You’re unsure how to prune a client.

Pruning pays off

While it can be unpleasant to prune a client, one key piece to remember is that pruning pays off. After you’ve pruned a toxic client, you will have more time for your current clients and the bandwidth to accept a better (and more profitable) new client to your firm. Or you will simply just be able to spend more time on your current clients. You will also experience greater enjoyment as you’re not hemorrhaging mental energy and money on bad-for-business clients.



Strategies for pruning

As with anything else when it comes to owning and running a successful practice, you have to create a solid plan. To help you build and implement a pruning practice at your firm, we recommend the following five steps to ensure your success.

1. Identify who needs to be pruned.

- The first step in determining which clients need to be pruned is to rate them. Your rating system should reflect your firm's values and goals and should rate clients both objectively and subjectively. We suggest doing this annually and using a report card system: A, B, C, D or F.

2. Have referrals available.

- If the client isn't a good fit for you and your practice, have referrals to other accounting professionals for the pruned client. It helps ease the transition to give referral sources (i.e., other CPA firms or solo accounting professionals) to your pruned clients.
- In many cases, the client isn't inherently toxic; it's simply that the individual or business wasn't a good fit for your firm, and you want to make sure they'll be well taken care of in the future. Networking with fellow MNCPA members, for instance, can help you connect with other accounting firms or professionals who might be a perfect match.

3. Prepare, practice and roleplay.

- Begin with the end in mind and create scripts based on your specific goal. We've provided specific examples below to get you started.
- Determine whether an email or letter are better than phone to communicate to the soon-to-be pruned client.
- The more you strategize about pruning the client, the more confidence you will have.
- Write out your email or script and then practice it. As you practice, pruning will become easier. You will develop confidence from the pruning experience as well. Here are some examples of pruning practices that you can use.

Example No. 1 Increasing your rates	"Joe, we are reaching out to let you know that as of Jan. 1, 2023, we are increasing our minimum annual fee to X. If this does not work for your business's budget, please let me know and I will make recommendations for another accounting professional that may be a better fit for you."
Example No. 2 Change of practice focus	"Steve, we've enjoyed helping you and Joan with your tax returns the past four years. However, our firm has decided that as of Jan. 1, 2023, we will focus our work with business clients going forward. We recommend you contact the specialists at 1040 Tax Help at 651-555-1234. Should you decide this is the route you want to go, please let us know and we will be happy to assist you with the transfer of your files."
Example No. 3 You're simply done	"Tina, recently we have noticed that there have been challenges in our working relationship. Because of these ongoing issues, we have made the decision that our firm is no longer the best fit to continue to help you with your accounting needs. As of XX dates, we conclude our engagement with you."

4. Debrief your pruning process

- Like any project, set aside time to discuss what went well and what can be improved about client pruning. Take the time to grieve or celebrate the specific pruned client. End the debrief process by visualizing how you want this process to go in the future.

5. Prune annually

- Start by making client pruning a part of your annual planning and ongoing business development review. As it becomes a component of regular business processes, you will begin to recognize it as a part of your business strategy instead of seeing it as a problem.

Final takeaways

By consistently pruning toxic clients, you can restore growth, satisfaction and profits to your firm. Through proper planning and practice, pruning can become easier and a regular part of your business processes. You have control over the clients you work with, so empower yourself to make the changes necessary, both in your mindset and business processes, for the benefit of your firm. At the end of the day, not every client is a great client. And having great clients at your firm keeps your firm profitable and your team happy. Let the pruning begin! ■



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Insurance Claims that Can Ruin Your Tax Preparation Business

Lauren Pitonyak

Tax preparers and enrolled agents have significant legal exposures. Consider some of the potential claims you might face and how professional liability insurance can help you mitigate them.

“Nothing is certain except death and taxes,” said Benjamin Franklin in 1789. But today, you can argue that there is another sure thing, which is the risk facing tax preparers when filing an incorrect return.

In truth, not every filing mistake leads to litigation. But many do. And when legal judgments ensue, tax preparers may regret not following another Franklin tip, “When in doubt, don’t.”

Tax Preparation Legal Liabilities

Today, you are dealing not only with people’s money but also their relationship with the often-feared Internal Revenue Service (IRS). When you make mistakes that cost them money, either in the form of higher tax liabilities or penalties, you will likely have unhappy clients on your hands. If the error is large enough or results in them being audited, you might find yourself a litigation target.

Making matters worse, not only are you vulnerable to civil litigation alleging professional negligence, but clients can also file claims with the IRS itself. For example, if you alter their tax returns without telling them, use an improper filing status, or misrepresent your qualifications (among many other

transgressions), clients have a statutory right to file a claim against you and your business. Depending on the nature of your error, the IRS might fine you between \$50 to \$100,000, as well as temporarily revoke your ability to file taxes on your own and as an agency (if an owner).

Fortunately, professional liability insurance can shield you against lawsuits and cover legal expenses related to an IRS proceeding. By transferring your liability risks to your insurance company, you will be able to operate your business knowing a serious lawsuit will not destroy your career or consume your personal assets. In addition, seeing if cybersecurity is part of the offering would protect your digital assets for both your company and your client’s personal information. Having these in place gives you a peace of mind and is priceless.

Legal Risks and Claims Scenarios

Creating and filing tax returns for a fee can be legally hazardous. You might miss allowable deductions or fail to sufficiently document claimed individuals on a return. Submitting wrong information or missing a key filing date can land the client in hot water, either in terms of owing higher taxes or having to pay IRS penalties. When your client is in trouble, you will likely be in danger as well.

Mounting data breaches against accounting and tax firms have significantly increased liability exposures. When hackers break into a

tax professional’s or an enrolled agent’s computer and steal valuable client information, they can use it to file IRS returns claiming phony tax refunds. Because tax preparers and enrolled agents must maintain data privacy, a cyber breach can have negative legal and IRS consequences.

The point is your legal exposure as a tax preparer or enrolled agent is broad and hard to predict. As the federal tax code becomes more complex over time (a highly likely prospect), your liabilities will rise in tandem.

What does this mean for your work as a tax preparer or enrolled agent? It means you potentially face liability for a claim. All you can do is know the tax code, adhere to tax filing best practices, and be transparent with your clients when problems arise.

To illustrate further, the following are several potential claim scenarios that might cause stress and worry for tax preparers and enrolled agents:

- The heirs of a wealthy high-tech entrepreneur were disappointed when their enrolled agent missed a filing deadline, exposing the entrepreneur’s estate to IRS penalties and interest charges. When the enrolled agent could not provide a reasonable explanation for why the filing did not occur on time, the heirs met with their attorney and decided to file a lawsuit against the agent to recover their losses.

- An enrolled agent filed a client's corporate tax return after the federal deadline. This resulted in a late filing penalty and interest. Again, the client filed a claim for the penalty and interest.
- An accountant who also prepares taxes incorrectly calculated a client's estimated tax payments. The client carefully made the estimated quarterly payments the accountant recommended but still fell short of making enough contribution against that year's tax liability. The payment gap led to a \$9,000 penalty, which the client demanded the enrolled agent pay.
- An enrolled agent neglected to include an important schedule in multiple years' tax returns. This resulted in a significant tax underpayment, sparking penalties and interest. The enrolled agent was liable for the penalties and interest.

As you can see, the claim scenarios just listed were varied. But they shared some common themes:

- The enrolled agent either made a mistake or failed to do something important.
- The error or omission cost the client money, not to mention aggravation.
- The passage of time sometimes compounded the enrolled agent's mistake.
- Clients were unhappy about the ensuing tax problem(s) and wanted financial compensation.

The point is, as a professional tax preparer or enrolled agent, you will consistently be exposed to legal risk because you are human and susceptible to making mistakes. Enrolled agents who transfer their risks to an insurance company make it easier to resolve such claims than if they were uninsured. That is because insurance companies are equipped to process claims and have the financial resources to deploy a robust legal defense on your behalf.



The Importance of Tax Preparer or Enrolled Agent Professional Liability Insurance

As a tax preparer or enrolled agent, it is essential to protect your business and personal finances against client litigation, both justified and contrived. The solution is to buy professional liability insurance designed to cover your specific job duties and issued by an insurance company you trust. Here is what you will receive when you transfer your legal risks to an insurance carrier:

- A claims adjuster and a defense attorney to manage your case and mount a strong legal defense, both at no additional charge to you.
- Hiring of an expert witness (or expert witnesses) in order to strengthen your legal case.
- Access to arbitration, mediation, or other forms of dispute resolution, which might produce a resolution sooner than with traditional litigation.
- Payment of court administration fees.
- Legal help with handling an IRS disciplinary proceeding.
- Attorney guidance with responding to subpoenas or request for documentation or testimony.
- Expense benefits relating to participation in the trial or arbitration sessions.
- Employee theft coverage.

As important as the above intrinsic benefits, the extrinsic benefits of having professional liability insurance are even more critical:

- It reduces financial doubt. Professional liability insurance replaces a considerable, unknown risk (the chance of getting sued) with a smaller, known expense (insurance premium). Most tax preparers and enrolled agents understand the benefit of this trade.
- It provides convenient access to a proven defense attorney. If a customer sues you, mounting a swift defense is important. Professional liability insurance equips you with an attorney and handles other legal logistics.
- It reduces stress. Facing a lawsuit can be an incredibly stressful and time-consuming experience. First, it raises the possibility of liability for a large settlement or judgement. Second, it can also raise questions about your professional competence, which may become public. Professional liability insurance pays for an attorney to help dismiss the claim(s) or settle outside of court.
- It fills in coverage gaps that general liability or other business insurance fails to address. Many tax preparers and enrolled agents believe their general liability insurance or business owner's policy (BOP) covers professional mistakes or negligence. In most cases, it only covers third-party injuries and property damage, not mistakes made during the rendering of tax-related professional services.

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Understanding the professional liability claims process

By Sarah Beckett Ference, CPA

May 1, 2021

Facing a professional liability claim can generate strong emotions. If a CPA discovers an error on a previously filed tax return, emotions may include guilt about having made an error, as well as anxiety about how to tell the client. If a CPA is served with a seemingly frivolous lawsuit, anger and frustration often follow. Irrespective of the situation or emotion, when a claim arises, the first call a CPA should make is to his or her professional liability insurer.

Contacting the insurer may produce feelings of worry or dread. Some may hesitate, especially if the issue appears minor. What will happen to me? Will this affect my premium or my coverage? How will this affect my reputation and my life? To help overcome these feelings of unease, we are going to pull back the curtain on the claim process and highlight what to expect if you face this unfortunate situation.

REPORTING

Professional liability policies are typically issued on a claims-made basis, meaning the policy provides coverage, subject to its terms and conditions, when a claim is made against the insured, not when the error or omission occurred. A claim often must be reported to the insurer in the same policy period in which the CPA becomes aware of the claim. Consequently, timely reporting is crucial. Policy language dictates the policyholder's specific responsibilities regarding when and how claims should be reported.

Professional liability policies can require reporting of both actual claims and potential claims. Actual claims are fairly straightforward and include service of a suit, institution of arbitration proceedings, and other demands for money or services. Potential claims are less obvious and may include acts or omissions that are reasonably expected to become the basis of a claim; for example, a tax practitioner realizes an error was made in a prior-year return, resulting in an underpayment of tax, or an auditor learns that the client's bookkeeper has been processing fictitious invoices and embezzling money from the client.

CPAs may question whether something should be reported, especially when it may appear minor or immaterial. However, claim outcomes generally do not get better with time, and what may appear trivial to the CPA may not be perceived the same by others. Do not attempt to address the matter yourself. Remember, your insurer probably has more experience handling claims and also possesses the desire and resources to help keep a potential claim from evolving into an actual one.

BUILDING THE DEFENSE TEAM

Resolution of a claim can take anywhere from a few months for a straightforward matter to several years. At CNA, the average accountant's matter can take 18 months to resolve and close. Thankfully, there are guideposts to help support and steer CPAs through this stressful time. The reported matter will first be assigned to a claim professional with experience handling accountants' professional liability claims; he or she may even have prior experience in law or other professions relevant to the matter. Similar to a CPA firm, many claim professionals work in teams, enlisting others with specific expertise depending on the circumstance presented. For example, complex claims such as class action lawsuits, those made by celebrity plaintiffs, or those that assert damages well in excess of the policy limit may be assigned to claim professionals with specific skill sets necessary to address the intricate and complex nuances of the matter.

The claim professional may assign defense counsel. Before counsel is assigned to defend a claim, he or she is extensively vetted. Criteria evaluated typically include the attorney's experience and track record handling accountants' professional liability matters, trial experience, licensing in and knowledge of the applicable jurisdiction, and written and oral communication skills. A CPA may be apprehensive to trust an attorney with whom he or she has had no prior dealings. Perhaps the CPA would prefer to use his or her own counsel or a friend or a neighbor who is an attorney. However, attorneys, similar to CPAs, develop specific expertise, and not every attorney has the requisite professional skills to defend accountants' professional liability matters.

DEVELOPMENT OF RESOLUTION PLAN

One of the first documents requested by the defense team will be the CPA's engagement letter. This helps the defense team understand the specific scope of services and what was mutually agreed to between the client and the CPA. The engagement letter also identifies the professional standards applicable to the service and, thus, defines the appropriate standard of care. An expert may be assigned to help the defense team assess the strength of the case and evaluate the CPA's adherence to the applicable standard of care. The expert will review engagement workpapers, documentation, and communications. Members of the engagement team may also be interviewed to gather additional insights.

The complexity and venue of the matter and the litigiousness of the plaintiff are just some of the considerations that influence the resolution plan. If the engagement letter does not already address it, mediation may be suggested as a more expeditious path toward resolution. Mediation represents a facilitated negotiating process in which the parties to a dispute meet with a neutral third party whose sole function is to work with the parties to create an acceptable outcome. When successful, mediation is generally quicker and less costly than litigation or even arbitration.

WHAT SHOULD CPAs EXPECT?

Professional liability insurers, defense counsel, and experts understand that a claim can be unsettling and disruptive and can support CPAs and help them get through what may be viewed as a nerve-wracking process.

CPAs should expect regular and clear communication with their defense team. They also should expect that their input will be heard and appreciated. Professional liability insurers should seek the CPA's written consent before settling any claim. If you are unhappy with the service received, there should be an avenue to provide your feedback.

WHAT CAN CPAs DO TO HELP?

Take advantage of resources provided by the insurer

Many professional liability insurers offer risk control resources to help a firm manage its risk. Resources may include sample engagement letters, articles with risk management tips, training and educational resources, and experienced professionals to provide direct, consultative advice to CPAs. Use of these resources may help prevent a claim or, at a minimum, help defend the claim should one arise.

Report early and often

Professional liability insurers want to know and help if there is a problem on the horizon. Early reporting is advantageous for both the CPA and the insurer, and consultation and communication with your insurer are strongly encouraged. When in doubt, report the matter and seek assistance from your insurer.

Understand and utilize policy benefits beyond claim defense

Not all claims start as a claim. Some may arise following a subpoena, deposition, or regulatory inquiry of the CPA. For this reason, many professional liability policies offer supplemental benefits to assist CPAs when responding to these items, and such benefits may be at no cost to the CPA.

According to most defense experts, few engagements are perfect and any set of workpapers has room for improvement. The defense team will provide an objective view of the strength of your defense based upon their experience and their view of how a judge or jury might perceive the matter. Equipped with this information and supported by an experienced defense team, you can then select the best path forward.

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Continental Casualty Company, one of the CNA insurance companies, is the underwriter of the AICPA Professional Liability Insurance Program. Aon Insurance Services, the National Program Administrator for the AICPA Professional Liability Program, is available at 800-221-3023 or visit [cpai.com](https://www.cpai.com) (<https://www.cpai.com>).

This article provides information, rather than advice or opinion. It is accurate to the best of the author's knowledge as of the article date. This article should not be viewed as a substitute for recommendations of a retained professional. Such consultation is recommended in applying this material in any particular factual situations.

Examples are for illustrative purposes only and not intended to establish any standards of care, serve as legal advice, or acknowledge any given factual situation is covered under any CNA insurance policy. The relevant insurance policy provides actual terms, coverages, amounts, conditions, and exclusions for an insured. All products and services may not be available in all states and may be subject to change without notice.

[_ \(https://future.aicpa.org/home\)](https://future.aicpa.org/home)

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SECTION 807. DELEGATION BY TRUSTEE.

(a) A trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

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(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with subsection (a) is not liable to the beneficiaries or to the trust for an action of the agent to whom the function was delegated.

(d) By accepting a delegation of powers or duties from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Comment

This section permits trustees to delegate various aspects of trust administration to agents, subject to the standards of the section. The language is derived from Section 9 of the Uniform Prudent Investor Act. See also John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 Mo. L. Rev. 105 (1994) (discussing prior law).

This section encourages and protects the trustee in making delegations appropriate to the facts and circumstances of the particular trust. Whether a particular function is delegable is based on whether it is a function that a prudent trustee might delegate under similar circumstances. For example, delegating some administrative and reporting duties might be prudent for a family trustee but unnecessary for a corporate trustee.

This section applies only to delegation to agents, not to delegation to a cotrustee.

For the provision regulating delegation to a cotrustee, see Section 703(e).

SECTION 810. RECORDKEEPING AND IDENTIFICATION OF TRUST PROPERTY.

(a) A trustee shall keep adequate records of the administration of the trust.

(b) A trustee shall keep trust property separate from the trustee's own property. (c) Except as otherwise provided in subsection (d), a trustee shall cause the trust property to be designated so that the interest of the trust, to the extent feasible, appears in records maintained by a party other than a trustee or beneficiary.

(d) If the trustee maintains records clearly indicating the respective interests, a trustee may invest as a whole the property of two or more separate trusts.

Comment

The duty to keep adequate records stated in subsection (a) is implicit in the duty to act with prudence (Section 804) and the duty to report to beneficiaries (Section 813). For an application, see *Green v. Lombard*, 343 A. 2d 905, 911 (Md. Ct. Spec. App. 1975). See also Restatement (Second) of Trusts Sections 172, 174 (1959).

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The duty to earmark trust assets and the duty of a trustee not to mingle the assets of the trust with the trustee's own are closely related. Subsection (b), which addresses the duty not to mingle, is derived from Section 179 of the Restatement (Second) of Trusts (1959). Subsection (c) makes the requirement that assets be earmarked more precise than that articulated in Restatement (Second) Section 179 by requiring that the interest of the trust must appear in the records of a third party, such as a bank, brokerage firm, or transfer agent. Because of the serious risk of mistake or misappropriation even if disclosure is made to the beneficiaries, showing the interest of the trust solely in the trustee's own internal records is insufficient. Section 816(7)(B), which allows a trustee to hold securities in nominee form, is not inconsistent with this requirement. While securities held in nominee form are not specifically registered in the name of the trustee, they are properly earmarked because the trustee's holdings are indicated in the records maintained by an independent party, such as in an account at a brokerage firm.

Earmarking is not practical for all types of assets. With respect to assets not subject to registration, such as tangible personal property and bearer bonds, arranging for the trust's ownership interest to be reflected on the records of a third-party custodian would not be feasible. For this reason, subsection (c) waives separate recordkeeping for these types of assets. Under subsection (b), however, the duty of the trustee not to mingle these or any other trust assets with the trustee's own remains absolute.

Subsection (d), following the lead of a number of state statutes, allows a trustee to use the property of two or more trusts to make joint investments, even though under traditional principles a joint investment would violate the duty to earmark. A joint investment frequently is more economical than attempting to invest the funds of each trust separately. Also, the risk of misappropriation or mistake is less when the trust property is invested jointly with the property of another trust than when pooled with the property of the trustee or other person.

**Request for Prompt Assessment Under
Internal Revenue Code Section 6501(d)**

See instructions on back.
Go to www.irs.gov/Form4810 for the latest information.

OMB No. 1545-0430

For IRS Use Only

Requester's name

Title

Kind of tax

- ☐ Income
☐ Gift
☐ Employment
☐ Excise

Number, street, and room or suite no. (If a P.O. box, see instructions.)

City, town, or post office, state, and ZIP code

Daytime phone number

Tax Returns for Which Prompt Assessment of Any Additional Tax Is Requested

Form Number	Tax Period Ended	SSN/EIN on Return	Name and Address Shown on Return	Service Center Where Filed	Date Filed

If applicable, provide the name of decedent's spouse (surviving or deceased).

Spouse's social security number

If corporate income tax returns are included, check the applicable box below:

- ☐ Dissolution has been completed.
☐ Dissolution has begun and will be completed either before or after the 18-month period of limitation.
☐ Dissolution has not begun but will begin before the 18-month period of limitation expires and will be completed either before or after that period expires.

Attached are copies of:

- ☐ The returns listed above.
☐ Letters of administration or letters testamentary.
☐ Other (describe): _____

I request a prompt assessment of any additional tax for the kind of tax and periods shown above, as provided by Internal Revenue Code section 6501(d).

**Sign
Here**

Under penalties of perjury, I declare that I have examined this request, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

☐ I certify that I have never been assessed any penalties for civil fraud for any federal or state tax matter nor have I been charged with, indicted for, or convicted of fraud. If you cannot certify this statement, attach a detailed statement explaining the circumstances under which you were assessed a penalty, charged with, indicted for, or convicted of fraud.

Signature of requester

Date

Identifying number

**Request for Discharge From Personal Liability Under
Internal Revenue Code Section 2204 or 6905**

OMB No. 1545-0432
For IRS Use Only

► See instructions on back.

Decedent's name		Date of death	Social security number
Requester's name			Kind of Tax <input type="checkbox"/> Income <input type="checkbox"/> Gift <input type="checkbox"/> Estate
Title			
Number, street, and room or suite no. (If a P.O. box, see instructions.)			
City, town, or post office, state, and ZIP code			Daytime phone number

Tax Returns for Which Discharge From Personal Liability is Requested

Form Number	Tax Period Ended	SSN/EIN on Return	Name and Address Shown on Return	Service Center Where Filed	Date Filed

If applicable, provide the name of the decedent's spouse (surviving or deceased)	Spouse's social security number
--	---------------------------------

I have attached the items checked to help expedite action on my request.

- ☐ Copies of returns listed above.
☐ Copies of letters of administration or letters testamentary.
☐ Other (describe):

I request a discharge from personal liability for any deficiency for the kind of tax and periods shown above, as provided by section 2204 or 6905 of the Internal Revenue Code.

**Sign
Here**

Under penalties of perjury, I declare that I have examined this request, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

- ☐ I certify that I have never been assessed any penalties for civil fraud for any federal or state tax matter nor have I been charged with, indicted for, or convicted of fraud. If you cannot certify this statement, attach a detailed statement explaining the circumstances under which you were assessed a penalty, charged with, indicted for, or convicted of fraud.

► Signature of requester	Date	► Identifying number
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U MN Ethics 2022 by Ruth Ann Michnay, CPA, MBT, EA, USTCP

Discussion A

Takeaway:

Discussion B-1

Discussion B-2

Takeaway:

FAX: 651-209-9697 Ruth Ann Michnay PA

U MN Ethics 2022 by Ruth Ann Michnay, CPA, MBT, EA, USTCP

Discussion C

Takeaway:

Discussion D

Takeaway:

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