

Tax Compliance Practice Liability. What is the Exposure?

Nebraska Supreme Court Rules on Tax Preparer's Liability

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“Compliance” practice means tax return preparation to an accountant. It means the same thing to many lawyers. Both professions know “compliance” practice may also encompass analysis, advice and assistance on observing or otherwise discharging a broad range of federal and state laws, regulations and guidelines ranging from annual domestic occupation tax reports and meeting minutes to intermittent environmental agency filings.

Each professional contact for every client poses a professional opportunity, and a corresponding risk. Few professionals will live lives so charmed as to be free from error. Those who are fortunate err at times of little consequence.

Yet, each professional wonders, often, “What *is* my exposure?” The question nags at a professional person's life constantly. The routine aspects of practice, like compliance, may be most sensitive, and may be among the most difficult of areas in which to access risk.

The client is responsible for compliance. Everyone is presumed to know the law. Some pieces of compliance information are ubiquitous - such as an April 15 income tax return deadline, and perhaps an October 15 deadline for all extensions.

Is the preparer responsible for tax, or late payment penalty, or non-filing penalties in each of those instances, where the taxpayer does not comply with the law and the tax advisor does not counsel against compliance?

A Real Life Situation

All these questions came to life for a Nebraska panhandle accounting firm in 2003. The firm “inherited” a local businessman's tax return business. It came to the accounting practice through brief association with another accountant of long standing in the community who became ill and unexpectedly departed from the area.

The firm's new client owned several corporations and a real estate investment business. He also had a history of taking extensions so returns were filed at the last legal moment after all permissible extensions were exhausted. In 2001, he made a large real estate sale. During a casual conversation, at which no request for an analysis was made, he hypothesized the transaction, asking, in general terms, what his exposure was. The accountant, from memory,

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recalled housing tax credits, and alternative minimum tax credit possible for future years, worth several hundred thousand dollars, mentioned they could only be used in a restricted way and asked for more information.²

Later, the accountant learned that a lawyer in the community, and a large commercial company whose business was to serve as a “qualified intermediary” were handling reinvestment of the funds, or at least some of them, in tax deferral exchanges under § 1031 of the Internal Revenue Code.³ A “qualified intermediary” must be someone without recent ties to the taxpayer whose job is to function wholly independently, hold an identified list of replacement properties, and hold the money until closing. The process for a § 1031 exchange is tightly controlled by IRS requirements.

The accountant heard nothing more of the large real estate sale until tax return preparation time. A corporate return was prepared. An actual audit of some of the client’s Wyoming business interest was conducted, and as was his historical practice, the taxpayer put his personal return on extension beyond April 15. He did not pay his tax at the time - largely because he did not know what it would be. The details of his § 1031 exchange, from late the previous year, were not fully worked out.

August 15 came and went. October arrived. The accountants prepared a return from the information they had and presented it. The taxpayer was livid. The credits mentioned in an earlier casual conversation could not be used to shelter the capital gains of land, and the taxpayer’s § 1031 exchanges had not been large enough to shield all of the gain. A six (6) figure tax was due.

Piqued, the taxpayer left the accountant’s office, with a prepared return in hand, knowing it was due, and elected against filing it for two (2) months while seeking other tax advice. A late filing came into penalty, and accumulating late filing penalties, were eventually assessed by the IRS. Interest was due from April 15 because the taxpayer had not paid his tax on time.

A Lawsuit Ensues

The accountant did not hear for a time about the client’s intentions. The bill for auditing services was not paid, and an invoice related to work on a complicated transaction in the Wyoming business was not satisfied. The accountant knew, by deduction, that the client was surely angry about the unexpected tax liability. He was right. Before long, a lawsuit was filed.

The Client’s Allegations

² “No good deed goes unpunished.” Mr. Lockwood was being helpful; it is clear from the facts that he was not expressing a researched, or reasoned opinion, but was thinking aloud about possibilities during a wholly unrelated client conference when asked a general question and made a response from recall. In part, the response was misunderstood, and perhaps abused. A written opinion, with an appropriate fee, would have been justified as a response to the client’s complex off-the-cuff question.

³ 26 U.S.C. Section 1031.

The client alleged that the accountant and his firm committed malpractice because they allegedly (a) failed to correctly assess and advise about the availability of tax credits to offset gains from the sale of real estate, (b) failed to advise him to pay his tax on April 15 or face a late payment penalty, and (c) should be required to pay all interest the client incurred, plus any penalties charged by the IRS. The client claimed he relied upon the accountant's advice and, by doing so, elected against either paying his tax on time, or pursuing, and completing, a Section 1031 exchange to defer tax liability.

The taxpayer's lawsuit sought recovery of all nonpayment penalties, late payment penalties, interest on tax not paid by April 15, and all tax the client owed. On the latter point, the client claimed the accountant's mention of the housing credits caused him to expose the funds to taxation which would have otherwise been protected by additional real estate purchases under § 1031.

The Client's Proof

Professional negligence claims require expert witnesses.⁴ To prevail in a professional negligence claim against a lawyer or accountant, the client must prove (1) a professional relationship existed and its scope, (2) the duty owed by the lawyer or accountant to the client, including the standard of professional care observed by practitioners of ordinary skill, knowledge, and diligence in the community,⁵ (3) breach of the duty by failure to provide the service that would have been provided by a practitioner of ordinary skill, knowledge and diligence, and (4) damages, proximately caused by the negligence.⁶

The taxpayer satisfied the expert witness requirement with testimony of an enrolled agent, not a CPA or a lawyer. The "enrolled agent" qualified under IRS rules as a tax preparer.⁷ Over objections from the accountant's lawyer, this witness, who admitted he was a long-time personal friend of the taxpayer, opined that the accountant's professional services were negligent, caused the taxpayer to expose funds to tax that could have been sheltered, and proximately caused loss. According to the enrolled agent, all the tax, all the late payment and non-filing penalties, and all the interest, were the tax preparer's fault.

The trial judge decided the enrolled agent's testimony was sufficient to require that the case be submitted to the jury. So, without an accountant testifying to a syllable about how Nebraska accountants do their work, except for a defense accountant, the jury was called upon to decide how much of the tax, penalties, and interest, if any, should be assessed to the accountant.

The trial, which consumed a week, involved focused cross-examination of the taxpayer, a sensitive appearance by the accused accountant who was personally hurt by the accusation, and a sharp contrast in legal styles.

⁴ *Thone v. Regional West Medical Center*, 275 Neb. 238 (2008).

⁵ "Community" generally means the state.

⁶ *World Radio Labs. v. Coopers & Lybrand*, 251 Neb. 261, 557 N.W.2d 1 (1996).

⁷ IRS Circular 230 describes and explains the Enrolled Agent Program. Education, training and licensure are not required though an IRS – prescribed exam must be passed.

In many ways, the taxpayer's case was superficial. The accountant's presentation was thoughtful and thorough. It attempted to assist the jury to understand the technical nuances, tax concepts, filing history, and general nature of the accountant's work. It also sought to expose the taxpayer's history of awareness through similar circumstances on previous occasions.⁸

The Verdict

The jury rejected more than ninety percent (90%) of the taxpayer's claim. It refused to hold the accountant responsible for any of the actual tax owed to the state or federal governments, which exceeded \$250,000.00. In particular, the jury rejected claims that the taxpayer had missed an opportunity to use a Section 1031 tax deferral because he claimed to have relied on advice about available tax housing credits in a decision not to do so.

The jury, however, determined that the accountant made a mistake by failing to advise the taxpayer that his tax had to be paid April 15, or he would incur late payment penalties, and be required to pay interest. The interest was due because the taxpayer underpaid his estimates and failed to pay his approximate tax by April 15. The penalties resulted from the taxpayer underestimating tax liability and for filing late, *i.e.*, filing after the October 15 extension date. The penalties and interest totaled approximately \$37,000.00. There was no claim that the accountants were delinquent with their work or caused the late filing to occur.

The jury made such an award, even though the taxpayer was a sophisticated businessman who habitually filed extensions on his April 15 returns and, when doing so, paid his tax. Further, the accountant knew that the consequences of noncompliance with IRS filing and payment requirements were covered orally pursuant to a checklist of topics and were well within the client's own knowledge and experience.

The Accountant Appeals

Despite success at trial eliminating nearly 90% of the total claim, the accountant accepted counsel's recommendation to appeal.⁹ The Nebraska Supreme Court ultimately reversed the jury's verdict and ensuing judgment and remanded for re-trial. *See Frank v Lockwood*, 275 Neb 735, 749 NW2d 443 (2008).¹⁰

⁸ A well respected CPA testified as an independent expert for the defense. His testimony focused on absence of liability and not on damages issues. This occurred for tactical reasons.

⁹ Establishing precedent is demanding of the client and the lawyer. Here, Mr. Lockwood's decision to appeal and seek a ruling favorable to tax practitioners required that he a) allow the controversy to become known statewide and beyond, b) endure the rigorous appellate process, which he chose to do on an active basis with his counsel, and c) shoulder the risk of a possible adverse outcome. The cost of the process is noteworthy. The value of the precedent to tax preparation professionals is far greater, and easily underappreciated. Mr. Lockwood knows it is easy to "let someone else do it". He is to be commended for his perseverance.

¹⁰ Mr. Domina was privately engaged by the Lockwood CPA firm in the *Frank* case to conduct the trial. Insurance Defense counsel also participated. Mr. Domina briefed and argued the case on appeal. Mr. Lockwood elected to have separately selected counsel involved.

The Accountant's Arguments and the Supreme Court's Response

As noted, the taxpayer contended at trial the accountant failed to inform him that his federal income tax had to be paid by April 15 even if the return was placed on extension. The jury's verdict awarded no tax, and found no fault for any tax being due, but required the accountant to pay the late payment interest.

On appeal, the accountant argued that the taxpayer kept the use of the tax money, enjoyed the benefit of the income, and either suffered no damage, or failed to prove the amount of damage suffered, because the taxpayer adduced no evidence of any difference between the benefit received by retaining the funds, and the detriment of an interest assessment due to the IRS. The accountant, in short, argued that the taxpayer should not be allowed to hold the accountant liable for all interest paid to the IRS, while at the same time retaining an enjoying full use and benefit of his money from April until December, when he finally elected to file the return and pay the tax due. To rule otherwise would result in a windfall to the client.

The Supreme Court was quick to agree with the accountant. The more difficult question, though, was burden of proof. Which party should be required to prove the difference between the IRS tax rate and the taxpayer's benefit, if any? Is such proof part of the taxpayer's burden in bringing suit for professional negligence, or is it the professional's burden because the offset constitutes proof of mitigation of damages?

The Supreme Court split 5-1¹¹ on this issue. The Court's majority held the taxpayer had the burden of proving his gross damages, his offsetting benefit, and his net damages. The Court held this information was primarily within his control, and this decision is consistent with damages law in other areas. For example, where a loss in gross income occurs, the claiming party must prove both the gross loss, and the net loss. Six members of the Supreme Court saw the judgment interest rule as analogous. The Court's majority held:

While we do not hold that plaintiffs are completely barred from recovering damages related to interest paid to the IRS, we think that the burden remains on the plaintiff to prove that the circumstances were such that he or she was damaged by the payment of interest. We therefore do not adopt a blanket rule precluding recovery of interest on taxes as an element of damages. Instead, we hold that interest on taxes is recoverable in accounting malpractice actions to the extent plaintiffs carry their burden of showing that they were damaged by the imposition of interest.

275 Neb at 746.

The Court's dissenting member believed the taxpayer should have the benefit of the doubt and require the burden of proving the value of retained funds in the taxpayer's hands should be on the accountant. The Court's dissenting Justice thought the taxpayer should have the benefit of the jury's verdict, and it should be the tax preparer's responsibility to prove the mitigated amount as net damages.

¹¹ Nebraska's seven member Supreme Court lost one participant due to prior connections to parties or lawyers in the case. Six members of the Court decided *Frank v Lockwood*.

As a result of the Court's ruling, Nebraska's law now requires that claims involving losses caused by interest charges due to a taxing authority, and resulting from alleged acts or omissions of a tax preparer, must be proven by the claiming taxpayer. The taxpayer must also prove the financial value of retaining the funds so net damages can be calculated by the jury.

After disposing of the interest issue, the Supreme Court addressed the question of penalties. Penalties for late filing constituted the bulk of the jury verdict in *Frank v. Lockwood*. The jury's \$37,000.00 verdict could have included no more than approximately \$2,500.00 for late payment penalties. Penalties for late filing constituted the bulk of the jury verdict in *Frank v. Lockwood*. The jury's \$37,000.00 verdict could have included no more than approximately \$2,500.00 for late payment penalties.

The Court surveyed the scarce case law available in other states, and noted that generally courts will not allow a taxpayer to pass the penalty for failure to make a timely tax filing to a tax preparer. It is the taxpayer's duty to comply with the law, and this compliance requirement is well-known. The Court concluded the taxpayer could not, under any circumstances, pass on to his tax preparer the penalties resulting from a late-filed return. The taxpayer's duty to file a return timely is not a delegable one.¹²

Late payment penalties were analytically more difficult for the Court. The Court reasoned a tax preparer's negligence, including negligent failure to advise the taxpayer to pay the tax on April 15, could make the preparer responsible for late payment penalties if proof of a negligent act, and penalties incurred as a proximate result, are proven. The Court concluded, based on the jury's verdict and the amounts of penalties and interests disclosed by the exhibits in the record, it could not ascertain the precise amount of the late payment penalty that might have been included in the jury's calculation and the matter had to be remanded on this issue.

In sum, the Court concluded the taxpayer could not recover interest because it was not proven at trial. It also barred recovery of late filing penalties as a rule of law. But, upon new trial, the taxpayer might be able to prove a modest amount due for late payment penalties, which amounted to no more than \$2500.00.

The Supreme Court's Decision

The liability of a tax preparer for penalties and interest incurred by a client was a matter of first impression at the time *Frank v. Lockwood* was decided. The Nebraska Supreme Court's 5-1 opinion in favor of the accountant and his firm announced important rules in the complex area of damages from alleged accounting malpractice. These rules now govern tax return preparer liability in Nebraska.

These rules may be summarized as follows:

¹² Of course there may be a circumstance where a tax preparer also holds a power of attorney with the IRS and is responsible for the taxpayer's duty in a fiduciary capacity. This situation was not dealt with by the Court's opinion or presented in *Frank v. Lockwood*.

Interest. Where an accountant's negligence is the proximate cause of a client's failure to pay taxes when due, and the client is found to be at fault for the untimely payment, the taxpayer can recover interest. But, the taxpayer must prove the difference between the amount of interest charged by the IRS, and the value of the money not paid for taxes, but held by the taxpayer in its possession, between the due date, and the eventual payment date, of the taxes owed.

Late Filing Penalties. Generally, an accountant will not be liable for penalties due to taxing authorities for unpaid taxes unless the accountant-tax preparer's conduct is the direct or proximate cause of the penalties. Where a taxpayer knows or should know when taxes are due, fails to pay them, and incurs *late filing penalties* the burden of the late filing penalty cannot be shifted under any circumstances to the preparer.

Late Payment Penalties. But, where the penalty is a *late payment penalty*, and late payment is caused by the accountant-tax preparer's failure to properly advise the client about the timing and need to make payment, the late payment penalty can, in some circumstances, be shifted to the accountant.

The decision reduces the recovery for the taxpayer to less than \$3,000. The case was ordered retried to determine whether the accountant would be held liable for any late filing penalty, or any interest incurred because the taxes were not paid on April 15, but were instead paid in December, nine months after they were due, and nearly 3 months after the last possible deadline for filing a return.

The Interest Issue

In *Frank v. Lockwood*, the taxpayer contended the accountant failed to inform him that his federal income tax had to be paid by April 15 even if the return was placed on extension. The jury's verdict awarded no tax, and found no fault for any tax being due, but to require the accountant to pay the late payment interest.

On appeal, the accountant argued (1) the taxpayer kept the use of the tax money, enjoyed the benefit of the income, and either suffered no damage, or failed to prove the amount of damage suffered, because the taxpayer adduced no evidence of any difference between the benefit received by retaining the funds, and the detriment of an interest assessment due to the IRS.

Since the damages issue required the Court accept the jury's verdict that the accountant did something wrong, and this point could not be questioned, the Nebraska Supreme Court's focus was solely on the recoverable damages. The Court acknowledged the taxpayer could not have it both ways, i.e., the taxpayer could not claim the accountant should pay all interest to the IRS while the taxpayer retained all benefits from using his money from April until December when he finally elected to file the return and pay the tax due.

But, who was to have the burden of proving the difference between the IRS tax rate and the taxpayer's benefit, if any? Is this part of the taxpayer's burden in a claim for professional negligence, or is it the professional's burden because the offset constitutes proof of mitigation of damages?

The Supreme Court split 5-1 on this issue. The Court's majority held the taxpayer had the burden of proving his gross damages, his offsetting benefit, and his net damages. The Court held this information was primarily within his control, and this decision is consistent with damages law in other areas. For example, where a loss in gross income occurs, the claiming party must prove both the gross loss, and the net loss. Six members of the Supreme Court saw the judgment interest rule as analogous. The Court's majority held:

While we do not hold that plaintiffs are completely barred from recovering damages related to interest paid to the IRS, we think that the burden remains on the plaintiff to prove that the circumstances were such that he or she was damaged by the payment of interest. We therefore do not adopt a blanket rule precluding recovery of interest on taxes as an element of damages. Instead, we hold that interest on taxes is recoverable in accounting malpractice actions to the extent plaintiffs carry their burden of showing that they were damaged by the imposition of interest.

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The Court's dissenting member believed the taxpayer should have the benefit of the doubt and require the burden of proving the value of retained funds in the taxpayer's hands should be on the accountant. The Court's dissenting Justice thought the taxpayer should have the benefit of the jury's verdict, and it should be the tax preparer's responsibility to prove the mitigated amount as net damages.

As a result of the Court's ruling, Nebraska's law now requires that claims involving losses caused by interest charges due to a taxing authority, and resulting from alleged acts or omissions of a tax preparer, must be proven by the claiming taxpayer. The taxpayer must also prove the financial value of retaining the funds so net damages can be calculated by the jury.

Late Filing Penalties

The Supreme Court differentiated, carefully, between two (2) different kinds of penalties involved in Mr. Frank's claims. The majority portion of the jury's verdict represented penalties assessed for late filings of tax returns. The Court surveyed the scarce case law available in other states, and noted that generally courts will not allow a taxpayer to pass the penalty for failure to make a timely tax filing to a tax preparer. It is the taxpayer's duty to comply with the law, and this compliance requirement is well-known. The Court concluded Mr. Frank could not, under any circumstances, pass on to his tax preparer the cost associated with late return filing. The taxpayer's duty to file a return timely is not a delegable one.¹³

Late Payment Penalties

¹³ Of course there may be a circumstance where a tax preparer also holds a power of attorney with the IRS and is responsible for the taxpayer's duty in a fiduciary capacity. This situation was not dealt with by the Court's opinion or presented in *Frank v. Lockwood*.

Late payment penalties were analytically more difficult for the Court than late filing penalties. The Court reasoned a tax preparer's negligence, including negligent failure to advise the taxpayer to pay the tax on April 15, could make the preparer responsible for late payment penalties if proof of a negligent act, and penalties incurred as a proximate result, are proven. The Court concluded, based on the jury's verdict and the amounts of penalties and interests disclosed by the exhibits in the record, it could not ascertain the precise amount of the late payment penalty that might have been included in the jury's calculation. The Court concluded the taxpayer could not recover interest because it was not proven at trial. Further, no recovery of late filing penalties could be made. But, upon new trial, the taxpayer might be able to prove a modest amount due for late payment penalties. The case was remanded on this narrow point.

The jury's \$37,000.00 verdict could have included no more than approximately \$2,500.00 for late payment penalties. This issue, alone, is available for jury consideration when retrial occurs.

The Court's Words

The Supreme Court's analysis of the late payment and late filing penalties issues show how vulnerable an account can be to a bald claim that she/he failed to advise a client when tax must be paid...something every American surely learns by age 18. The ritual of documenting advice is so important. The Court said:

As a general matter, it has been held that penalties may be recoverable as an element of damages when such penalties are the result of an accountant's negligence. (Citations omitted). We agree with these authorities that penalties may be recovered as an item of damages in an accounting malpractice action. Unlike interest, penalties are not a payment for use of money but instead are a payment beyond interest to penalize a taxpayer for late payment of taxes or late filing of a return. To recover penalties, the taxpayer must show that the accountant's negligence was the proximate cause of the penalties.

The penalties incurred by the Franks in this case appear to have been of two types--those incurred because the Franks failed to pay taxes when due on April 15, 2002, and those incurred because the Franks failed to file their returns when due as extended to October 15. Under federal law, *I.R.C.* § 6651 (2000) provides in subsection (a)(1) that a taxpayer may be assessed a penalty for failure to timely file a return and provides in subsection (a)(2) that a taxpayer may be assessed a separate penalty for failure to timely pay taxes due. In addition, *I.R.C.* § 6654 (2000) provides that penalties may be assessed for underpayment of estimated taxes. Nebraska law provides for similar penalties for failure to timely file returns, *Neb. Rev. Stat.* § 77-2789 (Reissue 2003), and for underpayment of estimated taxes, 316 *Neb. Admin. Code*, ch. 20, § 007 (1998).

The evidence indicates that the Franks were required to pay their federal and Nebraska tax liabilities for 2001 on April 15, 2002. Because extensions were filed for and granted, the tax returns themselves were not due on April 15, but were due on the extended due date of October 15. However, the Franks did not file their 2001 tax returns or pay the tax due on such returns until December. Because the Franks failed to timely

pay on April 15 and failed to timely file on October 15, they were subject to both penalties for late payment of taxes and penalties for late filing of returns.

As indicated above, there was sufficient evidence from which the jury could find that Lockwood was negligent in failing to advise the Franks to pay an estimate of their 2001 tax liability on April 15, 2002. Because the failure to timely pay taxes subjected the Franks to possible penalties, the jury could have found that Lockwood's negligence resulted in and was the proximate cause of any such penalties that were imposed. We therefore conclude that the district court did not err in denying Lockwood's motion for judgment notwithstanding the verdict with respect to any portion of the damages award that was attributable to penalties for the Franks' failure to timely pay taxes.

However, to the extent any penalties were imposed for the Franks' failure to timely file the tax returns, such late filing penalties were not a result of Lockwood's advice or the failure to pay taxes on April 15, 2002. Instead, based on the evidence, the late filing penalties were the result of the Franks' failure to file their 2001 federal and Nebraska tax returns on or before the extended due date of October 15. In this regard, there was evidence that Lockwood provided a tax return to the Franks in early October with instructions that stated that the return was to be mailed on or before October 15. The evidence further indicates that the return was not filed at that time because Frank chose to have another accountant and Frank's attorney review the return. Frank's testimony and the letter Frank's attorney sent to Lockwood in December indicated that Frank was aware that penalties and interest were accruing but chose to take time for a careful review of the returns. Therefore, the evidence was not sufficient for a jury to determine that Lockwood breached a duty with respect to the October 15¹⁴ filing deadline or that any damages resulting from the late filing of returns were the result of Lockwood's advice. Because late filing penalties imposed were not the result of Lockwood's negligence, the district court erred when it denied Lockwood's motion for judgment notwithstanding the verdict with respect to the portion of the damages award that was attributable to late filing penalties, and we reverse the district court's ruling to that extent.

275 Neb at 749-750.

What Does *Frank v Lockwood* Mean?

The Supreme Court's decision in *Frank v Lockwood* is most fairly read to mean three things:

- 1 Tax preparers must document the most basic advice: file the return by the deadline; state the deadline, and tell the client payment cannot be postponed past the original filing date.
- 2 Do not engage in offhand discussions about tax credits or complications. Though it costs the client more for the advice, put opinions in writing and do not make generalized comments except for clear general education reasons.

¹⁴ The law governing these dates have changed since the facts developed that gave rise to the case.

- 3 Use engagement agreements to define scope of services. Require clients to sign and assent to these terms. Keep these letters current.¹⁵
- 4 Make fees for services commensurate with professional risks. Hard to deal with clients require different, not standard, fees because they pose special risks.
- 5 When a claim is made, do not take it lightly, Be certain skilled counsel is engaged in analysis of the exposed professional person's position.

-- David A Domina

¹⁵ No attempt is made in this article to deal with IRS – imposed liability on tax preparers for negligence or incompetence. 26 USC §6694, and other statutory sections, as well as a series of regulations [see Treas. Reg. Section 1.6694-1(c)] not relevant to this article's focus on liability to the tax preparer's client, must be examined by the tax preparer.