

## **BEWARE OF UNSCRUPULOUS TAX PREPARERS!**

By Adam R. Crawford, Clinician, Spring 2006

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### **TAX PREPARERS**

Many taxpayers have their tax returns prepared by people they believe are professional tax return preparers. A tax return preparer is any person who prepares, for compensation, all or a substantial portion of a federal tax return or claim for refund.<sup>1</sup> Many tax return preparers are not required by law to have any sort of training. Many paid preparers are subject to no regulation by the IRS or by the state in which they practice. Attorneys, certified public accountants (CPA's), enrolled actuaries, and enrolled agents are subject to oversight through rules administered by the IRS. Attorneys and CPA's must pass licensing examinations to practice their professions. Enrolled agents who do not have prior experience working for the IRS must pass a written examination that tests their knowledge of tax law and procedure. Attorneys, enrolled agents, and CPA's are subject to continuing professional education requirements and ethical obligations. By contrast, income tax return preparers who are not attorneys, enrolled agents, or CPA's are subject only to the Internal Revenue Code's (IRC's) preparer penalties under IRC sections 6694 and 6695. Tax return preparers who lie about their education and qualifications are potentially subject to civil liability.<sup>2</sup> Tax return preparers occasionally make mistakes, leaving the taxpayer with a deficiency in taxes due. Taxpayers are legally responsible for the content on their own tax returns. Deficiencies also create penalties and interest that the taxpayer is responsible for paying.

The duty that a taxpayer has to file accurate returns cannot be avoided by shifting the responsibility to a tax return preparer. Penalties are exacted when the taxpayer has failed to comply with applicable tax laws in filing his or her income tax return.

The IRC provides for various penalties based on a taxpayer's failure to comply with the specific requirements of the Code, *e.g.* for failure to file certain returns or statements.<sup>3</sup> The Code also provides for penalties if a taxpayer gives a fraudulent statement.<sup>4</sup>

A penalty will not be imposed for tax related mistakes if the taxpayer can show that the mistake is due to reasonable cause, and not to willful neglect.<sup>5</sup> However, in the case of any interest or dividend return or statement, a penalty will not be imposed if the taxpayer can show that he exercised due diligence in attempting to meet the Code's requirements.<sup>6</sup>

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<sup>1</sup> I.R.C. § 7701(a)(36) (2005).

<sup>2</sup> I.R.C. § 7407 (1989).

<sup>3</sup> I.R.C. § 6651 (1999).

<sup>4</sup> I.R.C. § 6663 (1989).

<sup>5</sup> I.R.C. § 6724(a) (2005).

<sup>6</sup> *Id.*

In limited situations, a taxpayer may be able to reduce or avoid penalties caused by a tax return preparer's mistake. To avoid liability for a tax preparer's mistake, a taxpayer must establish all of the following:

- That he provided the return preparer with complete and accurate information from which the tax return could be properly prepared;
- That the incorrect return was the result of the preparer's mistakes;
- That the taxpayer in good faith relied on the advice of a competent return preparer; and
- That he read and reviewed the return and made sure that all income items were included.<sup>7</sup>

The preparer is potentially subject to a penalty if any part of an understatement of what the taxpayer owes is due to negligent or intentional disregard of rules or regulations by the preparer or if the understatement is due to the preparer's attempt to willfully understate the liability. An income tax return preparer can be fined \$250 per return for any understatement of liability if the income tax return preparer should have known the position was unjustified and did not disclose it to the taxpayer. An income tax preparer is subject to a \$1,000 fine per return for willful or reckless disregard of rules that results in an understatement of liability.<sup>8</sup> Penalties imposed upon tax return preparers are \$50 per return for not furnishing a copy of the tax return to the taxpayer, not signing the tax return, or not furnishing an identifying number.<sup>9</sup> A taxpayer who has been assessed penalties because a paid income tax preparer has made errors in the taxpayer's return might be able to bring an action against the tax return preparer to recover for such losses. However, if the tax return preparer can show that the portion of underpayment of taxes was reasonable and not the result of an intentional act, he may be relieved of liability for the assessed penalties.<sup>10</sup>

Some tax return preparers will correct their mistakes at no charge, even if that means preparing and filing an amended tax return. Correcting a mistake may result in the client owing additional taxes. When you are looking for a tax return preparer, be sure to check the policies that a prospective tax return preparer has for mistakes it makes, and be sure to keep copies of all of your documentation.

Some tax return preparers have little or no training in tax law and set up operations during tax return filing season to profit from tax return preparation. These tax return preparers are often unreliable and may be difficult to track down if the IRS contests the tax return.

Used car dealers who fill out or review information on income tax returns for their customers have been found to be income tax return preparers in situations in which the

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<sup>7</sup> *Loftus v. C.I.R.*, 1992 WL 95635 (T.C. 1992).

<sup>8</sup> I.R.C. § 6694 (1989).

<sup>9</sup> I.R.C. § 6695 (1997).

<sup>10</sup> I.R.C. § 6664 (1989).

car dealership completes the entire return and reviews the information, and the refund is then used as a down-payment on a car.<sup>11</sup>

Low-Income Taxpayer Clinics, such as the Michigan State University College of Law Tax Clinic, are defined under IRC section 7526 and are not considered income tax return preparers, so that the statutes pertaining to income tax return preparers do not apply.<sup>12</sup>

## **TAX ADVISOR**

Taxpayers often rely on advice from a tax professional in filling out their income tax returns. Tax advisors differ from income tax return preparers because they do not actually complete the income tax return. The tax advisor advises the taxpayer who then prepares the income tax return himself. A taxpayer may not be responsible for a mistake made on his return if he reasonably relied on the advice of a tax advisor. The taxpayer will still have to pay any tax deficiency, but may not have to pay penalties. To show reasonable reliance on a tax advisor's advice, the taxpayer must show that:

- (1) The advisor had sufficient expertise to justify the taxpayer's reliance;
- (2) The taxpayer provided necessary and accurate information to the advisor; and
- (3) The taxpayer actually relied on the tax advisor's judgment.<sup>13</sup>

An advisor with "sufficient expertise" refers to someone who is reasonably believed to have expertise in the matter at issue, such as an experienced attorney or an accountant. If the taxpayer knew or should have known that the advisor was wrong, the taxpayer's reliance is unreasonable.<sup>14</sup>

To provide necessary and accurate information to the tax advisor, the taxpayer must keep accurate records and fully disclose all relevant information to the tax advisor. The accountant must have been able to reach his decisions independently from the documentation and information he was given.<sup>15</sup>

The taxpayer has the burden of proving that he did in fact rely on the tax advisor's advice.<sup>16</sup> If a taxpayer only relied upon the advice of the tax professional about whether the position was plausible, not whether it was legal, reliance will not be established.<sup>17</sup>

Generally, situations in which penalties are waived for reliance on a tax professional's advice are complicated tax matters for which it would be burdensome to the taxpayer to fully apprise himself of the rules and regulations.

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<sup>11</sup> Rev. Rul. 86-55 (1986).

<sup>12</sup> Treas. Reg. § 301.7701-15 (2002).

<sup>13</sup> *Ellwest Stereo Theatres of Memphis, Inc. v. C.I.R.*, 1995 WL 760499 (T.C. 1995).

<sup>14</sup> *Hill v. C.I.R.*, 1974 WL 2660 (T.C. 1974).

<sup>15</sup> See *Reed-Merrill, Inc. v. C.I.R.*, 80 T.C.M. (CCH) 55, 56.

<sup>16</sup> *Ellwest Stereo*, 70 T.C.M. (CCH) 1655, 1660.

<sup>17</sup> *Skeen v. C.I.R.*, 864 F.2d 93, 96 (9th Cir. 1989).

## **TAX RETURN SOFTWARE USED FOR SELF-PREPARED RETURNS**

As is the case with tax return preparers, the taxpayer is responsible for any mistakes he makes on self-prepared returns. However, software programs generally guarantee that their calculations are 100% accurate. For example, if you use TurboTax and pay an IRS or state penalty or interest charge because of a TurboTax calculation error, TurboTax will reimburse you those charges.<sup>18</sup> This does not cover situations in which you simply plug the wrong numbers. Be sure to check the guarantee provided by whatever software program you use.

## **HELPFUL REFERENCE INFORMATION**

Tips for Choosing a Tax Preparer

(<http://www.irs.gov/individuals/article/0,,id=133088,00.html>)

Tax Preparer Fraud (<http://www.irs.gov/newsroom/article/0,,id=134094,00.html>)

## **CIRCULAR 230 DISCLOSURE**

The following is pursuant to US Department of Treasury Circular 230 which contains best practices for tax advisors:

If you are our client and the above contains an opinion on one or more Federal tax issues, that opinion was not written to be used by you and cannot be used by you to avoid penalties. If you would like a written opinion on which you can rely to avoid penalties, please contact us.

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<sup>18</sup> TurboTax - Common Questions Asked, *available at* [http://www.turbotax.com/tax\\_products/common\\_product\\_questions.html#guarantee](http://www.turbotax.com/tax_products/common_product_questions.html#guarantee).