CHAPTER 25

TAX ADMINISTRATION AND PRACTICE

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Rates of audit	Unchanged	1
2	Document matching and preparer penalties	Unchanged	2
3	Issue ID	Unchanged	3
4	Precedential value of letter ruling	Unchanged	4
5	Burden of proof	Unchanged	5
6	Audit cycles	Unchanged	6
7	Audit strategy	Unchanged	7
8	IRS payment of interest	Unchanged	8
9	Taxpayer penalties and interest	Unchanged	9
10	Tax administration and practice: terminology	Unchanged	11
11	Penalty for false information with respect to withholding	New	
12	Statutes of limitations	New	
13	Practice before the IRS	Unchanged	12
14	Ethical restrictions on tax practitioners	Unchanged	13
15	Computation of penalties	Modified	14
16	Failure to file and pay penalties; overall limitation; reasonable cause due to reliance on CPA	Unchanged	15
17	Negligence penalty	Unchanged	16
18	Fraud and negligence penalties imposed	Unchanged	17
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20	Overvaluation penalty	Modified	19
21	Undervaluation penalty	Unchanged	20
22	Overvaluation penalty	Unchanged	21
23	Civil fraud	Unchanged	22
24	Civil fraud	Modified	23

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
25	Determining estimated payments: individual	Unchanged	24
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34	Preparer penalties	Unchanged	33
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CHECK FIGURES

15.	Failure to file penalty $1,080.
16.a.	$280 failure to pay penalty.
17.	$1,900.
18.	$18,000 penalty for negligence.
19.b.	$1,785.
20.d.	$0 penalty due.
20.e.	$24,500.
20.f.	$105,000.
21.b.	$0 penalty due.
21.c.	$17,000.
21.d.	$90,000.
22.	$0 penalty due.
23.	$18,750.
24.	$7,500 fraud, $18,000 negligence.
25.	$13,750 each.
26.a.	$42,500 each.
26.b.	$25,500 each.
28.a.	None.
28.b.	Seven years.
28.c.	Six years.
29.a.	$258,000.
29.c.	No statute of limitations.
30.a.	$12,000.
33.d.	Criminal penalty § 7201.
33.e.	$250 penalty for no realistic possibility.
33.f.	Probably none.
34.c.	$30,000.

DISCUSSION QUESTIONS

1. Less than 0.5% of all individual tax returns are audited in a given tax year. However, certain types of both taxpayers and income—including, for instance, high-income individuals (about 3%), cash-oriented businesses, real estate transactions, and estate- and gift-taxable transfers (15 to 30%)—are subject to much higher probabilities of audit. One's state of residence also affects the chances of audit. p. 25-3

2. Much of the IRS's recent efforts has been devoted to the document matching program, in both form design and data creation. Special programs target industry- and item-specific audit possibilities. In addition, through correspondence audits, the penalty system, and Circular 230 sanctions, the IRS has been placing increased pressure on the tax practitioner community to reduce the number and importance of conflicts in interpretation of the tax law. p. 25-3

3. The IRS maintains that it can raise three to four dollars in revenue for every dollar its annual appropriation is increased, but political pressures keep the agency from getting "too large," due to both left-wing fears of Big Brother and right-wing general opposition to big government. IRS measures to walk this fine line have included a greater dependence on document matching—although its computer systems may never catch up to those of the taxpayer, and the monumental mid-1980s loss on the issue of withholding on interest and dividend income continues to haunt the agency—and continued stratified sampling—which is looking for greater returns on audit efforts by concentrating on non-filers, cash-oriented transactions including the underground economy, and white-collar underpayments, all of which possess the potential for high levels of payment of income and payroll tax, and penalty and interest amounts.

   Real budget dollars appropriated to the IRS decline ever year. And concerns about a Big Brother society may be the ultimate constraint on the size of the agency and the visibility of its audit activities.

   p. 25-3 and *Tax in the News*

4. TAX FILE MEMORANDUM

   November 6, 2003

   From: Rick J. Taylor

   Re: Precedential value of letter ruling received

   The receipt of an unfavorable letter ruling does not force negative tax consequences upon a taxpayer. The nature of the ruling process is more multidimensional in application.

   A letter ruling represents the current opinion of the IRS relative to the consequences of a narrowly defined set of facts. If the terms of the proposed transaction are altered, the holding might be irrelevant. Rulings frequently are declared obsolete or are superseded by new rulings as the tax law changes. However, modification of a ruling generally is not applied retroactively to the taxpayer who received the ruling initially, if it was relied on in good faith in a transaction substantially similar to that described in the ruling.

The IRS may revoke any ruling if, upon subsequent audit, an agent finds a misstatement or omission of facts or substantial discrepancies between the facts as described in the ruling request and those encountered in the transaction.

p. 25-4

5. The IRS bears the burden of proof in a court proceeding, when the taxpayer has satisfied bookkeeping and substantiation requirements, and where the taxpayer has cooperated fully with IRS requests throughout the audit process.

   In the case of civil fraud (which could result in the imposition of a 75% penalty), the burden of proof is clearly on the IRS. To successfully assess the penalty, the IRS must show by a preponderance of the evidence that the taxpayer had a specific intent to evade a tax.

   In the case of criminal fraud (a conviction of which could result in monetary fines and/or imprisonment), the burden of proof is also on the IRS. Here it must show that the taxpayer was guilty of willful evasion "beyond the shadow of any reasonable doubt."

   pp. 25-5 and 25-19

6. As a practical matter, most individual returns are examined about two years from the date of their filing. No conclusions can be drawn prior to the third year after the filing date, though, in light of the statute of limitations.

   Mathematical errors and document matching concerns are the only IRS-initiated corrections that are likely to occur within one year of the date the return is filed. Large corporations are audited every year. Thus, a taxpayer should not feel "too comfortable" with respect to avoiding an audit until enough time passes. Two months is not enough time, even if the refund check has been received.

   p. 25-8

7. Settlement of factual issues with the IRS agent generally is desirable, since further administrative appeals and litigation can be a time-consuming and costly process. An agent must adhere strictly to IRS policy as reflected in published rulings, regulations and other IRS releases. Since he or she usually cannot resolve an issue based upon the hazards of litigation, it may be desirable to resolve factual issues at the agent level and to attempt to reach a settlement of the remaining unresolved issues with the Appeals Division.

   One problem with not disposing of a case at the agent level is that new issues may be raised where the return will come under closer scrutiny.

   p. 25-10

8. No. If an overpayment is refunded to the taxpayer within 45 days after the due date of the return or after the date the return is filed, whichever is later, no interest is allowed. p. 25-14

9. a. *FALSE*. The government is required to pay interest at the applicable Federal rate to any taxpayer who has made an overpayment of tax. Interest on the overpayment begins to accrue from the later of 45 days after the unextended due date of the return or 45 days after the return actually is filed. However, if the refund is not made within this 45 day period, interest begins to accrue from the due date of the return. p. 25-14

   b. *FALSE*. Tax penalties may not be deducted as itemized deductions on an individual's income tax return. The Code characterizes them as additions to tax, and Federal income taxes are not deductible. p. 25-14

   c. *FALSE*. If a taxpayer fails to pay a tax that is shown on his or her return by the unextended due date, a penalty is imposed. However, this penalty is not imposed if the failure is attributable to reasonable cause or to the failure to pay estimated tax (for which there is a special penalty). Reasonable cause usually is presumed to exist if an individual is granted an automatic filing extension and the balance due does not exceed 10% of the total tax. The same rule applies to a corporation [Reg. §§ 301.6651(c)(3) and (4)]. pp. 25-14 and 25-15

   d. *TRUE*. Prior to the time that the case is referred to the Justice Department for prosecution or defense, the IRS can compromise on any civil or criminal case that does not involve drugs. However, the IRS will not enter into a compromise with a taxpayer if the liability has been established by a valid judgment, and there is no doubt as to the IRS's ability to collect the amounts that are due. p. 25-12

   e. *FALSE*. Although the general rule is that assessment must be made within three years from the later of the date that the return actually is filed or the unextended due date of the return, the three-year period is extended when:

   - there is a substantial understatement of gross income (greater than 25%);
   - the taxpayer files no return or files a false or fraudulent return with the intent to evade tax; or,
   - the IRS and the taxpayer agree to extend the statute of limitations period with respect to a return that is under audit.

   pp. 25-21 and 25-22

   f. *FALSE*. A taxpayer who has filed a return must file a claim for credit or refund within three years of the date in which the return was filed, or two years from the date on which the tax was paid, whichever is later. This period may be extended when:

   - the IRS and the taxpayer agree to extend the period;
   - the overpayment results from a business bad debt or from a discovery of a worthless security; or,
   - the claimed overpayment results from the carryback of a net operating loss, capital loss, or certain credits.

pp. 25-21 and 25-23

10. a. An offer in compromise is the means by which the taxpayer offers to reduce a liability resulting from an alleged violation of laws or failure to pay an internal revenue liability. It is binding on the IRS and the taxpayer, because it is a legally enforceable promise that cannot be rescinded, unless there has been a misrepresentation of the assets of the taxpayer by falsification or concealment, or a mutual mistake relative to a material fact. Absent grounds for rescission, a taxpayer who has entered into a valid compromise may not subsequently prosecute a claim for refund. Generally, an offer in compromise is used in collection cases to settle a tax liability for less than the assessed amount (e.g., where the taxpayer is not likely to pay the full amount of deficiency). The IRS has become more accommodating in its acceptance of offers in compromise, to both reduce the total amount of tax due and spread it out over an installment payment period.

A closing agreement is a formal written agreement that is made between a taxpayer and the IRS. It is the only agreement that is binding on the IRS by operation of statute (an offer in compromise is binding under contract, rather than tax law). Unlike an offer in compromise, a closing agreement is final and conclusive on both the government and the taxpayer, unless there is a showing of fraud, malfeasance or a misrepresentation of a material fact, by either party. The IRS discourages the use of closing agreements because of their finality. Moreover, the IRS's closing agreement procedures are restrictive and cumbersome.

p. 25-12

b. If a taxpayer fails to pay either a tax that is shown on his or her return, or an assessed deficiency, within ten days of an IRS notice and demand, a penalty is imposed. The penalty is one-half percent of the required liability, after adjusting for any prior payments and credits, for each month (or fraction thereof) that the tax is not paid. The maximum penalty that may be imposed is 25% of the outstanding tax.

If a taxpayer fails to file a required return, a penalty is imposed unless it is shown that the failure is due to some reasonable cause, and not the taxpayer's willful neglect. The penalty is 5% of the amount of the tax, less any prior payments and credits, for each month (or fraction thereof) that the return is not filed. The maximum penalty that may be imposed is 25%. The penalty is increased to 15% per month, up to a maximum of 75%, if the failure to file is fraudulent.

The failure-to-file penalty is reduced by the one-half percent failure-to-pay penalty, for any month in which both apply. The failure-to-file penalty can be avoided if an extension of the return's due date is granted by the IRS, and the IRS can waive the concomitant failure-to-pay penalty, as a means of encouraging more taxpayers to file on a more timely basis.

pp. 25-15 and 25-16

c. A *thirty-day letter* is a document that formally notifies the taxpayer of the examiner's findings, requests that the taxpayer agree to the proposed adjustments, and informs the taxpayer of his or her appeal rights. If no response to this notice is received within thirty days, the taxpayer will be sent a statutory notice of deficiency ("ninety-day letter"), which permits him or her a pre-payment Tax Court review of the deficiency.

A *ninety-day letter* is a statutory notice of deficiency that is issued by the District Director when the taxpayer and the IRS cannot agree on the proposed adjustments after an appeals conference or when the taxpayer has not responded in a timely manner to a thirty-day letter. Once the statutory notice of deficiency is mailed, the taxpayer has ninety days to file a petition with the Tax Court for a redetermination of the deficiency. If this period is allowed to expire, the taxpayer still can pay the deficiency and file a suit for refund in the appropriate District Court or the U.S. Court of Federal Claims.

Figure 25-1

d. Neither negligence nor fraud is defined by the Code or the Regulations. However, both terms have been defined by the courts. Negligence has been defined as a lack of due care or failure to do what a reasonable and prudent individual would do under similar circumstances. The negligence penalty usually is applied to taxpayers who fail to report gross income, overstate their deductions, or fail to keep adequate books and records, provided that they are not found to have held a specific intent to evade the tax.

Fraud is described as actual, intentional wrongdoing. The intent required is the specific purpose to evade a tax believed to be owing. This definition has been expanded to include acts that are done without a bad or evil purpose.

It is the taxpayer's deceptive or misleading conduct that distinguishes fraud from mere negligence.

pp. 25-16 and 25-19

e. Tax penalties may involve both criminal and civil offenses. Criminal tax penalties are imposed only after the usual criminal process, in which the taxpayer is entitled to the same constitutional guarantees that are given to nontax criminal defendants. Usually, a criminal penalty provides for imprisonment. Civil tax penalties are collected in the same manner as other taxes, and usually only provide for monetary fines. A taxpayer may be liable for both criminal and civil sanctions. Criminal and civil penalties are not mutually exclusive; thus, a taxpayer who is convicted or acquitted of a criminal tax offense, also may be liable for a civil penalty. pp. 25-14 and 25-19

11. Maggie may be subject to a civil penalty of $500. If the required degree of willfulness (and an actual underpayment) is present, an additional criminal penalty could be a fine of up to $1,000, or imprisonment of not more than one year, or both. pp. 25-20 and 25-21

12. Statutes of limitations form an outer boundary for the appeals process, for both taxpayer and government. The statutes tend to recognize that the mere passage of time affects adversely the administration of the tax law, as evidence is lost and witnesses' memories grow dim. The statutes bind both parties, such that restrictions as to issues in dispute and the means by which to support them can aid both sides in the determination of a final tax.

The statutes may bind the parties unduly, though, when workloads, work stoppages, difficulties in obtaining information in a global environment, and other factors by their nature slow down the enforcement process.

Certain exceptions exist in the law to allow additional time where information might be difficult to discover (e.g., worthlessness of securities, failure to file any return). The tax statute can be extended in most cases by mutual consent, although this power can be abused by the government in its scheduling of audit activity and by the taxpayer in its process of disclosing information to the Treasury.

p. 25-21

13. a. Yes. Regular full-time employees may represent their employers.

    b. Yes. Lorraine falls under the employee-employer exception and not the return-preparer exception.

p. 25-23, Example 15, and Circular 230

14. a. IRS Circular 230
    AICPA Code of Professional Conduct
    AICPA Statements on Standards for Tax Services
    IRC penalty provisions

    b. IRS Circular 230
    IRC penalty provisions

    c. IRS Circular 230
    Codes and interpretations of the ABA and state bar associations
    IRC penalty provisions

    d. IRS Circular 230
    EA Code of Professional Ethics
    IRC penalty provisions

    e. IRS Circular 230
    IRC penalty provisions

pp. 25-23 to 25-29

PROBLEMS

15. *Failure to Pay*

Underpayment	$8,000
Penalty rate	X 0.005
Penalty per month outstanding	$40
Months late	X 7
Penalty	$ 280

Failure to File

Underpayment	$8,000
Penalty rate	X 0.05
Penalty per month outstanding	$ 400
Months late	X 3
Penalty before reduction	$1,200
Less: Concomitant failure to pay penalty (3 months X $40)	(120)
Penalty	$1,080

The failure to file penalty applies from the extended due date of the return, three months in this case. Lacking IRS approval, the automatic four-month extension of time to file does not extend the time to *pay* the tax. Thus, the failure to pay penalty applies for seven months.

Example 10

16. a.

Failure to pay penalty (1/2 of 1% X $7,000) X 8 months		$ 280
Plus: Failure to file penalty (5% X $7,000) X 5 months	$1,750	
Less: Failure to pay penalty for same period	175	1,575
Total penalties		$1,855

The failure to file penalty cannot exceed a total of 25%. Consequently, this penalty ceases to apply after 5 months (i.e., 5% X 5 months = 25%). The failure to pay penalty also is limited to a total of 25%. (At the rate of 1/2 of 1% per month, such penalty can continue to run for as long as 50 months.) Example 10

b. Reliance by a taxpayer on a CPA to file generally does not constitute reasonable cause so as to avoid the failure to file and pay penalties. p. 25-16

17. $1,900 (20% X $9,500). p. 25-16

18.

Penalty attributable to civil fraud (75% X $110,000)	$ 82,500
Penalty attributable to negligence (20% X $90,000)	18,000
Total fraud and negligence penalties	$100,500

If the underpayment is partially attributable to negligence and partially attributable to fraud, the fraud penalty is applied first. Example 12

19. a. Olivia is liable for both the failure to file penalty (she did not apply for and obtain an extension of time for filing her return) and the failure to pay penalty (a portion of her tax liability was unpaid as of April 15, the statutory due date for her return). Her “I was too busy” excuse would not qualify as reasonable cause to exempt her from the two penalties. pp. 25-14 and 25-15

b. For these purposes, she is considered to be six months late in filing her return [April 15 to October 4 (part of a month counts as a full month)]. The penalty for failure to file is 5% per month (up to a maximum of 25%); the penalty for failure to pay is 1/2 of 1% per month (up to a maximum of 25%). During any month in which both penalties apply, the penalty for failure to file is reduced by the penalty for failure to pay.

Calculations, based on tax due balance of $7,000, are as follows.

Failure to pay penalty (1/2 of 1% per month X 6 months)		$ 210
Plus: Failure to file penalty (5% per month X 5 months)*	$1,750	
Less: Failure to pay penalty for same period	175	1,575
Total penalties		$1,785

*As the failure to file penalty cannot exceed 25%, the limit is 5 months (i.e., 5 months X 5% = 25%).

This problem does not address the issue of the penalty for underpayment of estimated tax. If such penalty applies, it is considered an addition to the tax for purposes of any penalties (or interest) due.

Example 10

20. a. $0. Reported valuation ($50,000) is not at least 200% of correct value ($30,000).

b. $0. Additional tax ($7,000) is less than $10,000, and reported valuation ($50,000) is not at least 200% of correct value ($30,000).

c. $0. Reported valuation ($50,000) is not at least 200% of correct value ($40,000).

d. $0. Reported valuation ($250,000) is not at least 200% of correct value ($150,000).

e. $122,500 additional tax X 20% penalty rate = $24,500 penalty assessed.

f. $262,500 additional tax X 40% penalty rate = $105,000 penalty assessed (reported value is overstated by at least 400%).

pp. 25-17 and 25-18

21. a. $0. Additional tax ($2,500) is less than $5,000, and the reported valuation ($20,000) is not 50% or less than the correct value ($25,000).

b. $0. Valuation claimed ($80,000) is not 50% or less than the correct value ($150,000).

c. $85,000 additional tax X 20% penalty rate = $17,000 penalty assessed.

d. $225,000 additional tax X 40% penalty rate = $90,000 penalty assessed (reported value is 25% or less than the correct value).

p. 25-18

22. Under § 6662, the minimum penalty is $5,000. Arnold would owe $4,500 [30% (tax bracket) X $15,000 (overvaluation)], but the penalty for overvaluation does not apply because the reported valuation is not at least double that found correct by the IRS. p. 25-18

23. 75% X $25,000 = $18,750. Example 12

24.

Apply civil fraud penalty first	75% X $10,000	=	$ 7,500
Accuracy-related penalty due to negligence	20% X $90,000	=	18,000
Total penalty due			$25,500

pp. 25-16 and 25-19

25. ***Current-Year Method***

First Quarter Payment [$85,000 tax ÷ 4 payments X 90% required]	$19,125
Second Quarter Payment	19,125
Third Quarter Payment	19,125
Fourth Quarter Payment	19,125

Prior-Year Method

First Quarter Payment [($50,000 ÷ 4) X 110%]	$13,750
Second Quarter Payment	13,750
Third Quarter Payment	13,750
Fourth Quarter Payment	13,750

Thus, Trudy will use the prior-year method for her estimates this year.

p. 25-20

26. a.

First Quarter Payment [($170,000 tax ÷ 4 payments) X 100% required]	$42,500
Second Quarter Payment	42,500
Third Quarter Payment	42,500
Fourth Quarter Payment	42,500

Cannot use prior-year exception; no positive tax on last year's return.

b.

First Quarter Payment	$25,500
Second Quarter Payment	25,500
Third Quarter Payment	25,500
Fourth Quarter Payment	25,500

Use the prior-year exception. Thus, each payment = 25% X $102,000 = $25,500. The remaining liability of $68,000 ($170,000 – $102,000 paid in installments) is due without penalty with the Form 1120. A Form 2220 should be attached to prove that no underpayment penalty is due.

c.

First Quarter Payment (25% X $102,000)	$25,500
Second Quarter Payment ($42,500 X 2 = $85,000 due – $25,500 paid first quarter)	59,500
Third Quarter Payment	42,500
Fourth Quarter Payment	42,500

Kold is a "large corporation," so it can use the prior-year exception only on its first quarter payment. Underpayments are due with the next installment. Thus, the basic payment = 25% X $170,000 = $42,500.

p. 25-20

27. TAX FILE MEMORANDUM

November 6, 2003

From: Mark A. Dorschner

Re: Scooter Company liabilities to IRS

Scooter owes the original $100,000 in FICA and Federal income taxes, as redirected by Jeff, plus a 15% penalty for underdepositing of payroll taxes, under § 6656. On top of that, the IRS will assess a 100% penalty (another $100,000) against the "responsible person" under § 6672, because Jeff's failure to remit the withholdings was willful in intent. Thus, before considering interest charges, $215,000 is due.

Additional criminal penalties may be assessed, depending on the evidence surrounding Jeff's actions. Because this may involve jail time and even more monetary penalties, we must work to avoid this type of assessment by the IRS.

Because Scooter is now insolvent, the IRS will come after Jeff's and Julie's personal assets to satisfy these liabilities. It likely does not matter that Julie appears not to have been involved in the underpayment scheme for this purpose. She is a "responsible person" under the law as the board chair. We must ascertain that the IRS does not assess more than the proper total that is due—because so many parties are involved, they may assess the entire amount due from the company *and* from its two shareholders. This is improper, however, and we must monitor the IRS's computations throughout this difficult time.

p. 25-21

28. a. The absence of a return precludes the running of the statute of limitations. § 6501(c)(3) and p. 25-21

b. Although claims for refund normally are limited by the 3-year rule, seven years applies in the case of bad debts and worthless securities. § 6511(d)(1) and p. 25-23

c. For a substantial omission (i.e., more than 25%) of gross income, a 6-year statute of limitations comes into play. § 6501(e) and Example 13

d. If the omission was deliberate, fraud probably is involved. There is no statute of limitations on fraud. § 6501(c)(1) and p. 25-21

e. The normal 3-year statute applies. Unlike the substantial omission of income situation, the 6-year statute does not materialize. p. 25-21

29. a. Suzanne must omit an amount of gross income which is in excess of 25% of the gross income stated on the return for the 6-year statute of limitations to apply. Here, the omission must exceed $258,000 [($960,000 + $72,000) X 25%]. When gross income for the period includes capital gains, such capital gains are not reduced by capital losses. Example 13

b. No. This extended period of limitations rule has been interpreted to include only the omission of items affecting income, not the omission of items affecting cost of sales. Footnote 49

c. There is no statute of limitations on fraud. § 6501(c)(1) and p. 25-21

30. a. Only $12,000. Because the refund claim was not filed within three years of the filing of the return, Mark is limited to the amount he actually paid during the last two years (i.e., $12,000). § 6511(b)(2)(B) and Example 14

b. Mark is not entitled to interest on the $12,000 unless the IRS failed to make the refund within 45 days of the amended-return filing date (May 18, 2005). If the refund is not made by July 2, 2005, interest accrues from the date of the now-discovered overpayment (June 1, 2004) through the refund payment date. § 6611(e), Reg. § 301.6611-1(j), Example 14, and p. 25-13

c. The amended return should have been filed by April 15, 2005, to allow a refund of the full $18,000 and interest thereon.

31. TAX FILE MEMORANDUM

January 6, 2004

From: Tanya G. Harris

Re: Carol's refund claim

Carol informed me that she attached a Post-It note to her Form 1040 for 2003, with a brief explanation for why she reduced the amount due. The reduction was attributable to an adjustment for a prior year. The IRS certainly will ignore this informal "refund claim" and assess her the missing $1,000 in tax, plus interest and perhaps a penalty.

Carol failed to meet the compliance requirements for making a proper refund claim for the following reasons:

- She did not use a Form 1040X for the adjustment year, restating the tax due to her inventory computation.
- She did not document the computations used to make her claim in sufficient detail.

pp. 25-22 and 25-23

32. Rod may represent himself for all years involved. The same holds true for Cheryl, who is a CPA. Ann may represent Rod only for tax year 2003 and only at the agent level. Under Circular 230, only Rod and Cheryl may appear before the Appeals Division of the IRS. Example 15

33. a. The tax adviser is not subject to any return preparer penalties merely for suggesting to the client various means by which to acquire excludible income provided these means involve legal activities. The tax adviser does not violate any disclosure requirements or rules governing improper conduct when he or she gives the client this information.

b. The tax adviser could be charged with a criminal violation of the tax statutes. This criminal penalty would be levied under § 7201 for attempting to evade or defeat the tax. The adviser apparently could not be charged with some of the more common preparer penalties, such as willful understatement of liability, because the problem does not state that this tax adviser assisted in the preparation of a return [therefore, we cannot determine if the adviser is an income tax return preparer within the definition of § 7701(a)(36)]. Moreover, the problem does not indicate whether the client followed the suggestions. The tax adviser could be charged with a civil penalty under § 6701, because the scope of this statute is not limited to income tax preparers.

   Therefore, if the tax adviser assists or advises with respect to the preparation or presentation of any portion of a return, affidavit, or other document in connection with any matter arising under the Internal Revenue laws, he or she is subject to the civil penalty provided in § 6701 for aiding and abetting a tax understatement.

c. The tax adviser is not subject to any civil income tax preparer penalties, since the return preparer rules apply only to income tax return preparers. These rules do not apply to conduct with respect to excise, estate and gift, or employment tax returns. However, the tax adviser could be charged with a penalty for aiding and abetting an understatement of tax liability, which is a civil penalty under § 6701 of the Code. Unlike the other civil preparer penalties, this penalty is not restricted to income tax return preparers, as defined in § 7701(a)(36). In addition, the tax adviser presumably could be charged with a criminal penalty. A person who willfully aids or assists in the preparation of a return or other document that is false as to any material matter is guilty of a violation of § 7206(2).

d. The answer to this question is the same as that for b. above.

e. If any part of an understatement of liability with respect to an income tax return is due to a position for which there was not a realistic possibility of being sustained on its merits, a tax return preparer who knows *or should have known* of such a position is subject to a $250 penalty. Accordingly, if the return contained a position for which there was not a realistic position of being sustained on its merits, and this unrealistic position would have been discovered by the tax return preparer had he or she conducted the usual review of the return, the IRS could levy this penalty on the preparer.

   Even if the facts suggest, though, that the return was prepared negligently, the penalty may be ignored if the preparer's normal office practice, when considered together with other facts and circumstances, such as the technical tax knowledge of the preparer, indicates that the error would occur only rarely, and the normal office practice was followed in preparing the return. It is likely that the tax adviser would be charged with a negligence penalty, because the normal office practice was not followed with respect to this return. The adviser could not be charged with either a criminal or civil fraud penalty because the adviser did not exhibit the requisite intent to act in a deceptive or misleading manner.

f. The penalty for understatements due to unrealistic positions would not apply, since the mathematical error was not the result of an unrealistic position being taken on the return. It is unlikely that a taxpayer penalty would be assessed in this case, but the preparer is liable to the client for any interest and penalties the client incurs because of the preparer's failure to exercise due care.

pp. 25-23 to 25-25

34. a. 30 infractions X $50 penalty each = $1,500 total penalty under § 6695.

b. 20 infractions X $250 penalty each = $5,000 total penalty under § 6694(a). Repeated infractions over the years or other evidence might instead bring about a reckless conduct penalty of $1,000 per infraction under § 6694(b).

c. 3 infractions X $10,000 penalty each = $30,000 total penalty under § 6701. The penalty is assessed on Gerry, not the intern. This penalty is in lieu of both the unrealistic position and the willful and reckless conduct penalties.

pp. 25-25 and 25-26

35. a. False.

b. False. The CPA should withdraw only if the client refuses to correct the error or if continuing in the engagement would compromise the client's case.

c. False. Reasonable estimates are acceptable.

d. True. The error should not be disclosed to the IRS without the client's consent.

e. False. Only if the error has a carryover effect so as to preclude the correct determination of the tax liability for the current year. Example 20

pp. 25-26 to 25-29