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## 2021 SuperfastCPA Review Notes

[Updated for the July 2021 changes]

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# I. ETHICS, PROFESSIONAL RESPONSIBILITIES AND FEDERAL TAX PROCEDURES

## A. ETHICS AND RESPONSIBILITIES IN TAX PRACTICE

### 1. REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

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The regulations governing an accountant practicing before the IRS (representing a client before the IRS) are from the Treasury Department's Circular 230.

**Defining "Practice before the IRS":**

Circular 230 defines this as:

- All matters connected with presenting to or corresponding with the IRS relating to a taxpayer's rights, privileges, or liabilities under the laws or regulations administered by the IRS.
- This includes (but is not limited to):
  - Preparing & filing documents with the IRS.
  - Communicating with the IRS.
  - Representing a client at IRS hearings or meetings.
  - Rendering written advice with potential for tax avoidance or tax evasion.

**Who can "practice before the IRS"**

In general, it can only be:

- Attorneys
- CPAs



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- Enrolled agents

**Some key points from Circular 230:**

If a client requests their records be returned to them, the CPA must comply, even if the client still owes the CPA money for their services.

A CPA should not represent a client if it would create a conflict of interest, specifically to another client.

If the CPA finds an error made in a previous year, the CPA must advise the client of the error. However, what to do about it is up to the client. The CPA is NOT required to notify the IRS of the error, and they are not required to file an amended return (the client may choose to do this, but the key is that the only rule in this situation is that the CPA must notify the client of the error).

A CPA is not required to verify information provided by a client. The CPA is allowed to rely on good faith regarding the information provided by the client.

When an authorized officer or employee of the IRS makes a lawful request for records or information, the CPA is required to submit the records requested unless the CPA believes in good faith and on reasonable grounds that the records or information are privileged.

All paid tax return preparers must register with the IRS. Preparers will not represent a taxpayer before the IRS, this is limited to attorneys, CPAs, or an enrolled agent.

No practitioner may charge "unconscionable" fees for representing a client before the IRS.

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**A CPA can charge a contingent fee under three circumstances:**

1) For services rendered dealing with an IRS examination or challenge to an original return or amended return or claim of refund.

2) When claiming a refund solely for statutory interest or penalties previously assessed by the IRS.

3) If the CPA is representing the client in judicial proceedings dealing with the IRS.

Even though some CPAs become very familiar with tax law, there is nothing in the regulations that authorizes a CPA to practice law in any form.

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## 2. INTERNAL REVENUE CODE AND REGULATIONS RELATED TO TAX RETURN PREPARERS

Tax return preparers are required to obtain a preparer tax identification number (PTIN). Signers and non-signer preparers are subject to this requirement.

**The definition of a tax return preparer (TRP) is:**

“Any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code.”

This includes anyone who prepares any federal income tax returns, and estate and gift tax returns, and is paid to do so. Being compensated is key. One layperson helping their mom do her taxes in TurboTax is not considered a preparer.

Keep in mind it includes anyone who prepares a “substantial portion” of the return as well, not just the signing TRP.

**Tax return preparer penalties**

If a TRP aids or abets federal tax evasion, then the TRP can be prohibited from working as a preparer, AND face federal criminal prosecution.

If a TRP endorses or otherwise negotiates a refund check issued to a taxpayer, this is not allowed and the TRP will pay a fine of $545. So, a TRP cannot endorse and cash a client’s refund check, even if for some reason the client asked them to.

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**Understating a taxpayer's tax liability**: If the preparer takes unreasonable positions which understate a taxpayer's tax liability, the penalty is the greater of $1,000 or 50% of the income derived by the TRP with respect to the return or claim for refund. Also, if there is understatement due to willful or reckless conduct, the penalty is the greater of $5,000 or 75% of the income derived by the TRP with respect to the return or claim for refund.

**Failure to furnish a copy to the taxpayer**: If the TRP fails to provide the client with a copy of the return, there is a $50 penalty for each instance.

**Failure to sign a return**: A penalty of $50 for each instance of not properly signing a return.

**Failure to provide PTIN**: A penalty of $50 for each failure to provide the TRP's identification number on a return.

**Failure to retain a copy**: A penalty of $50 for each instance of not retaining a copy of the return.

**Failure to file a correct information return**: Any person that employs other TRPs needs to file an information return that lists the names and social security numbers of such employees. Failure to file this information results in a penalty of $50.

**Failure to be diligent in determining eligibility for earned income credit**: This results in a penalty of $545 for each failure.

**Promoting abusive tax shelters**: Penalty is $1,000 for each case in which such a shelter was planned or arranged.

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**Aiding and abetting understatement of tax liability**: This results in a $1,000 fine.

**Unauthorized disclosure of information by a TRP**: If a TRP discloses or uses information from preparing a return for any other purpose then preparing and filing the return, there is a $250 fine for each use of such information, up to a maximum of $10,000 in a calendar year. This is also a misdemeanor, and upon conviction a fine of $1,000 and imprisonment of up to a year. Also, if the disclosure or use is made in connection with a crime relating to the misappropriation of another person's taxpayer identity, the penalty increases to $1,000 for each use or disclosure, up to a maximum of $50,000 in a calendar year.

**Exceptions to disclosing tax return information:**

- Disclosure related to a court order
- Disclosure as part of a quality or peer review
- Disclosure to any party with the client's express consent

**Fraud and false statements**: This is guilty of a felony, and upon conviction a fine of not more than $100,000 and possibly imprisonment for not more than 3 years, or both.

**Fraudulent returns or statements**: This is guilty of a misdemeanor, and upon conviction a fine of not more than $10,000 and possibly imprisonment of not more than a year.

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## B. LICENSING AND DISCIPLINARY SYSTEMS

**State Boards of Accountancy**

These are the boards of each state that govern the practice of CPAs within their jurisdiction.  These are bodies that issue licenses to practice in their jurisdictions, so it is also up to the state board to revoke a CPA's license to practice. The AICPA nor the PCAOB can directly revoke a CPA's license to practice, this must be done by the CPA's state board.

**Each state board has the same general requirements to become a licensed CPA:**

1) 150 hours of college education. Most states now require a master's degree.

2) State-specific ethics course.

3) Ongoing CPE.

4) Passing the CPA exams.

5) 2,000 hours of professional experience.

There are a number of reasons a state board will revoke a CPA's license and possibly impose fines:

- Fraud in obtaining a certificate.
- Failing to properly renew the CPA license.
- If the CPA's right to practice is revoked before a federal or state agency, such as the PCAOB.
- Violation of professional standards.
- Conviction of a felony or any crime involving dishonesty.

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- Dishonesty, fraud, or gross negligence while performing services for clients.
- Failing to file the CPA's own tax returns.

**AICPA**

The AICPA works closely with state boards of accountancy, but implementing and enforcing regulations is up to the individual state boards.

The AICPA can't directly revoke a CPA's right to practice, but most state boards have rules that mirror the rules of the AICPA. This is why it's important for CPAs to adhere to the rules of the AICPA. There is also the Joint Ethics Enforcement Program that involves joint enforcement of the AICPA's and the state board's ethics rules.

**The AICPA will suspend or expel members without a hearing for:**

- Filing a fraudulent tax return.
- If a state board revokes that CPA's license to practice.
- If the CPA is convicted of a crime punishable by imprisonment for 5 years (convicted of a felony).
- Failing to file their own tax return.

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## C. FEDERAL TAX PROCEDURES

### 1. AUDITS, APPEALS, AND JUDICIAL PROCESS

**Audit Process**

The first part of the audit process is matching up returns with W-2s and 1099s. Then returns are assigned a score, and from there the scores are used to decide which returns will be audited.

The IRS has 3 years from the later of 1) the date the return was filed or 2) the date the return was due to impose additional tax. However, if the gross income omitted was more than 25% of the gross income claimed on the return, then the statute of limitations is 6 years. If there was fraud involved in the return, then there is no time limitation on the IRS assessing additional taxes and penalties.

Audits can be handled through written correspondence, in the field, or in an IRS office.

The taxpayer can hire an enrolled agent, a CPA, or an attorney to represent him/her in the audit.

After the audit is complete, the IRS agent reports their audit findings in an Income Tax Examination Changes report.

Then there is a negotiation period about whether the taxpayer agrees with the findings in the Income Tax Examination Changes report.

**If an agreement is reached:**

When an agreement is reached, then the agent will issue a "Revenue Agent's Report", which the taxpayer will sign. If the taxpayer agrees to

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the findings and signs this report, then the taxpayer cannot pursue relief through the appeals process, AND the IRS cannot come back later with additional judgements regarding the items listed in the report. But this only applies to the specific items outlined in the agreement.

**If an agreement is not reached (the appeals process):**

If the taxpayer and the agent cannot come to an agreement during the negotiation process, then the taxpayer will receive a copy of the agent's report and a 30-day letter. The 30-day letter is a notice that the taxpayer has 30 days to appeal the decision, and it includes instructions on how to appeal. The taxpayer is NOT required to respond to this letter, and if they don't, they will then receive a 90-day letter. The IRS wants the taxpayer to agree to the "Revenue Agent's Report", but again, the taxpayer is not required to respond to this 30-day letter.

If the taxpayer wants to appeal, they will file a petition to request an appellate conference. This petition needs to outline the taxpayer's position for each item and include support for taking each position. The IRS does not have to grant an appeal, but they usually will. This process takes place between the taxpayer and the IRS appeals office, as opposed to the formal judicial process. If an agreement is reached during the appeals process, then the audit process is over.

**IF the taxpayer:**

1) Does not reach an agreement during the appeals process, OR

2) Does not respond to the 30-day letter, THEN

The taxpayer will receive the 90-day letter.

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After the 90-day letter is received, the taxpayer now has 90 days to file a Tax Court petition with the U.S. Tax Court. Once a petition has been filed with the Tax Court, the IRS cannot enforce its assessment until after the Court's decision is finalized.

If the taxpayer does not file a tax court petition, after 90 days the findings of the audit are binding, and the IRS will move to collect the amounts owed. After the 90 days, the taxpayer's only recourse is through U.S. District Court or the U.S. Claims Court, but the deficiency will have to be paid before the court process can begin.

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## 2. SUBSTANTIATION AND DISCLOSURE OF TAX POSITIONS

According to Statements on Standards for Tax Services (SSTSs) #1, the CPA needs to comply with standards from taxing authorities, if possible, on taking a specific tax position. A CPA/TRP that takes an "unreasonable position" can be punished.

**There are different levels of what a "reasonable position" means according to SSTS #1:**

A "reasonable basis" would be if the CPA did their research and concluded there is a 20-33% chance the IRS would support the position. At this level, there needs to be a disclosure of the position so that the IRS can review it.

A "realistic possibility" of a position being upheld would be 33% or more.

However, Congress is the overriding authority and there is a provision that says it needs to be "substantial authority" to take a given tax position. In this case, "substantial" means at least a 40% chance that the IRS would accept the position. You don't need to know how to judge the percentage, or how a "40% chance" would be calculated, but the standard is a 40% chance that the IRS would agree with the position.

So, the main thing to remember is that in general, there needs to be a 40% or more chance that the IRS would support a position in order to take any given federal tax position. If it is not a federal tax issue, then the AICPA SSTS rule of greater than 33% would apply.

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For a “tax shelter”, it is automatically unreasonable unless there is a “more likely than not” (more than 50%) chance that the IRS would accept the position.

The CPA needs to inform the client of potential penalties if the position is rejected, and if applicable, how penalties can be avoided through proper disclosure of the position.

**What is “appropriate disclosure” for a tax position?**

The information regarding the position needs to be “appropriately disclosed”, and this disclosure should include a description of the position being taken, the amount of tax involved, and the basis for the position. If the taxing authority has a specific form for such a position, then that form needs to be used. Or, if there are specific administrative guidance for a certain position, that needs to be followed as well.

Remember, a CPA does not have to verify every number the client provides, but the CPA should make a “reasonable inquiry” if something does not add up, or even just to clarify something with the client. If the client wants to pursue a tax position that the CPA does not believe would be upheld, the CPA should decline to prepare or sign the return. If the client tells the CPA that documentation for a position exists, then the CPA can take the client at their word and does not need to take further action.

If it turns out that the client just lied to their CPA about a deduction, and is later figured out by the IRS, the CPA is not subject to any penalties.

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Going along with this, the declaration that the CPA signs on a client's return is warranting that the information provided by the client was relied upon in preparing the return unless it appeared incorrect or incomplete. This does not mean that every figure provided by the client was fully audited and substantiated by the CPA.

**Other things to know:**

If legislation causes a change to previous advice given to a client, the CPA is actually NOT required to notify the client of the changes, unless the exact issue was specifically the reason for the engagement.

If a question on a federal return has not been answered, there needs to be "reasonable grounds" for not answering the question.

If errors are discovered on a previous return, the CPA's duty is to inform the client of the errors and suggest an amended return, but the decision is up to the client.

If, for example, a CPA does a client's return, and then the client alters figures before sending in the return, and then the CPA finds out later, the CPA is NOT obligated take any action such as contacting the IRS, but the CPA should obviously evaluate their relationship with the client in respect to any further engagements.

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## 3. TAXPAYER PENALTIES

There are multiple types of penalties charged by the IRS to taxpayers who do not file or pay their taxes on time, there's also accuracy penalties (paying the right amount of tax).

**Non-filing penalties**

The penalty for filing late is 5% a month of the tax due, up to 25% of the tax due. There is a minimum penalty if the return is filed more than 60 days late of the lesser of $435 or 100% of the unpaid tax. If the taxpayer does not owe any taxes or is due a refund, no penalties will apply.

If the failure to file is deemed fraudulent, then the penalty increases to 15%, up to a maximum of 75% of the unpaid taxes.

**Non-payment or late-payment penalties**

Taxes are due by the filing date. If they are not paid by the filing date, interest on late payments starts to accrue immediately.

The late payment penalty is 0.5% (1/2 a percent) per month, up to a max of 25% of the taxes owed. However, if the non-filing penalty is also applicable, then that 5% per month accrues and the 0.5% penalty is not applicable.

**Estimated Tax Payments**

For individuals, taxes are paid through withholding, or through estimated tax payments.

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If the amount of tax owed total will be more than $1,000, then the taxpayer must make estimated tax payments on the 15th of April, June, September, and January. (Again, this is if taxes aren't being paid through withholding)

No penalty will be imposed if the tax payments during the year were at least 90% of the current year's taxes or 100% of last year's taxes. If the taxpayer's AGI exceeds $150,000, then the tax payments during the year must be 110% of last year's taxes.

**Accuracy penalties**

A 20% of the tax due penalty for an inaccurate tax position due to negligence. This is waived if there is a reasonable basis for the position.

A 20% of the tax due penalty for substantially understating the tax due. This is waived if there is substantial authority for taking the position, OR if the position was appropriately disclosed on the return.

**What is a "substantial understatement"?**

An understatement is substantial if it is more than the larger of 1) 10% of the correct tax amount, or 2) $5,000 for individuals. For corporations it is if the understatement is the lesser of 1) 10% of the correct tax (or a flat $10,000 if 10% is larger) or 2) $10 million.

A 20% of the tax due penalty if there is a substantial overstatement or 40% for a gross overstatement of the value or basis of any property. Substantial is 150% or more of the actual value, gross is 400% or more of the actual value.

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If fraud is involved in the underpayment, then there is a 75% of the tax due penalty.

**Other things to know:**

If a taxpayer wants to make a claim for a refund on paying too much tax in a previous year, the form they would use is the 1040X, the "Amended US Individual Income Tax Return".

To file an amended return, the taxpayer has 3 years after the filing date of the original return, or 2 years after the payment of tax related to the return, whichever is later.

If the taxpayer files a "frivolous" tax return, there can be a penalty of $5,000. If a taxpayer and their spouse file a "frivolous" joint return, they will be fined $5,000 each. A frivolous return is a return that does not include enough information to calculate the correct amount of tax, or the information clearly shows that the tax reported is substantially incorrect.

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## 4. AUTHORITATIVE HIERARCHY

For federal tax purposes, here is the hierarchy of authority for determining tax positions or tax planning:

- At the very top, you have the US Constitution, or in other words, Congress.
- Then you have the IRS's Internal Revenue Code (IRC) Statutes.
- Then you have the US Treasury Regulations.
- Then you have Judicial Authority in the following order:
  - US Supreme Court
  - US Circuit Court of Appeals
  - US District Court
  - US Tax Court
  - US Court of Federal Claims

Then you have IRS Positions such as:

- Revenue Rulings
- Revenue Procedures
- Private Letter Rulings or Determination Letters
- IRS forms, publications, or FAQs

In general, the main source will be the IRS Internal Revenue Code. A CPA would then try to find support from some source below that if nothing explicit was found in the IRC.

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## D. LEGAL DUTIES AND RESPONSIBILITIES

### 1. COMMON LAW DUTIES AND LIABILITIES TO CLIENTS AND THIRD PARTIES

**Common Law Liability to Clients**

CPAs have an obligation to their clients to exercise due professional care. With an engagement letter, it provides the client and other third parties with rights of recovery. Therefore, if the CPAs are not performing within the agreement set forth in the contract this will be considered a breach of contract. The clients may also claim negligence against the CPAs if the work was performed but contained errors or was not done professionally. This is considered a tort action.

In order to recover from an CPA under common law, the client must prove:

- Duty of care
- Breach of Duty
- Losses
- Causation

CPAs may defend against a breach of contract if they can prove that the client's loss occurred because of factors other than negligence by the auditors. If the CPA proves the loss resulted from causes other than the CPA's negligence, a client may be accused of contributory negligence. If a state follows the doctrine of contributory negligence, the CPA may eliminate their liability to the client based on contributory negligence by the client. Many states do not follow this doctrine. Most states

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permit a jury to assess the fault and apply the correct percentage of fault to the parties involved. This is called comparative negligence.

**Common Law Liability to Third Parties**

If a third party brings a suit against a CPA there are several things the third party must prove:

1) They must prove that the CPA had a duty to exercise due care.

2) They must prove that the CPA knowingly breached that duty.

3) They must prove that the CPA's breach was the direct cause of the loss.

4) They must prove that they suffered an actual loss.

**A few examples:**

If a CPA recklessly departs from the standards of due care when performing an audit, the CPA can be held liable to third parties who relied on the audited financial statements based on gross negligence. A breach of contract would only be applicable to direct clients of the CPA. Also, it is a 'reckless departure' that results in gross negligence. If it was failure to comply with some standards of due care, then it would be negligence, not gross negligence.

A failure to complete an audit on time would result in a breach of contract (breaching the terms set in the engagement letter), and the client could sue the CPA firm for breach of contract under common law.

If an audit is performed according to Generally Accepted Auditing Standards (GAAS), even if a material misstatement is not detected

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which later causes injury to users of the statements, the auditor will have a good defense against being sued.

Understand "privity of contract" or lack of privity: This means that in a lot of cases a defense for the CPA would be lack of privity of contract, meaning that a third party cannot sue the CPA if the audit was not for their express purpose. On the other hand, when a client has a contract with a CPA, there is privity of contract, and if the CPA fails to fulfill the requirements of the contract, that is breach of contract. The client can sue for damages resulting from the breach of contract.

Going along with "privity", there was the Ultramares case that specified in cases of negligence, the CPA will be held liable to the client and any third parties that were intended beneficiaries of the contract. But this does not include all third parties, just intended beneficiaries of the contract. This would mean users of the financial reports, such as a bank using the statements to decide whether to give the audited company a loan.

The best description of the relationship between a corporation and the CPA firm it hires to do its audit is an employer (the corporation) and an independent contractor (the CPA firm).

Knowingly issuing an unqualified opinion when there is a material misstatement is fraud, not negligence or breach of contract.

"Constructive fraud" occurs when the following elements are present: 1) a false misrepresentation of a material fact 2) reckless disregard for the truth, 3) reasonable reliance by the injured party, 4) injury, 5) a

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fiduciary relationship between the parties. With constructive fraud, intent (scienter) does not need to be proven as with actual fraud.

The term “strict liability” will never be used to determine the liability of a CPA. This is term specifically for some product liability cases.

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## 2. PRIVILEGED COMMUNICATIONS, CONFIDENTIALITY, AND PRIVACY ACTS

**There are just a few situations where a CPA can legally disclose confidential information:**

1) If GAAP requires disclosure.

2) A valid subpoena or summons has been issued. The CPA is not required to inform the client that the information has been subpoenaed.

3) During a peer review of the CPA's firm.

4) Disclosure to another firm member if pertinent to the engagement.

5) An ethics review.

When it comes to outsourcing work, which may involve confidential client information, the CPA firm is responsible for maintaining the confidentiality of clients' information, but the CPA is NOT required by law to notify the client when confidential information is shared with an outsourcing partner.

If the IRS requests confidential client information, the CPA is not obligated to comply, unless as noted above it involves a valid subpoena.

When it comes to workpapers involved in an audit, the workpapers are not subject to the same privileged communication rules as the client's own source documents and information. The workpapers remain the property of the CPA firm after the audit, and the workpapers can be obtained by third parties if they appear to be relevant to issues in litigation.

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If a partner dies, his clients' workpapers can be assigned to a surviving partner.

**Other things to know:**

Under federal law, there is no "accountant-client" privilege regarding confidentiality. However, several states do have an accountant-client privilege.

Read this one carefully: If a CPA firm is selling their practice, it IS permitted to let prospective buyers of the practice view confidential client information. BUT, if the purchase goes through, before any confidential records are actually turned over to the buyer of the firm, they would need the client's permission.

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