

Tax Action Memo®TAM-1197
January 16, 2007**Update on Outsourcing Tax Returns**

<p>Type of Clients: All.</p> <p>Situation: To adequately service clients, you're considering outsourcing tax preparation work.</p> <p>Deadline: N/A.</p>	<p>Tax Action Required: Read this article for the latest on the growing trend of outsourcing tax preparation services.</p>
---	---

Background

As you've likely discovered, finding qualified staff is a major problem, of which technology can solve only so much. This has led numerous firms on a search for the best way to adequately serve their clients with a reduced or static number of people. Some firms have turned to tax return outsourcing to solve this dilemma and many more are considering it.

Outsourcing has been controversial from the beginning. A firm that chooses to outsource returns must be careful to ensure that legal requirements surrounding outsourcing are followed and ethical considerations are addressed. It must also be prepared to deal with client questions and issues. And finally it is critical for such a firm to have a process in place to make sure that the returns are prepared accurately.

Legal Requirements and Ethical Considerations of Outsourcing

IRS. IRC Sec. 7216(a) imposes a criminal penalty for tax return preparers who knowingly or recklessly disclose or use tax return information for a purpose other than preparing a tax return. A violation of IRC Sec. 7216 is a misdemeanor, with a maximum penalty of up to one year imprisonment or a fine of not more than \$1,000, or both, together with the costs of prosecution.

Unfortunately, there is also a serious potential problem pending. Treasury has issued proposed regulations under IRC Sec. 7216 that substantially modify disclosure rules for tax returns. Essentially, these rules require specific client consent for any disclosure of tax return information. The definition of tax return information is also expanded by the regulations. When finalized, these regulations will require specific client written consent to disclosure of tax return information to anyone outside of the U.S.

While the proposed regulations are very controversial, this is a development practitioners must monitor. "We don't outsource so why should we care?" you ask. The proposed rules affect any disclosure to third parties—not just those to vendors outside the U.S.

AICPA. The AICPA also imposes some ethical requirements on CPA practitioners. Under ET 291.023-024, an AICPA member outsourcing any work (including tax returns) remains responsible for the oversight of all services performed by a third party and for ensuring that all professional services are performed with professional competence and due professional care.

In addition, ET 191.224-225 requires disclosure of any outsourcing. Prior to disclosing confidential client information to a third-party service provider, an AICPA member must inform the client, preferably in writing, that the member may use a third-party service provider. If the client refuses to consent or objects, the member must provide the service without using the third-party service provider or decline the engagement.

Before an AICPA member outsources returns, the member must contract with the third-party service provider to maintain the confidentiality of the information and be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential information to others.

Note: Although foreign outsourcing to India may be what comes to mind when discussing these issues, outsourcing can occur anywhere, even in the U.S. It's important to understand that the requirements for outsourcing discussed here apply both to foreign and U.S. outsourcing.

State Accountancy Rules. Most states have adopted the AICPA Code of Conduct as part of the state accountancy rules. Therefore, the disclosure requirements are generally binding on CPAs in that state. Some states have gone beyond the AICPA rules and created their own more restrictive requirements. For example, California requires written notice to a client if confidential client information is provided to persons or entities outside the U.S. North Carolina requires a written disclosure to a client that a third-party provider is being used to assist a CPA in rendering any professional service to the client.

Bottom Line: Be sure to check with your state board before outsourcing any return.

Managing the Client Relationship

When it comes to managing the client relationship, it pays to be honest. Regardless of legal and ethical requirements applicable to your firm, we don't recommend hiding the fact you're outsourcing. It's important to discuss with clients (in letter form or in person) the process and the steps the firm has taken to ensure security and quality.

It's also best not to pressure a client who balks. Instead, prepare those returns in-house or fire the client. Be sure to stress the importance of the organizer in getting the correct information onto the return.

Establishing a Good Outsourcing Process

Assuming the firm fully complies with all the legal and ethical considerations and addresses the client issues outsourcing raises, it must still establish a good outsourcing process.

Finding a Vendor. The first step in the process is to select an outsourcing vendor. Unfortunately, there are no good guidelines for selecting vendors. However, the steps and due diligence taken in selecting the vendor should be well documented. It's important to carefully check on the levels of security the vendor uses, both for the data and for the preparation site. It's also important to find out whether a specific team of individuals will be assigned to prepare the firm's returns and what technical support is available. This provides continuity and develops a familiarity with issues clients tend to have.

As previously discussed, the firm may be required to enter into a confidentiality agreement with the vendor. Even if not required, it's still a good idea. The agreement should include any security requirements, a requirement that the vendor maintains no copy of client data and, of course, the price for the service. Certainly, any other issues that are important to the firm should be included.

Other vendor issues to address include compatibility of systems and any additional hardware or software needed to create compatibility. Turnaround time, firewall issues, and transfer of data are other issues to discuss before the agreement is signed.

Processing Returns. Assuming the legal and ethical requirements are met, there's still has a lot of work to do. The outsourcing process has different stages:

- Organizing and scanning the data.
- Uploading the data to the vendor.
- Monitoring the progress of the return.
- Downloading the data.
- Reviewing, printing, and processing the final return.

Organizing and Scanning the Data. The first step in the outsourcing process is to prepare the data for transmittal to the vendor. That's where the client organizers come into play. The organizer provides a great start to the process. Clients should be strongly encouraged to complete the organizer prior to the tax appointment. If the client doesn't complete the organizer, consider completing it as much as possible during the interview process.

Bottom Line: Time spent organizing and completing the information on the front end makes it much easier to get a good product out the back end of the process.

Once the data is complete, it's time to scan it. Part of the scanning process is to determine whether the vendor will use the original documents (1099s, W-2s, etc.) or will use the completed organizer. Investing in one or more high-speed, high-quality scanners can reduce the input errors caused by fuzzy or illegible numbers, thus making the process more efficient. Also, consider scanning software for automatic bookmarking to create consistency in the preparation process. Even if automatic bookmarking isn't used, consider standardizing the bookmarking.

Uploading the Data to the Vendor. Once the data is scanned, it's ready to be transmitted to the vendor. This should be straightforward, but it's still important to do the following:

- Mandate encryption during transmission.
- Maintain an updated list of returns transmitted and date transmitted.
- Make sure the firm can "bring the return back" without the vendor consent at any time.
- Develop a process to provide additional or updated information (i.e. amended K-1s, 1099s, etc.) to the vendor.

There are a number of issues that can prove troublesome that should be addressed early in the process. These include:

- Multistate returns.
- Military spouses.
- Vendor's lack of familiarity with local businesses.
- Vendor's lack of familiarity with state issues (i.e. credits).
- Lack of complete information when the return is sent to the vendor.

- Children's returns sent separately (a huge potential problem since Congress raised the age for children subject to the "kiddie tax" to 18 effective in 2006).
- Related entity returns and information that needs to be cross-referenced.

Monitoring the Progress of the Return. It's very important to monitor the progress of the returns daily. Tracking software is available to help do this. One person in the firm should be responsible for monitoring the progress of returns and liaising with the vendor. Expected turn around times should be established to identify returns that need special attention or followup.

Downloading the Data. Once a return is completed, it must be downloaded. This requires a process for notification of completion as well as updating the tracking process. It's also important to create an in-firm notification process to advise the responsible partner that the return is back.

Reviewing, Printing, and Processing the Final Return. Since the practitioner is still responsible for the return, a review of the final product is critical. The type of review (e.g. full review, review of the two-year comparison) can depend on the complexity of the return, but some review should occur for each return.

During the review, it's important to make sure all issues and diagnostics from the vendor are cleared and corrected. The practitioner should also determine whether returns needing additional information (i.e. K-1s) remain with the vendor for completion or should be returned when substantially completed. The final step is generally to process the return for e-filing, with a copy to the client.

Conclusion

Properly planned and monitored, outsourcing tax returns can reduce the stress of tax season. However, if inadequately planned, it can cause disaster. Outsourcing isn't for everyone, but it is one option that can help reduce tax season stress and ease the problem of finding qualified staff.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member Michael E. Mares, J.D., CPA, of PFK Witt Mares, PLC in Newport News, Virginia.