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January 22, 2010

Monica L. Baker
Director Examinations, SBSE
Internal Revenue Service
5000 Ellin Road
Lanham, MD 20706

Re: Letter dated January 5, 2010
Prepare Accurate Individual Income Tax Returns

Dear Ms. Baker;

On January 8, 2010 I spoke at a Seminar given by the Boston Tax Institute. The topic of my part of the program was handling preparer penalties under IRC§6694. The seminar was attended by tax professionals seeking continuing education credits and specific tax education. My lecture also qualified for 2 credit hours of professional education credits on ethics.

I intended to begin my presentation by praising the IRS for its announced program to require registration, testing and continuing education for return preparers. While almost no one in attendance would be covered by the new regulations, they will affect everyone. However, before I started, I was handed a copy of your letter of January 5, 2010 and asked for my comments. I have enclosed a copy for your reference.

Your letter startled me because it did not fairly state the requirements of a return preparer under either IRC§6694 or Circular 230. Your letter states that with respect to Schedule C preparation, the preparer "must ask sufficient questions and review sufficient taxpayer records to determine that income and expenses reported are correct and complete." Tax return preparers preparing any return are simply not required to do any such thing and I am amazed that you do not know that.

The regulations under IRC§6694 plainly state that "the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer. A tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm). The tax return preparer is not required to audit, examine or review books and records, business operations, documents or other evidence to verify independently information provided by the taxpayer". Reg. §1.6694-1(e). Circular 230 states that a practitioner "may rely in good faith without verification upon information furnished by the client." Reg.§10.34(d). In both cases, the regulations admonish the preparer/practitioner not to ignore the implications of information furnished and to make reasonable inquires if the information as furnished appears to be incorrect or incomplete. These requirements are a far cry from the statements in your letter.

If the Internal Revenue Service believes that the regulations covering return preparers, as now in effect should be changed, it knows how to achieve that result. It is unfair for you to send letters and to suggest that tax professionals will be visited to provide information to them about errors the IRS is seeing. Return preparers are not required to detect errors made by taxpayers nor do they have time during January to "visit" with IRS agents particularly if those agents are spreading misinformation like that contained in the enclosed letter.

I am circulating this letter and your letter to the professionals who attended the seminars where I discussed the preparer penalties. I will circulate your reply as well. I believe that you owe the preparer community an apology for the confusion your letter may have caused.

Sincerely;

Edward DeFranceschi

**Internal Revenue Service** | **Department of the Treasury**

Date: January 5, 2010

## Prepare Accurate Individual Income Tax Returns

Dear

The Internal Revenue Service is taking a number of steps to contact paid tax return preparers to improve the accuracy and quality of filed tax returns and heighten awareness of preparer responsibilities. We are sending letters to and visiting a segment of the return preparer community to provide information on the kinds of errors we are seeing. This letter describes common errors made by taxpayers and return preparers and your general responsibilities as a return preparer.

We encourage you to review this information now to ensure you fulfill your responsibilities and avoid making these common errors. Beginning the last week of January, IRS representatives will visit many of the preparers who receive this letter to discuss their obligations as a return preparer.

**What Are Paid Return Preparers Required To Do?**
As a paid return preparer, you must take all necessary steps to file accurate Federal individual income tax returns on behalf of your clients. These steps include reviewing the applicable tax law to ensure that all income has been reported on the return, and that only credits, expenses and deductions allowed under the Internal Revenue Code are taken. We describe below common errors we are finding on Form 1040 returns (Schedule C, Schedule A, the Earned Income Tax Credit, and the First-Time Homebuyers Credit). Please review this information and ensure you are accurately applying the law to your clients' specific circumstances.

<u>Common Schedule C Errors</u>: Return preparers must ask sufficient questions and review sufficient taxpayer records to determine that income and expenses reported are correct and complete. For more information, consult IRS Publication 334, *Tax Guide for Small Business*.

- Gross receipts must be fully reported. Taxpayers should provide books and records to substantiate the fact they are conducting a business and the gross income received during the year, or you must receive sufficient information in the form of other documentation which enables you to reconstruct their income.
- Expenses claimed for the business must be ordinary and necessary for that type of business. Taxpayers should provide books and records to substantiate Schedule C expenses, or you must receive sufficient information in the form of other documentation which enables you to reconstruct their expenses.
- All expenses claimed must be paid or incurred during the taxable year and the allowable amount of the expense must be properly computed.

Common Schedule A Errors: Return preparers should ask sufficient questions to determine the taxpayer's correct itemized deductions. Taxpayers may not know the tax law and incorrectly believe they can claim deductions on Schedule A for nonqualifying expenditures. For more information, go to www.irs.gov and review Tax Topics 501 through 514.

- Unreimbursed Employee Business Expense, Form 2106. Taxpayers may only claim allowable unreimbursed expenses.
- Mileage claimed on Form 2106. Taxpayers must have documentation to support business miles claimed.
- Travel, meals, and entertainment expenses. Taxpayers must have documentation for the business purpose associated with the deduction, as well as receipts to support the expenses claimed.
- Charitable Contributions. Taxpayers must have receipts for all cash contributions and adequate documentation for all non-cash contributions. In some cases, an appraisal may be required to substantiate a large non-cash contribution.

Earned Income Tax Credit (EITC) Common Errors: Return preparers should ask sufficient questions and accurately complete appropriate worksheets or forms to ensure that the taxpayer is entitled to the credit. EITC return preparers are subject to additional due diligence requirements, including completion of certain documents, record-keeping requirements, and reasonable inquiry of taxpayers. For more information about these due diligence requirements, see the IRS's Due Diligence Continuing Professional Education module at www.eitc.irs.gov/rptoolkit/main/ddmodule/. More detailed information on EITC eligibility criteria and EITC errors can be found at www.eitc.irs.gov or in Publication 596, *Earned Income Credit*. Common EITC errors are listed below.

- Claiming a child that is not a qualifying child. Taxpayers may only claim a child that meets the age, relationship, and residency requirements.
- Married taxpayers filing with an incorrect single or head of household filing status.
- Inaccurately reporting income.
- Using incorrect Social Security Numbers or incorrect last names.

First-Time Homebuyers Credit (FTHBC) Common Errors: Return preparers must ask sufficient questions and review sufficient taxpayer records to determine eligibility for any of the three versions of this credit and the accuracy of the amount of credit claimed. For more information on eligibility for the credit, go to www.irs.gov and select Tax Topics 611 and 612 and IR-2009-108. The most common errors noted on returns claiming the credit are listed below.

- Claiming the credit prior to closing or taking occupancy of home.
- Filing an incomplete or incorrect Form 5405, *First-Time Homebuyer Credit*.
- Claiming more than 10% of the purchase price.
- Failing to meet prior home ownership rules.
- Both spouses incorrectly claiming FTHBC when filing status is married-filing separate.
- Married taxpayers incorrectly claiming FTHBC when one spouse was a prior homeowner.

**Your Responsibilities as a Paid Tax Return Preparer**

Return preparers are required to exercise due diligence in preparing tax returns. As a general rule of thumb, that means knowing the underlying substantive law affecting an item of income or deduction. Publication 470, *Limited Practice Without Enrollment*, and Treasury Department Circular 230 (if you are also a practitioner) outline your due diligence responsibilities.

- A return preparer must exercise due diligence in preparing or assisting in the preparation, approving, and filing of returns, documents, affidavits, or other papers relating to Internal Revenue Service matters.

- The return preparer must also exercise due diligence in determining (1) the correctness of oral and written representations made by the return preparer to the IRS, and (2) the correctness of representations made by the return preparer to the client with reference to any matter administered by the IRS.

**Consequences of Filing Incorrect Returns**

Return preparers are expected to be knowledgeable in tax law and to prepare accurate returns. The consequences of preparing inaccurate returns can be severe and can extend to both you and your client. These consequences may include any or all of the following:

- If your clients' returns are examined and found to be incorrect, your clients may be subject to accuracy or fraud penalties plus accrued interest on any underpayment.
- Return preparers who prepare a client return for which any part of an understatement of tax liability is due to an unreasonable position taken on the return based on the preparer's advice, can be assessed a minimum penalty of $1,000 (IRC section 6694(a)).
- Return preparers who prepare a client return for which any part of an understatement of tax liability is due to the return preparer's reckless or intentional disregard of rules or regulations by the tax preparer, can be assessed a minimum penalty of $5,000 (IRC section 6694(b)).

The assessment of return-related penalties against a return preparer may result in:

- Suspension or expulsion of the return preparer's firm from participation in IRS *e-file*;
- Injunctions barring the return preparer from preparing tax returns;
- Referral for criminal investigation; or
- Disciplinary action by the IRS Office of Professional Responsibility (if the return preparer is also a practitioner).

**Where to Find More Information**

If you need additional information, visit our website at www.irs.gov. The IRS provides educational material through the Tax Topics feature, as well as links to educational material for practitioners at www.irs.gov/taxpros.

Sincerely,

Monica L Baker

Monica L. Baker
Director, Examination
Small Business/Self-Employed Division

Ms. Baker has responded to my letter dated January 22, 2010. It's not much of a response. She refers me to the IRS FAQ which the IRS issued after the letters of January 5, 2010. The link is http://irs.gov/taxpros/article/0,,id=217947,00.html. Those questions and answers continue the problem. The IRS acknowledges that they are not changing the rules for due diligence under Cir 230 or IRC§6694 but then in a subsequent answer expand the tax professionals' responsibilities beyond what either Cir 230 or the preparer penalty regulations require. The IRS admits that it is not the preparer's burden to audit the client while preparing a return. If so, why undertake the half measures suggested in the Q & A?

I have also attached a "script" that is being used by the IRS agents when they visit a preparer's office in connection with one of the 10,000 letters. It was provide by a Boston Tax Institute colleague. If you are contemplating making time for this type of a visit, please keep in mind that item 3a is simply wrong. With that in mind do you have time, at this time of the year, to be actually misinformed? Remember when the "script" says that it is "critical" that the visit take place, the author of that "script" does not appear to have any idea what is critical for you or any other tax professional at this time of year.

**DEPARTMENT OF THE TREASURY**
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

FEB 24 2010

Edward DeFranceschi
DeFranceschi & Klemm, P.C.
6 Beacon Street,
Boston, MA 02108

Dear Mr. DeFranceschi:

I am writing in response to your letter dated January 22, 2010, which expressed concerns with the language in the January 5, 2010, letter that the IRS sent to some return preparers. In particular, you expressed that the letter did not fairly state the requirements of a return preparer under either IRC Section 6694 or Circular 230.

The IRS sent letters to approximately 10,000 return preparers and has visited some of them to provide information on the kinds of errors we are seeing, review general responsibilities of a return preparer and review the potential consequences of filing incorrect returns. These visits are part of the IRS's efforts to improve the accuracy and quality of filed tax returns and to heighten awareness of preparer responsibilities.

Our January 5th letter did not impose new due diligence requirements. Circular 230 contains the regulations that govern the practice of tax practitioners – for example, attorneys, CPAs, and enrolled agents – before the IRS. Publication 470, *Limited Practice Without Enrollment,* contains guidance for other tax return preparers who are not tax practitioners subject to the rules in Circular 230. IRC §§ 6694 and 6695, and the related regulations, contain guidance regarding the application of civil penalties to all tax return preparers. Each of these documents require tax return preparers to exercise due diligence in the preparation of tax returns and claims for refund.

In response to similar questions, we will be posting answers to many frequently asked questions (FAQs) on the IRS web site, irs.gov. The specific link to the FAQs is http://www.irs.gov/taxpros/article/0,,id=217947,00.html.

Thank you for your letter and insight which is helpful as we plan any future initiative. If you have any additional comments, you can contact my Senior Operation Adviser, Thomas Franke at (202) 283-2825.

Sincerely,

Monica L Baker

Monica L. Baker
Director, Examination

# Script – For use when conducting visitations preparer visitations

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| 1 | **Revenue Agent Provides Identification and Explains Purpose of Visit** |
| | * This filing season, the IRS is taking a number of steps to contact a sample of return preparers.<br>* Objectives of the contacts:<br>  o Improve the accuracy and quality of filed tax returns<br>  o heighten awareness of preparer responsibilities.<br>* IRS sent letters to and is visiting some return preparers to provide information on the kinds of errors we are seeing, review the general responsibilities as a return preparer and review the consequences of filing incorrect returns.<br>* Discuss what will transpire during visit:<br>  o Talk about common errors on Sch. C, Sch. A, EITC and First-time Homebuyer's Credit<br>  o Talk about your responsibilities as a return preparer<br>  o Discuss the consequences of filing incorrect returns<br>  o Discuss where to find more information<br>* Length of Visit will be about 1-2 hour(s) |
| 2 | **Confirm Identification of Preparer** **(record information in section 1 of checksheet)** |
| 3 | **Discuss the Following Issues with the Preparers:** |
| 3a | Common Schedule C Errors: Return preparers must ask sufficient questions and review sufficient taxpayer records to determine that income and expenses reported are correct and complete. For more information, consult IRS Publication 334, *Tax Guide for Small Business.*<br><br>• Gross receipts must be fully reported. Taxpayers should provide books and records to substantiate the fact they are conducting a business and the gross income received during the year or you must receive sufficient information from the taxpayer in the form of other documentation which enables you to reconstruct their income.<br>• Expenses claimed for the business must be ordinary and necessary for the type of business. Taxpayers should provide books and records to substantiate Schedule C expenses or you must receive sufficient information in the form of other documentation which enables you to reconstruct their expenses.<br>• All expenses claimed must be paid or incurred during the taxable year and the allowable amount of the expense must be properly computed. |
| 3b | Common Schedule A Errors: Return preparers should ask sufficient questions to determine the taxpayer's correct itemized deductions. Taxpayers may not know the tax law and may incorrectly believe they can claim deductions on Schedule A for nonqualifying expenditures. For more information, go to www.irs.gov and review Tax Topics 501 through 514. |

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| | • Unreimbursed Employee Business Expense, Form 2106. Taxpayers may only claim allowable unreimbursed expenses.<br>• Mileage claimed on Form 2106. Taxpayers must have documentation to support business miles claimed.<br>• Travel, meals, and entertainment expenses. Taxpayers must have documentation for the business purpose associated with the deduction, as well as receipts to support the expenses claimed.<br>• Charitable Contributions. Taxpayers must have receipts for all cash contributions and adequate documentation for all non-cash contributions. In some cases, an appraisal may be required to substantiate a large non-cash contribution. |
| 3c | Common Earned Income Tax Credit (EITC) Errors: Return preparers should ask sufficient questions and complete appropriate worksheets or forms to ensure that taxpayers are entitled to the credit. EITC return preparers are subject to additional due diligence requirements, including completion of certain documents, record-keeping requirements, and reasonable inquiry of taxpayers. For more information about these due diligence requirements, see the IRS's Due Diligence Continuing Professional Education module at www.eitc.irs.gov/rptoolkit/main/ddmodule/. More detailed information on the EITC eligibility criteria and EITC errors can be found at www.eitc.irs.gov or in Publication 596, *Earned Income Credit.* Common EITC errors are listed below.<br><br>• Claiming a child that is not a qualifying child. Taxpayers may only claim a child that meets the age, relationship, and residency requirements.<br>• Married taxpayers filing with an incorrect single or head of household filing status.<br>• Errors regarding income reporting.<br>• Using incorrect Social Security Numbers or incorrect last names. |
| 3d | Common First-Time Homebuyer Credit (FTHBC) Errors: Return preparers must ask sufficient questions and review sufficient taxpayer records to determine eligibility for any of the three versions of this credit and the accuracy of the amount of credit claimed. For more information on eligibility for the credit, go to www.irs.gov and select Tax Topics 611 and 612 and Notice 2009-108. The most common errors noted on returns claiming the credit are listed below.<br><br>• Credit claimed prior to closing or taking occupancy of home.<br>• Incomplete or incorrect Form 5405, *First-Time Homebuyer Credit.*<br>• More than 10% of the purchase price claimed.<br>• Taxpayer does not meet prior home ownership rules.<br>• Married filing separate taxpayers each incorrectly claim credit on his or her separate returns.<br>• Married taxpayers claim FTHBC when one spouse was a prior homeowner. |

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| 4 | **Discuss the Preparer's Responsibilities as a Paid Tax Return Preparer** |
| | Return preparers are required to exercise due diligence in the preparation of tax returns. As a general rule of thumb, that means knowing the underlying substantive law affecting an item of income or deduction. Publication 470, *Limited Practice Without Enrollment* and Treasury Department Circular 230 (if you are also a practitioner) outline your due diligence responsibilities.<br><br>• A return preparer must exercise due diligence in preparing or assisting in the preparation, approving, and filing of returns, documents, affidavits, or other papers relating to Internal Revenue Service matters.<br>• The return preparer must also exercise due diligence in determining (1) the correctness of oral and written representations made by the return preparer to the IRS, and (2) the correctness of representations made by the return preparer to the client with reference to any matter administered by the IRS. |
| 5 | **Discuss the Consequences of Filing Incorrect Returns** |
| | Return preparers are expected to be knowledgeable in tax law and to prepare accurate returns. Both you and your clients may be adversely affected by the preparation of incorrect returns. These consequences may include any or all of the following:<br><br>• If your clients' returns are examined and found to be incorrect, your clients may be subject to accuracy or fraud penalties plus accrued interest on any underpayment.<br>• Return preparers who prepare a client return for which any part of an understatement of tax liability is due to an unreasonable position taken on the return based on the preparer's advice can be assessed a minimum penalty of $1,000 (IRC section 6694(a)).<br>• Return preparers who prepare a client return for which any part of an understatement of tax liability is due to the return preparer's reckless or intentional disregard of rules or regulations by the tax preparer can be assessed a minimum penalty of $5,000 (IRC section 6694(b)).<br><br>The assessment of return-related penalties against a return preparer may result in:<br><br>• Suspension or expulsion of the return preparer's firm from participation in IRS *e-file*;<br>• Injunctions barring the return preparer from preparing tax returns;<br>• Referral for criminal investigation; or<br>• Disciplinary action by the IRS Office of Professional Responsibility (if the return preparer is also a practitioner). |
| 6 | **Discuss Where to Find More Information** |
| | If you need additional information, visit our website at www.irs.gov. The IRS provides educational material through the Tax Topics feature, as well as links to educational material for practitioners at www.irs.gov/taxpros. |
| 7 | **Ask the Preparer if they have any questions** |

Responses to Anticipated Questions:

Why did I receive this letter?
The preparers receiving the letters are among those with large volumes of specific tax returns where the IRS typically sees frequent errors. The letters are intended to remind preparers to be vigilant in areas where the errors are frequently found.

Why was I selected for a visit?
Selections for visitations were made from among those preparers with the highest volume of returns where the IRS typically sees frequent errors and to ensure broad coverage in all states throughout the country.

Suggested conversation for scheduling the appointment:

As you know from the letter you received, IRS is reaching out to a number of preparers to talk about the most common errors on filed returns, your obligations as a paid preparer and the consequences of filing inaccurate returns. It is important that we meet as soon as possible and I realize that you are busy getting ready for filing season so I wanted to let you know that I'm available at 9 a.m. on Jan. 26th or 1 p.m. on Feb. 1st. Which date is most convenient for you?

or, if the preparer responds that they are unable to meet for any of the options presented then a follow up might be something like:

It is critical that I visit your place of business and discuss these items with you. These discussions are imperative to the work that you will do for the remainder of the filing season and I'm sure you'll agree that you want to make sure you have the most information available in order to properly prepare your client's tax returns. The only way we can do that is to meet on XXXX.

or, if a preparer states that they don't prepare returns with EITC or FTHBC:

The revenue agent can acknowledge that concern and then spend a few minutes reviewing the law in the event that they have to prepare such returns in the future so that they avoid some of the common errors that we frequently see.