

superfastCPA

REG REVIEW NOTES

2024

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Table of Contents

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|---|-----------|
| Table of Contents..... | 2 |
| How to Use These Review Notes:..... | 5 |
| AICPA Blueprints and “Representative Tasks”..... | 5 |
| A Note on Year-Specific Tax Figures..... | 6 |
| Area I – Ethics, Professional Responsibilities and Federal Tax Procedures..... | 7 |
| A. Ethics and Responsibilities in Tax Practice..... | 7 |
| 1. Regulations Governing Practice Before the Internal Revenue Service..... | 7 |
| 2. Internal Revenue Code and Regulations Related to Tax Return Preparers..... | 16 |
| B. Licensing and Disciplinary Systems..... | 23 |
| C. Federal Tax Procedures..... | 26 |
| 1. Audits, Appeals and the Judicial Process..... | 26 |
| 2. Substantiation and Disclosure..... | 33 |
| 3. Taxpayer Penalties..... | 52 |
| 4. Authoritative Hierarchy..... | 55 |
| D. Legal Duties and Responsibilities..... | 58 |
| 1. Common Law Duties and Liabilities to Clients and Third Parties..... | 58 |
| 2. Privileged Communications, Confidentiality and Privacy Acts..... | 69 |
| Area II – Business Law..... | 76 |
| A. Agency..... | 76 |
| 1. Authority of Agents and Principals..... | 76 |
| 2. Duties and Liabilities of Agents and Principals..... | 84 |
| B. Contracts..... | 91 |
| 1. Formation..... | 91 |
| 2. Performance and Discharge..... | 102 |

| | |
|--|------------|
| 3. Breach and Remedies..... | 116 |
| C. Debtor-Creditor Relationships..... | 126 |
| D. Federal Laws and Regulations (Employment Tax, Qualified Health Plans, Bankruptcy, Worker Classifications and Anti-bribery)..... | 152 |
| E. Business Structure..... | 170 |
| 1. Selection and Formation of Business Entity and Related Operation and Termination..... | 170 |
| 2. Rights, Duties, Legal Obligations and Authority of Owners and Management..... | 178 |
| Area III – Federal Taxation of Property Transactions..... | 183 |
| A. Basis of Assets..... | 183 |
| B. Cost Recovery (Depreciation and Amortization)..... | 196 |
| Area IV – Federal Taxation of Individuals..... | 211 |
| A. Gross Income (Inclusions and Exclusions)..... | 211 |
| B. Reporting of Items From Pass-Through Entities..... | 237 |
| C. Adjustments and Deductions to Arrive at Adjusted Gross Income and Taxable Income..... | 242 |
| D. Loss Limitations..... | 264 |
| E. Filing Status..... | 279 |
| F. Computation of Tax and Credits..... | 286 |
| Area V – Federal Taxation of Entities (Including Tax Preparation)..... | 295 |
| A. Differences Between Book and Tax Income (Loss)..... | 295 |
| B. C Corporations..... | 311 |
| 1. Computations of Taxable Income, Tax Liability and Allowable Credits..... | 311 |
| 2. State and Local Tax Issues..... | 320 |
| C. S Corporations..... | 328 |
| 1. Eligibility and Election..... | 328 |
| 2. Determination of Ordinary Business Income (Loss) And | |

| | |
|--|-----|
| Separately Stated Items..... | 334 |
| 3. Basis of Shareholder's Interest..... | 346 |
| D. Partnerships..... | 354 |
| 1. Determination of Ordinary Business Income (Loss) And Separately Stated Items..... | 354 |
| 2. Basis of Partner's Interest..... | 363 |
| E. Limited Liability Companies..... | 371 |
| F. Tax-Exempt Organizations..... | 374 |

How to Use These Review Notes:

The best way to use these review notes is in the following ways:

1. Read from these review notes as a part of your mini sessions each day. Switch between reading a few pages of these notes and taking quizzes on the SuperfastCPA app. Doing this multiple times a day will get you through the notes at least a couple or more times throughout your study process.
2. When doing your 2-hour main study session each day, before starting a new section or topic, find that topic in these review notes and read through it to get a base understanding of what you are about to study. This doesn't need to be a deep read, just a primer to get you started.
3. Read through these review notes all the way through at least 2-3 times in the two days of your 48-hour cram session before your exam.

AICPA Blueprints and “Representative Tasks”

We have made these review notes to mirror the AICPA blueprints.

You will notice that each section says one of the following:

Remembering and Understanding, Application, Analysis, or Evaluation (Evaluation will only be on the Audit exam).

- If a section says Remembering and Understanding, that means it will almost certainly be tested as a Multiple Choice Question if it is tested.
- If a section says Application, that means it could be tested as either a Multiple Choice Question or a Simulation.
- If a section says either Analysis or Evaluation (for Audit only), it will almost certainly be tested as a Simulation.

A Note on Year-Specific Tax Figures

One thing that's very helpful for you to know, is that with all the year-specific tax figures, such as deduction amounts, credit amounts, phase-outs, and income ranges, etc, is that the AICPA doesn't expect you to memorize all these figures.

What they want to see is that you know how to apply the deduction or credit. Therefore, the specific figures will almost always be given to you in the problem itself.

Here's a direct quote from the AICPA Blueprints for REG:

“Candidates will not be tested on their knowledge of specific tax rate percentages, amounts or limitations that are indexed to inflation. Absent any stated assumptions, candidates should assume that transactions or events referenced in the question occurred in the current year and should apply the most recent provisions of the tax law in accordance with the timing specified in the CPA Exam Policy on New Pronouncements.”

Area I – Ethics, Professional Responsibilities and Federal Tax Procedures

A. Ethics and Responsibilities in Tax Practice

1. Regulations Governing Practice Before the Internal Revenue Service

Remembering and Understanding: Recall the regulations governing practice before the Internal Revenue Service.

The primary regulations that govern practice before the Internal Revenue Service (IRS) are outlined in Treasury Department Circular No. 230, "Regulations Governing Practice before the Internal Revenue Service." These regulations provide the rules and standards governing tax practitioners who represent taxpayers before the IRS.

Who Can Practice Before the IRS?

Only certain individuals can practice before the IRS, including attorneys, certified public accountants (CPAs), enrolled agents, enrolled actuaries,, and other qualified individuals under certain circumstances.

Duties and Restrictions Relating to Practice Before the IRS

- Diligence as to Accuracy:
 - Practitioners have a responsibility to be thorough and accurate when preparing, approving, and filing any documents related to IRS matters.

- This extends to verifying the accuracy of both oral and written representations made to clients and the Treasury Department.
- Prompt Disposition:
 - Practitioners must avoid causing unnecessary delays in any matter before the IRS.
 - This emphasizes efficiency and timely resolution in the best interest of the client.
- Assistance from or to Disbarred or Suspended Persons:
 - Practitioners should not work with anyone who has been disbarred or suspended from practicing before the IRS, especially if the collaboration might violate the conditions of that person's suspension or disbarment.
- Notaries:
 - If practitioners are also notaries public, they cannot perform notarial acts (like taking acknowledgments or certifying documents) in matters where they are also representing or counseling a client before the IRS.
- Fees:
 - Fees charged by practitioners should be reasonable.
 - They should not charge a fee based on outcomes, like the amount of tax refund or avoidance, with some exceptions.
 - Contingent fees, which are based on specific results or outcomes, are mostly prohibited.
- Return of Client's Records:
 - Practitioners must return any records of clients upon request.
 - They cannot hold onto a client's records due to disputes over payment or other reasons.

- **Conflicting Interests:**
 - A conflict of interest can arise if representing one client might be directly adverse to another.
 - In situations with potential conflicts, practitioners need informed, written consent from all affected parties to proceed.
- **Solicitation:**
 - Practitioners should ensure that their solicitations (like advertising) are not misleading or false.
 - They must follow specific rules about how they advertise, represent their services, and disclose fee structures.
 - They are prohibited from receiving undisclosed commissions for referrals.
- **Negotiation of Taxpayer Checks:**
 - Practitioners should not endorse or cash any checks issued to their clients by the government, such as tax refund checks.
- **Practice of Law:**
 - For those who are not legally licensed, there are specific restrictions on practicing law in the context of representing clients before the IRS.
- **Standards for Advising Clients:**
 - When giving tax advice, practitioners must ensure it's based on factual and legal assumptions that are reasonable.
 - They should always take into account all relevant facts and not solely rely on statements or representations made by the taxpayer or other parties.
- **Standards for Preparing Returns:**

- Practitioners have a responsibility to avoid willful or grossly negligent actions that would understate a client's tax liability.
- They should never sign a return or claim that they know (or should reasonably know) lacks a legitimate basis.

Application: Apply the regulations governing practice before the Internal Revenue Service given a specific scenario.

Here are several specific scenarios and the action the CPA should take based on the scenario:

Scenario: A CPA realizes they have made an error in a client's tax return from the previous year.

Action: The CPA should promptly inform the client of the mistake, advise on the necessary corrective measures (e.g., filing an amended return), and rectify the error without charging the client for the corrective work.

Scenario: A CPA is offered a percentage of a client's tax refund as payment for their services.

Action: Decline the offer, as fees based on the refund amount are generally prohibited. Charge the client a reasonable fee based on the complexity and time required for the work.

Scenario: A client requests the return of all their documents, but there's an outstanding bill for the CPA's services.

Action: Return the client's records promptly without withholding them for payment. Try to resolve the payment issue separately.

Scenario: A CPA discovers a potential conflict of interest while representing two clients on a related matter.

Action: Disclose the conflict to both clients and obtain informed written consent from each before continuing representation.

Scenario: A CPA's advertisement claims they can guarantee clients a tax refund.

Action: Immediately remove or amend the advertisement. Circular 230 prohibits false or misleading advertisements. Ensure all future advertisements comply with the guidelines.

Scenario: A client presents a tax position to the CPA that seems to have little to no basis in law or fact.

Action: Advise the client against taking the position on their return. Explain the potential consequences of taking a position that's not well-supported.

Scenario: A CPA is offered a commission by another professional for referring a client for a specific financial product.

Action: Decline the commission. Disclose any potential referral arrangements to the client. Circular 230 prohibits undisclosed commissions.

Scenario: A CPA discovers that a new client's previous year's return, prepared by another advisor, has material noncompliance with an IRC requirement.

Action: Inform the client of the discovered noncompliance, provide clear advice on rectifying the situation, and assist with any necessary corrective actions like filing an amended return.

Scenario: A client asks a CPA to provide testimony in an administrative proceeding related to their taxes, but the client asks the CPA to exaggerate certain aspects.

Action: Decline the client's request to give false testimony. Provide only accurate and truthful statements in any testimonial or representation.

Scenario: A CPA who is also a notary public is asked by their client to notarize documents related to an IRS matter they are representing.

Action: Politely decline to perform the notarial act for that particular matter due to the potential conflict of interest. The client should seek another notary for this purpose.

Scenario: A CPA receives an email that appears to be from the IRS, requesting detailed client information for an audit.

Action: Do not immediately provide the information. Verify the legitimacy of the request directly with the IRS, as there are phishing scams that impersonate IRS communications.

Scenario: A client provides records that seem to be altered or suspicious in nature and insists on using them for the tax return.

Action: Do not use the suspicious records. Discuss concerns with the client, advising them on the importance of accuracy and the potential legal implications of submitting fraudulent information.

Scenario: A CPA becomes aware of a colleague's consistent habit of endorsing or negotiating clients' checks without proper authorization.

Action: Report the misconduct to the appropriate authorities or governing body. Such actions are a violation of trust and could have legal implications.

Scenario: During a routine audit, a CPA identifies a recurring error made by their firm in multiple clients' tax returns.

Action: Notify all affected clients of the oversight, advise on corrective measures, and rectify the errors promptly without charging extra fees for the corrections.

Scenario: A client asks the CPA to hold onto and not deposit a post-dated check for payment until a specified date.

Action: Agree to the client's request and ensure the check isn't deposited until the specified date. It's essential to honor such agreements and maintain trust.

Scenario: A CPA discovers a colleague is advertising a guaranteed \$5000 tax refund for any client without seeing their financial information first.

Action: Address the issue with the colleague and advise them to amend or remove such misleading advertisements. Circular 230 prohibits false or deceptive advertising.

Scenario: A client, in an attempt to reduce their taxable income, asks the CPA to list personal vacations as business expenses.

Action: Decline the client's request. Inform them of the potential legal ramifications of misrepresenting personal expenses as business expenses.

Scenario: A CPA realizes they accidentally viewed another client's confidential tax information while searching for files.

Action: Do not disclose or use the information seen. Ensure proper protocols are followed to prevent such mishaps in the future and consider notifying the affected client if deemed necessary.

Scenario: A CPA feels a certain part of Circular 230 is ambiguous and is unsure about the right course of action for a particular client situation.

Action: Seek guidance or clarification from legal counsel or professional organizations specializing in tax practice. It's always better to be sure rather than make assumptions.

Scenario: A client shares with the CPA their plans to deliberately hide offshore income to evade taxes.

Action: Strongly advise the client against such actions, citing the severe legal penalties associated with tax evasion. If the client persists, consider terminating the professional relationship while adhering to confidentiality obligations.

2. Internal Revenue Code and Regulations Related to Tax Return Preparers

Remembering and Understanding: Recall who is a tax return preparer.

According to Circular 230, a tax return preparer is generally defined as any person who prepares for compensation, or who employs or engages others to prepare for compensation, any return of tax or any claim for refund of tax. The emphasis here is on the act of preparation "for compensation," meaning individuals who assist with tax return preparations without getting paid are not considered tax return preparers under this definition.

It's also important to note the distinction between tax return preparers and practitioners. While all practitioners (like attorneys, CPAs, and enrolled agents) can be tax return preparers if they prepare returns for compensation, not all tax return preparers are considered practitioners under Circular 230. This is because some tax return preparers may not have the authorization to represent taxpayers before the IRS.

Lastly, there are specific exclusions to the definition. For example, individuals who only furnish typing, reproduction, or other mechanical assistance in the preparation of a return are not considered tax return preparers for the purposes of Circular 230.

The IRS requires tax return preparers to meet certain standards and qualifications, including registering with the IRS and obtaining a Preparer Tax Identification Number (PTIN). Additionally, tax return preparers are subject to various ethical and professional standards, including due diligence requirements and

confidentiality requirements, as set forth in the regulations governing practice before the IRS.

SAMPLE

Remembering and Understanding: Recall situations that would result in tax return preparer penalties, and Application: Apply potential tax return preparer penalties given a specific scenario.

Scenarios Related to Preparing a Tax Return

Scenario: A tax return preparer knowingly understates a client's tax liability by claiming deductions or credits the client is not entitled to.

Penalty: The greater of \$1,000 or 50% of the income derived by the preparer from the return or refund claim. If the understatement is due to willful or reckless conduct, the penalty is \$5,000 or 75% (whichever is greater) of the tax preparer's income to prepare the tax return or claim.

Scenario: A tax preparer fails to furnish a copy of a tax return or refund claim to a taxpayer.

- 2023 Penalty: \$55 for each failure, with a maximum penalty of \$28,000 for the calendar year.
- 2024 Penalty: \$60 for each failure, with a maximum penalty of \$30,000 for the calendar year.

Scenario: A tax preparer neglects to sign a tax return or refund claim.

- 2023 Penalty: \$55 for each unsigned return or claim, with a maximum penalty of \$28,000 for the calendar year.
- 2024 Penalty: \$60 for each unsigned return or claim, with a maximum penalty of \$30,000 for the calendar year.

Scenario: A tax preparer omits their preparer tax identifying number (PTIN) on a tax return or claim.

- 2023 Penalty: \$55 for each omission, with a maximum penalty of \$28,000 for the calendar year.
- 2024 Penalty: \$60 for each omission, with a maximum penalty of \$30,000 for the calendar year.

Scenario: A tax preparer doesn't retain a copy or list of a tax return or claim they prepared.

- 2023 Penalty: \$55 for each failure to retain, with a maximum penalty of \$28,000 for the calendar year.
- 2024 Penalty: \$60 for each failure to retain, with a maximum penalty of \$30,000 for the calendar year.

Scenario: A tax preparer neglects to file the correct information on tax returns.

- 2023 Penalty: \$55 for each incorrect filing, with a maximum penalty of \$28,000 for the calendar year.
- 2024 Penalty: \$60 for each incorrect filing, with a maximum penalty of \$30,000 for the calendar year.

Scenario: A tax preparer endorses or negotiates any check payable to another person.

- 2023 Penalty: \$560.00 for each improper endorsement or negotiation.
- 2024 Penalty: \$600.00 for each improper endorsement or negotiation.

Scenario: A tax preparer is not diligent in determining a taxpayer's eligibility for specific tax benefits, including the head of household filing status, dependent credits, American Opportunity Credit, Earned Income Tax Credit, and Lifetime Learning Credit.

- 2023 Penalty: \$560.00 for each failure to determine eligibility.
- 2024 Penalty: \$600.00 for each failure to determine eligibility.

Other Scenarios Resulting in TRP Penalties

Scenario: An individual organizes or sells abusive tax shelters.

Penalty: For making false statements about the tax benefits of the transaction, the penalty is 50% of the gross income the person earned from the activity. For providing a gross valuation overstatement, the penalty is the lesser of \$1,000 or 100% of the gross income derived from the activity for each entity or arrangement and for each sale.

Scenario: An individual assists in underestimating another person's tax liability on their tax return.

Penalty: \$1,000 for regular returns and \$10,000 for corporate tax returns. This penalty can be assessed only once for documents related to the same taxpayer for a singular tax period or event.

Scenario: A tax preparer makes an unauthorized disclosure or use of information provided for preparing a tax return after July 1, 2019.

Penalty:
\$250 for each unauthorized disclosure or use, capped at \$10,000 per year. If the unauthorized disclosure or use is

linked to an identity theft crime, the penalty is \$1,000 for each instance, with a maximum annual penalty of \$50,000.

Scenario: An individual commits fraud or makes false statements on tax returns.

Penalty: The individual can be fined up to \$100,000 (\$500,000 for corporations), face imprisonment for up to 3 years, and may be required to cover the costs of prosecution. This also applies to fraudulent activities associated with offers in compromise or closing agreements.

Scenario: An individual prepares fraudulent tax returns, statements, or other documents.

Penalty: The individual can be fined up to \$10,000 (\$50,000 for corporations) and imprisoned for up to 1 year.

Scenario: A tax preparer knowingly or recklessly discloses or uses information provided to prepare a tax return for purposes other than its preparation.

Penalty: The tax preparer can be fined up to \$1,000, imprisoned for up to 1 year, and may also be required to pay for the costs of prosecution.

Scenario: An individual engages in unlawful conduct concerning tax shelters and reportable transactions.

Penalty: The U.S. government can initiate legal action in a federal district court to cease the individual's unlawful actions. This might relate to violations in Circular 230 and other rules about practicing before the IRS.

SAMPLE

B. Licensing and Disciplinary Systems

Remembering and Understanding: Understand and explain the role and authority of state boards of accountancy.

State Boards of Accountancy play a critical role in the oversight and regulation of the accounting profession within their respective states in the U.S. Their role and authority encompass a range of responsibilities, primarily centered around licensing and regulating Certified Public Accountants (CPAs) and CPA firms. Here's a breakdown:

Licensing and Renewal

- CPAs: State Boards are responsible for granting licenses to individuals who meet specific educational, examination (typically the Uniform CPA Exam), and experience requirements.
- CPA Firms: Firms often must register with the state board to legally provide public accounting services in that state.

Setting Professional Standards

While many states adopt standards set by national bodies like the American Institute of CPAs (AICPA), the state boards have the authority to set and enforce additional or differing standards as they deem necessary for their jurisdiction.

Oversight and Regulation

- Continuing Professional Education (CPE): Most state boards mandate CPAs to complete a certain number of CPE hours

to ensure that they remain up-to-date with the latest industry knowledge and standards.

- Peer Review: CPA firms may be required to undergo periodic peer reviews to ensure the quality of their audit and attestation services.

Ethics and Conduct

State boards enforce ethical standards and conduct for CPAs within their jurisdiction. They might adopt the AICPA's Code of Professional Conduct or establish their own.

Disciplinary Actions

- State boards have the authority to investigate complaints and alleged violations related to the practice of accounting. Depending on their findings, they can impose penalties, fines, or even revoke a CPA's license.
- The boards can also monitor and take action against individuals or firms practicing without a license or those that claim to be CPAs without proper certification.

Protection of the Public

A primary mandate of state boards is to protect the public interest. This means ensuring that individuals and firms providing accounting services adhere to the highest standards of professionalism, ethics, and competence.

Advisory Role

Many state boards also play an advisory role to the state's legislature on matters concerning the accounting profession,

ensuring that any new laws or regulations are in the best interest of the public and the profession.

Reciprocity

State boards handle issues related to license reciprocity, which is when a CPA licensed in one state seeks a license in another state without having to retake the CPA exam.

In summary, the State Boards of Accountancy play an essential role in ensuring the integrity, competence, and professionalism of the accounting profession within their respective states. They ensure that the public can trust and rely on the services provided by CPAs.

C. Federal Tax Procedures

1. Audits, Appeals and the Judicial Process

Remembering and Understanding: Explain the audit and appeals process as it relates to tax matters.

1. Initiation of an Audit:

- Selection for Audit: Returns can be selected randomly, due to document mismatches, or because of issues with related returns (e.g., business partners).
- Notification: The taxpayer will receive a notice detailing the year or years in question and the items to be reviewed.
 - Timeline: After a return is filed, the IRS typically has 3 years to audit it. For significant underreporting of income (more than 25% of the gross income stated on the return), this can extend to 6 years.
 - Deadline to Respond: The taxpayer usually has 30 days to respond. Failure to do so may lead to changes based on the available information, potentially resulting in added tax, penalties, and interest.

2. Types of Audits:

There are three primary types of audits:

- Correspondence Audit: Conducted entirely by mail and is limited to a few specific items on the return.
- Office Audit: Requires the taxpayer to come to an IRS office for the examination. It's more detailed than a correspondence audit.

- **Field Audit:** An IRS agent visits the taxpayer's home, business, or accountant's office to examine records and conduct the audit.

Duration: The audit's length depends on the type, complexity, and the taxpayer's responsiveness. A simple office audit might last a few hours, while a detailed field audit could span several months.

3. Examination:

During the examination, the IRS will ask for evidence or clarification on certain items on the return. This may include receipts, bills, legal papers, or other records.

Taxpayers have the right to representation during the audit, either by themselves, a CPA, attorney, or enrolled agent.

4. Conclusion of Audit:

Once the examination is complete, one of three outcomes occurs:

- **No Change:** The IRS accepts the return as filed.
- **Agreed:** Taxpayer agrees with the proposed changes and signs the examination report or other form provided by the IRS.
- **Disagreed:** Taxpayer doesn't agree with the proposed changes. In this case, they can request a conference with an IRS manager, seek mediation, or file an appeal if they don't reach an agreement with the IRS.

Deadline to Agree/Disagree: Typically, the taxpayer has 30 days to agree or disagree with the findings.

5. Appeals Process:

Agreement: If the taxpayer agrees with the findings, they sign the report or an examination report, which may result in a change in tax owed.

Disagreement: If the taxpayer disagrees, they can request a conference with an IRS manager.

Appeal: If still in disagreement after the managerial conference, the taxpayer has the option to file an appeal. The general deadline for filing an appeal is 30 days from the report's date.

If the taxpayer disagrees with the audit results, they can file an appeal with the IRS Office of Appeals, an independent organization within the IRS.

Appeals Conference: A conference will be scheduled with an Appeals Officer. It's more informal and is designed to handle tax disputes without going to court.

- If an agreement is reached, the taxpayer signs a form that outlines the changes and any additional tax owed.
- If no agreement is reached, the taxpayer has further recourse, including litigation.

Fast Track Mediation: For unresolved issues, taxpayers can request Fast Track Mediation aiming to settle disputes within 60 to 120 days.

Statutory Notice of Deficiency: If no agreement is reached, the IRS sends a Statutory Notice of Deficiency, or the “90-Day-Letter”.

Deadline to Petition Tax Court: The taxpayer has 90 days (150 days if addressed outside the U.S.) from the notice date to pay the deficiency or to file a petition with the U.S. Tax Court.

6. Tax Court:

If the taxpayer and the IRS Office of Appeals can't come to an agreement, the taxpayer can take the issue to the U.S. Tax Court.

Taxpayers can represent themselves or have legal representation in Tax Court.

The court's decision can be accepted, or if the taxpayer disagrees, they can appeal to a higher court.

7. Resolution and Collection:

After the appeals and potential court process, if the IRS's findings stand or if the taxpayer agrees with the audit results, a bill is issued. Payment is generally expected upon receipt, but installment or alternative arrangements can be considered.

8. Penalties and Interest:

If the audit determines a taxpayer owes additional tax, penalties and interest might also be assessed, depending on the nature and extent of the underpayment.

Remembering and Understanding: Explain the different levels of the judicial process as they relate to tax matters.

U.S. Tax Court:

Purpose: This is the most common venue for taxpayers to dispute an IRS deficiency notice. Unlike other courts, taxpayers don't need to pay the disputed amount before suing.

Decision: Decisions can be appealed to the relevant U.S. Court of Appeals.

Federal District Court:

Purpose: If a taxpayer wishes to dispute the IRS after paying the tax in question, they can sue for a refund in their local federal district court.

Jurisdiction: The court hears a broad range of federal cases, not just tax disputes.

Decision: Decisions can be appealed to the relevant U.S. Court of Appeals.

U.S. Court of Federal Claims:

Purpose: This court, located in Washington, D.C., is another venue for taxpayers seeking refunds after paying disputed taxes.

Decision: Decisions can be appealed to the U.S. Court of Appeals for the Federal Circuit.

U.S. Court of Appeals:

Purpose: This is the intermediate appellate level. If a taxpayer or the IRS is dissatisfied with the decision from the U.S. Tax Court, Federal District Court, or Court of Federal Claims, they can appeal to the U.S. Court of Appeals.

Jurisdiction: There are 13 circuits, each covering a specific geographic area. The U.S. Court of Appeals for the Federal Circuit, in particular, hears appeals from the Court of Federal Claims.

Decision: Decisions can be appealed to the U.S. Supreme Court, but that court hears very few tax cases.

U.S. Supreme Court:

Purpose: This is the highest court in the U.S., and it has discretionary jurisdiction, meaning it can choose which cases it wants to hear.

Decisions: The court's decisions are final, with implications for all taxpayers, not just the parties involved in the case.

Collection Due Process (CDP) Hearings:

Before a taxpayer's unpaid tax can be levied, the taxpayer has the right to a hearing. This doesn't fall within the typical judicial process, but it's worth noting.

Purpose: The taxpayer can challenge the amount of tax due, or if they can't pay, propose a collection alternative like an installment agreement or offer in compromise.

Administrative Appeals and Mediation:

Before going to court, the IRS offers an appeals process as an alternative to litigation.

Fast Track Mediation: A process offered by the IRS for quicker, less formal dispute resolution.

2. Substantiation and Disclosure

Remembering and Understanding: Summarize the requirements for the appropriate disclosure of a tax return position.

The appropriate disclosure of a tax return position refers to the taxpayer's obligation to provide sufficient information regarding a position taken on a tax return, especially if the position might result in an understatement of tax liability. Ensuring the appropriate disclosure of a tax position is vital in avoiding certain penalties.

Here's a summary of the requirements for appropriate disclosure:

Transparent Reporting:

Positions taken on the tax return that are contrary to rules, regulations, or established precedents must be transparently and clearly reported.

Form 8275 and Form 8275-R:

Form 8275 and Form 8275-R are both used to disclose uncertain tax positions, but they serve different purposes:

- Form 8275, Disclosure Statement, is used to disclose items or tax positions that are not otherwise adequately disclosed on a tax return. Its use is applicable when a position taken is not necessarily contrary to IRS regulations but is not clearly presented on the tax return. However, this form does not provide penalty protection for the taxpayer if the IRS challenges the position and imposes penalties.

- Form 8275-R, Regulation Disclosure Statement, on the other hand, is used specifically to disclose positions that are contrary to Treasury regulations. If this form is used appropriately to disclose a position that may be subject to accuracy-related penalties, it can provide penalty protection for the taxpayer, potentially saving them from those penalties if the IRS disputes the position taken on their tax return.

In summary, the choice between the two forms depends on the nature of the tax position being taken and whether it is contrary to Treasury regulations, with Form 8275-R offering the additional benefit of penalty protection under certain circumstances.

Adequate Disclosure for Penalties:

Adequate disclosure can help taxpayers avoid accuracy-related penalties under IRC Section 6662. However, simply disclosing a position doesn't mean it's accepted by the IRS, nor does it protect against all penalties.

Attach Relevant Statements:

If specific IRS forms or schedules are not available for disclosing a particular item, the taxpayer should attach a clear and concise statement specifying the amount, the source, and the basis for the position being taken.

Substantiation and Disclosure of Tax Positions:

There are different standards of confidence a taxpayer might have in a given tax position and the likelihood of that position being upheld if challenged by the IRS. Here's an example scenario and then a breakdown of each:

Scenario: *A company has spent a significant amount on a corporate retreat for its employees. The retreat included team-building exercises, training sessions, and leisure activities. The company wishes to deduct the full cost of the retreat as a business expense on its tax return.*

A position that is not frivolous: At the most basic level, a tax position should not be "frivolous." A frivolous position is one that is patently improper. It's a position that has no basis in law or fact and is typically taken with the intent to delay or impede tax administration. Claiming such positions can result in penalties.

Example: *The company claims a deduction for the full amount of the retreat, even including the leisure activities. While most tax professionals would advise caution given that purely recreational expenses might not be wholly deductible, the company argues that the retreat, as a whole, had a business purpose. Though this position might be seen as aggressive, it isn't utterly without merit or solely intended to impede tax administration. It's a position that's more than just a baseless claim.*

Reasonable basis standard: This standard requires that there's at least a 20 percent chance that the tax position would be upheld if challenged. A position that meets the "reasonable basis" standard is a significant step above a frivolous or meritless position. It means that there's some foundation in the tax law for the position, even if it's not the most likely interpretation.

Example: Upon researching, the company finds a few tax court cases where businesses were allowed to deduct leisure activities as part of broader team-building exercises. While these cases are not directly on point, and the prevailing view is that leisure activities aren't generally deductible, there's a slight argument to be made. Based on this, the company feels there's at least a 20% chance that, if challenged, the deduction might be upheld.

Substantial authority standard: Here, there must be more than a 40 percent chance that the tax position would be sustained upon examination by the IRS. The position has considerable support in law or fact. The substantial authority standard requires a more robust level of confidence and support than the reasonable basis standard. It usually involves a closer look at court decisions, IRS rulings, and other authoritative sources.

Example: Let's say the company discovers multiple tax rulings, court cases, and authoritative commentary suggesting that if leisure activities are minor and incidental to the primary business purpose of the retreat (like training), they might be deductible. Given this breadth of support, the company believes there's a solid foundation (more than 40% confidence) for claiming the entire retreat as a business expense.

More-likely-than-not standard: For a tax position to meet this threshold, there should be a greater than 50 percent chance that the position would be upheld if reviewed by the IRS or in court. Essentially, it's more likely than not that the position is correct. This level of confidence is particularly

relevant for financial statement purposes, especially under certain accounting standards like ASC 740 (related to income taxes), where companies might need to evaluate and disclose the likelihood of success for their tax positions.

Example: Upon further investigation, the company finds several recent and directly relevant tax court decisions that have allowed similar deductions. These decisions highlight that as long as the primary purpose of the retreat is business-oriented, even the leisure components can be deducted as necessary for the overall business objective. Armed with this information, the company believes that it's more likely than not (over 50% confidence) that their deduction would be sustained if challenged.

The percentages, while they might seem arbitrary, serve essential purposes in the context of tax reporting and compliance:

Risk Management and Internal Reporting: A company's management and its board of directors need to understand the potential risks associated with the tax positions the company is taking. If there's a significant amount of money involved and only a 20% chance that the position will be upheld, that's a potentially substantial financial risk. On the other hand, a position with a more-likely-than-not chance of being upheld is seen as a safer bet.

Financial Statement Reporting: Publicly traded companies are required to present financial statements that provide a fair and transparent view of their financial position. For tax positions that are uncertain, companies might need to set

aside (or "book") a reserve for potential future tax liabilities. The likelihood of a tax position being upheld can affect whether a reserve is needed and its size.

Penalty Avoidance: The U.S. tax system imposes penalties on taxpayers who underpay their taxes. By disclosing a tax position based on a recognized standard (like the "reasonable basis" standard), a taxpayer might avoid certain penalties, even if the IRS ultimately disagrees with the position taken.

Encouraging Transparency: The standards act as a framework that encourages taxpayers to think critically about their positions. If they believe there's only a 20% chance of success, they might choose to disclose that position to avoid potential penalties. This disclosure helps the IRS understand the taxpayer's viewpoint and can streamline any subsequent audit or review process.

Informing Decisions on Whether to Litigate: If a taxpayer and the IRS disagree on a position and the disagreement leads to litigation, the taxpayer's belief in the strength of their position (as evidenced by which standard they thought it met) might influence the IRS's decision on whether to litigate or settle.

Professional Responsibility: Tax advisors have ethical and professional duties. Advising a client to take a position that doesn't meet any of the recognized standards could lead to professional sanctions or penalties for the advisor.

In essence, while the ultimate outcome (i.e., whether the position is upheld or not) is crucial, these standards serve to guide behavior, inform various stakeholders, and manage risks in the interim. They're a way to navigate the inherent uncertainties that come with complex tax law.

Accuracy-Related Penalty:

For positions where the taxpayer has a reasonable basis but does not meet the "substantial authority" standard, disclosing the position can prevent the imposition of the 20% accuracy-related penalty.

Non-Disclosed Positions:

If a position is not adequately disclosed on the tax return, the taxpayer must meet a higher standard, "more likely than not" (greater than 50% likelihood of being upheld), to avoid accuracy-related penalties.

Reportable Transactions and Listed Transactions:

Certain transactions identified by the IRS because of their potential for tax avoidance or evasion must be disclosed. Failing to disclose such transactions can lead to significant penalties. These are typically disclosed on Form 8886 (Reportable Transaction Disclosure Statement).

Remembering and Understanding: Recall requirements to report foreign bank accounts.

Reporting foreign bank accounts and other financial accounts is an essential component of U.S. federal tax compliance for individuals and entities that have financial interests in or authority over such accounts. The primary tool for this reporting is the Report of Foreign Bank and Financial Accounts (FBAR).

Here's an overview of the requirements related to reporting foreign bank accounts:

Who Must File an FBAR:

U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities, must file an FBAR if:

- They have a financial interest in or signature authority over one or more accounts, including bank accounts, brokerage accounts, mutual funds, trusts, or other types of foreign financial accounts, and
- The aggregate value of all foreign financial accounts exceeds \$10,000 at any time during the calendar year.

Exceptions from FBAR Reporting:

Certain accounts are not required to be reported, such as:

- Accounts jointly owned by spouses
- Accounts held in an IRA
- Accounts held in a retirement plan
- Certain trust beneficiaries (under specific circumstances).

Some individuals (such as certain foreign financial account holders or children) may also have exceptions, but it's crucial to verify the details to ensure compliance.

Form to File:

The FBAR is electronically filed using FinCEN Form 114, which is not a tax form and is not filed with the IRS. It's filed directly with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).

Due Date:

The FBAR must be filed by April 15th of the year following the calendar year being reported. However, filers who miss this deadline receive an automatic extension to October 15th.

Form 8938 - Statement of Specified Foreign Financial Assets:

Separate from the FBAR, certain taxpayers may also need to report their foreign financial accounts and assets on IRS Form 8938, which is attached to their annual federal income tax return. The thresholds for filing Form 8938 vary based on the taxpayer's filing status and residence (either inside or outside the U.S.).

Penalties:

Failing to file an FBAR can carry hefty penalties. Non-willful violations can result in a penalty of up to \$10,000 per violation. Willful violations can result in a penalty of up to the greater of \$100,000 or 50% of the balance in the account at the time of the violation. There are also potential criminal penalties for willful violations.

Voluntary Disclosure:

Taxpayers who have not reported an income from a foreign financial account or who have not filed an FBAR should consider consulting with a tax professional about the IRS's voluntary disclosure programs. Participating in a voluntary disclosure program can help reduce penalties and protect against potential criminal prosecution.

Application: Identify situations in which disclosure of tax return positions is required.

Here are some scenarios where disclosure may be required:

Uncertain Tax Positions: If a taxpayer or tax preparer believes that a position on a tax return may not be sustained upon IRS examination but has a reasonable basis, they would disclose this to avoid penalties related to underpayment of tax.

Example: A freelance graphic designer uses a home office exclusively for work and claims a home office deduction. The area used is not clearly separated from the living area, raising questions about the validity of the deduction. They disclose this position to mitigate any potential challenge from the IRS.

Positions Contrary to IRS Regulations: If a taxpayer takes a position that is contrary to an IRS regulation, they would use Form 8275-R to disclose this position, detailing the reasons why they believe the regulation is invalid or does not apply to their situation.

Example: An investor in solar energy projects claims a tax credit for a project in a manner that conflicts with recent IRS regulations interpreting the tax code's requirements for such credits. They use Form 8275-R to disclose their contrary position, arguing that the regulation doesn't reflect the legislative intent.

Positions with No Clear Guidance: Sometimes, the tax code may be ambiguous, or there may be no clear guidance on how a particular transaction should be treated. Disclosure is used in

these cases to inform the IRS of the position taken and the rationale behind it.

Example: A software company receives an advance payment for services to be provided over several years. Due to ambiguous tax code provisions on such transactions, they disclose their position on recognizing the income over the service period instead of the year of receipt.

Conservative Tax Planning: In some cases, taxpayers may engage in conservative tax planning that involves interpretations of tax law that, while defensible, are not certain. Disclosure is a way to mitigate potential penalties by being transparent about these interpretations.

Example: A restaurant owner donates excess food to local shelters and claims a charitable contribution deduction. Since the market value of perishable food can be subjective, they disclose this deduction to avoid any penalty if the IRS deems the claimed value excessive.

Use of Tax Treaties: When a taxpayer takes a position that relies on the benefits of a tax treaty that may reduce or eliminate U.S. tax, and the application of the treaty is not clear-cut, disclosure is appropriate.

Example: A taxpayer works in the U.S. but is a resident of a country that has a tax treaty with the U.S. The treaty exempts their income from U.S. tax, but the IRS might question their residency status. They disclose this position to show their interpretation of the treaty benefits.

Large or Complex Deductions: Taxpayers claiming large or complex deductions that could be questioned by the IRS might disclose these positions to pre-emptively address any potential disputes.

Example: A construction company undertakes a large project that involves environmental cleanup and claims a deduction for the cleanup expenses. Given the complexity and the large amount of the deduction, they disclose the position due to the potential for the IRS to scrutinize the claim.

Transfer Pricing: Multinational companies often need to disclose their transfer pricing positions due to the complexity and the potential for different interpretations of arm's length pricing.

Example: A multinational company sells goods to a subsidiary in another country. They set the transfer price based on their own analysis of what would be an arm's length transaction. Given the complexity of transfer pricing and potential for different interpretations, they disclose their methodology and pricing strategy.

Novel Tax Law Interpretations: If a taxpayer relies on a novel interpretation of tax law, especially one that has not been tested in courts or is not supported by IRS guidance, they should disclose this position.

Example: An individual invents a new type of eco-friendly fuel and claims a research and development credit. The tax law is unclear on whether this type of innovation qualifies. They disclose their claim, outlining their interpretation that encourages environmentally beneficial research.

In each of these scenarios, the disclosure serves as a means to inform the IRS of a taxpayer's position and the basis for it, potentially avoiding accuracy-related penalties by demonstrating a good faith effort to properly report taxable income.

SAMPLE

Application: Identify whether substantiation is sufficient given a specific scenario.

Let's explore several hypothetical scenarios involving uncertain tax positions:

Scenario 1: Deducting Home Office Expenses

Facts: Jenny, a freelance graphic designer, works primarily from her home office. In 2023, she decides to deduct 50% of her total housing costs as home office expenses. However, only 20% of her home's square footage is dedicated to her office, and she sometimes uses this space for personal activities.

Substantiation Assessment: Jenny's claim of 50% may not be sufficiently substantiated. The IRS usually requires that for a space to qualify for a home office deduction, it must be used regularly and exclusively for business. Given the mixed use of her office and the discrepancy between square footage and claimed deduction, the IRS may challenge her position. An adequate disclosure of her reasoning might mitigate penalties, but she may still face adjustments to her deduction.

Scenario 2: Classifying Workers as Independent Contractors

Facts: XYZ Corp. hires several workers to perform tasks similar to those of their full-time employees. However, to save on employment taxes and benefits, XYZ classifies these workers as independent contractors. They do not exert excessive control over their working hours or methods, but the nature of the job is consistent with roles typically held by employees.

Substantiation Assessment: The classification of workers as employees vs. independent contractors is a common uncertain tax position. The IRS uses a multi-factor test to determine worker status, considering the degree of control, the financial arrangements, and the nature of the relationship. If audited, XYZ Corp. might struggle to substantiate the classification. If XYZ does not disclose this position and cannot substantiate it, they could face penalties and back taxes.

Scenario 3: Accelerating Expense Recognition

Facts: ABC Company, a tech startup, incurs significant R&D costs in developing a new software. They decide to deduct all the costs in the current tax year, even though some of the expenses relate to projects expected to generate income in future years.

Substantiation Assessment: The IRS generally requires expenses to be matched with the income they generate. Deducting all R&D costs in the current year, without regard to when the income is recognized, is an uncertain position. ABC Company would need strong justification for their treatment of the R&D costs, and even with disclosure, they may face challenges from the IRS.

Scenario 4: Claiming Ambiguous Tax Credits

Facts: LMN Corp. operates in an industry that recently received new tax incentives. The language of the new law is vague, and LMN believes they qualify for a particular credit. They claim it, even though the IRS has not issued clarifying guidance.

Substantiation Assessment: Given the lack of clear guidance, LMN's position is uncertain. Their interpretation might be reasonable, but without regulatory clarification, the IRS might not agree. If LMN can provide a well-reasoned legal argument for their position and disclose it properly, they might avoid penalties, but they might still face challenges.

Scenario 5: Allocation of Income Between Entities

Facts: DEF Corp. operates in the U.S. and in several foreign countries through various subsidiaries. For certain transactions, DEF allocates income between the U.S. parent company and a foreign subsidiary, leading to a lower overall tax rate due to differences in U.S. and foreign tax rates.

Substantiation Assessment: Transfer pricing regulations require that intercompany transactions be priced as if they were between unrelated parties (at arm's length). If DEF cannot provide adequate documentation showing that their income allocation reflects arm's length pricing, the IRS could adjust the income allocation. Proper disclosure of the methodology used and the rationale behind it would be crucial.

Scenario 6: Deduction of Travel Expenses

Facts: George, a real estate agent, travels frequently for both business and personal reasons. He often combines business trips with vacations. For a particular year, he deducts all his travel expenses, claiming they were all business-related.

Substantiation Assessment: The IRS requires that for travel expenses to be deductible, they must be ordinary,

necessary, and directly related to the taxpayer's business. If George cannot provide a clear separation of his business and personal travel or lacks records like itineraries, meeting agendas, or client communications, his deductions could be disallowed. Proper documentation and potentially pro-rating expenses between business and personal would be necessary.

Scenario 7: Claiming a Charitable Contribution

Facts: Stella donates a piece of art to a museum and claims a charitable deduction based on an appraisal she received. The appraised value is significantly higher than recent sales of similar artworks.

Substantiation Assessment: The IRS requires that non-cash charitable contributions over a certain value be substantiated with a qualified appraisal. If Stella's appraisal is seen as inflated or not conducted by a qualified appraiser, her deduction might be challenged. Proper disclosure of the appraisal method and ensuring the appraiser's qualifications would be essential.

Scenario 8: Deduction for Environmental Clean-Up Costs

Facts: HIJ Company incurs costs for cleaning up a polluted site they purchased. They classify these costs as ordinary and necessary business expenses and deduct them in the current year. The potential future benefit of the clean-up extends beyond the current tax year.

Substantiation Assessment: The IRS may view the environmental clean-up costs as capital expenditures, which

should be capitalized and not immediately deducted. HIJ Company would need to substantiate why they believe their treatment of the costs as ordinary and necessary business expenses is appropriate. Disclosing their reasoning and potentially citing any precedents or guidance supporting their position would be key.

In all these scenarios, the taxpayer's interpretation might be reasonable, but the lack of clear-cut guidance or the aggressive nature of the position introduces uncertainty. Proper disclosure and substantiation are key in these situations.

3. Taxpayer Penalties

Remembering and Understanding: Recall situations that would result in taxpayer penalties relating to tax returns, and Application: Identify taxpayer penalties given a specific scenario.

Here are some of the most common taxpayer penalties, including examples:

Earned Income Tax Credit Penalty:

Explanation: This penalty arises when a taxpayer claims the Earned Income Tax Credit (EITC) fraudulently or with reckless or intentional disregard of rules. The EITC is a refundable tax credit for low to moderate-income working individuals and couples, particularly those with children.

Example: If Jane, a single mother, provides incorrect information about her income to artificially inflate her EITC, she could face this penalty and may be barred from claiming EITC for the next 10 years.

Penalty for Failure to Make Sufficient Withholding and Estimated Income Tax Payments:

Explanation: Taxpayers are expected to pay tax throughout the year. If they don't have enough tax withheld, or if they don't make the appropriate estimated tax payments, they can be penalized.

Example: Bob is a freelancer who earns irregular income. He doesn't make quarterly estimated tax payments, and at the end of the year, he owes much more than he has paid. As a result, he may incur this penalty.

Failure-to-File Penalty:

Explanation: This penalty is assessed if a taxpayer does not file their return by the tax filing deadline (usually April 15), unless they have an extension.

Example: Sarah forgets to file her tax return by April 15 and does not request an extension. She is charged a monthly penalty until she files.

Failure-to-Pay Penalty:

Explanation: This is charged for failing to pay taxes owed by the due date.

Example: Mike files his tax return on time and realizes he owes \$2,000. However, he doesn't pay this amount by April 15. He will face this penalty for any unpaid amount.

Negligence Penalty for Understatement of Tax:

Explanation: This penalty applies when the IRS determines that an understatement of tax liability is due to negligence or disregard of rules or regulations.

Example: If Anna neglects to include a source of income on her tax return, resulting in lower tax liability, and the IRS determines this was due to negligence, she could face this penalty.

Penalty for Substantial Understatement of Tax:

Explanation: This penalty is imposed when the understatement of tax exceeds a certain percentage (usually 10%) of the tax required to be shown on the return, or if it exceeds a specific dollar amount.

Example: John files a tax return showing he owes \$5,000, but the IRS finds that he actually owes \$12,000. Because his understatement is substantial, he might be subject to this penalty.

Penalty for a Substantial Valuation Misstatement:

Explanation: This penalty is applied when a taxpayer overstates the value of property or understates the value of donated property, affecting their tax liability.

Example: Mary donates a piece of art to a museum and claims its value is \$50,000 for a charitable deduction. Later, it's found that the art's actual value is only \$10,000. She could face this penalty for the substantial misstatement.

Fraud Penalties (both civil and criminal):

Explanation: Fraud penalties are applied when there's intentional wrongdoing on the part of the taxpayer to evade tax laws.

Example: Tom deliberately hides income streams, fabricates deductions, and provides false information to reduce his tax liability. Upon an IRS audit, he's found guilty of tax fraud and faces both civil and potential criminal penalties.

4. Authoritative Hierarchy

Remembering and Understanding: Recall the appropriate hierarchy of authority for tax purposes.

The U.S. federal tax system operates within a hierarchy of authority. This hierarchy provides guidance and helps resolve issues where contradictions or ambiguities might exist.

Here's a summary of the authoritative hierarchy for federal taxation in the United States:

Internal Revenue Code (IRC):

Often referred to as the "Tax Code," the IRC is the cornerstone of federal taxation. It's a comprehensive law that defines how federal taxes are levied, administered, and collected.

The IRC, enacted by Congress, has the highest authority in tax law. It establishes and codifies the rules regarding income, estate, gift, employment, and excise taxes.

Treasury Regulations:

These are official interpretations of the IRC issued by the Department of the Treasury.

Treasury Regulations provide the IRS's official interpretation of the IRC and give detailed guidance on its application. They can be either "final," "temporary," or "proposed" and are a primary source to turn to after the IRC itself.

Revenue Rulings and Revenue Procedures:

These are official IRS interpretations of the IRC, aiming to promote uniform application of the tax laws.

Revenue Rulings provide the IRS's position on specific tax issues, while Revenue Procedures offer guidance on the procedural aspects of taxation (e.g., how to file certain forms or make certain elections).

IRS Private Letter Rulings:

These are written statements issued by the IRS in response to taxpayer requests for guidance on specific tax situations.

While they directly address the individual taxpayer's specific situation, they also give insight into the IRS's stance on particular issues. However, they cannot be relied upon as precedent by other taxpayers.

U.S. Supreme Court Decisions:

The U.S. Supreme Court is the highest court in the land and its decisions have broad implications.

When the Court makes a ruling on a tax matter, it provides a binding interpretation of the law.

Lower Federal Court Decisions:

These include decisions from the U.S. Tax Court, U.S. District Courts, and the U.S. Court of Federal Claims.

These courts handle many tax-related cases, and their decisions serve as precedents, unless overturned by higher courts.

IRS Publications, Notices, and Forms:

These provide practical guidance to taxpayers on various tax issues.

Though not legally authoritative, these materials are helpful for understanding the IRS's interpretation and application of tax laws.

Other Sources:

Other sources, like treatises, articles, and tax journals, provide interpretations, analysis, and opinions on tax issues.

While not authoritative, these sources can be valuable for insight, especially on complex or novel tax issues.

When interpreting tax laws and making decisions, practitioners often start at the top of this hierarchy and work their way down, ensuring they adhere to the highest authoritative sources first.

D. Legal Duties and Responsibilities

1. Common Law Duties and Liabilities to Clients and Third Parties

Remembering and Understanding: Summarize the tax return preparer's common law duties and liabilities to clients and third parties.

Tax return preparers have a range of duties and potential liabilities stemming from their professional relationships with clients and, in some situations, third parties. Let's delve into three primary areas of potential liability: breach of contract, negligence, and fraud.

Breach of Contract

This arises when the tax preparer fails to fulfill the terms of the agreement (either written or oral) made with the client regarding the preparation of tax returns or related services.

When a tax preparer enters into a contract with a client, they are obligated to perform the specified services in a competent and timely manner. A breach occurs when there's a failure to perform as agreed upon.

Example: A client hires a tax preparer to file their tax return by the IRS deadline, but the preparer files it late without a valid reason. If the client incurs penalties or interest due to this delay, the tax preparer could be liable for breach of contract.

Negligence

Negligence refers to the failure of the tax preparer to exercise the degree of care that a reasonably competent professional would exercise under similar circumstances.

Negligence in the context of a tax return preparer (such as a CPA) and a client revolves around the concept of a professional duty of care and the consequences of breaching that duty.

1. Duty:

Every tax return preparer owes a duty of care to their client. This duty is rooted in the professional standards and expectations for tax return preparers, and it entails providing competent and diligent services in line with the prevailing professional standards. Essentially, preparers must exercise the same level of skill and care that others in their profession would under similar circumstances.

2. Breach of Duty:

A breach occurs when the tax return preparer fails to uphold the standard of care owed to the client. This could involve errors, omissions, or other acts that fall below the professional standards for tax preparation.

3. Injury:

For a negligence claim to be valid, the client must have suffered some harm or injury. This could be financial harm due to incorrect tax filings, penalties, interest, or additional taxes owed.

4. Causation:

Causation means that the injury suffered by the client was a direct result of the tax return preparer's breach of duty. It's not enough for the client to have suffered harm; that harm must have been caused by the preparer's negligence.

5. Damages:

Damages refer to the actual monetary losses that the client incurred due to the preparer's negligence. These might include any penalties, interest, or additional tax liabilities, as well as potential legal fees or other related costs.

General Rule vs. Minority Rule:

General Rule: Traditionally, the duty of care owed by a tax return preparer was only to the client with whom they had a contractual relationship. This means that if a third party relied on a negligently prepared tax return and suffered harm, they generally could not sue the preparer because there was no direct professional relationship (or privity of contract) between them.

Minority Rule: Some jurisdictions have expanded the scope of liability. Under the minority rule, a tax return preparer may be liable to third parties who the preparer could foresee would rely on the information. This means even if there's no direct contractual relationship, if the preparer should have reasonably foreseen that a third party would rely on their work and suffer harm due to negligence, the preparer could be held liable.

Example: If a tax return preparer knows that their client is seeking a loan and that the bank will rely on the tax returns to make its decision, under the minority rule, the preparer might be liable to the bank if there's negligence in the tax preparation that leads to harm for the bank.

In practice, the scope of a tax return preparer's liability for negligence can vary based on jurisdiction and specific circumstances. Tax professionals should be aware of the rules and standards in their jurisdiction and ensure they adhere to best practices to mitigate potential risks.

Fraud

Fraud involves intentional wrongdoing or deceit by the tax preparer with the aim of causing harm or loss to the client or a third party.

Five Elements of “Actual Fraud”

Actual fraud, sometimes simply referred to as “fraud,” involves intentional misrepresentation or deceit with the purpose of causing harm or inducing another party to act or refrain from acting based on that misrepresentation. The five elements required to establish actual fraud are:

1. Misrepresentation:

This means that a false statement or a misleading omission was made. The person making the misrepresentation must know that the statement is false or must make the statement recklessly without knowing whether it's true or false.

Example: A seller of a home states that the roof is brand new when, in reality, it is over 10 years old and has multiple leaks.

2. Scienter (Intent to Deceive):

The party making the misrepresentation must have an intention to deceive the other party. This element distinguishes actual fraud from innocent misrepresentation where there's no intent to deceive.

Example: A car salesman knows that a used car has a faulty transmission but tells a potential buyer that the car is in perfect condition, intending to deceive the buyer.

3. Reliance on the Misrepresentation:

The deceived party must have relied on the false statement or misleading omission when making a decision.

Example: A buyer decides to purchase a business based on the seller's false claims about the business's profitability. If the buyer had known the true financial state of the business, they would not have made the purchase.

4. Justifiable Reliance:

The reliance on the misrepresentation must be justifiable. This means that the deceived party had a reasonable basis for believing the misrepresentation. If it's obvious that the statement was false or if the deceived party was reckless in their reliance, this element may not be satisfied.

Example: If a piece of jewelry is sold for \$10 and the seller claims it's genuine diamond, the buyer's reliance might not be considered justifiable because the price is too good to be true for a real diamond.

5. Damages:

The deceived party must have suffered some harm or loss as a result of their reliance on the misrepresentation.

Example: A person invests in a company based on fraudulent financial statements provided by the company's CEO. The company later goes bankrupt, and the investor loses their entire investment.

All these elements need to be present for actual fraud to be established in most legal jurisdictions.

“Actual Fraud” vs “Constructive Fraud”

Constructive fraud and actual fraud are both forms of deceit, but they differ primarily in intent and the nature of the misrepresentation.

Constructive Fraud:

Intent: Constructive fraud does not require an intent to deceive. It typically arises from a breach of a legal or equitable duty, which, irrespective of the breaching party's intent, the law expressly declares to be fraudulent because of its tendency to deceive others, to violate public or private confidence, or to injure public interests.

Nature: It often involves a misrepresentation made without the knowledge of its falsity, or reckless conduct without taking the necessary steps to ascertain the truth. It might also involve a failure to disclose information when there's a duty to do so.

Example of Constructive Fraud: An agent responsible for purchasing property for a client fails to disclose that they also have a personal financial interest in the sale of that property. Even if the agent believed the purchase was in the client's best interest and had no intent to deceive, the failure to disclose the personal interest can constitute constructive fraud because of the breach of duty.

Actual Fraud:

Intent: As previously discussed, actual fraud requires an intent to deceive or defraud another party. The deceiving party knows they are making false representations or is making claims recklessly without knowing whether they're true or false.

Nature: It involves deliberate deceit that leads another party to act to their detriment.

Example of Actual Fraud: A seller intentionally hides defects in a used car and claims it's in "perfect condition" to make a sale. The buyer, relying on this statement, purchases the car, only to find out later that it has numerous issues.

The main distinction between the two is the presence or absence of intent to deceive. Constructive fraud arises from a breach of duty or negligence that leads to deception, even

if unintentionally. Actual fraud involves a direct intent to deceive or defraud another party.

Fraudulent acts by tax preparers might include intentionally falsifying tax return information, misappropriating client funds, or making false statements to clients or third parties about tax matters.

To be held liable for fraud, there generally needs to be evidence of intent to deceive or harm. Merely making an error or mistake on a tax return doesn't amount to fraud unless there's evidence of an intent to deceive.

Example: A tax preparer intentionally inflates deductions on a client's tax return to get the client a higher refund, and then takes a percentage of the increased refund as their fee without the client's knowledge. This act constitutes fraud, and the preparer can be held liable both criminally and civilly.

Tax return preparers should be aware of these duties and liabilities to uphold professional standards and avoid potential legal repercussions.

Application: Identify situations which result in violations of the tax return preparer's common law duties and liabilities to clients and third parties.

Here are a few examples where a TRP violates their common law duties to clients and/or third parties:

Breach of Contract:

Missed Deadlines: A client contracts a tax return preparer to file their taxes before the deadline. The preparer assures the client they will meet the deadline but fails to do so without a valid reason, leading to late filing penalties for the client.

Not Providing Promised Services: A tax return preparer offers a package that includes tax planning advice for the next fiscal year. After preparing and filing the client's tax return, the preparer does not provide the promised tax planning advice.

Unauthorized Actions: A tax return preparer files an extension for the client without the client's consent or knowledge. The client was prepared to pay all due taxes on time and did not wish for an extension.

Negligence:

Overlooking Deductions: The tax return preparer fails to ask the client about potential tax deductions. As a result, the client ends up paying more tax than necessary, missing out on significant deductions they were eligible for.

Incorrect Data Entry: The preparer enters the wrong figures from the client's financial documents, leading to an incorrect tax amount. The client then faces penalties and interest for underpayment.

Not Keeping Up with Tax Code Changes: The tax code has undergone significant changes. However, the preparer doesn't invest time in understanding the new rules and applies old ones, leading to an incorrect return.

Fraud (Including Constructive Fraud):

Misrepresentation for Higher Fees: A tax return preparer tells the client that they have found a way to save them an additional \$10,000 in taxes, but it would require a special service with an extra fee. The client agrees and pays, but the preparer doesn't do any additional work and simply pockets the fee.

Falsifying Deductions: The preparer adds fake deductions to the client's return to inflate a refund, without the client's knowledge, hoping to gain favor and ensure repeat business.

Constructive Fraud - Overstating Qualifications: A preparer claims to be a certified tax expert with special certifications and extensive experience in the client's specific industry. Relying on this representation, the client hires the preparer. The return has multiple errors because the preparer doesn't truly understand the industry-specific rules. Here, even if the preparer believed they could competently complete the

return, the misrepresentation of their qualifications led to harm.

SAMPLE

2. Privileged Communications, Confidentiality and Privacy Acts

Remembering and Understanding: Summarize the rules regarding privileged communications as they relate to tax practice.

Privileged communications refer to the right of a client to refuse to disclose certain confidential communications with specific professionals, like attorneys. In the context of tax practice in the United States, this concept has some unique aspects.

Section 7525 Privilege:

- Coverage: The IRS Restructuring and Reform Act of 1998 introduced Section 7525, extending the attorney-client privilege to communications between a taxpayer and any federally authorized tax practitioner, which includes CPAs, enrolled agents, and enrolled actuaries, in regard to tax advice.
- Scope: The privilege only applies to non-criminal tax matters before the IRS and non-criminal tax proceedings in federal courts. It does not apply to state tax matters unless a given state has enacted a similar privilege.
- Limitations: The privilege doesn't extend to communications regarding corporate tax shelters or to any written communications promoting tax evasion.

Tax Practitioner-Client Privilege:

- Unlike attorney-client privilege, which can be used to shield any kind of advice given by an attorney to their client, the tax practitioner-client privilege specifically covers tax advice. It

doesn't protect information that is used to prepare a tax return.

Exceptions to Privilege:

The privilege is lost if the communication is further disclosed to a third party.

It doesn't apply if the client seeks advice for a fraudulent or illegal purpose (crime-fraud exception).

Communications made in the presence of a third party are generally not privileged.

Work Product Doctrine:

While not a privilege per se, the work product doctrine can protect documents prepared in anticipation of litigation from being disclosed to opposing parties. This doctrine might protect certain tax work papers, especially those that analyze tax positions for potential litigations.

Kovel Arrangements:

Named after a court case, Kovel arrangements allow attorneys to extend the attorney-client privilege to non-attorneys who assist in providing legal services. For example, if an attorney hires a CPA to help understand complex financial transactions, communications involving the CPA may still be protected as long as they are in service of providing legal advice.

Limitations and Considerations:

Clients and tax professionals should be aware that certain records, such as those required to be maintained by tax regulations, are generally not privileged.

State laws can vary, and not all states recognize tax practitioner-client privilege.

If a client waives the privilege, either intentionally or inadvertently, protections can be lost.

Workpapers Created by a CPA or CPA Firm

Workpapers, often referred to as "working papers," are documents created by a CPA or CPA firm as part of their work on a client's financial statements, tax returns, or other engagements. They provide the basis for the CPA's or CPA firm's conclusions and offer a record of the underlying data and its analysis, as well as any professional judgments made in reaching conclusions.

Ownership of Workpapers:

- **Ownership:** Typically, workpapers created by a CPA or a CPA firm in the course of rendering professional services are the property of the CPA or the firm, not the client—even if the client has paid for the accounting services.
- **Client's Right:** The client has a right to the financial statements, tax returns, or other deliverables prepared for them, but not to the workpapers themselves.

Rules Regarding Privileged Communications and Workpapers:

Confidentiality: Generally, the CPA is prohibited from disclosing any confidential client information without the client's explicit permission. This includes information contained in workpapers.

Limited Exceptions: There are certain exceptions where a CPA might be required or permitted to share workpapers:

- **Subpoenas or Court Orders:** A CPA might have to provide workpapers if they are subpoenaed or ordered by a court.
- **Peer Reviews:** During peer reviews to assess a firm's adherence to professional standards, selected workpapers might be reviewed. However, the reviewers are also bound by confidentiality rules.
- **Regulatory or Licensing Bodies:** Some regulatory bodies, like the IRS or state boards of accountancy, may have the authority to inspect workpapers in specific circumstances.
- **Successor Auditors:** With a client's consent, a successor auditor may review a predecessor's workpapers to gain an understanding of specific matters.

Not Absolute Privilege: It's essential to differentiate between confidentiality and privilege. While CPAs must keep client information confidential, this obligation is not the same as the attorney-client privilege. In many legal situations, workpapers can be compelled as evidence.

Federal Tax Workpapers Exception: Some workpapers related to federal tax issues may receive a kind of "conditional privilege"

from the IRS under certain conditions, though this privilege is not absolute and has many exceptions.

Client Waiver: The client can waive confidentiality, allowing the CPA to share workpapers. This waiver should be explicit and in writing.

While workpapers are confidential, they are not absolutely privileged. CPAs must be cautious about maintaining client confidentiality and be aware of the situations in which they may be required to share workpapers.

Application: Identify situations in which communications regarding tax practice are considered privileged.

Here are 10 example situations where communications regarding tax practice would be privileged under the U.S. rules:

Audit Discussion: A taxpayer meets with her CPA to discuss how best to handle an upcoming IRS audit. The taxpayer shares concerns and asks for the CPA's advice on potential legal consequences.

Foreign Account Inquiry: A taxpayer emails his tax attorney, inquiring about the potential tax implications and reporting requirements of having a bank account in a foreign country.

Estate Planning: During an estate planning meeting, a client shares confidential financial information with an enrolled agent to determine potential estate tax liabilities and strategies to minimize them.

Tax Litigation Strategy: A company's CFO consults with the company's tax attorney regarding strategies to contest a significant tax deficiency in federal court.

Mergers and Acquisitions: Before a major acquisition, a company's CEO and CFO meet with an external CPA to understand the tax implications of the deal.

Divorce Implications: A taxpayer going through a divorce contacts her tax practitioner to discuss the tax consequences of dividing assets and potential alimony payments.

Real Estate Transaction: A property developer speaks with his tax attorney about the tax implications of a complex commercial property sale, including potential capital gains and available deductions.

Charitable Donations: A taxpayer consults her enrolled agent about the tax implications of donating a valuable piece of art to a museum.

Kovel Arrangement: An attorney, unsure about certain international tax regulations, hires a CPA under a Kovel arrangement. The client, attorney, and CPA meet to discuss the international tax matter, with the understanding that the CPA's input assists the attorney in providing legal advice.

Trust Setup: A wealthy individual meets with a tax practitioner to discuss setting up a trust for his children and grandchildren. They discuss the tax benefits, potential pitfalls, and required reporting for such a trust.