Chapter 3: Ethics

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

INTRODUCTION

The Internal Revenue Service made it well known that they are increasing the number of tax examiners and consequently the number of tax audits. Commissioner Everson also requested the Office of Professional Responsibility increase its staff to better regulate and oversee tax professionals. The Commissioner said he expects tax professionals to be "pillars of our tax system, not the architects of its circumvention." To date, the office staff size has tripled. Most of the new hires are attorneys, meaning increased enforcement action is expected. While this should not be the incentive for tax professionals to become more ethical in their decisions, it has certainly caused them to review how they handle transactions and whether they are in compliance with Circular 230.

Circular 230 is the IRS guide for tax preparer regulation. The most recent version of Circular 230 was released in June 2005. While Circular 230 defines the regulations, the implementation of the regulations is unclear in many situations. One area of tax abuse is tax shelters. The new regulations specifically address these.

The federal tax system is founded on the principles of compliance and voluntary self-assessment. Consequently, it is necessary for taxpayers to have confidence in the honesty and integrity of both IRS employees and the tax professionals providing advice. In order to restore confidence, the IRS issued final regulations setting forth best practices applicable to all tax professionals. The regulations are mandatory for professionals who provide covered opinions. A part of the American Jobs Creation Act of 2004 allows the IRS to assess substantial monetary penalties against tax professionals who violate any provision of Circular 230. The act also allows the IRS to assign monetary penalties to the professional's employer. The penalty can be up to the amount of the fees collected. Section numbers referred to in this chapter are section numbers in Circular 230.

This chapter discusses four primary areas. They are:

1. Circular 230 including the new regulations dealing with §§10.35, 10.36, and 10.37,
2. The American Jobs Creation Act of 2004 and the increased penalty rules which affect all tax preparers,
3. Penalties which can be assessed against a preparer, and
4. Recent enforcement action against tax preparers which includes criminal actions.

Before discussing the recent changes, it is important to review some of the basic rules and definitions governing tax preparers.

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TAX PROFESSIONALS GOVERNED BY CIRCULAR 230

What was once called the Office of the Director of Practice is now named the Office of Professional Responsibility (OPR). However, the old name still appears in Circular 230. Attorneys, certified public accountants, enrolled agents, enrolled actuaries, and other persons representing taxpayers before the IRS are governed by the rules contained in Circular 230.

DEFINITION OF A PREPARER

The definition of a tax preparer is broad. The IRS defines a tax preparer as someone who:

1. Prepares a tax return for a fee, or
2. Employs one or more persons to prepare returns for a fee.[1]

The IRS does not look at professional qualifications or education when making this determination. If the person is considered a return preparer, he has signature, disclosure, and recordkeeping requirements. A person who prepares a return for a friend, neighbor, or relative is not considered a return preparer and does not have these requirements if he is not compensated.

The IRS and the courts have made a number of rulings on who is a return preparer, and these include:

1. A person who reviews a tax return may be considered a tax preparer.[2]
2. A general partner who prepares the partnership return, which is in turn reported on a limited partner's Form 1040, may be considered the preparer of the Form 1040. This may be true even though he never saw the Form 1040, if the partnership Schedule K-1 constitutes a major portion of the income reported on the Form 1040.[3]
3. If a preparer reports a net operating loss (NOL) in one year and a second preparer carries this NOL to another year, the first preparer may be held liable for preparer penalties in year two if the original NOL was incorrectly computed.[4]
4. If a corporation return practitioner prepares the shareholder returns for free, the practitioner may be considered a preparer for the shareholder return.[5]
5. A taxpayer who writes a program to prepare simple returns, and then rents the computer to other people to prepare their own returns, may be considered a tax preparer of all of the returns.[6]
6. An accountant who reviews an accounting client's self-prepared return may be considered the tax preparer even though he did not make any changes on the client's return.

Anyone who is considered a tax preparer must comply with the regulations regarding tax preparers and is subject to any of the applicable preparer penalties.

1. IRC §7701(a)(36)
2. Letter Ruling 7902033, October 11, 1978
3. Rev. Rul. 81-270, 1981-2 CB 250, January 1, 1981
4. Rev. Rul. 81-171, 1981 CB 589, January 1, 1981
5. *M. Papermaster, DC,* 81-1 USTC ¶9217, April 21, 1980
6. Letter Ruling 8111071, December 17, 1980

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PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

While anyone is entitled to prepare tax returns for compensation, the IRS has developed specific rules regarding who can "practice" before the IRS. The IRS defines practice as presenting before the IRS or any of its officers or employees any matter relating to taxpayer rights, privileges, or liabilities under laws or regulations administered by the IRS. A presentation can include, but is not limited to:

- Preparing and filing documents,
- Corresponding or communicating with the IRS, or
- Representing a client at a meeting, conference or hearing with the IRS.

Practice before the IRS is limited to four groups:

- Attorneys,
- Certified public accountants,
- Enrolled agents, and
- Enrolled actuaries (limited practice).

Attorneys and certified public accountants must be licensed in a state in order to practice before the IRS. In states where the CPA designation is made upon successful completion of an examination, and where the individual does not plan to practice accounting, and therefore is not licensed by the state, the individual does not qualify to practice before the IRS. In a state where licensure is a two part process — the first part requiring the passage of an examination, followed by a year of experience — simply passing the exam does not allow the individual to practice before the IRS.[7]

An unenrolled preparer is limited in what he can do. In order to sign a Form 2848, *Power of Attorney and Declaration of Representation,* for an offer in compromise, and if the offer is based on doubt of liability, the preparer must meet two conditions:

1. He must have signed the taxpayer's return in the year of dispute.
2. The offer must fall under the jurisdiction of Compliance Examination.

If the offer covers more than one year, the preparer must have signed all year's returns. If the offer is turned over to Compliance Collection, the tax preparer will not be able to represent the client.[8]

LICENSE RENEWAL FOR ENROLLED AGENTS

In order for an enrolled agent to have his enrollment renewed, he must meet continuing education requirements.

SSN/TIN Ending Number	Renewal Dates
0,1,2,3	June 1, 2004–July 31, 2004
4,5,6	November 1, 2004–January 31, 2005
7,8,9	November 1, 2005–January 31, 2006

Subsequent enrollment cycles will be held each three years between November 1 and January 31. License renewal for CPAs and attorneys is regulated by various state licensing authorities. The rules vary among the different states and professions.

7. IRS Chief Counsel Advice 200431013, July 30, 2004
8. IRS Chief Counsel Advice 200431015, July 30, 2004

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CONTINUING EDUCATION

Tax professionals who qualify to practice before the IRS are required to participate in continuing education. For CPAs and attorneys, the number of required hours is mandated by their state controlling board. However, enrolled agents are licensed by the IRS and must follow Circular 230 requirements as stated below.

For enrollment after April 1, 2007, 72 hours of continuing education are required in each three-year cycle. The required education must include at least 16 hours of continuing education each year, which includes 2 hours of ethics each year. However, at the end of the three-year cycle, the total hour requirement is 72. For enrollment effective after March 31, 2004, the requirement is 16 hours in each calendar year. The old requirement consisted of 16 hours of continuing education each year and did not contain an ethics requirement.

Enrolled agents are required to keep records of the continuing education they receive. This information includes:

1. Name of the sponsoring organization;
2. Location of the program;
3. Title of program and description of its content;
4. Written outlines, syllabi, textbook, and/or electronic materials required or provided;
5. Dates attended;
6. Credit hours claimed;
7. Name of the instructor; and
8. Certificate of completion and/or signed statement of hours of attendance.

Enrolled agents can also obtain credit hours by instructing tax courses or writing published tax material. The number of credit hours awarded for these services is discussed in §10.6 of Circular 230.

UNENROLLED PREPARERS

As previously mentioned, unenrolled preparers are limited in how they can interact with the IRS. Consequently, the OPR has less control of their actions. The unenrolled preparer does not have any continuing education requirements. However, many go to the same tax seminars and workshops as the preparers who are authorized to represent taxpayers.

Both the United States House and Senate have introduced bills to impose registration and continuing education requirements on these tax preparers.[9] While none of these bills were enacted, it is expected that regulation will occur in the future.

The bills have not gone as far as recommending all unenrolled preparers become enrolled agents. However, some have considered some degree of testing. If a bill passes, it will present many challenges to the OPR since there are over 1.2 million tax preparers. It is estimated over 900,000 preparers are not currently eligible to practice before the IRS, and the manpower and dollars needed to test and monitor the continuing education would use a substantial portion of the IRS budget.

9. Senate Bill 832

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§10.35. REQUIREMENTS FOR COVERED OPINIONS

The thrust of §10.35 is to better regulate the opinions given by accountants and attorneys to their clients. These opinions are generally provided to wealthy clients who are concerned whether a transaction is considered illegal or abusive by the IRS. The new regulations are for §10.35 of Circular 230 and are the standards for "covered opinions." A covered opinion is defined to include written advice that concerns one or more federal tax issues arising from:

1. A listed transaction;
2. Any plan or arrangement, the principle purpose of which is to avoid or evade tax; or
3. Any arrangement or plan with a significant purpose of tax avoidance or evasion if the written advice is:
   a. A reliance opinion,
   b. A marketed opinion,
   c. Subject to confidentiality, or
   d. Subject to contractual protection.

Most tax preparers are never involved with a covered opinion. However, §10.35 covers all written advice given to clients. A "reliance opinion" is written advice that concludes at a confidence level of at least more-likely-than-not that one or more significant federal tax issues will be resolved in the taxpayer's favor.

The IRS stated that written advice is not treated as a reliance opinion if the author discloses in the advice that it is not written for the purpose of avoiding penalties.

Caution. While the primary purpose of §10.35 was to eliminate fraudulent tax shelter opinions, it is possible the IRS could use this section to sanction any preparer who gives a written opinion regarding any tax transaction.

Note. Tax preparers should protect themselves from violating §10.35. Simply adding the appropriate statement at the bottom on their opinion satisfies §10.35. However, it is suggested practitioners explain the reason for the statement to the client before presenting the written opinion.

Clarification

The IRS released Treasury Decision 9201 on May 18, 2005. This further modified the regulations on covered opinions. The Treasury Decision defined **three exceptions** to a "covered opinion." These are:

1. Written advice after a tax return is filed.
2. Advice provided by taxpayer's in-house counsel.
3. Negative advice. This includes advising the client that the IRS is not likely to resolve an issue in the taxpayer's favor.

§10.36. PROCEDURES TO ENSURE COMPLIANCE

The purpose of §10.36 is to take enforcement of §10.35 to the company level. Any practitioner who has principal authority over the firm's tax practice is required to ensure compliance with §10.35. The practitioner may be subject to discipline through willful, reckless, or gross incompetence in enforcing §10.35.

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§10.37. REQUIREMENTS FOR OTHER WRITTEN ADVICESM

A new provision sets forth the requirements for written advice that is not a covered opinion under §10.36 discussed earlier. Practitioners must not give written advice (including electronic communications) if the practitioner:

- Bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events);
- Unreasonably relies upon representations, statements, findings, or agreements of the taxpayer or any other person;
- Fails to consider all relevant facts that the practitioner knows or should know; or
- Takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be stated.

Unlike the section on covered opinions, this section does not require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of the law to those facts, or the practitioner's conclusion about the law and the facts. Scope of the engagement and the type and specificity of the advice sought by the client, in addition to all the other facts and circumstances, are considered in determining whether a practitioner has failed to comply with the requirements of this section.

The tax preparer is held to a higher standard if he knows the written advice he is giving is used by other taxpayers in evaluating transactions with the purpose of tax avoidance or evasion.

Question A. Darlene, a tax preparer, responds to a client regarding the treatment of a like-kind exchange. The question deals with the consequences of missing the 180-day exchange period. Darlene sends her client a note stating that missing the deadline would invalidate the tax-free exchange, but not to be concerned since the IRS will never find out. Is Darlene in violation of §10.37?

Answer A. Darlene is in violation because she is basing her opinion on the "audit lottery."

§10.38. ESTABLISHMENT OF ADVISORY COMMITTEES

To promote and maintain the public's confidence in tax advisors, the OPR is authorized to establish one or more advisory committees composed of at least five individuals who can practice before the IRS. These committees should be balanced among those who practice as attorneys, accountants, and enrolled agents and may review and make recommendations regarding professional standards or best practices for tax advisors.

All practitioners are governed by Circular 230 and the Internal Revenue Code. In addition, some may also be governed by the professional standards or codes of conduct of their respective professional or licensing organizations. All practitioners should perform in an ethical manner and keep in mind the need to:

- Serve their clients with professionalism,
- Keep information confidential,
- Maintain tax positions that have substantial authority,
- Corroborate information that appears to be incorrect or incomplete,
- Be an advocate for the client,
- Document all research,
- Keep copies of all returns and supporting documentation, and
- Maintain proper oral and written communications.

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§10.33. BEST PRACTICES FOR TAX ADVISORS

The revision to §10.33 requires a tax advisor provide the highest quality representation concerning federal tax issues by adhering to best practices. While the Regulation describes "best practices," they are considerd "solely aspirational" rather than mandatory. This section of Circular 230 includes advice and information on preparing or assisting in the preparation of tax documents. Best practices include the following:

1. Clear communication with the client regarding the terms of the engagement.
2. Establishing the facts, determining which are relevant, and evaluating whether they are relevant to the law prior to arriving at a conclusion.
3. Advising the client regarding the importance of the conclusion reached. This also includes advice on whether the taxpayer may avoid accuracy-related penalties if he relies on the advice.
4. Acting fairly and with integrity in practice before the IRS.

The manager of the tax practice is responsible for seeing that he has taken reasonable steps to ensure employees are consistent with best practices. Unfortunately, the IRS has not given any guidance on what they consider to be reasonable. All the IRS can say is that they look at all of the facts and circumstances of the case. The tax practice manager should at least be sure all employees are familiar with the provisions of Circular 230.

> **Note.** Firms with standards in place, which can be articulated to the IRS in case of an inquiry, should not have a problem meeting the best practices standard.

OTHER CIRCULAR 230 REQUIREMENTS

The following sections of Circular 230 were not changed by the December and May regulations and notices. However, it is important that tax preparers understand their implications.

§10.20. INFORMATION TO BE FURNISHED

It is important that tax preparers respond to IRS requests in a timely manner. If the taxpayer's representative has a valid signed power of attorney (POA) on file, the IRS will make all requests for documents and appointments to the representative. While an audit request may come at the most inopportune time, the revenue agent normally tries to accommodate both the taxpayer and his representative. However, the agent cannot be delayed indefinitely. If the IRS determines the practitioner is intentionally causing unreasonable delay to the audit process, it can bypass the POA and contact the client directly.[10] Continually ignoring an IRS request ultimately results in a contact from OPR.

Question A. The client of a tax preparer is being audited. The IRS requests information about the client from the tax preparer. The tax preparer requests the information from the client, but does not follow-up. What's wrong with this approach?

Answer A. A key consideration is whether the tax preparer believes in good faith and on reasonable grounds that the information is privileged or not privileged. If the information is not privileged, then the tax preparer should act with reasonableness to provide the information himself or to indicate the identity of the individual who has the information and should not interfere with any effort by the IRS to obtain the records or information.

It is incumbent on the tax preparer to follow up regarding the request. If he does not receive a response from the client, then the IRS is notified that the information is in the hands of the client. When the information is not directly in the hands of the practitioner or the client, then the practitioner should make reasonable inquiry of the client to determine if another individual has the information, but has no duty to inquire of any other parties. The practitioner may have to notify the IRS and provide information he has regarding the identity of any individual believed to be in possession or control of the information.

10. IRS Pub. 947, *Practice Before the IRS and Power of Attorney*

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The IRS is sometimes asked whether a practitioner is violating this section by insisting that a summons be issued. The client may not want to release the documentation and consequently resists the request. The IRS issues a summons to compel release of the information. The practitioner is not in violation of this section because the client exercises his right to summons.

§10.21 KNOWLEDGE OF CLIENT'S OMISSION

If a preparer detects an error when reviewing a tax return, he is required to advise the client of the error and notify the client of the error's consequence. It is the client's decision whether to correct the error. Obviously, it is much easier for the preparer if the client agrees to correct the error. The preparer's duty is to make the corrections in a manner which will minimize tax and penalties to the client.

While the preparer is not required to "audit" the books of the client, he is required to make reasonable inquiries if he suspects errors in the information given by the client. Failure to make these inquiries can result in a preparer penalty.

A preparer is not required to obtain a copy of a new client's previously filed returns, but it is an excellent source of background information in analyzing the current year's return.

Question B. A tax preparer prepares the return of a father. For the first time, he also prepares the return of the son. The son works in a factory and helps the father with his lawn care business during busy times. The son mentions the work when picking up his return from the preparer, but states he was paid in cash and not given any wage statement. He says his father told him not to worry about it because the father included it as a miscellaneous expense. What are the duties of the tax preparer?

Answer B. When a practitioner is aware of an omission or error, the practitioner has an obligation to advise his client promptly of the omission or error and of the consequences of noncompliance. If the practitioner still has possession of the return, he should not release it to his client until it has been corrected. If the return is in the possession of the client, the practitioner should advise him the return is incorrect and should not be filed. In this situation, the practitioner should also contact his other client, the son's father, and advice him of the knowledge of the omission and the possible consequences associated with his noncompliance.

Question C. Ted interviews Jerry, a new client, prior to preparing his tax return. Jerry gives Ted a Form W-2 that reports $30,000 from his employer, and he states this is only source of income. Ted notices Jerry is wearing a ten carat diamond ring, drives a Porsche and the address on the Form W-2 shows he lives in a neighborhood of million dollar houses. Ted asks Jerry if this is his only income and Jerry answers affirmatively.

Ted continues to probe and mentions that the IRS would question the amount of income because of Jerry's lifestyle. Jerry tells Ted not to worry, this is how he has filed for years and there have been no problems. He tells Ted confidentially that he is a professional poker player and makes thousands of dollars each year playing Texas Hold'em. Since this income is not reported, it is not taxable. Ted tries to educate Jerry that this is taxable income. However, Jerry gets mad and walks out. Does Ted have an obligation to report Jerry's unreported income to the IRS?

Answer C. No. If Ted were to prepare the return as Jerry insists, he would be in violation of §10.21. If Ted reports Jerry to the IRS, he is in violation of confidentiality rules.

§10.22. DILIGENCE AS TO ACCURACY

The tax professional is required to exercise due diligence in three areas when practicing before the IRS:

1. Assisting, approving, preparing, or filing tax returns and other documents;
2. Determining the correctness of both written and oral determinations made by the practitioner to agents of the IRS, and
3. Determining the correctness of both written and oral determinations made by the practitioner to the client(s) with reference to any matter administered by the IRS.

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Question D. What is the preparer's obligation when preparing a current return when there is an uncorrected error on the prior return?

Answer D. The preparer may not prepare the current return in a manner which perpetuates the error. If this is impossible, the preparer should withdraw from the engagement.

According to opinions stated by *Standards of Practice* authors, the taxpayer should be allowed to perpetuate the error in year two if it overstates year-two income and produces a correct total income for years one and two combined.[11]

> **Example 1.** Rapid Auto Parts overstates its closing inventory of $50,000 in 2004. When preparing the 2005 tax return, the error is found. If the tax preparer amends the 2004 return, the client will pay a substantial tax increase, as well as interest on the underpayment. If the 2004 inventory is carried to 2005 as the beginning inventory and a correct 2005 ending inventory is used, the 2005 income will be overstated by $50,000, which will make the combined 2004–2005 income correct. While this is a violation of §10.22, if the preparer reduces the beginning inventory by $50,000, the correct amount, the taxpayer will have omitted $50,000 of income in the two year period. The easiest solution is to amend 2004, but there are times the taxpayer may refuse.

Question E. The client takes her return to the preparer. The tax preparer mentions in passing that her son has been interested in learning the business and perhaps joining the tax practice. The client later learns the tax preparer had her son prepare the return as a learning experience. Should the client be concerned?

Answer E. The client need not worry if she knows the tax preparer is familiar with this section of Circular 230. Careful planning and supervision of tax preparation is important. The tax preparer has to exercise due diligence if relying on the work of others and use reasonable care in supervising, training, and evaluating her employees. Further, this section requires the practitioner to exercise due diligence in all matters before the IRS such as preparing, approving, and filing returns as well as oral or written representations before the IRS.

Question F. Richard is preparing a tax return for a new client. After the initial interview with the client, he spent eight hours preparing the 2005 depreciation schedule. He called the client regarding the cost of a purchase and found all of the assets were acquired from the former spouse as part of a divorce settlement. Since the client paid cash to the ex-spouse in exchange for the equipment, he believed the equipment was eligible for depreciation. Richard explained the situation to the client and refused to increase the basis. The client refused to accept the carryover basis and Richard found it necessary to cancel the engagement. How does Richard get remunerated for his time?

Answer F. He probably will not get paid. Taking legal action against the client would probably create more problems for Richard than the fee is worth. Most malpractice insurance companies recommend their customers not bring suits against their clients.

There are times when a tax preparer must decline an engagement or walk away from an engagement because he cannot change the client's behavior. It may be difficult to recover fees for the time spent before canceling the engagement. The preparer is normally better off forgetting the fee and looking at this as a cost of doing business.

11. *Standards of Practice, 6th Edition.* Bernard Wolfman, James P. Holden, and Kenneth L. Harris, Tax Analysts, 2004

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§10.23. PROMPT DISPOSITION OF PENDING MATTERS

Practitioners may not unreasonably delay the prompt disposition of any matter before the IRS. To avoid delay, practitioners should keep their clients informed and seek options to expedite the completion of work. But events can occur beyond the practitioner's control, so the IRS applies a reasonableness standard when investigating alleged practitioner delay. The IRS looks for behavior patterns, stall tactics, or lack of proper procedures to determine a practitioner's role in any delay.

It may be possible that a revenue agent can contribute to a delay. It is not considered a breach of §10.23 if an agent returns to a case and the practitioner, as representative, cannot respond quickly due to other client commitments.

Question G. A client brings in information about his mother's estate. The return due date is one month away. This is a very busy time for the tax preparer. He does not have experience with estate returns, so he will need to do considerable research. The client comes away from the meeting thinking the preparer will begin working on the return immediately. However, after several months, the client still has not been called back by the practitioner or otherwise contacted. What should the preparer have done?

Answer G. Clearly, there are several underlying issues with this scenario. The tax preparer has an ethical obligation to not misrepresent or conceal limitations in his abilities to provide the services. Furthermore, the tax preparer should turn away the work given his lack of knowledge or skills to competently perform the duties. Or, he should refer the services to someone with the competency to complete the work.

Question H. Larry, a tax preparer, represents Fred in an audit. The revenue agent has requested a meeting with Fred. Larry does not want Fred to meet with the agent and continually tells the agent that Fred is unavailable on all days the agent is available. In frustration, the agent contacts Fred directly and finds Larry did not advise Fred of any of the meetings. Is Larry in violation of §10.23?

Answer H. Larry is definitely in violation of §10.23. He has not been truthful with the IRS. If he had requested Fred schedule a meeting, but Fred refused to do so, Larry should advise Fred of his responsibility and notify the agent that Fred is the person creating the delay. Upon continued refusal by Fred, Larry should consider dropping the engagement.

Question I. Willie is the best tax preparer in Somewhere, South Dakota. She represents over 90% of the town's taxpayers. In order to provide service to all of her clients, Willie files hundreds of extensions. She remains busy until October 15 each year. During the tax filing season, five of her clients are selected for audit. Willie refuses to schedule any audits unless they are in November or December. Is Willie in violation of §10.23?

Answer I. Willie could be in violation of §10.23. The fact she is overworked is not the fault of the IRS. It is her duty to tell clients if she will be unable to offer timely service.

§10.24. ASSISTANCE FROM OR TO DISBARRED OR SUSPENDED PERSONS AND FORMER IRS EMPLOYEES

A practitioner may not knowingly and directly or indirectly accept assistance from anyone who is under disbarment or suspension from practice before the IRS or from any former government employee where the provisions of §10.25 or any federal law would be violated.

Question J. The tax preparer has to represent a client before the IRS. Not being familiar with details of the process, he seeks assistance from another preparer who has experience. In the course of working with the second preparer, he finds the individual is very knowledgeable about IRS processes and is extremely helpful. However, the first preparer also finds out the second preparer was disbarred from practice before the IRS because of tax evasion. The first tax preparer is going before the IRS, and the other preparer served solely as a reference. Should the first tax preparer be concerned given the information provided was extremely helpful and consistent with IRS policies and rules?

Answer J. Unfortunately, this section is very specific in this regard. When the first tax preparer learns of the second's history, the working relationship must be severed. The tax preparer is left with the ethical dilemma of whether to use the information he has learned from the second tax preparer.

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Question K. Karen is a CPA, licensed in both New York and Florida. She lost her license in New York for preparing a fraudulent state tax return. She still has a license to practice in Florida. Can Karen practice before the IRS?

Answer K. No. Since New York suspended her license, she is also considered suspended by the IRS.

§10.25. PRACTICE BY FORMER GOVERNMENT EMPLOYEES, THEIR PARTNERS, AND THEIR ASSOCIATES

A former government employee, who within one year of termination had official responsibility for a transaction, may not knowingly assist with that transaction or represent a client involved in that transaction for two years after termination. Transactions are broadly defined to include decisions, determinations, findings, letter rulings, technical advice, chief counsel advice, or contracts administered by the IRS. This requirement also applies to members of a firm which has a former government employee unless the firm isolates this employee and ensures he cannot assist in the representation.

Question L. A taxpayer comes to a tax practitioner for assistance with an audit of his individual income taxes. One audit issue is the treatment of a Schedule K-1 from a partnership. Three years ago, the practitioner was employed by the IRS, but he is now operating a private tax practice. It turns out that the practitioner, in his last year of employment with the IRS, audited the return of the partnership. The practitioner agrees to assist the new client because he has some familiarity with the taxpayer's situation and thinks he can adequately represent this taxpayer. Is this OK?

Answer L. Yes. Section 10.25 is comprehensive and addresses some very specific situations and contains several definitions of terms in prescribing whether a former government employee can or cannot practice.

§10.26. NOTARIES

Section 10.26 states that a practitioner may not certify papers or perform any official act as a notary public for any matter administered by the IRS and, for which, the practitioner has an interest.

Question M. A client has papers that need to be notarized for a mortgage. The practitioner prepares her tax returns. Can the practitioner notarize the papers?

Answer M. Yes, as long as the matter has no relationship to any matter before the IRS. Since this is a mortgage transaction, it is highly unlikely to be a matter before the IRS. However, the practitioner should inquire.

§10.27. FEES

A practitioner may not charge an **unconscionable** fee for representing a client. However, the term "unconscionable" is not defined and, is therefore subject to interpretation. Specifically, practitioners may not charge a **contingent** fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original return.

Question N. A taxpayer doesn't think her old tax preparer was taking advantage of all the possible deductions allowed for C corporations. In the following year, she goes to a new preparer who is well versed in corporate taxes. Based on his preliminary assessment, the new preparer sees an opportunity to save an additional $50,000 in taxes due to some gray areas in the regulations. The preparer indicates his fees will be the normal fee for corporate returns plus 20% of the additional savings in tax liability resulting from the extra work and his expertise. Is this an acceptable practice?

Answer N. The preparer in this situation should not assess a contingent fee.

Contingent fees include any fee arrangement where the practitioner reimburses the client for all or a portion of the client's fee in the event that a position taken on a tax return is challenged and whether that challenge is sustained or not. A contingent fee may be charged, however, for preparation of or advice in connection with an **amended return** or a claim for refund unless it is a claim for refund made on the original tax return. Practitioners should reasonably expect that the claim for refund will receive substantive review by the IRS. A professional preparing an original return should not charge a contingent fee.

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§10.28. RETURN OF CLIENT'S RECORDS

A practitioner should return the client's original papers or electronic materials, but he does not have to provide the return that was prepared, any claim for refund, schedule, affidavit, appraisal, or other documents pending the client's performance of his contractual obligation to pay the fees for preparation of those documents.

Question O. A taxpayer brings all the information necessary to prepare his Schedule C and his personal return to a tax preparer. Later, the taxpayer calls to see how much he owes, but does not come in to pick up the return until six months later. He says he does not want the return, only his original papers, and does not pay. What must the preparer give him?

Answer O. If requested by the client, a practitioner must promptly return any and all records that are necessary for the client to comply with his federal tax obligations. The preparer does not have to provide a depreciation schedule prepared as part of the Schedule C work. The preparer may also retain copies of the records. He is obligated to provide any return or other documents prepared and previously presented to the client for a prior representation if the document is necessary for the taxpayer to comply with current federal tax obligations.

§10.29. CONFLICTING INTERESTS

A practitioner must not represent a client before the IRS if the representation involves a conflict of interest. Common situations where conflicts may arise include representation of former spouses, business partners, and officers of a closely-held corporation and the corporation. These situations require analysis of the nature of the conflict, its impact on the preparer's ability to adequately represent all of the clients, and full disclosure to the clients before obtaining consent.

If the preparer believes he will be able to provide competent and diligent representation to each client and representation is not prohibited by law, it is important to disclose to all who the preparer will be representing and to have each affected client give him informed consent, confirmed in writing. A practitioner is required to retain copies of this written consent for 36 months following the conclusion of the tax matters.

Question P. A married couple enters into divorce proceedings. The tax preparer served this couple for many years. Normally, the wife takes care of all responsibilities for getting the tax records prepared for the preparer. Now, both the husband and wife separately approach the preparer to provide tax services. To whom does the preparer provide service? Is there a conflict of interest?

Answer P. A conflict of interest is defined as existing when:

- The representation of one client is directly adverse to another client, or
- There is significant risk that the representation of one or more clients is materially limited by the practitioner's responsibilities to clients or others.

Question Q. Harry and Sally, husband and wife, are equal partners in H & S Enterprises Partnership. Harry decides the partnership needs the liability protection of an LLC. He and Sally meet with their attorney for the initial formation meeting. After the meeting Harry calls the attorney and tells him to issue all of the stock in his name for estate planning purposes, but to not to discuss this with Sally. Does this put the attorney into a conflict-of-interest position?

Answer Q. Besides the obvious tax question of eliminating a partner, this presents a conflict of interest problem. The attorney must either tell Harry that he needs to inform Sally of the decision in writing or cancel the engagement.

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Question R. Two brothers, Robert and John, took over the family business from their father. They have been very successful and have three of their sons involved in the business. They decide to incorporate the business and meet with an attorney. At the final incorporation meeting, Robert suggests that the sons should become partial owners of the business and suggests that each of the three boys receive one share of stock, while he and John receive the balance. Therefore, the attorney issues one share to each son and 498 ½ shares to Robert and 498 ½ shares to John. Does the attorney have a conflict of interest?

Answer R. In this situation, Robert has two sons in the business and John has one. This transaction just gave Robert and his family control of the business. Once John realizes what has happened, he may want to hold the attorney liable for not advising him of this situation. If each brother had their own attorney in the transaction, a lawsuit for conflict of interest would not be an issue. However, John might have an issue with his attorney not advising him that the transaction would cause him to lose control of the business.

Question S. Jamestown Tax Service specializes in tax and accounting for medical offices. One of their clients is selling his medical practice to another of Jamestown's clients. Both practices request that Jamestown represent them in the negotiation of the sale/purchase and the allocation of asset values. Can Jamestown represent both medical practices?

Answer S. If Jamestown receives signed consents from both clients, it can represent them. However, this is not a good idea. Since the valuations are not in the best interest of both parties, Jamestown is putting itself at risk for a malpractice lawsuit if one of the practices believes they did not get a "fair" deal.

Question T. Ramona represents one of her clients in an audit. There are numerous audit issues. For one of the issues, a revenue agent could assess a preparer penalty if the taxpayer looses the issue. Ramona agrees to accept all of the agent changes if the agent eliminates the issue which could result in a preparer penalty. Does Ramona have a conflict of interest?

Answer T. Most definitely. In this case, the conflict is between Ramona and the taxpayer. Ramona should challenge the issue the same as she would any other issue if the taxpayer is not clearly wrong.

§10.30. SOLICITATION

The following restrictions are placed on practitioners for solicitations:

1. Practitioners may not use false, fraudulent, or coercive statements or claims for any IRS matter or make misleading or deceptive claims in any form of public communication or private solicitations.

   Enrolled agents may not use the term "certified" or imply an employer/employee relationship with the IRS in advertisements or solicitations.

   Practitioners cannot make uninvited written or oral solicitations in IRS matters if the solicitation would violate federal or state laws or professional regulations.

   Lawful solicitations must clearly identify the solicitation as such and, if applicable, identify the source used to choose the recipient.

2. Practitioners may publish and disseminate written fee schedules if a statement is included disclosing whether clients are responsible for such costs.

   Practitioners must abide by their publish rates for at least 30 days after the last publication.

3. Fees may be communicated via methods that do not cause the communication to be untruthful or deceptive.

   Practitioners may not persist in contacting prospective clients if the clients express a desire to be left alone.

   Practitioners must retain a recording of all television and radio solicitations and a copy of all direct mail or e-commerce solicitations along with the distribution list for a period of at least 36 months from the date of last activity.

4. Practitioners may not knowingly assist or accept assistance from anyone who obtains clients or otherwise practices in a manner forbidden by this section.

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Question U. The tax preparer advertises "due to our unique qualifications and association with the IRS, we are able to provide you with expert and reliable tax services." Is there anything wrong with making this statement?

Answer U. The problematic part of the advertisement is the phrase is "association with the IRS." Practitioners must exercise caution and may not make a misleading or deceptive claim. Potential clients may be misled by the reference to "association with the IRS."

Question V. Hard Nose Tax Preparers, Inc. advertises on national television that they can settle tax debts for "pennies on the dollar." On their website, they have a table that lists various clients (name not shown), the region where the taxpayer lives, the original tax owed, and the settled amount due. They charge clients a large retainer which is due whether a successful offer in compromise is accepted by the IRS. Is this firm in violation of §10.30?

Answer V. Whether Hard Nose is in violation depends on whether they can prove the claim they make on the website. If the IRS raises a challenge, they must give the IRS the names of the taxpayers listed. If these are not accurate settlements, the OPR will probably rule the firm is in violation. However, if the firm removes the table and ceases to make the erroneous claims, the IRS may not impose a sanction.

§10.31. NEGOTIATION OF TAXPAYER CHECKS

A practitioner may not endorse or otherwise negotiate any check issued to a client by the government in respect of a federal tax liability.

Question W. A client comes to his preparer and asks to have his anticipated refund sent to the preparer's office. He requests the preparer cash the check, take out his fee payment, and give him the balance. He does not have a bank account because of the monthly charges for low balance accounts. Is the preparer allowed to do this?

Answer W. **No.** This violates §10.31, even though the preparer might want to help the client.

§10.32. PRACTICE OF LAW

The practice of law is limited to members of the bar and is so stated in this section.

Question X. A client wants to set up a corporation and raises questions about how they are taxed and other related matters. For an additional fee, the tax preparer offers to draft the incorporation documents. The preparer believes that since he has seen many examples of good incorporation documents and much of it is just boilerplate language that he can accomplish this and file it with the state. Can he offer this service?

Answer X. **No.**

§10.34. STANDARDS FOR ADVISING WITH RESPECT TO TAX RETURN POSITIONS AND FOR PREPARING SIGNED RETURNS

This section addresses reliance on information provided by the client. It indicates that practitioners may rely on client-provided information furnished in good faith without verification upon information furnished by the client. Practitioners should probe further to make sure the client is not fabricating the information. The practitioner should make reasonable inquiries to determine if the information appears to be correct, consistent with an important fact or factual assumption, and is complete. The possibility that a tax return will not be audited, that an issue will not be raised on audit, and that the issue will be settled may not be taken into account when taking a position on tax return.

Section 10.34 also stipulates a **realistic possibilities standard** which means a position taken is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the possibility has approximately a **one in three** or greater likelihood of being sustained on its merits.

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Question Y. The client knows that charitable contributions of a modest nature are not generally subject to recordkeeping or audit and mentions that to the tax preparer. The client then states "I gave $240 to each of four charities and donated $490 in clothing to the local vets group, so include that on Schedule A of my tax return." Because this really isn't a substantive tax issue, does §10.34 of Circular 230 apply here, and should the tax preparer really be concerned?

Answer Y. This situation presents an interesting dilemma for the tax preparer. On the practical side, small dollar amounts to charities are not normally questioned (by the IRS) and are not typically subject to rigorous recordkeeping. Nonetheless, the tax preparer must weigh ethical concerns even when the amount to be deducted is not significant, but there is a clear potential for inaccuracy.

Question Z. The client does not want to pay self-employment (SE) tax on a particular transaction. While IRS rulings and court cases indicate the income is SE income, the preparer believes Congress will enact legislation in the future which will exempt the income from SE tax. Can the practitioner avoid assessing SE tax on this transaction?

Answer Z. Practitioners may not sign a tax return if the practitioner determines the tax return contains a position that does not have a realistic possibility, as defined above, of being sustained unless the position is not frivolous and is adequately disclosed to the IRS.

To the contrary, if the practitioner determines the position satisfies the realistic possibility standard or is not frivolous and the position is adequately disclosed, then the practitioner may advise the client to take the position.

Practitioners must be careful to inform the client of the penalties that may apply for the position advised, prepared, or reported and inform the client of any opportunity to avoid these penalties.

§10.51. FALSE AND MISLEADING INFORMATION

Giving false or misleading information, or participating in any way in giving false or misleading information to the Department of Treasury or any of its employees in connection with pending or matters likely to be pending and knowing the information is false or misleading is a violation of §10.51.

Question AA. Brittany is an EA representing Nolan in an audit. Nolan prepares his own tax return. In the year of the audit, Nolan purchased a farm and allocated $20,000 to a silo which he expensed under §179. During the audit, the revenue agent challenged the value of the silo. Nolan asked Brittany to represent him in the audit and discussed the silo issue with her. Unknown to Nolan, Brittany was a friend of the former farm owner and knew a silo never existed on the farm. She confronted Nolan with this fact and asked to see the silo. Nolan said he sold the silo and it was removed from the farm. When asked how he would prove the silo value to IRS, Nolan produced a bill of sale for the silo as well as a picture of the silo. Is Brittany in violation of §10.51 if she gives these documents to the agent?

Answer AA. Yes. Even though Brittany is not required to substantiate the existence of the silo, because she knows the documents are false, she may not give them to the IRS. Brittany should excuse herself from the engagement immediately.

Another issue about which the IRS is concerned involves changing information on Form 2848, *Power of Attorney*. If a change is made, a new power of attorney (POA) must be filed.

Question AB. Travis is representing Mr. and Mrs. Karr for the audit of their 2003 Form 1040. Travis completes the Form 2484 only showing 2003 as the year for representation. After the form is signed, he remembers the IRS may also look at the 2002 return. Rather than prepare a new POA for the Karrs, he adds 2002 to the existing POA. Is Travis in violation of §10.51?

Answer AB. Yes. If the IRS finds this situation, they are likely to notify OPR of the infraction.

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SANCTIONS

The OPR is concerned about tax preparers' ethics in three areas of the preparers' behavior:

1. As individuals,
2. As tax preparers, and
3. In their relationship with the IRS.

INDIVIDUAL BEHAVIOR

The first concern pertains to whether the tax preparer has met all of his tax filing requirements. This includes timely filing of tax returns, as well as making timely payments. This covers not only his personal Form 1040, but any applicable payroll tax returns or business returns.

This behavior is very easy for the OPR to monitor. All the OPR must do is match the preparer's SSN, PTIN, and/or FEIN against existing IRS data files. Failure to timely file returns has resulted in numerous reprimands or suspensions.

Question A. June, an enrolled agent, is involved in an unfriendly divorce. Her husband refuses to give her the information required to file a timely return, including extensions. She finally receives this information and files her return. The OPR later requests information regarding the late filing. What should she do?

Answer A. June should immediately respond to the OPR with the facts related to her late filing. If she required court intervention to obtain the necessary information, she should submit this information to the OPR. Depending on all the relevant facts, the OPR may dismiss this issue or issue a letter of reprimand. The letter of reprimand is not public information. June should be sure she files all future returns timely.

TAX PREPARER BEHAVIOR

The second concern relates to actions an individual takes in relation to his work as a tax preparer, and whether the actions are ethical. This includes actions such as:

- Preparing fraudulent returns,
- Engaging in practices which create conflicts of interest, and
- Performing any other normal tax preparer activities.

BEHAVIOR TOWARD THE IRS

The third area of concern relates to actions which create problems for the IRS. Examples include failing to keep appointments with IRS personnel, or refusing to provide requested documentation. Normally, the OPR will only look at these actions at the request of IRS employees.

These cases do not necessarily result in a sanction. One case cited by the OPR involved a tax preparer who continually called the revenue agent the morning of the audit and cancelled the appointment. He would not make another appointment until the agent initiated contact. After numerous attempts to perform the audit, the agent had his manager contact the preparer. Again, the appointment was cancelled. Finally, in desperation, the agent notified the OPR. Once the OPR notified the preparer and informed him that he was in violation of Circular 230, the preparer changed his behavior. No sanction was issued. However, if the preparer repeats this action, he could be sanctioned in the future.

In these cases, the OPR is only trying to modify the behavior of a preparer, not to see how many preparers they can disbar.

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§10.50. TYPES OF SANCTIONS

The IRS can impose various sanctions on tax professionals under §10.50 of Circular 230. These include censure, suspension, and disbarment. These sanctions can be applied for:

- Incompetence or disreputable behavior,
- Failure to comply with regulations,
- Intentionally defrauding, or
- Willfully and knowingly misleading or threatening a client or prospective client.

There are 12 **primary** reasons the IRS could begin enforcement action against a preparer. These are:

1. Conviction of a criminal offense under the tax laws. An example might be the fraudulent filing of the professional's personal return.
2. Conviction of a criminal offense involving dishonesty or breach of trust. A practitioner who had control of a client's assets — such as a trustee — and who misappropriated these funds, could be disbarred.
3. Conviction of any felony under federal or state law which would render the practitioner unfit to practice before the IRS. For example, it would be difficult to practice before the IRS if the practitioner were incarcerated.
4. Giving false and misleading information to the Department of Treasury in connection with a pending or likely-to-be-pending tax matter. An example would be a practitioner forwarding fraudulent information from the client to the IRS when the practitioner knows this information is fraudulent.
5. Solicitation of employment by implying to the prospective employer that the applicant had a special means of causing favorable action by the IRS, or one of its employees. For example, applying for employment and telling the employer that his brother-in-law was the agent in charge of the company audit.
6. Willfully failing to file a federal tax return.
7. Misappropriating or failing to promptly remit client funds for payment of taxes to the IRS. An example might occur when the tax preparer has clients who do not have checking accounts. The preparer offers to take cash from the client for payment of taxes, but fails to remit part or all of this money to the IRS.
8. Bribing or threatening an IRS employee in an attempt to receive favorable treatment.
9. The IRS can impose sanctions on tax professionals who are suspended or disbarred.
10. Assisting another person in his practice before the IRS while under suspension or disbarment.
11. Engaging in contemptuous conduct in connection with practice before the IRS. For example, a practitioner may not use abusive language or make false accusations or statements they know are not true.
12. Knowingly giving a false opinion which is intentionally misleading regarding federal tax laws.

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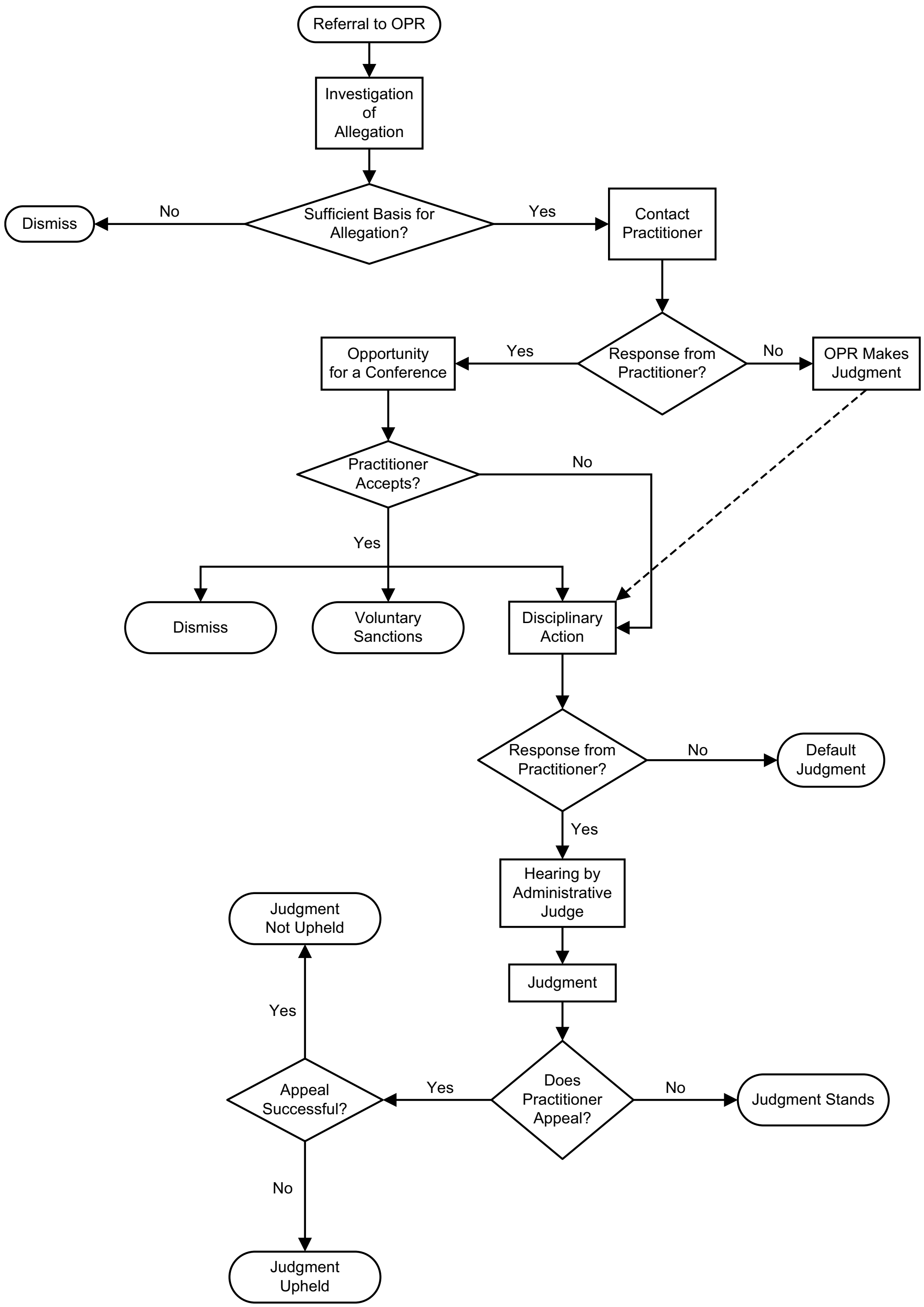
PROCESS

A complaint against a tax practitioner can be filed by a client, a peer, or an IRS employee. The complaint is filed with the director of the Office of Professional Responsibility. It becomes his duty to investigate the complaint by notifying the practitioner and listening to the practitioner's answer. Depending on the response, the director can dismiss the complaint or continue the investigation. The following flow chart illustrates the steps in the complaint process.



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CONSEQUENCES

If a practitioner is **suspended**, he cannot practice before the IRS until the end of the suspension period. On the other hand, **censure** allows the practitioner to continue to practice. In either case, the director may place restrictions on the practitioner. If the practitioner is **disbarred,** he may not practice before the IRS until he is reinstated. The practitioner may not file for reinstatement until at least five years after the disbarment. Even if the practitioner is disbarred, he may still continue to prepare federal tax returns. Disbarment is only from practicing before the IRS. However, no one who is authorized to practice before the IRS may be associated with the disbarred practitioner.

UNENROLLED PREPARERS

An unenrolled preparer is any individual who prepares and signs a tax return as the preparer. Even if the preparer does not sign the return, he is classified as an unenrolled preparer. An unenrolled preparer can only participate in the examination function of a return he prepared. He cannot practice before appeals officers, revenue officers, or counsel. He cannot execute claims for refund, receive refund checks, execute consents to extend the statutory period for assessments or collections, execute closing agreements, or execute waivers of restriction on assessment or collection of a deficiency in tax.

The following individuals may practice before the IRS:

- An individual on his own behalf,
- An individual representing an immediate family member,
- A regular full-time employee representing his employer,
- A general partner or a regular full-time partnership employee representing the partnership,
- A general partner or a regular full-time employee representing a corporation or trust, and
- An individual representing any individual or entity which is outside the United States, before the IRS, when such representation takes place outside the United States.

TAX PREPARER CRIMINAL ENFORCEMENT ACTIVITY

Mark W. Everson was confirmed by the U. S. Senate on May 1, 2003, to be Commissioner of Internal Revenue. Upon accepting the position, Everson stated one of his objectives was to restore taxpayer's faith in the tax system. In order to do this, he determined it was necessary to begin enforcement at the top of the tax return chain. Therefore, he began by investigating IRS employees and tax return preparers. He commented "you could not expect taxpayers to file accurate returns if the IRS and tax advisors were not following the law."

Since taking his position, the IRS has released the following statistics regarding enforcement action against tax preparers.

	FY 2002	FY 2003	FY 2004
Investigations initiated	254	229	206
Prosecution recommendations	89	169	167
Indictments/information	61	109	121
Convictions	64	67	117
Incarceration rate*	86.6%	83.7%	84.4%
Average months served	23	19	19

*Incarceration may include prison time, home confinement, electronic monitoring, or a combination.

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The following case summaries were taken from the IRS website and are excerpts from public record documents on file in court records in the judicial district in which the legal actions were filed. The last names of the tax preparers have been omitted but can be found in the original IRS release. The following cases are taken from FS-2005-8, January 2005.

Tax Preparer Sentenced to 33 Months

On December 16, 2004, in Hartford, CT, Patrick, a self-employed tax return preparer, was sentenced to 33 months in prison to be followed by three years supervised release. In July 2004, Patrick was indicted on 38 counts of aiding and abetting in the preparation of false tax returns, one count of interfering with the administration of IRS laws, and one count of knowingly and willfully failing to appear in court when required. Patrick was found guilty by jury on September 20, 2004, on 10 counts of aiding and abetting in the preparation of false tax returns.

Court Bars South Florida Man From Selling Bogus Trusts and Preparing Federal Tax Returns for Others

On December 3, 2004, in Ft. Lauderdale, FL, Louis of Lake Worth, FL, was permanently barred by a federal court from preparing federal income tax returns for others and from representing customers before the IRS. Louis was also barred from selling a fraudulent tax scheme involving sham trusts. According to papers filed in the case, Louis told customers they could use his trusts to get "tax deductions for the expenses incurred in being alive."

Court Bars Ohio Men's Fraudulent Tax Schemes

On November 8, 2004, in Akron, OH, James and Terrence were permanently barred by a federal court from preparing income tax returns for customers and from representing customers before the IRS. The court found that the two Canton-area men prepared income tax returns that hid customers' income and claimed improper deductions. They also sold sham trusts and falsely advised customers that they need not report income earned within the United States. James and Terrence were also barred from selling or promoting tax fraud schemes.

Sacramento Tax Preparer Sentenced to 21 Months in Prison for False Tax Return Scheme

On November 4, 2004, in Sacramento, CA, Brent was sentenced to 21 months in prison in connection with his participation in a scheme involving the filing of false returns with both the California Franchise Tax Board (FTB) and the IRS. Brent pleaded guilty to mail fraud and aiding and assisting in the preparation of a false income tax return and forging endorsements on Treasury checks. Brent admitted that he provided his tax return clients with a correct copy of their state and federal income tax returns, and then altered the returns prior to actually sending them to the FTB and the IRS. The returns Brent submitted without the knowledge and consent of his clients included bogus deductions to reduce the taxpayers' state and federal tax liability, which in turn caused the issuance of larger refunds than were actually due. Upon receipt of falsely inflated refund checks, which Brent directed the IRS and FTB to mail directly back to him, Brent would forge his clients' signatures and personally deposit or cash the refund checks. Brent then issued new checks to his clients for the amount of the refund they were led to believe they were getting. Brent improperly kept the difference between the correct refund amount and the fraudulent and inflated refund amount.

Irving, TX, Tax Preparer Sentenced

On October 21, 2004, in Irving, TX, Leanne was sentenced to 36 months in prison following her guilty plea in May 2004. Leanne, who operated Executive Financial Consultants, pleaded guilty to three counts of aiding and assisting in the preparation and presentation of a false and fraudulent tax return.

Leanne was a trained tax return preparer. However, she would inaccurately and falsely advise and counsel her clients that the following things were deductible on Schedule A: personal clothing worn to work; personal hygiene items; vitamins; gym fees; haircuts; manicures and pedicures; mileage to and from work; and money spent at restaurants. Leanne also admitted she prepared amended tax returns for clients using basically the same methodology and claiming the taxpayer was owed more. She admitted to preparing at least 788 false tax returns or false amended tax returns beginning approximately in 1999 and continuing through June 2002.

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Court Stops Fraudulent Tax-Return Preparer

On October 19, 2004, in Norfolk, VA, Ronald was permanently barred by a federal court from preparing federal income tax returns for others and representing people before the IRS. The court found that Ronald had prepared fraudulent tax returns for customers in Virginia, Maryland, Pennsylvania, New York, South Carolina, Alabama, Texas, Arizona, and California.

Hamden Tax Preparer Sentenced to Four-Year Federal Prison Term

On October 13, 2004, in New Haven, CT, John was sentenced to 48 months in prison followed by one year of supervised release for assisting clients of his tax preparation business with filing materially false federal income tax returns and for failing to file his own federal income tax return for the 2001 calendar year. John was also ordered to pay all back taxes plus penalties and interest and accepted a permanent injunction that bars him from engaging in the business of preparing income tax returns or from further acting as an income tax preparer in the future. John, who was a self-employed tax preparer for approximately 40 years, admitted that between 1999 and 2001, he willfully prepared hundreds of federal income tax returns in which he falsely represented that his clients were lawfully entitled to claim itemized deductions, business expenses, rental expenses, and other deductions to which they were not entitled. John also acknowledged that he intentionally sought to interfere with the IRS's ability to investigate and audit his preparation of those returns and that as a result of his actions, he deprived the IRS of nearly $1 million in tax revenue. John further admitted that he willfully failed to file his own income tax return for the calendar year 2001, as required by law, despite earning more than $250,000 from his tax preparation business that year.

St. Louis Tax Preparer Sued

In an article by Robert Patrick published in the St. Louis Post Dispatch on April 6, 2005, a St. Louis tax preparer was sued by the federal government. The government alleges the false returns she filed may have cost the government more than $6.5 million. The preparer worked for a major tax preparation chain and filed 1,751 returns between 2000 and 2003. The investigation showed that of the 2% of the returns examined, all reported fictitious or inflated deductions. On the average, each return lost the government $3,767. The preparer's employer assured the IRS and the public they had no knowledge of the fraud. The preparer had worked for the company since 1984.

These are just a few of the cases the IRS prosecuted. In FS-2005-15, April 2005, the IRS announced it obtained more than 100 injunctions against tax scheme promoters. Many of these injunctions require the tax preparer to turn over client lists and cease preparing tax returns for others. In its attempt to curtail tax return preparation fraud, the IRS established a **tax fraud hotline at 1-800-829-0433.**

SANCTION INFORMATION

In its effort to encourage tax professionals' compliance with Circular 230, the IRS publishes the names of tax preparers who have resigned or been disbarred, suspended, or censured. The listing is released in an Internal Revenue Bulletin (IRB). Only those preparers who are eligible to practice before the IRS are listed. This includes attorneys, certified public accountants, enrolled agents, and enrolled actuaries.

Since the publication of IRBs, a practitioner's eligibility to practice before the IRS may have been restored. To verify a practitioner's current status, taxpayers can contact the OPR by mail or email. The email address is **OPR@irs.gov.**

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The following table shows the IRBs which list the sanctioned tax professionals.

IRB Issue	Date	Page Numbers
2005-11	3/14/2005	738–744
2004-46	11/15/2004	845–851
2004-32	8/09/2004	184–188
2004-22	6/01/2004	1001–1005
2004-07	2/17/2004	499–501
2003-30	7/28/2003	222–227
2003-11	3/17/2003	603–609
2002-34	8/26/2002	419–425
2001-05	1/29/2001	482–484
2000-34	8/21/2000	206–207
2000-23	6/05/2000	1244–1248
1999-12	3/22/1999	38–41
1998-39	9/28/1998	50–52
1998-22	6/01/1998	27–29
1998-20	5/18/1998	28–29
1998-06	2/09/1998	98–99

TAX PREPARER PENALTIES

The American Jobs Creation Act (AJCA) of 2004 created a major enforcement tool for the IRS. It extended the assessment of penalties to the company level. In the past, the IRS could only assess monetary penalties against the tax preparer. The assessed penalty was also limited to a fixed dollar amount. With the enactment of AJCA, the IRS can assess penalties against the tax preparer's employer. In addition, the amount of the penalty is only limited by the fee collected for the infraction.

> **Example 2.** Tim Practitioner files the return for Sam Taxpayer. Tim recommends a tax strategy which involves off-shore bank accounts. He charges Sam $20,000 for the tax planning advice. In addition, Tim also presents the strategy to 30 other clients who follow his advice. Upon audit, it is determined that this strategy is illegal. Not only is Tim sanctioned and penalized by the IRS, his firm is also liable for a $600,000 penalty or ($20,000 × 30).

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Not all IRS actions against tax preparers result in sanctions. Some simply result in a preparer penalty. Some penalties are assessed on an employer, while others are assessed on the employee preparing the tax return. Actions where the IRS can assess a penalty include:

Violation	Amount	Employee	Employer	IRC Section
Understatement of taxpayer's liability due to unrealistic positions	$250 per return	Y	Y	6694(a)
Willful attempt to understate liability or reckless or intentional disregard of rules	$1,000 per return	Y	Y	6694(b)
Failure to furnish copy of return to taxpayer	$50 per failure	Y	N	6695(a)
Failure of preparer to sign return	$50 per failure	Y	Y	6695(b)
Failure to furnish identifying numbers	$50 per failure	Y	N	6695(c)
Failure to maintain copies of the returns prepared or maintain a listing of clients	$50 per failure	Y	N	6695(d)
Failure to file information returns required by IRC §6060	$50 per failure	Y	N	6695(e)(1)
Failure to provide all information required under IRC §6060	$50 per item	Y	N	6695(e)(2)
Endorsing or negotiating a tax refund check	$500 per check	Y	Y	6695(f)
Failure to comply with due diligence for EIC	$100 per failure	Y	Y	6695(g)
Promoting abusive tax shelters	$1,000 per activity or, if less, 100% of income derived	Y	Y	6700
Aiding and abetting understatements	$1,000 per return ($10,000 per corporate return) per preparer	Y	Y	6701
Improper disclosure or use of information	$250 per disclosure	Y	Y	6713
Fraud and false statements	$100,000 fine ($500,000 in the case of a corporation) and/or 3 years imprisonment	Y	Y	7206
Willful delivery or disclosure of fraudulent documents or information to the IRS	$10,000 fine ($50,000 in the case of a corporation) and/or 1 year imprisonment	Y	Y	7207
Unauthorized disclosure of taxpayer information	$1,000 fine and/or 1 year imprisonment and prosecution costs	Y	Y	7216

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ASSESSMENT

An examiner is not allowed to discuss the possibility of assessing a preparer penalty in front of the taxpayer. Most preparer penalties must be assessed within three years from the time the return is filed. However, the penalty for willful understatement of liability may be assessed at any time. This penalty has no statute of limitations.

Prior to assessing a preparer penalty for understatement of liability, the IRS sends a report of the examination to the preparer. It also sends a 30-day letter notifying the preparer of the proposed penalties and a demand for payment is made. The preparer must make a 15% payment and then file a claim for refund. Within 30 days after the claim is denied, the preparer must bring suit. The suit can be filed within 30 days after the expiration of the six-month period beginning on the date the claim for refund was filed. The IRS cannot begin collection proceedings on the penalty until the court has made its final decision.

In order to have the penalty abated the preparer must prove:

- The position taken was adequately disclosed,
- He did not know or could not have known that the questioned position was taken on the return, and
- There was reasonable cause and good faith concerning the position.

If it is determined that the tax liability was not understated, the penalty is abated.

PENALTY ABATEMENT

The 1954 Tax Code contained 13 different penalties which could be assessed. Today, this has grown to more than 150 different penalties. Many of the penalties, once assessed, can be abated if there is a valid reason. Unfortunately, the grounds for abatement can be as ambiguous as parts of the tax code itself. The following terms may be found in discussions of abatement:

- Reasonably prudent person,
- Frivolous,
- More-likely-than-not,
- Substantial authority,
- Reasonable attempt to comply with the law,
- Preponderance of evidence,
- Realistic possibility of success,
- Reasonable basis,
- Reliance, and
- Adequate disclosure

REALISTIC POSSIBILITY OF SUCCESS

The realistic probability of success argument may be used if the tax issue in question is not frivolous and was adequately disclosed on the return. There must be a one-in-three chance the issue will be decided favorably on its merits.

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REASONABLE BASIS

This is on the lowest end of the scale when comparing abatement reasons. In this case, perhaps the tax preparer relied on an old ruling which is now obsolete. Depending on the issue, this might be a reason for abatement. Relying on the unlikely possibility of having the return audited is not a reasonable argument for abatement.

MORE-LIKELY-THAN-NOT

This more-likely-than-not standard is interpreted as having a greater than 50% likelihood of being sustained in a challenge. It is used when there is authority on both sides of an issue.

SUBSTANTIAL AUTHORITY

Taxpayers can avoid the substantial underpayment of tax penalty if a position, overturned on their return, was based on substantial authority. On a scale where "reasonable basis" is on the low end and "more-likely-than-not" is on the high end, substantial authority falls somewhere in between.

> **Example 3.** Tom claimed a deduction of $10,000 on his 2002 income tax return. While the deduction related to a "gray" area, the tax preparer found a court case which allowed the deduction. The preparer also found three other cases which disallowed the deduction. Because the one case was in Tom's district, this could constitute substantial authority.

> **Example 4.** Assume the same facts as **Example 3**, except three cases favor the taxpayer and the case in Tom's jurisdiction disallowed the deduction. Because the majority of the cases allowed the deduction, Tom would have a substantial authority argument.

DEALING WITH GRAY AREAS

Many decisions a tax professional makes are in the "gray" area of the law. For many of these situations, there is clearly a wrong answer, or one which is obviously against the law. For example, advising a client that no types of income are taxable is obviously a wrong answer. However, advising the client to include all types of receipts as taxable, a very conservative position, is not fair to the client. The "right" answers lie somewhere between the right and left sides of the scale. It is up to each individual preparer to decide where he is most comfortable in advising his client. It is the responsibility of the practitioner to determine the "best practice."

Determining the best practice could place the practitioner in a tenuous position. His responsibility is twofold. He is responsible to the client to provide the best service possible, and he is responsible to the government to insure enforcement of the law.

Some sections of Circular 230 are fairly straightforward about how the tax professional must act. Other areas are subject to interpretation by the practitioner and/or the IRS. Nevertheless, it is incumbent on the practitioner to be familiar with the rules of good conduct (sections of subpart B) to avoid running afoul of these provisions. Professionals also need to keep in mind the applicability of any state laws or regulations, as well as codes of ethics or similar requirements of their business associations or trade groups.

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ANTI-TAX LAW EVASION SCHEMES

Note. Chapter 13, "Rulings and Cases," includes sections entitled "Tax Fraud" and "IRS Procedures — Audits" which contain descriptions of abusive tax schemes and fraudulent situations.

The IRS has identified a number of tax evasion schemes. Tax professionals should not prepare returns for taxpayers who insist on using one of the following arguments to avoid paying income tax. Preparing such a return can result in the preparer being sanctioned by the IRS.

1. The voluntary nature of the federal tax system can consist of two different arguments. One is that the filing of tax returns is voluntary and the second it that paying income tax is voluntary. The courts have addressed the issue of voluntary filing as far back as 1938.[12] The same conclusion was reached in many other cases including a 1999 case.[13]

   The courts have emphatically stated that the payment of taxes is not voluntary. They quote IRC §1 for individual income taxes and IRC §11 for corporate income taxes. In one publicized case, the court pointed out that the imposition of the frivolous argument penalty was specifically intended to apply to this type of case.[14] However, there are still tax protesters making the argument.

2. A second general argument concerns the meaning of income — both taxable income and gross income. The three basic arguments are:

   a. Wages, tips, and other compensation received for personal services are not income. Some taxpayers argue there is no taxable gain when a person exchanges wages for labor. They use the theory that the basis in the labor is the same as the fair market value of the wages. Others argue that the Sixteenth Amendment to the United States Constitution did not authorize a tax on wages and salaries, but only on gain or profit. In one case,[15] the court cited the Supreme Court's statement, "this language was used by Congress to exert in this field 'the full measure of its taxing power.'… And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except specifically exempted."

   b. Another contention is that only foreign-source income is taxable. This contention comes from a misreading of IRC §861, et seq., and IRC §911, et seq; as well as the accompanying regulations. In 2004, the IRS expressed its position on these arguments in Rev. Ruls. 2004-30 and 2004-28. In a more recent case, the court characterized the argument as "reminiscent of tax-protester rhetoric that has been universally rejected by this and other courts."[16]

   c. An additional contention is that Federal Reserve Notes are not income. They argue since it not a valid currency, it is not taxable. This argument has been rejected on numerous occasions.[17]

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12. *Helvering v. Mitchell,* 303 U.S. 391, 399, March 7, 1938
13. *Johnson v. Commr.,* TC Memo, 1999-312, 78 T.C.M.(CCH) 468,471, September 22, 1999
14. *Schiff v. United States,* 919 F2d 830, 833 (2d Cir. 1990-6085), cert. denied, November 21, 1990
15. *Commr. v. Glenshaw Glass Co.,* 348 U.S. 426, 429-30, March 28, 1955
16. *Williams v. Commr.,* 114 TC 136, 138, March 1, 2000
17. *United States v. Condo,* 741 F2d 238, 239 (9th Cir. 1984), 85-1 USTC ¶ 9273, July 5, 1984

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3. The third general argument concerns the meaning of certain terms in the Code:

a. Some taxpayers argue they are not a "citizen" of the United States, but a citizen of the state in which they reside. Therefore, they are not liable for federal taxes. This argument is rebutted in the Fourteenth Amendment which states, "[a]ll persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State where they reside." In one case this court rejected this as a "purely frivolous" argument.[18]

b. Other taxpayers contend the "United States" consists only of the District of Columbia, federal territories, and federal enclaves. The courts have denied this claim since 1916. This was reconfirmed in a more recent case where the court imposed penalties for making a frivolous claim.[19] This case has been cited in numerous other cases.

c. Another contention some taxpayers make is that a taxpayer is not a "person" as defined by the Code. Consequently, they are not subject to the federal income tax laws. This argument is negated by IRC §7701(a)(14). The courts have commented on this argument numerous times.[20]

d. The term "employee" is subject to interpretation by some taxpayers. These taxpayers contend that the federal government can only tax employees of the federal government. Thus, employees of the private sector are immune from federal taxation. This argument is based on IRC §3401(c), which defines "employee" and states that the term "includes an officer, employee or elected official of the United States." While this does not address how other employee wages are taxed, IRC §7701(c) states that the use of the word "includes" "shall not be deemed to exclude other things otherwise within the meaning of the term defined." In a 1994 case, the court called this argument "nothing but tax protester rhetoric and legalistic gibberish." The court imposed a $2,500 penalty for bringing a frivolous case before the court.[21]

4. There are tax protesters who attempt to make constitutional amendment claims. These claims basically fall into four different arguments.

a. There are taxpayers who contend that federal income taxes constitute a "taking" of property without due process of law, violating the Fifth Amendment. This very old argument was resolved by the Supreme Court in 1916.[22]

b. Fifth Amendment protection is cited by taxpayers who contend they do not have to file tax returns or provide financial information because of the self-incrimination protection of the amendment. This argument was made as early as 1927 and was rejected by the Supreme Court.[23]

c. There is also a Thirteenth Amendment argument made by some taxpayers. They believe compelled compliance with the federal tax laws is a form of servitude. This argument was addressed by a Court of Appeals when they said, "if the requirements of the tax laws were to be classed as servitude, they would be the kind of involuntary servitude referred to in the Thirteenth Amendment."[24]

d. Sixteenth Amendment arguments are also made. The argument is the Sixteenth Amendment was never properly ratified and therefore federal income tax laws are unconstitutional. Some claim the State of Ohio was not properly a state at the time of ratification. This argument was also laid to rest in a 1916 case previously cited.[25]

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18. *United States v. Sileven,* 985 F2d 962 (8th Cir. 1993), November 13, 1992
19. *In Re Lowell H Becraft, Jr; Unites States of America, Plaintff/Appellee, v. Kenneth W. Nelson;* 885 F2d 547, September 6, 1989
20. *Biermann v. Commr.,* 769 F2d 707, 708 (11th Cir. 1985), August 26, 1985
21. *Pabon v. Commr.,* TC Memo 1994-476, 68 T.C.M. (CCH) 813, 816, September 29, 1994
22. *Brushaber v. Union Pacific R.R.,* 240 U.S. 1, 24, January 24, 1916
23. *United States v. Sullivan,* 274 U.S. 259, 264, May 16, 1927
24. *Porth v. Brodrick,* 214 F2d 925, 926 (10th Cir. 1954), August 7, 1954
25. *Brushaber v. Union Pacific R.R.,* 240 U.S. 1, 24 (1916), January 24, 1916

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5. Tax protesters also use two other arguments as basis for their contention they do not owe federal income tax. Neither of these arguments have a legal basis.

   a. One argument is that the IRS is a private corporation. It was not created by positive law and does not have the authority to enforce the Internal Revenue Code. Several cases have addressed this issue and have been ruled in favor of the government.[26]

   b. A final argument that is made is that taxpayers are not required to file a federal income tax return because the instructions and regulations associated with the Form 1040 do not display an Office of Management and Budget (OMB) control number as required by the Paperwork Reduction Act (PRA). The courts have held that either the PRA applies to the forms themselves and not to their instructions and the Form 1040 does have a control number or that Congress created the duty to file forms in IRC §6012(a). Congress did not enact the PRA's public protection provision to allow OMB to abrogate any duty imposed by Congress.[27]

Regardless of the taxpayer's claim, if he asks for a tax professional's help to escape taxation by making one of the previously listed contentions, the tax professional should explain case law to the taxpayer and then refuse to be involved with the taxpayer.

> **Note.** Additional citations and case details can be found on the IRS website at **www.irs.gov** by searching for "Anti-Tax Law Evasion Schemes."

ADDITIONAL INFORMATION

For additional information regarding the OPR's enforcement of Circular 230, a tax professional can go to the Tax Talk Today® website and listen to the May 10, 2005 presentation by the director of OPR, Cono Namorato, and other employees and tax professionals. The website address is **www.TaxTalkToday.tv**. The preparer should click on "View Archives."

> **Note.** The Ethics Chapter in the *2004 University of Illinois Federal Tax Workbook* contains additional examples of ethical issues a tax professional may face in his practice.

26. *Salman v. Dept. of Treasury,* 899 F. Supp. 471 (D. Nev 1995), April 13, 1995

27. *United States v. Neff,* 954 F2d 698, 699 (11th Cir. 1992), February 28, 1992

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