

REG Complete Study Guide, Part I

Olivia Anderson · True North Accounting & Business Solutions · Study notes for educational use. Always confirm details against the current AICPA Blueprints and authoritative standards.

Taxation and Regulation, Area I: Ethics, Professional Responsibilities and Federal Tax Procedures, and the first half of Area II: Business Law. Parts 2 and 3 cover the rest of business law and the tax areas.

AREA	TOPIC	WEIGHT
I	Ethics, Professional Responsibilities and Federal Tax Procedures	10–20%
II	Business Law	15–25%
III	Federal Taxation of Property Transactions	5–15%
IV	Federal Taxation of Individuals	22–32%
V	Federal Taxation of Entities, Including Tax Preparation	23–33%

Area I: Ethics, Professional Responsibilities and Federal Tax Procedures

Treasury Department Circular 230

Circular 230 governs **practice before the IRS**: representing clients, communicating with the IRS on their behalf and preparing and filing documents.

Unlimited representation rights: attorneys, CPAs and enrolled agents who are not suspended or disbarred. Enrolled actuaries and enrolled retirement plan agents have rights limited to their areas.

Limited representation rights: unenrolled preparers who hold an Annual Filing Season Program record of completion can represent clients only for returns they prepared and signed, and only before revenue agents, customer service representatives and the Taxpayer Advocate Service, during examinations. Other unenrolled preparers have no representation rights.

DUTIES AND RESTRICTIONS

1. **Competence:** have the knowledge, skill and preparation needed, or become competent through study or by consulting someone who is.
2. **Diligence:** act with due diligence in preparing returns and documents, and don't unreasonably delay a matter.
3. **Client omissions:** if a practitioner learns a client hasn't complied with the tax laws or has made an error or omission, the practitioner must promptly tell the client and explain the consequences.
4. **Return of client records:** on request, promptly return the client's records needed to comply with federal tax obligations, even if there's a fee dispute. The practitioner may keep copies, and may withhold their own work product until paid if state law allows.
5. **Conflicts of interest:** a practitioner may represent clients with a conflict only if they reasonably believe they can provide competent, diligent representation, it's not prohibited by law, and each affected client gives informed consent, confirmed in writing.
6. **Fees:** unconscionable fees are prohibited. **Contingent fees are generally prohibited** for preparing an original return, amended return or claim for refund. They are permitted for:
 - Services in connection with an IRS examination of, or challenge to, an original return
 - An amended return or refund claim filed within 120 days of receiving a written notice of examination
 - A claim for refund solely of statutory interest or penalties
 - Services in judicial proceedings
7. **Written advice (§10.37):** base it on reasonable factual and legal assumptions, reasonably consider all relevant facts, use reasonable efforts to identify the facts, don't rely on unreasonable representations and don't consider the chance of an audit. The old "covered opinion" rules were eliminated in 2014.
8. **Solicitation:** advertising is allowed if not false, misleading or coercive. Practitioners may not imply special influence with the IRS.

SANCTIONS

The IRS Office of Professional Responsibility can impose censure, suspension, disbarment and monetary penalties for incompetence, disreputable conduct or willful violations.

Examples of disreputable conduct: a conviction for a tax crime or a crime of dishonesty, giving false information to the IRS, willfully failing to file one's own return or evading one's own tax, and trying to influence an IRS employee with threats or gifts.

A disbarred practitioner may generally petition for reinstatement after five years.

Question: A CPA wants to charge 30% of the refund for preparing a client's original return. Is that allowed?

Answer: No. Contingent fees are prohibited for preparing an original return. They are allowed for services related to an IRS examination, among the other exceptions.

Return Preparer Rules and Penalties

A **tax return preparer** prepares all or a substantial portion of a return or refund claim for compensation. People who only type a return, furnish typing or software, or prepare returns for their employer or without pay aren't preparers.

Preparers must sign returns, include their **PTIN**, give the taxpayer a copy and keep a copy of each return, or a list of clients and returns, for three years.

UNDERSTATEMENT PENALTIES (IRC §6694)

PENALTY	WHEN	AMOUNT
Unreasonable position	Understatement due to a position the preparer knew or should have known was unreasonable	Greater of \$1,000 or 50% of the preparer's income from the return
Willful or reckless conduct	Willful attempt to understate, or reckless or intentional disregard of rules	Greater of \$5,000 or 75% of the preparer's income from the return

When is a position unreasonable?

- **Undisclosed position:** unreasonable unless there is **substantial authority** for it.
- **Disclosed position:** unreasonable unless it has a **reasonable basis**.
- **Tax shelters and reportable transactions:** unreasonable unless it is **more likely than not** to be sustained.

These standards are often described as roughly a 20% likelihood for reasonable basis, about 40% for substantial authority and more than 50% for more likely than not. The regulations don't state percentages. A reasonable cause and good faith defense applies to the unreasonable position penalty.

OTHER PREPARER PENALTIES

- Failure to sign, furnish a copy, include a PTIN or keep records: a per-failure penalty, adjusted annually for inflation, with an annual cap
- Endorsing or negotiating a client's refund check: a per-check penalty, inflation-adjusted
- **Due diligence failures** for the earned income credit, child tax credit and credit for other dependents, American opportunity credit, and head of household status: a per-failure penalty, inflation-adjusted. Preparers must complete eligibility checklists, make reasonable inquiries, document them and keep records for three years.
- Aiding and abetting an understatement (§6701): \$1,000 per return, or \$10,000 for a corporate taxpayer's return
- Improper disclosure or use of return information (§6713): \$250 per disclosure, up to \$10,000 a year. A knowing or reckless violation is also a misdemeanor.

Taxpayer Penalties

PENALTY	RATE
Failure to file	5% of the net tax due per month or part of a month, up to 25%. Returns more than 60 days late face a minimum penalty, adjusted for inflation, or 100% of the tax if less
Failure to pay	0.5% per month, up to 25%
Both in the same month	The failure-to-file penalty is reduced by the failure-to-pay penalty
Accuracy-related	20% of the underpayment due to negligence, a substantial understatement or a substantial valuation misstatement. For individuals, an understatement is substantial if it exceeds the greater of 10% of the correct tax or \$5,000
Civil fraud	75% of the underpayment due to fraud. The IRS must prove fraud by clear and convincing evidence

Example: \$10,000 of tax, with the return filed and tax paid three months late.

- Failure to pay: $0.5\% \times 3 \times \$10,000 = \$150$
- Failure to file: $5\% \times 3 \times \$10,000 = \$1,500$, reduced by \$150 to \$1,350
- Total: **\$1,500**

Estimated tax penalties apply to underpayments of required installments, computed like interest. Payroll tax **deposit penalties** range from 2% to 15% depending on how late the deposit is.

Defenses: reasonable cause and good faith, such as serious illness, a death in the family, a disaster or reliance on a competent adviser given full information, apply to most civil penalties but not fraud. Ignorance of the law is not reasonable cause.

CRIMINAL PENALTIES

CRIME	TYPE	MAXIMUM FINE (INDIVIDUAL / CORPORATION)	MAXIMUM PRISON
Tax evasion (§7201)	Felony	\$100,000 / \$500,000	5 years
False return under penalties of perjury (§7206)	Felony	\$100,000 / \$500,000	3 years
Willful failure to file or pay (§7203)	Misdemeanor	\$25,000 / \$100,000	1 year

"Willful" means a voluntary, intentional violation of a known legal duty.

Sources of Tax Authority

Primary authority

1. **Internal Revenue Code:** enacted by Congress. The highest authority, together with tax treaties.

2. **Treasury Regulations:** final regulations carry great weight. Temporary regulations take effect immediately and expire after three years. Proposed regulations are not binding but count as substantial authority. A citation such as Reg. §1.162-5 means income tax (1), Code section 162, regulation 5.
3. **Revenue Rulings:** the IRS's application of the law to specific facts. Taxpayers with substantially similar facts can rely on them.
4. **Revenue Procedures:** procedural guidance, such as how and when to make elections.
5. **Court decisions.**

Other IRS guidance

- **Private letter rulings** respond to one taxpayer's request and bind the IRS only for that taxpayer. Technical advice memoranda are issued during examinations. Neither can be cited as precedent.
- **IRS publications** are explanations for taxpayers and are not authority.

Substantial authority (Reg. §1.6662-4) can come from the Code, regulations, court cases, revenue rulings and procedures, and also private letter rulings, technical advice memoranda and General Counsel memoranda issued after 1976. It cannot come from treatises, articles, legal opinions or IRS publications.

THE COURTS

COURT	PAY FIRST?	JURY?	APPEALS GO TO
U.S. Tax Court	No	No	The taxpayer's regional Circuit Court of Appeals
U.S. District Court	Yes, then sue for refund	Available	The regional Circuit Court of Appeals
U.S. Court of Federal Claims	Yes	No	The Court of Appeals for the Federal Circuit

The Supreme Court hears few tax cases. Its decisions are binding everywhere. The Tax Court's small case procedure is available for disputes of \$50,000 or less, and those decisions can't be appealed.

IRS Procedures

EXAMINATIONS

Returns are selected by computer scoring, information matching (W-2s and 1099s), related examinations and other sources.

- **Correspondence audits:** by mail, on a few items. The most common type.
- **Office audits:** at an IRS office.
- **Field audits:** at the taxpayer's location, the most comprehensive, usually for businesses.

The **Taxpayer Bill of Rights** includes the rights to be informed, to quality service, to pay no more than the correct amount, to challenge the IRS's position and be heard, to appeal in an independent forum, to finality, to privacy, to confidentiality, to retain representation and to a fair and just tax system.

Representatives are authorized on **Form 2848**, power of attorney.

APPEALS

1. **30-day letter:** the examination report. The taxpayer can agree, request an Appeals conference or do nothing.
2. **Appeals conference:** with an independent Appeals officer, who may consider the hazards of litigation in settling.
3. **90-day letter (statutory notice of deficiency):** the taxpayer has 90 days, or 150 days if addressed outside the U.S., to petition the Tax Court without paying.
4. **Alternatively,** pay the tax, file a refund claim and sue in District Court or the Court of Federal Claims.

STATUTES OF LIMITATIONS

Assessment

- Generally **3 years** from the later of the return's due date or the date it was filed
- **6 years** if gross income is understated by more than 25%
- **No limit** for a fraudulent return or no return

Refund claims: the later of **3 years from the date the return was filed** or **2 years from the date the tax was paid**. A return filed early is treated as filed on the due date, and withholding and estimated payments are treated as paid on the due date.

COLLECTION

- **Federal tax lien:** arises automatically when tax is assessed, demanded and unpaid. Filing a public notice establishes priority against certain other creditors.
- **Levy:** the actual seizure of property. The IRS must give a final notice of intent to levy at least 30 days before. Certain property is exempt, such as unemployment benefits, workers' compensation, certain amounts of wages and limited amounts of personal effects and tools of a trade.
- **Installment agreements:** penalties and interest continue to accrue. Agreements are guaranteed for individuals owing \$10,000 or less who meet certain conditions.
- **Offers in compromise:** settling for less than the full amount based on doubt as to liability, doubt as to collectibility or effective tax administration. The taxpayer must be current on filing and estimated payments and can't be in an open bankruptcy.

INNOCENT SPOUSE RELIEF

Relief from joint and several liability on a joint return:

1. **Traditional innocent spouse relief:** for an understatement the requesting spouse didn't know or have reason to know about.
2. **Separation of liability:** allocates the deficiency between spouses who are divorced, legally separated or not living together.
3. **Equitable relief:** when it would be unfair to hold the spouse liable and the other forms don't apply. It's also available for underpayments.

Legal Duties and Responsibilities

- **Privilege:** under IRC §7525, communications between a taxpayer and a federally authorized tax practitioner have a limited confidentiality privilege, similar to attorney-client privilege, in noncriminal tax matters before the IRS and in federal courts. It does not cover written communications promoting tax shelters.
- **Work papers** generally belong to the CPA, but client-provided records belong to the client.
- **Liability to clients** can arise from breach of contract or negligence. **Liability to third parties** depends on the state's approach: privity or near-privity, the Restatement's foreseen users, or all reasonably foreseeable users.

Area II: Business Law, Part I

Agency

An **agency** is a fiduciary relationship in which an agent acts on behalf of a principal.

Creation: by agreement, express or implied, by ratification, by estoppel or by operation of law. The principal must have contractual capacity, but the agent doesn't need it. Consideration isn't required.

AUTHORITY

- **Express actual authority:** granted orally or in writing.
- **Implied actual authority:** reasonably necessary to carry out express authority, or customary for the position.
- **Apparent authority:** created by the **principal's** conduct, which leads a third party to reasonably believe the agent has authority. *Example:* a company lets an employee use the title "Sales Manager," and a customer reasonably relies on it.
- **Ratification:** the principal approves an unauthorized act after the fact. The principal must have had capacity, must know the material facts and must ratify the whole transaction before the third party withdraws. Ratification can be express or implied by accepting benefits.

DUTIES

The agent owes the principal: loyalty, with no self-dealing, competing or secret profits; obedience to lawful instructions; reasonable care; accounting, with no commingling; and notification of material facts.

The principal owes the agent: compensation (reasonable value if no amount was agreed), reimbursement of authorized expenses, indemnification for losses in authorized acts and cooperation.

LIABILITY TO THIRD PARTIES

Contracts

PRINCIPAL IS	WHO IS LIABLE
Disclosed	The principal. The agent isn't, unless the agent agreed to be
Partially disclosed (identity unknown)	Both the principal and the agent
Undisclosed	Both. The third party may elect whom to hold liable once the principal is discovered

Torts: under **respondeat superior**, an employer is liable for an employee's torts committed within the scope of employment. Employers generally aren't liable for an employee's "frolic" outside the scope of employment, or for independent contractors' torts, except for inherently dangerous activities, nondelegable duties or the principal's own negligence in hiring or supervising.

Employee or independent contractor? The key factor is the right to control how the work is done. Others include who supplies the tools, the length of the relationship, the method of payment and whether the work is part of the principal's regular business.

TERMINATION

- **By the parties:** mutual agreement, expiration, fulfillment of purpose, revocation by the principal or renunciation by the agent. A principal can revoke but may be liable for breach.
- **By operation of law:** death or insanity of either party, the principal's bankruptcy, impossibility or illegality.

Third parties who dealt with the agent need **actual notice** of termination. Constructive notice, such as publication, suffices for others. No notice is needed when the agency ends by operation of law.

An **agency coupled with an interest**, where the agent has a property interest in the subject matter, can't be revoked by the principal and survives the principal's death.

Contracts

A valid contract requires **mutual assent** (offer and acceptance), **consideration**, **capacity** and a **legal purpose**.

OFFERS

An offer requires intent, definite terms and communication to the offeree.

- Under the **UCC** (sale of goods), an offer generally needs only the quantity. Open terms like price can be filled in.
- Under **common law** (services and real property), essential terms must be definite.

Termination of offers

- Revocation by the offeror, effective when received. An offer can be revoked any time before acceptance unless it's an option contract or firm offer.
- Rejection or counteroffer by the offeree. A mere inquiry isn't a rejection.
- Lapse of time, death or insanity of either party, destruction of the subject matter or supervening illegality.

Option contract: the offeree pays to keep the offer open.

Firm offer (UCC): a merchant's signed written promise to keep an offer open is irrevocable without consideration for the stated time, up to three months.

ACCEPTANCE

- **Common law:** the mirror image rule applies. Any change is a counteroffer.
- **UCC:** an acceptance with additional terms is still an acceptance. Between **merchants**, additional terms become part of the contract unless the offer limits acceptance to its terms, the terms materially alter it, or the offeror objects within a reasonable time. If a nonmerchant is involved, additional terms are only proposals.
- **Mailbox rule:** an acceptance sent by an authorized or reasonable method is effective when sent. Offers, revocations and rejections are effective when received.
- **Silence** generally isn't acceptance, unless prior dealings make it so.

CONSIDERATION

A bargained-for exchange of legal value. Courts don't judge its adequacy.

- **Not consideration:** a preexisting duty, past consideration, an illusory promise ("I'll buy if I feel like it") or moral obligation alone.
- **Modifications:** require new consideration under common law, but only good faith under the UCC.
- **Promissory estoppel** can substitute for consideration: a promise, reasonable and foreseeable reliance, actual detrimental reliance and injustice if not enforced.

CAPACITY

- **Minors** can disaffirm contracts before majority and for a reasonable time afterward. They're liable for the reasonable value of necessities. Ratification after reaching majority makes the contract binding.
- **Persons adjudicated incompetent:** their contracts are void. Otherwise, contracts of persons lacking mental capacity are voidable.
- **Intoxicated persons:** voidable if the other party knew of the intoxication, with prompt disaffirmance on becoming sober.

LEGALITY

Illegal contracts are void, such as agreements to commit crimes, usury or illegal gambling.

- **Licensing:** a contract by an unlicensed party is void if the license is regulatory, protecting the public, and generally enforceable if it only raises revenue.
- **Noncompete agreements** are enforceable if reasonable in time, geography and scope and protect a legitimate business interest.
- **Exculpatory clauses** aren't enforced for gross negligence or intentional conduct, or where public policy forbids them.

THE STATUTE OF FRAUDS

These contracts must be evidenced by a signed writing. Remember **"MY LEGS"**:

- **Marriage**, in consideration of
- **Year**: can't be performed within one year
- **Land**: interests in real property
- **Executor's promise** to pay estate debts personally
- **Goods** priced at \$500 or more (UCC)
- **Suretyship**: a promise to pay another's debt, unless the main purpose rule applies

UCC exceptions: a merchant's written confirmation binds the other merchant unless they object within 10 days. Specially manufactured goods, admissions in court and goods paid for or accepted are also enforceable without a writing.

Real property: part performance, such as payment plus possession or improvements, can make an oral contract enforceable.

The one-year rule applies only if performance is impossible within one year. A lifetime contract could be performed within a year.

THE PAROL EVIDENCE RULE

A complete written contract can't be contradicted by earlier or contemporaneous agreements. Parol evidence **is admissible** to show fraud, duress or mistake, a condition precedent, a later modification, to explain ambiguity, or to show usage of trade, course of dealing or course of performance.

PERFORMANCE AND BREACH

- **Conditions:** a condition precedent must occur before a duty arises. A condition subsequent ends a duty.
- **Satisfaction clauses:** judged subjectively, in good faith, for personal taste, and objectively for mechanical fitness.
- **Common law** requires **substantial performance**. The **UCC perfect tender rule** lets a buyer reject nonconforming goods, subject to the seller's right to cure and the special rules for installment contracts.
- A **material breach** excuses the other party's performance. A **minor breach** allows damages only.
- **Anticipatory repudiation:** the nonbreaching party may sue immediately, wait for performance, suspend its own performance or urge retraction.
- **Excuses:** objective impossibility, such as destruction of the subject matter, death in a personal services contract or illegality; commercial impracticability; and frustration of purpose.

REMEDIES

- **Compensatory damages** put the injured party where performance would have left them. **Consequential damages** must have been foreseeable.
- **Liquidated damages** are enforced if they reasonably estimate damages that are hard to measure. Otherwise they're an unenforceable penalty.
- **Punitive damages** are generally not available for breach of contract.
- The injured party must **mitigate** damages.

- **Specific performance** is available when money is inadequate, as for land or unique goods, but not for personal services.
- **Rescission** undoes the contract. **Reformation** rewrites it to reflect the parties' true intent.