

## TAX LITIGATION ISSUES

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### *Sanctions for Tax Professionals*

This spring, the Department of Treasury and Internal Revenue IRS (IRS) issued two notices regarding the types of financial penalties that can be imposed on tax professionals. The first notice addresses the regulation of the behavior of professionals who practice before the IRS and the type of monetary sanctions that can be asserted for inappropriate conduct. The second notice deals with a statute that allows the imposition of monetary sanctions on preparers of tax returns that contain an understatement of taxes based on an unreasonable position by the taxpayer.

In both instances, the government proposes to clarify the statutes involved and the behavior that can lead to penalties.

#### **Circular 230: Practitioner Penalties**

Pursuant to 31 USC §330, the government regulates professionals who practice before the IRS in what is referred to as Circular 230. Subsection 330(b) provides that a person admitted to practice before the IRS can be suspended or disbarred from that practice or censured if he is found: (1) to be incompetent; (2) to be disreputable; (3) to have violated prescribed regulations; or (4) to have knowingly and willfully misled or threatened a client or prospective client, with the intent to defraud.

In 2004, §330 was amended to expand the sanctions that the secretary of Treasury may impose for such prohibited conduct to include monetary penalties.<sup>1</sup> Specifically, the statute authorizes the imposition of monetary penalties on practitioners who engage in the conduct outlined in subsection 330(b). In addition, the practitioner's employer or firm or another entity also may be sanctioned if the practitioner was acting on its behalf in connection with the conduct giving rise to such penalty and the employer, firm, or other entity "knew, or reasonably should have known, of such conduct." Finally, the statute states that the monetary



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penalty "shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty."<sup>2</sup>

In April 2007, the IRS and Treasury Department issued Notice 2007-39 (the April Notice) "to provide guidance to practitioners, employers, firms and other entities that may be subject to monetary penalties under [§330]." The April Notice observes that while monetary penalties may be imposed in addition to, or in lieu of, any suspension, disbarment or censure, a practitioner should not offer to accept monetary sanction as a "bargaining point" to avoid other appropriate sanctions.<sup>3</sup>

The April Notice then details the application of monetary penalties under the statute. In determining whether a penalty should be imposed, the IRS will consider elements including: (i) the level of culpability; (ii) whether the practitioner, employer, firm, or other entity violated a duty owed to the client; (iii) the actual injury or potential injury caused by the prohibited conduct; and (iv) the existence of aggravating or mitigating factors. Mitigating factors may include whether the practitioner, employer, firm, or other entity: (i) took prompt action to correct the noncompliance after discovery of the prohibited conduct; (ii) promptly ceased engaging in the conduct; (iii) attempted to rectify any harm caused by the conduct; or (iv) undertook measures to ensure that the conduct would not occur again.<sup>4</sup>

In determining the amount of the penalty to be imposed, the IRS will consider amounts that the practitioner "could reasonably expect to realize, irrespective of whether the amounts have

actually been realized." However, the IRS will not impose penalties "in cases of minor technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct."<sup>5</sup>

Furthermore, monetary penalties can be imposed separately against the practitioner, his employer or firm, or another entity. The April Notice sets forth the factors the IRS will consider determining whether a practitioner was acting on behalf of his employer, firm or another entity. Specifically, the April Notice provides a relationship warranting the sanction of the employer, firm, or other entity exists if: (1) an agency relationship existed between the practitioner and the employer, firm, or other entity; (2) the purpose of the agency relationship was to provide services in connection with practice before the IRS; and (3) the prohibited conduct giving rise to the penalty arose in connection with the agency relationship.

The April Notice also addresses when a practitioner's employer or firm, or another entity will be deemed to have the requisite knowledge to warrant imposition of monetary sanctions. It provides that the employer, firm, or other entity will be deemed to have known of the misconduct if: (1) one or more members of the principal management of the entity "has information from which a person with similar experience and background would reasonably know of the prohibited conduct"; or (2) the entity, through willfulness, recklessness, or gross indifference, did not take reasonable steps to ensure compliance with Circular 230.<sup>6</sup>

The April Notice is clear, however, that in determining whether to impose monetary sanctions on a firm, employer or other entity, it will consider factors beyond whether the firm, employer or entity had knowledge of the prohibited conduct. These additional factors may include: (i) the gravity of the misconduct; (ii) any history of noncompliance by the employer, firm, or other entity; (iii) preventative measures in effect prior to the misconduct; and (iv) any corrective measures taken in response to the misconduct.<sup>7</sup>

Finally, the April Notice invites comments from the public regarding the procedures detailed therein "in order to develop a penalty system that best encourages compliance with Circular

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230." Comments are to be submitted to the IRS by Aug. 13, 2007. The IRS will consider public comments regarding the rules and standards relating to monetary penalties under Circular 230 and respond as it deems necessary.

## Penalties Under IRC §6694

Section 6694 of the Internal Revenue Code (IRC) states that tax return preparers may be penalized for preparing a tax return containing an understatement of tax that is due.<sup>8</sup> Section 6694(a) imposes a penalty for any understatement due to "unreasonable positions," while §6694(b) imposes a greater penalty for understatements due to willful or reckless conduct. In May, Congress amended this statute, and other portions of the IRC, to broaden the statute's reach, change the standard of conduct necessary to avoid imposition of such penalties, and increase the amount of the monetary penalties that can be imposed.<sup>9</sup>

First, Congress amended the definition of a "tax return preparer," as set forth in §7701(a)(36) of the IRC, striking the word "income" from the definition. Accordingly, tax return preparers now include persons preparing non-income tax returns, such as estate, gift, excise, nonprofit, or employment tax returns. As a result, while §6694 previously only applied to those persons who prepared income tax returns or claims for refunds, the penalties provided for in the statute can be imposed based on a broader range of returns.

Congress also increased the amount of penalties applicable under the statute. Those preparers filing returns with "unreasonable" positions under §6694(a) can be penalized an amount equal to the greater of \$1,000 or 50 percent of the income derived by the preparer with respect to the return or claim at issue.<sup>10</sup> Prior to amendment, preparers fined under this subsection could only be penalized up to \$250.<sup>11</sup> Preparers found to have engaged in "willful or reckless conduct" under §6694(b) can be penalized an amount equal to the greater of \$5,000 or 50 percent of the income derived by the preparer with respect to the return or claim at issue—an increase from \$1,000 under the old statute.<sup>12</sup>

The amendments also alter the standards of conduct that must be met by those practitioners seeking to avoid the imposition of penalties for preparing a return containing an understatement due to an "unrealistic" position under §6694(a). Prior to the amendment, such penalties could be imposed where: (1) the understatement was "due to a position for which there was not a realistic possibility of being sustained on its merits"; (2) the preparer knew or reasonably should have known of such position; and (3) such position was undisclosed or was frivolous.<sup>13</sup>

After the amendments, §6694(a) now applies where: (1) the preparer knew or reasonably should have known of the position; (2) "there was not a reasonable belief that the position would more likely than not be sustained on its merits"; and (3) such position was undisclosed or had no reasonable basis.<sup>14</sup>

Thus, the amendments require a tax practitioner defending against the imposition of penalties for an "unrealistic position" to satisfy a higher standard of conduct. The "realistic possibility" standard—defined by the IRS as a "one-in-three chance of success"<sup>15</sup>—was replaced with the requirement that there be a reasonable belief that the tax treatment would "more likely than not be sustained on its merits" (i.e., greater than 50 percent chance of success). Furthermore, where the taxpayer's position is disclosed, a practitioner can no longer defeat the imposition of penalties by showing that the understated position was not frivolous, but must now demonstrate that it was reasonable (i.e., possessing sound judgment<sup>16</sup>). Both before and after the amendment, the practitioner can

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avoid penalties by showing that there was good cause for the understatement and that she acted in good faith.

In response to these amendments, the IRS and the Department of Treasury issued Notice 2007-54 (the May Notice) to provide guidance and transitional relief to tax return preparers, noting that Congress' amendments "raise questions regarding activities representing preparation of a tax return, who is a return preparer within the meaning of §7701(a)(36) (as amended), and how the statute applies to signing and nonsigning preparers."<sup>17</sup> Although the amendments under the act were effective immediately, the IRS determined the altered standards set forth in 6694(a) would not be applied to refunds due on or before Dec. 31, 2007.<sup>18</sup> This additional time allows the IRS to alter existing regulations and procedures as needed.

## Enforcement of Penalties

Circular 230 was enacted by the IRS to "enhance public confidence in tax professionals."<sup>19</sup> The IRS Office of Professional Responsibility (OPR) was established in January 2003, replacing the Office of Director of Practice, and charged with enforcing the standards set forth in Circular 230. In conjunction with an increased focus on enforcement within the IRS, OPR's efforts to sanction practitioners who do not comply with Circular 230 have increased, along with the size of its staff. The director of

OPR has stated the office's intent to focus on high impact tax cases in hopes of "lead[ing] to a change in overall practitioner behavior."<sup>20</sup>

The penalty provisions set forth in §6694 were established to "strengthen the deterrent to aggressive reporting of tax positions."<sup>21</sup> Accordingly, such penalties have been imposed on practitioners where a taxpayer has been penalized for the filing of a frivolous tax return under §6702 of the IRC or has taken an unreasonable or frivolous position with regard to the taxpayer's liability.<sup>22</sup>

The notices regarding sanctions of tax professionals appear to have been devised as part of the government's efforts in the tax shelter area. The new sanctions, however, are applicable to a wide range of conduct and different types of tax returns. As a result of the stiffer penalty amounts, tax practitioners must be more cautious in taking aggressive positions requested by their clients and may require more documentation. When those positions are taken, they are more likely to be disclosed to the IRS. Commentators observe that this may result in clients "shopping around" for a more "amenable tax pro willing to agree to what the client wants," and that "the new law represents 'an attempt to deputize' more tax practitioners by 'holding them to a higher standard.'"<sup>23</sup>

1. Section 822 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

2. 31 USC §330(b).

3. IRS, "Disciplinary Actions Under Section 822 of the American Jobs Creation Act of 2004," Notice 2007-39 at p. 2.

4. Id. at p. 3.

5. Id.

6. Id. at pp. 4-5.

7. Id. at p. 6.

8. 26 USC §6694.

9. Section 8246 of the Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28.

10. 26 USC §6694(a)(1).

11. May Notice at p. 4.

12. 26 USC §6694(b)(1); May Notice at p. 4.

13. IRS, "Preparer Penalty Provisions Under the Small Business and Work Opportunity Act of 2007," Notice 2007-54 at pp. 2-3.

14. 26 USC §6694(a)(2) (emphasis added).

15. Treas. Reg. §1.6694-2(b)(1).

16. Id.

17. Id. at pp. 1-2.

18. Id. at pp. 4-5. The amendments set forth in §6694(b) would be effective immediately, however, as "transitional relief is not appropriate for return preparers who exhibit willful or reckless conduct."

19. IRS, "IRS, Treasury Clarify Circular 230 Written Opinion Standards" (May 18, 2005).

20. Edward Burrows and David Pratt, 2006 ASPPA Annual Conference, "Workshop 43, Circular 230 Issues" at pp. 2-3.

21. Department of Treasury, Office of Tax Policy, "Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code" (October 1999).

22. IRS, Chief Counsel Advisory, 2005 WL 1563069 (July 1, 2005).

23. Herman, "The IRS Has a New Weapon: Your Tax Pro"; see also Susan T. Edlavitch and Brian S. Masterson, "Practical Guide for Compliance With Circular 230 and the Reportable Transaction Disclosure Framework Post-AJCA," BNA Tax Management Memorandum Vol. 46, No. 9 (May 2, 2005).