Chapter 2: Ethics

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

WHAT'S NEW

CIRCULAR 230 MONETARY PENALTIES

In the past, the IRS had the authority to sanction enrolled preparers through censure, suspension, and disbarment. However, this authority only applied to enrolled agents, CPAs, attorneys, and enrolled actuaries who practice before the IRS. The IRS issued Notice 2007-39 in April 2007, expanding the sanctions to include monetary penalties that they are now authorized to impose. These penalties apply to prohibited conduct under section 10.52 of Circular 230, *Violation of Regulations*.

The American Jobs Creation Act of 2004 amended Section 330(b) of title 31, United States Code to expand sanctions as follows:

> *"The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative."*

The new monetary penalties may be imposed against a preparer who:

- Is incompetent or disreputable,
- Fails to comply with the regulations prescribed under Section 330, or
- Willfully and knowingly misleads or threatens, with intent to defraud, a client or potential client.

As stated in the act, the monetary penalties may also be imposed against an employer, firm, or other entity if the practitioner was acting on its behalf in connection with the prohibited conduct and the employer knew or should have known about the prohibited conduct.

These new penalties only apply to prohibit conduct occurring after October 22, 2004, the act's enactment date. The total monetary penalties cannot exceed the gross income derived (or to be derived) from the prohibited conduct giving rise to the penalties. These penalties may be imposed for a single act of prohibited conduct or for a pattern of misconduct. These penalties have not replaced the IRS's ability to suspend, disbar, or censure a practitioner and may be imposed in addition. The penalties may not be used as a "bargaining point" that a practitioner may offer to avoid suspension, disbarment, or censure.

While the statute allows the IRS to impose penalties as long as they do not exceed the collective gross income derived from the prohibited conduct, the IRS is not required to impose the maximum penalty. The IRS considers the following factors in determining penalty amounts:

- The level of culpability of the practitioner
- Whether the practitioner violated a duty owed to a client or potential client
- The actual or potential injury caused by the prohibited conduct
- The existence of the aggravating or mitigating factors

Mitigating factors may include whether the practitioner, employer, firm or other entity:

- Took prompt action to correct the noncompliance,
- Promptly ceased to engage in the prohibited conduct,
- Attempted to rectify any harm caused by the conduct, or
- Undertook measures to ensure the prohibited conduct would not occur in the future.

Monetary penalties are not imposed for minor technical violations if there is little or no injury to the client or the public and it is unlikely that similar conduct will be repeated. The IRS may impose separate penalties against the practitioner and his employer.

If a practitioner acts on behalf of his employer or firm in connection with prohibited conduct and was considered to have an agency relationship with the employer, firm, or other entity, then separate monetary penalties may be imposed if the employer knew, or should have known, of the prohibited conduct. An employer is considered to know, or should have reason to know, of the prohibited conduct if:

1. A member of the principal management team has information from which a person with similar experience and background would reasonably know of the prohibited conduct; or
2. The firm, through willfulness, recklessness, or gross indifference, did not take reasonable steps to ensure compliance with Circular 230; and individuals associated with the firm engage in a pattern or practice of failing to comply with Circular 230.

Example 1. Attorney Sandy specializes in tax planning and works at a national accounting firm's headquarters. Sandy is involved in development of off-the-shelf tax planning strategies, including Strategy X. Sandy has wide discretion over her day-to-day work products and rarely supervises other professionals at the firm. She rarely deals directly with clients, as this work is handled by other firm partners or employees. Sandy works directly with the firm's other attorneys, accountants, and support staff across the country to market and fine-tune Strategy X. Clients of the firm are examined by the IRS with respect to Strategy X, but Sandy is not identified as a representative on any Form 2848, *Power of Attorney and Declaration of Representative*.

Sandy reports to the director of the firm's tax practice. The director provides general oversight of Sandy and is aware of the strategies developed, including Strategy X, although he is not necessarily familiar with the technical tax details of the strategy. The director also knows Strategy X generates measurable revenue for the firm.

The IRS's Office of Professional Responsibility (OPR) determines that Sandy engaged in prohibited conduct in the creation, promotion, and marketing of Strategy X. Sandy acted on behalf of the firm because an agency relationship existed between Sandy and the firm, and the misconduct arose in connection with that agency relationship. The firm's director had reason to know of the prohibited conduct. The director, who is a member of the firm's principal management, had general knowledge that Sandy developed the tax advantaged strategies. Even in the absence of general knowledge, the director would need to inquire into Strategy X because it added measurably to the firm's revenue. Sandy and the firm are subject to a monetary penalty.

Example 2. Andrew, an unenrolled preparer who owns and operates his own firm, provides preparation services to the public and specializes in preparing Forms 656, *Offers in Compromise*. Andrew's firm employs and Andrew supervises ten attorneys, CPAs, and enrolled agents (all practitioners) and fifteen unenrolled preparers. His firm is structured in such a manner that the first and predominant contact with clients is with an unenrolled preparer. The unenrolled preparer assists clients with preparing Form 656, which is later submitted directly to the IRS. Andrew does not review individual Forms 656 but has provided specific instructions to his staff regarding how to complete false and misleading Forms 656 in violation of Circular 230. In order to facilitate the submission to the IRS, Andrew's procedure is to authorize one of his ten practitioners to submit a Form 2848 on behalf of a client much later in the process, well after submission of the fraudulent Forms 656.

Although Andrew is not a practitioner, his actions in submitting the Forms 2848 are done on behalf of the firm pursuant to an agency relationship and occur in connection with prohibited conduct. Andrew's firm is considered to know or have reason to know of the prohibited conduct because Andrew, a member of principal management, instructed his staff regarding the completion of the forms in violation of Circular 230. Andrew's actions subject his firm to a monetary penalty.

WHISTLEBLOWER OFFICE

The Tax Relief and Health Care Act of 2006 established a Whistleblower Office within the IRS. Its purpose is to process tips received from individuals who spot tax problems in their workplace while conducting day-to-day personal business or anywhere else they may be encountered. Stephen A. Whitlock, former director of the Office of Professional Responsibility, was appointed director of this new office. During Whitlock's 27-year government career, he helped run anti-fraud and abuse programs at the Defense Department, as well as directing OPR.

The Whistleblower Office can grant rewards between 15% and 30% of the total proceeds the IRS collects, if the IRS takes action on the information provided. The office is responsible for assessing and analyzing incoming tips. After determining their degree of credibility, the office assigns the information to the appropriate IRS office for further investigation.

NEW DIRECTOR OF OPR

Commissioner Everson appointed Michael R. Chesman as director of the Office of Professional Responsibility. Chesman, an attorney, has a long history of working for the IRS. In addition to working in the Chief Counsel's office, he was the director of the Office of Taxpayer Burden Reduction. In that position, he was able to save taxpayers more than 200 million hours of work by simplifying tax responsibilities or eliminating unnecessary filing requirements.

As the director of OPR he is responsible for setting, communicating, and enforcing standards of competence, integrity, and conduct among tax practitioners. These practitioners specifically include attorneys, certified public accountants, enrolled agents, and others who represent taxpayers before the IRS.

REPORTING SUSPECTED TAX FRAUD

In its attempt to close the tax gap, the IRS encourages the reporting of suspected tax fraud. These efforts are being conducted in both the Office of Professional Responsibility and the Whistleblower Office. Anyone who suspects or knows of an individual or company that is not complying with the tax laws may report this activity by completing Form 3949-A, *Information Referral*. The form is available on the IRS website, where it can be completed, printed, and mailed to:

Internal Revenue Service
Fresno, California 93888

A reporter of fraud is not required to identify herself, but it is helpful to do so. The reporter's identity can be kept confidential and she may be entitled to a reward.

Form **3949 A** (12-2005)	Department of the Treasury - **Internal Revenue Service** **Information Referral** (*See instructions on reverse*)	OMB # 1545-1960

1. Taxpayer Name	2. Business Name
a. Street Address	a. Street Address
b. City/State/ZIP	b. City/State/ZIP
c. Social Security Number (SSN)	c. Employer Identification Number
d. Occupation	d. Principal Bus Activity
e. Date of Birth	
3. Marital Status ☐ Married ☐ Single ☐ Head of Household ☐ Divorced ☐ Separated	3a. Name of Spouse

4. Alleged Violation of Income Tax Law (Check all that apply).

☐ False Exemption	☐ Unsubstantiated Income	☐ Unreported Income	☐ Failure to Withhold Tax
☐ False Deductions	☐ Kickback	☐ Narcotics Income	☐ Wagering/Gambling
☐ Multiple Filing	☐ False/Altered Documents	☐ Public/Political Corruption	☐ Earned Income Credit
☐ Organized Crime	☐ Failure to Pay Tax	☐ Failure to File Return	☐ Other (Describe below)

5. Unreported Income and Tax Years (Fill in Tax Years and dollar amount(s), if known, e.g., TY2005 $10,000)

TY____ $________ TY____ $________ TY____ $________ TY____ $________ TY____ $________ TY____ $________

a. Comments (Briefly describe the facts of the alleged violation - Who/What/Where/When/How. Attach another sheet, if needed).

b. Are books/records available? ☐ Yes ☐ No	c. Do you consider the taxpayer dangerous? ☐ Yes ☐ No

d. Banks, Financial Institutions used by the taxpayer:

Name:	Name:
Address:	Address:
City/State/ZIP:	City/State/ZIP:

e. Please describe how you learned and/or obtained the information in this report (Attach another sheet, if needed):

6. Your Name:

a. Address:

b. City/State/ZIP:

c. Telephone Number (Please include the Area Code):

For Paperwork Reduction Act, see Instructions

Catalog Number 47872E

Form **3949 A** (12-2005)

Instructions

Provide the following information for the Person/Business You Are Reporting if Known:

1. Name
   a. Street Address of Residence
   b. City, State, and Zip Code
   c. Social Security Number
   d. Date of the Person's Birth

2. Business Name
   a. Street Address of Business
   b. City/State/Zip Code
   c. Enter Employer Identification Number
   d. Describe the Primary Business Activity

3. Indicate Martial Status
   M - Married **S** - Single **HH** - Head of Household **Div** - Divorced **Sep** - Separated
   3a. Enter name of spouse, if applicable.

4. Check all Tax Violations That Apply to Your Report or Describe in Comments If Not Listed.

5. If your report involves unreported income, indicate the year(s) and the dollar amount(s)
   5a. Briefly describe the facts of the alleged violation(s) as you know them. Please attach another sheet, if you need more room.
   5b. Indicate (Yes or No) if books and/or records are available that substantiate your report.
   5c. Indicate (Yes or No) if you consider the person to be violent or dangerous and provide an explanation in the comments section of this form.
   5d. List name and address of bank(s) and/or financial institution(s) used by the taxpayer if known.
   5e. Briefly explain how you learned of or obtained the information contained in your report. Please attach another sheet, if you need more room.

6. Enter your name, street address, city, state, zip code and a telephone number where you can be contacted. Indicate time of day you may be contacted if appropriate. **This Information is not Required to Process Your Report.**

Send the completed Form to the Internal Revenue Service Campus Location below:

Internal Revenue Service
Fresno, CA 93888

PAPERWORK REDUCTION NOTICE: We ask for the information on this form to carry out the Internal Revenue laws of the United States. This report is voluntary and the information requested helps us determine if there has been a violation of Income Tax Law. We need it to insure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administrations of any Internal Revenue laws. Generally, tax returns and tax return information are confidential, as required by Code section 6103.

The time required to complete this form will vary depending on individual circumstances. The estimated average time is 15 minutes. If you have comments concerning the accuracy of these time estimates or suggestions for making the form simpler, we would be happy to hear from you. You can email us at *taxforms@irs.gov (please type "Forms Comment" on the subject line) or write the Internal Revenue Service, Tax forms Coordinating Committee, SE:W:CAR:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224.

Do not send this completed form to the Tax Form Coordinating Committee. Instead, send it to the IRS location shown above.

Catalog Number 47872E — Form **3949 A** (12-2005)

CONTINUED SCRUTINY OF TAX PROFESSIONALS

The IRS and the Tax Division of the Department of Justice periodically issue news releases highlighting the conviction of tax preparers and advisers. Here are some of the announcements about cases in 2007:

1. A federal court in Detroit permanently barred Peter and Doreen Hendrickson of Commerce Township, Michigan from filing tax returns and forms on which they falsely report their income as zero. The injunction order, signed by U.S. District Judge Nancy G. Edmunds, also requires the couple to repay more than $20,000 in federal income, social security and Medicare taxes that they obtained by filing false tax returns with the IRS.

   The order notes that the couple based their improper conduct on a book Peter Hendrickson wrote called *Cracking the Code.* The book states that federal tax withholding and income taxes on wages are applicable only for a limited class of people, primarily government employees. The court found that position to be "false and frivolous," and cited an earlier court decision holding the position to be "preposterous."

   Based on advice in Hendrickson's book, individuals have unlawfully filed tax returns with false substitute W-2 wage statements they prepare reporting little or no wage income. They also fail to submit the correct W-2 wage statement they receive from their employers. Hendrickson's scheme is number five on the IRS's 2007 list of the "Dirty Dozen" tax scams, posted at **http://apps.irs.gov/newsroom/article/0,,id=167983,00.html.**

   The Justice Department sued the Hendricksons and seven others last year in suits filed in California, Nevada, Michigan, Alabama, Kansas, and Florida, seeking to recover erroneous tax refunds that the nine defendants had received as a result of acting on the advice in Hendrickson's book. The government has now prevailed against all nine defendants. Information on those suits is available at **www.usdoj.gov/tax/txdv06219.htm.**

   Peter Hendrickson was convicted in 1992 on federal criminal charges for failing to file a federal income tax return and for a conspiracy involving a firebomb placed in a bin at a U.S. Post Office in Royal Oak, Michigan on April 16, 1990, the last day on which tax returns could be postmarked that year. Hendrickson testified at a co-conspirator's trial that he wrapped a tea bag around the bomb's tubing as a reference to the Boston Tea Party tax protest.

   Since 2001, the Justice Department has obtained injunctions against more than 235 tax fraud promoters and fraudulent return preparers. More information about the Justice Department's efforts to stop tax scams can be found at **www.usdoj.gov/tax/taxpress2007.htm.** Information about the Justice Department's Tax Division can be found at **www.usdoj.gov/tax.**

2. A federal court in Seattle shut down a nationwide "warehouse banking" scheme whose promoter falsely promised customers they could legally hide their income, assets, and identities from the IRS. The warehouse bank, known as Olympic Business Systems (OBS), is operated by Des Moines, Washington, resident Robert Arant.

   The court order, called a preliminary injunction, was signed on April 27 by Judge Marsha J. Pechman of the U.S. District Court for the Western District of Washington. A temporary restraining order freezing Olympic's assets was previously signed on April 17 by Chief Judge Robert L. Lasnik. The court orders were initially filed under seal, but the court ordered them unsealed.

   In papers filed in support of obtaining the injunction, the government alleged that Olympic deposited almost $28 million of customer funds into accounts that OBS maintained in its own name at commercial banks. Olympic allegedly used the funds to pay customers' bills and expenses while promising to leave no paper trail.

   Judge Lasnik's order held that Arant "is or should be aware that courts have repeatedly held that warehouse banks are tax evasion schemes." In 2004, a California federal court permanently closed a similar warehouse bank. Details about that case are available at **www.usdoj.gov/tax/txdv04785.htm.** In 2005, a federal court in Oregon sentenced operators of a warehouse bank to prison after their criminal convictions. Details are available at **www.usdoj.gov/tax/txdv05070.htm.**

3. A former IRS district director pleaded guilty to conspiring to defraud the United States through his involvement in a tax fraud scheme promoted by the Topeka, Kansas-based "Renaissance, The Tax People, Inc." During a hearing before U.S. District Judge Carlos Murguia in Kansas City, Kansas, Jesse Ayala Cota admitted to defrauding the U.S. Treasury of more than $1.3 million and to earning more than $300,000 from his participation in the scheme.

4. The Justice Department asked a federal court to permanently bar Marva Bilberry of Belton, Missouri from preparing tax returns for others. The civil injunction suit, filed in Kansas City with the U.S. District Court for the Western District of Missouri, alleges that Bilberry operated a business called Bilberry Bookkeeping & Tax Service that prepared fraudulent income tax returns for customers in the Kansas City metropolitan area.

   According to the government complaint, 98% of the Bilberry-prepared returns examined by the IRS required adjustments — averaging $3,167 in additional tax per customer. Bilberry allegedly prepared tax returns with inflated medical expenses, employee business expenses, charitable contribution deductions, and home business expenses.

   The complaint states that the IRS estimates that Bilberry's misconduct cost the federal Treasury more than $2.4 million since 2003. The government complaint asks the court to order Bilberry to give the Justice Department a list of her customers' names, addresses, e-mail addresses, and social security numbers.

5. Todd Eugene Strand of Murrieta, CA pleaded guilty in a Kansas City, Kansas federal court to conspiracy to defraud the United States in the assessment and computation of taxes and mail fraud charges for his involvement in a tax fraud scheme.

   The indictment alleged that from June 1997 though April 2002, Strand and co-defendants Daniel Joel Gleason, Michael Craig Cooper, and Jesse Ayala Cota operated a scheme to defraud the IRS and individuals. The scheme marketed a program promoted by the Topeka-based Renaissance, The Tax People, Inc., designed to sell illegal tax deductions through false and misleading representations. Strand pled guilty to conspiracy to commit mail and wire fraud and to defraud the United States in connection with the promotion of a fraudulent tax scheme. He also pleaded guilty to a separate charge of aiding and abetting mail fraud.

   In his plea, Strand admitted that beginning in November 1995 he served as co-conspirator Michael Craig Cooper's right-hand man. Strand held the position of vice president of Renaissance, the Tax People, Inc. By August 23, 1999, Strand was the national marketing director for Renaissance, and had earned more than $250,000 in income from his involvement with the company.

   "People who promote or participate in schemes to evade federal income taxes harm not only the federal Treasury, but all honest taxpayers." said Eileen J. O'Connor, Assistant Attorney General for the Justice Department's Tax Division. "Working together with the Internal Revenue Service and United States Attorney's Offices, the Tax Division has made investigating and prosecuting such crimes a high priority."

   According to the indictment, Renaissance's tax package, which went by various names, including the "Tax Relief System," offered its customers tax return preparation, tax advice, and audit protection services. Renaissance claimed that, by following this program, its customers could lawfully reduce their income taxes by deducting personal expenses as legitimate business expenses.

   "As a national marketing director for Renaissance, Mr. Strand peddled a fraudulent 'tax relief system' through promotional meetings, conferences, rallies, conference calls, and promotions by mail," said Eric Melgren, U.S. Attorney for the District of Kansas.

Renaissance charged customers between $300 and $1,200 to join and an additional $100 monthly per package purchased. Renaissance told customers the program would pay for itself through reduced federal income tax withholdings and directed customers to file amended Forms W-4 with their employers, reducing taxes withheld from their salaries. Strand admitted he and his co-conspirators prepared and caused to be prepared a substantial number of false federal income tax returns. These returns falsely inflated deductions and tax credits.

"There are many knowledgeable and reputable tax advisors, but when promoters such as Todd Strand of the Renaissance group promise a system that enables taxpayers to avoid paying income taxes: Buyer Beware," said IRS Criminal Investigation Chief Eileen C. Mayer. "The IRS is very concerned that taxpayers are being misled by unscrupulous promoters making outlandish claims that their system helps taxpayers avoid paying income taxes. If you aren't sure about a tax arrangement, seek expert advice. The IRS website has information about how to detect scams, schemes and cons."

As part of his plea, Strand admitted that he and his co-conspirators falsely assured Renaissance customers that the tax programs were legal. Strand acknowledged that on October 16, 2000, a co-conspirator sent an e-mail message to the Renaissance customers falsely stating the existence of written endorsements from "over 2,000 tax attorneys, enrolled agents and Certified Public Accountants (CPA) that every strategy contained in the Tax Relief System is absolutely sound, unassailable and proven over the past 40 years." Strand further admitted that the conspiracy defrauded Renaissance customers of more than $75 million and caused a tax loss in excess of $20 million.

Strand faces a potential maximum sentence of 10 years in prison followed by up to three years of supervised release, a $500,000 fine, and liability for the costs of prosecution. U.S. District Judge Carlos Murguia scheduled sentencing for January 7, 2008. This case was investigated by criminal investigators from the IRS and from the U.S. Postal Service.

The IRS attempts to obtain as much publicity as possible about tax fraud convictions. They believe the publicity discourages other taxpayers from underreporting or participating in tax schemes.

LICENSING OF ALL TAX PREPARERS

Legislators continue to promote bills which will require the licensing of tax preparers. On April 3, 2007, the IRS announced it sued operators of more than 125 offices of a major tax preparation chain. It accused them of cheating the U.S. Treasury out of more than $70 million by "preparing tax returns based on falsehoods and fabrications." Some managers and employees received kickbacks for helping customers file the false returns. The complaint targeted five franchises that operate offices in five cities in Georgia, Illinois, Michigan, and North Carolina, as well as 24 individuals. All of the complaints were against one franchisee.

Senator Jeff Bingaman (D-NM) introduced S. 1219, *Taxpayer Protection and Assistance Act of 2007*, a bill that would require the Treasury Department to set standards for commercial tax return preparers and have the OPR administer the regulation of paid tax preparers. The bill requires unenrolled preparers to pass a competency exam and take continuing education classes. The bill is co-sponsored by Senators Daniel K. Akaka, John F. Kerry, Gordon H. Smith, Richard Durbin, Joseph I. Lieberman, Charles E. Schumer, and Mark L. Pryor. The Senate Finance Committee approved a similar bill in 2006, but it was not considered by the full senate. The House passed a version of the Tax Protection Act, but it does not regulate tax preparers. Excerpts from the bill include:

- *Not later than 1 year after the date of the enactment of this Act, the Secretary of the Treasury shall prescribe regulations…*
  - *To regulate those compensated preparers not otherwise regulated under regulations…*
- *The Secretary shall develop (or approve) and administer an eligibility examination designed to test:*
  - *The technical knowledge and competency of each preparer:*

- *To prepare Federal tax returns, including individual and business income tax returns, and*
- *To properly claim the earned income tax credit, and*

- *The knowledge of each such preparer regarding such ethical standards for the preparation of such returns…*

- *Shall require a renewal of eligibility every 3 years and shall set forth the manner in which a preparer described in paragraph (1)(A) must renew such eligibility.*
- *As part of the renewal of eligibility, such regulations shall require that each such preparer show evidence of completion of such continuing education requirements as specified by the Secretary.*
- *The Secretary shall impose a penalty of $1,000 for each Federal tax return, document, or other submission prepared by a preparer described in paragraph (1)(A) who is not in compliance with the requirements of paragraph (2) or (3) or who is suspended or disbarred from practice before the Department of the Treasury under such regulations. Such penalty shall be in addition to any other penalty which may be imposed.*

Note. It is interesting to note that if an individual prepares taxes for free through a program such as the Volunteer Income Tax Assistance (VITA) program, the IRS requires the preparer to undergo training and pass a certification test. However, if they charge a fee for tax preparation, no certification is required.

TAX MALPRACTICE

Tax professionals should have more concerns than just meeting the April 15 deadline. Each year, they are subject to greater scrutiny. A major concern is compliance with IRC §§6694 and 6695, and Circular 230.

IRC §6694 UNDERSTATEMENT OF TAXPAYER'S LIABILITY BY TAX RETURN PREPARER

The Small Business and Work Opportunity Tax Act of 2007 expands the scope of the tax return preparer penalties to all types of tax returns.[1] Therefore, the phrase, "income tax return preparer," is replaced by the phrase, "tax return preparer." The amendment is effective for tax returns prepared after May 25, 2007.

In addition, the amendment increases the amount of the return preparer penalty for the understatement of a tax liability from $250 to the **greater of** $1,000 or 50% of the income derived (or to be derived) by the preparer for the return or refund claim. Further, the standards of conduct that must be met to avoid imposition of the penalty are amended in two ways. The "realistic possibility" standard for undisclosed positions has been replaced by an "unreasonable position" standard.[2] Second, for disclosed positions, the act replaces the nonfrivolous standard with the requirement that there will be a reasonable basis for tax treatment of the position.

1. IRC §7701(a)(36)
2. IRC §6694(a)(2)

Understatement Due to Unreasonable Positions

Under the "unreasonable position" standard, the penalty is imposed if:

- The preparer knew, or reasonably should have known, of the position,
- There was not a reasonable belief that the tax treatment of the position would **more likely than not** be the proper treatment, and
- The position was not disclosed or there was not a reasonable basis for the position.

Under both the prior and current law, disclosure is adequate if made:

- On Form 8275, *Disclosure Statement,*
- On Form 8275-R, *Regulation Disclosure Statement*, or
- Pursuant to IRS revenue procedures.

Under new law, the penalties apply unless there is a **reasonable basis** for the tax treatment. The IRS has yet to define reasonable basis for these penalties. However, for accuracy-related penalties,[3] basing a position on one or more recognized authorities meets the reasonable basis standard. To meet this standard, the preparer must also take into account the relevance and persuasiveness of the authorities, as well as subsequent developments.

> **Note.** See the first section, "Explanation of Contents," in Chapter 15, "Rulings and Cases," for a list of recognized authorities. Positions may satisfy the **reasonable basis standard** even if they do **not** satisfy the **substantial authority standard**.

A reasonable cause exception applies if it is shown that there was reasonable cause for the understatement and the preparer acted in good faith.

Prior to the amendment, a $250 penalty could be assessed if a tax preparer took a position that the IRS later ruled unrealistic. There must have been a realistic possibility that the position would be sustained on its merits. This pertained to an issue where the preparer should have known or knew there was little chance it would be sustained. The penalty could also be assessed if it was a frivolous position. One possible way to avoid the penalty was to disclose the position on the original tax return. A position meets the realistic standard if a well-informed analysis by a person with income tax knowledge would conclude that the position has at least a one-in-three chance of being sustained. However, the opinions found in legal periodicals or the opinions of other tax professionals do not constitute legal authority. The possibility the return will not be audited could not be taken into account.

The following examples help define the unreasonable position issue.

Example 3. Preparer Willis has been preparing a client's returns for many years. One position on his client's return was questionable, but there were no specific statutes regarding the deduction. In 2006, the IRS published a statute which specifically prohibits the deduction. If Willis fails to abide by the new statute, he is considered to have known or should have known of the position, and there was no reasonable belief that the position would more likely than not be sustained on its merits (clearly in view of the new statute). He can be subject to a penalty.

Example 4. Use the same facts as **Example 3.** Willis reads the committee report and finds that Congress did not intend this statute to apply to a business such as his client's. However this is not stated in the statute. Following either the committee report or the statute is considered a realistic position. However, following the committee report does constitute a disregard of a rule or regulation and must be disclosed on the tax return.

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3. Treas. Reg. §1.6662-3(b)(3)

Note. IRC §6694 as revised by the act, requires that a preparer must satisfy a higher standard ("more likely than not") than the standard the taxpayer must satisfy ("substantial authority") in order to avoid the imposition of an understatement penalty for an undisclosed, non–tax-avoidance item reported on the taxpayer's return. Thus, it is possible for a preparer to be subject to a penalty for a position taken on a prepared return, even though the taxpayer would not be subject to a penalty for that same position.

Willful or Reckless Conduct

Previously, a $1,000 penalty could be assessed if a tax preparer willfully understated tax liability or overstated a refund, or for a reckless or intentional disregard of the rules. Several recent cases in which these penalties were assessed and upheld include:

- The preparer followed taxpayers' instructions without consulting regulations, and excluded items from gross income.
- The tax preparer was aware certain items were disallowed on the taxpayer's audit. After the audit, he prepared the current year's return and claimed the same deductions.
- The tax preparer continually, intentionally, and completely disregarded tax laws and understated the customer's tax liability. He actively solicited customers by promising large refunds. He manipulated taxable income and reported fictitious deductions.

The act increased the penalty for willful or reckless conduct from $1,000 to the **greater of $5,000** or 50% of the income derived (or to be derived) by the preparer.

Under the act, and applicable to IRC §6694(a) (unrealistic positions), transitional relief is available for all returns, amended returns, and refunds due on or before December 31, 2007, to estimated returns due on or before January 15, 2008, and to 2007 employment and excise returns due on or before January 31, 2008. No transitional relief applies to IRC §6694(b) (willful or reckless conduct).

IRC §6695 — OTHER ASSESSABLE PENALTIES

Although penalties for noncompliance are the most obvious, a tax preparer can be assessed penalties for other negligent practices. Other penalties include:

- Failure to furnish copy of return to taxpayer: $50
- Failure to sign return: $50
- Failure to furnish identifying number: $50
- Failure to retain copy or list: $50
- Failure to file correct information returns: $50
- Negotiation of the client's refund check: $500
- Failure to be diligent in determining eligibility for earned income credit: $100

Earned Income Credit Diligence

In order to meet the diligence test and avoid the earned income credit (EIC) penalty, the preparer must:

1. **Complete an eligibility checklist by:**

   a. Completing Form 8867, *Paid Preparer's Earned Income Credit Checklist*, or

   b. Recording in the preparer's paper or electronic file the information necessary to complete the checklist. This information must be based on information provided by the taxpayer or reasonably obtained by the preparer.

2. **Compute the credit by:**

   a. Completing the worksheets contained in the Form 1040 instructions; or

   b. Otherwise recording the information necessary to complete the worksheet, including the method used to make the computation. Again, this information must be based on information provided by the taxpayer or reasonably obtained by the preparer.

3. **Rely on knowledge.** If the preparer knows that the information being relied upon to compute the credit is incorrect, he may not compute the credit. The preparer may not ignore the implications of information furnished to, or known by, the preparer and must make reasonable inquiries if the information appears to be incorrect, inconsistent, or incomplete.

4. **Retain records including:**

   a. A copy of the completed Eligibility Checklist or alternative eligibility record

   b. A copy of the Computation Worksheet or alternative computation record

   c. A record of how and when the information was used to complete the Eligibility Checklist and Computation Worksheet, including the identity of the person furnishing the information

   These records must be retained for three years after June 30 following the date the return was presented to the taxpayer for signature. The records may be retained on paper or electronically.

MALPRACTICE CLAIMS

Malpractice claims can arise for numerous reasons.

Inaccurate Advice

Tax professionals face increasing risks of malpractice suits each year. One professional liability insurance company indicated that over 66% of the 2005 tax claims involved client allegations the preparer failed to advise them properly or used improper tax treatment in preparing their returns. Improper treatment covers such areas as nonmechanical calculation errors or the incorrect use of a tax basis or depreciation method.[4]

Failure to advise claims can result from casual telephone conversations where informal advice is given. This type of call can result in the client not giving sufficient facts or not understanding the consequences of the advice received.

> **Example 5.** At 8:00 p.m., November 5, 2006, Accountant Smith is watching his favorite television program. His phone rings and he receives a call from one of his largest clients. The call may go something like this: "Hello Joe, this is Tony. Sorry to bother you, but I have a quick question. I'm sure you know the answer off the top of your head. I may decide to get rid of the Florida property. Does it qualify for a like-kind exchange? It appears I can make $400,000 if I dump it now."

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4. Joseph Wolfe, CAN, "Accountants Professional Liability," www.cpai.com/show-article?id=19

Joe immediately thinks of the commercial building Tony owns in Florida and responds, "Sure, as long as you meet all of the time requirements and do not take any cash prior to closing on the replacement property." Tony says thank you and hangs up.

On March 3, 2007, Tony comes into the office to have his tax return prepared. He mentions the sale of his winter home in Florida, but reminds Joe that he said it was not taxable as it was traded for another property in the Bahamas. Tony reminds Joe that he assured Tony the transaction was not taxable when he was called back in November. Joe informs Tony the property does not qualify for IRC §1031 treatment for two reasons: the property is a personal residence, and the replacement property is not in the United States. Consequently, Tony owes $60,000 of federal income tax on the sale.

Shortly thereafter, Joe receives a letter from Tony's attorney requesting reimbursement of the taxes paid on the transaction.

Undoubtedly Joe, in **Example 5**, would have given Tony a different answer if the question had been posed in an office setting. Tony would have been "on the clock" and Joe would have probed for more information. In order to prevent the problem Joe is now facing, he should have followed up on the conversation the next morning. He should document the details of the call and why he gave the opinion. He should have also told Tony that the answer might change if more information were collected.

Late Tax Filings

Clients do not like to pay late filing penalties and interest. They often look for a reason to blame the tax preparer for the late filing. Allegations include the preparer not getting the return to them on time or believing the preparer was filing the return for them. The increased use of electronic filing can either prevent this problem or increase the likelihood of a problem.

Example 6. Eric goes to Scott's Tax Service to have his return prepared. Scott agrees to have the return electronically filed. Eric's wife is not available to sign the Form 8879, but he plans to have it signed and to return the form in a week. Both Eric and the Scott forget about the form until the IRS notifies Eric that they have not received a tax return.

Fault lies with both Eric and Scott. Taxpayers are ultimately responsible for filing their tax returns. However, Scott should have had controls in place to create awareness that the return was not filed.

Calculation Errors

These types of errors can arise in a number of ways. The client presents details of transactions for the year. While he provided totals on the document, the total is incorrect. Errors also occur in incorrect spreadsheet formulas or inaccurate transfers of data into the tax software program. While the final tax return from a tax package may appear to be correct, it is still necessary to review the forms.

The current year tax return should be compared to the prior year's return. This check often reveals income or deductions from a prior year that are not shown on the current year return. Preparers should not assume the client's filing status or number of dependents are the same. This information should be confirmed by using an organizer and asking the client.

Most professional tax software products have numerous edit checks in place to prevent errors. However, these checks can be overridden or disabled. The tax preparer should be careful to check the edits each year.

Engagement Scope

Tax practitioners should issue engagement letters to their clients. Disputes often arise when the client assumes the preparer provides a service which the preparer does not provide.

Example 7. Mark and Julie tell their tax preparer that they plan to sell their business using an installment sale. When they file their tax return, they are surprised by the huge tax liability created by depreciation recapture. They believed that the tax preparer should have warned them that most of the gain would be recognized in the year of sale. The tax preparer did not realize the comment about the sale was a request for tax planning advice.

The use of an engagement letter could prevent this misunderstanding. Engagement letters are discussed later in this chapter.

Election Errors

Many tax elections are irrevocable. Before making an election, the tax preparer should discuss consequences with the taxpayer. In addition, many elections must be made on a timely-filed tax return. Failure to make the election can cost a taxpayer thousands of dollars.

Example 8. Tom and Kathleen's 2006 tax return results in a NOL of $500,000. The tax preparer believes this was caused by the timing of income and that the next year's return will have $500,000 more income than normal. Therefore, the preparer elects to forego the 2-year carryback period.

Due to a downturn in the economy, Tom and Kathleen sell the business early in 2007. The operations show a small loss and there is no gain from the sale. While there was a $600,000 profit in the second carryback year, it could not be used because of the prior election. It appears Tom and Kathleen will never get any tax advantage from the NOL.

Had the preparer discussed the details of the NOL election with the client, she would have found out about a possible sale. At least, that was the client's testimony in court.

Phantom Tax Returns

Some clients conduct business in numerous states. The preparer may file tax returns for only some of the states, not realizing that business was conducted in an additional state. The client is then liable for substantial penalties for failing to file a tax return.

State tax law varies considerably across states. If a preparer knows that a client performs services or conducts business in other states, he should make it clear whether:

- It is the client's responsibility to research the filing requirements of the various states,
- It is the preparer's responsibility to conduct the research for a fee,
- The preparer will refer the client to a preparer in that state, or
- The preparer will confer with another preparer more familiar with that state's laws.

Example 9. Sammy receives a $10 million salary for playing baseball. During the year, he plays in 15 different states. He does not realize one of the states calculates his state income based on the total number of games played in the state. Twelve games were played in that state, and the state tax department assessed Sammy the tax, penalties, and interest on over $745,000 of income.

Sammy's attorney wants the tax preparer to pay the penalties and interest.

Documentation

Tax preparers should document all discussions with their clients. The documentation can be written or electronic, and should note the date of the discussion, issue, facts, and advice given. This information is very valuable in the case of an audit or dispute with the client.

Dabbling

A tax professional should avoid any engagement in which he does not feel competent. Tax preparation is not an occupation which should be learned on-the-job. Many years ago, the standard for a new tax preparer training was to look at the prior year's tax return, and do what that preparer did. Laws change much more rapidly today, and yesterday's return may not reflect the current law. Even after researching a new issue, a competent tax preparer will ask a knowledgeable person to review his work if it is in a new area. If the engagement is in a field where the preparer wishes more work, he may share the engagement with an expert so he is qualified for the next client.

> **Example 10.** Rebecca is asked by her client to advise and prepare the tax work on a reverse like-kind exchange. Rebecca knows some other clients are also considering similar transactions. If the reverse exchange does not qualify for IRC §1031 treatment, the client will owe $225,000 in federal income tax. Rebecca should find an expert in reverse exchanges and work with that person on her client's transaction.

Client's needs sometimes grow beyond the expertise of their tax practitioner. Unless the tax practitioner evaluates her client's needs each year, she may find that she is unable to adequately serve the client. The client who ran a business out of his college dormitory room can develop it into a multi-billion dollar business. This client's current needs are far greater than they were originally.

Tax professionals should evaluate their client's needs each year. They must make sure the client is assigned to the tax preparer with the most expertise in the client's field. If the client has an issue outside the firm's expertise, the firm should disengage with the client on that issue. As part of this process, the firm should see if there are additional services they can provide to the client for additional fees.

Referrals

Even referring a client to another practitioner can lead to a lawsuit. When the client receives the referral, he assumes he is being referred to a competent person. If that person fails to perform, many times the client will sue both the person who provided the service and the one who made the referral. A tax professional should perform due diligence before making a referral. In addition, he should write to the client, telling him that he is not responsible for the services of the referred professional. If he is receiving a fee from the referred professional, he should also state that in the letter.

> **Example 11.** Rebecca in **Example 10** referred her client to a firm which advertises their §1031 specialty. She does not know the firm and has never had any contact with them. Unfortunately, the transaction is not handled correctly and the $225,000 tax liability is owed. Rebecca receives a letter stating she is included in the lawsuit the client has against the referred firm. The court determines Rebecca has no liability in this issue, but she incurs $25,000 of legal expense and lost time.

Risk Management

The tax professional manages her risk. This is a function which must occur throughout the year.

- The process begins by issuing engagement letters.
- Next, the professional reviews the current year's software product for any new or deleted features or edits.
- She takes the time to review each completed tax return before it is given to the client or electronically filed. This review is more than a cursory review of the return. It includes matching up all of the tax documents provided by the client.
- Finally, the professional carefully reviews old client files before they are destroyed to determine if they contain any information which might be needed in the future, such as basis amounts.

When a tax professional has trouble collecting a fee, he should reconsider before filing a lawsuit against the client. The professional liability insurance industry recommends foregoing the fee versus taking the client to court. The reasons behind their recommendation are:

1. A lawsuit is expensive. In addition to the cost of the attorney, the accountant has to invest the time necessary to collect information, give depositions, and appear in court.
2. Many times the client will countersue. He will allege that the work was not performed properly. The accountant will then have to review all the work, knowing other accountants will review the work looking for the slightest mistake.
3. The accuracy of the work product will eventually be decided by a judge or jury, neither of whom may understand accounting or tax preparation.
4. Depending on the locale of the case, the accountant may receive substantial negative publicity. This may drive off existing clients or deter new individuals from becoming clients.

If the preparer has any concerns about being paid for services rendered, he should work from a retainer, or halt work until payment for past services are received.

ETHICAL DILEMMA SCENARIOS

Tax preparers are often faced with ethical dilemmas in their day-to-day tax practice. Responses to these issues vary from person to person depending on factors such as age, education, professional stature and locale. The following ethical dilemmas are designed to provoke thought and discussion. When evaluating the dilemma, consider the following questions.

- What are the issues of the situation (e.g., conflict of interest, due diligence, Circular 230 or IRC provisions)?
- What are the factors to consider in the situation (e.g., who is affected by the situation, what alternatives are available to those who must resolve the dilemma, what are the consequences of each alternative)?
- What is the appropriate action in the situation?

SITUATION #: ________

What are the issues? ________

Who is affected, what alternatives are available, and what are their consequences? ________

What is the appropriate action? ________

SITUATION #: ________

What are the issues? ________

Who is affected, what alternatives are available, and what are their consequences? ________

What is the appropriate action? ________

SITUATION 1

Jim and Janet Ashcroft ask Charles P. Anderson, a CPA and lawyer, to represent them for an audit of their 2005 tax return. Charles did not personally prepare their return that year, but he agrees. Jim and Janet file a power of attorney designating Charles as their representative. While they are preparing for the audit, Jim tells Charles, "You know, I did make a little income off the books that year giving singing lessons to some kids in the neighborhood. We never declared that income on the return." Understandably concerned, Charles asks, "What's a little income?" Jim replies, "Oh, about $15,000." The audit appointment is scheduled for next week.

What should Charles do about this income revelation?

SITUATION 2

After their audit, the Ashcrofts fail to pay Charles for the services rendered, saying they were "disappointed" with how the audit played out (in other words, that Jim was forced to disclose the $15,000 income from the singing lessons). Charles charges only the fees to which the parties previously agreed. The Ashcrofts' 2006 tax return was prepared, but not yet filed. The return is due next week. Charles is in possession of the completed return, a P&L statement that he prepared for Jim's business, original sales receipts and equipment leases from Jim's business, and a W-2 from Janet's part-time job as a secretary.

What can Charles do to have his fees paid?

SITUATION 3

Ronald E. Abernathy is an enrolled agent. He is preparing a 1040 return for tax year 2007 for Sharon and Izzy Osborne, who itemize their deductions. When Ronald gets to the part about deducting charitable contributions, Izzy asks, "What do most people claim?" Ronald responds that the IRS typically does not question deductions in the range of 3–5%, but that it's the actual amount of the contributions that matter. Seizing on the numbers that Ronald just cited, Sharon replies, "That's us; put down 5%."

What should Ronald do?

SITUATION 4

Jim is a revenue officer with the IRS. He receives a power of attorney from Quentin, a practitioner, authorizing Quentin to represent a taxpayer in a collection matter. Jim sends Quentin a request for information listing 12 specific records to be submitted within two weeks, which is a reasonable time under the circumstances. Quentin calls Jim the day before the information is due, stating that he is having trouble assembling the records, and requesting a one-week extension. Jim grants the extension. The day the information is due, Quentin submits three of the items under cover of a letter stating that the taxpayer went on vacation without turning over the other records. Then, over a period of two weeks, Jim leaves five phone messages for Quentin, none of which are returned. After Jim sends Quentin a certified letter requesting the records, Quentin calls and schedules a meeting. Quentin does not appear for the meeting, but calls the next day to say that since the taxpayer had not turned over the other records, there was no point in meeting.

Has Quentin subjected himself to an IRS penalty?

SITUATION 5

Allen is an enrolled agent. He represents two clients in connection with an IRS challenge to expenses claimed on a joint return filed in 2005. Betty and Barney are the clients and they were formerly married. Allen, concerned with a conflict of interest, informs Betty and Barney of his concerns, and fully discloses the possible conflict of interest. He advises them that his representation of them both is unlikely to negatively affect his exercise of independent professional judgment with respect to either of them.

However, after accepting the joint representation, Allen discovers an amendment to the code that provides for a more liberal construction of the "innocent spouse rule" of IRC §6013(e). What should Allen do?

SITUATION 6

Oscar Garcia, a professional baseball player, acquires a local sports bar during the year. The bar yields significant tax losses. On the advice of his accountant, Oscar consults with Hugh Loser, an expert in the area of passive loss rules. Oscar seeks advice regarding whether his participation in the business constitutes "material participation" under IRC §469. Hugh concludes that his involvement does meet this standard. With this information, Oscar's accountant prepares his return reflecting Hugh's advice.

Who is the preparer for Oscar's return?

SITUATION 7

Thad Venture, a member of an accounting firm, is engaged to prepare the corporate return of The Amber Corporation. Brock Thompson, another accountant in the same firm, has recently rendered an opinion on a financial statement of Chaos, Inc. as part of a registration statement filed with the Securities and Exchange Commission (SEC). In the course of preparing the Amber Corporation's return, Thad discovers information indicating that the SEC opinion prepared by Brock regarding Chaos, Inc. is misleading. Thad discloses this information to his partner, Brock.

Brock decides an amended statement needs to be filed with the SEC, informs the client (Chaos, Inc.), and advises the SEC. Brock explains that the information was revealed as part of a confidential disclosure which came to his attention after the statement was filed, but Brock does not disclose the identity of the Amber Corporation nor the tax return information itself.

Has there been a breach of confidentiality?

SITUATION 8

Chris Hanson is a tax practitioner who specializes in tax issues related to bankruptcy. He is engaged by Paddy O'Furniture to request a ruling from the IRS holding that income from the discharge of certain debt owed by Paddy to unrelated creditors is excludable under IRC §108. Chris plans to submit a copy of Paddy's valuation report as of the date of discharge, reflecting the extent of Paddy's insolvency prior to the discharge. Before filing the ruling request, Chris learns that Paddy's valuation report fails to reflect several additional assets which would significantly reduce the amount of Paddy's insolvency prior to the discharge.

Paddy instructs Chris to file the ruling request as originally drafted, omitting the new financial information. What should Chris do?

SITUATION 9

Mitchell Goebel consults Ron Johnson, an enrolled agent, concerning the tax consequences of making a gift of 500 shares of Apple stock, a publicly-traded corporation, to his daughter. Mitchell transferred the stock certificates to his daughter in June, when the fair market value of the stock was $120 per share. In December, when the value of the stock declined to $50 per share, Mitchell consults Ron concerning the gift tax consequences of the transfer. In general, the value of the stock on the date of the gift determines the donor's gift tax liability. Mitchell asks Ron to draft a document reflecting that the stock was transferred by gift in December, not June.

What should Ron do?

SITUATION 10

Samantha Tar is a very successful CPA. She primarily has a representation practice. She was asked to represent Crazy Eddie's Electronics in connection with a protest before the IRS Appeals Office. The IRS is challenging certain deductions made by Crazy Eddie's as failing to meet the requirement of IRC §183 (the activity was allegedly not entered into for profit). Samantha discovers three cases that seem to be "on all fours" with the Crazy Eddie's case. Two of the cases support her position, and one case supports the government position.

What should Samantha do with the negative impact case?

SITUATION 11

Cindy is an associate at a law firm in Chicago. She consults with Hunter, a CPA and lawyer, with respect to the tax consequences of her planned departure from the law firm for a one-year period to pursue an L.L.M. degree. Treas. Reg. §1.162-5 provides that Cindy may deduct her tuition expenses (as well as room and board) if the expense is incurred to improve or maintain her existing skills as a lawyer. Cindy stated that it is unlikely she will return to the law firm, and instead is pursuing an L.L.M. in hopes of landing a teaching job at a law school. Cindy asks Hunter to draft a "leave of absence" document to be signed by the firm, reflecting the fact that Cindy may return to the firm after her study and that the firm will keep a position open for her. Cindy believes that such a document gives her a defense if the deduction of her education expenses is challenged by the IRS.

Should Hunter draft the leave of absence document?

SITUATION 12

Brutus is Caesar's accountant. In preparing Caesar's 2006 income tax return, Brutus negligently overstates an item creating an apparent net operating loss (NOL) available to be carried forward to the next year. In the next year, Anthony takes over the preparation of Caesar's return. Anthony has no association with Brutus or his firm. Anthony prepares Caesar's 2007 return using information presented by Caesar, including a copy of his 2006 return. Anthony is unaware of the negligent overstatement, but checks the amount of the NOL claimed on the amended returns filed for the 3-year carryback period to determine what the proper amount of the NOL for the current year should be. Anthony then files the 2007 return.

Who is responsible for the mistakes on the returns?

CIRCULAR 230 CASE DEVELOPMENT

IRS OFFICE OF PROFESSIONAL RESPONSIBILITY REFERRALS

Sources of Referrals

Referrals concerning attorneys, CPAs, and EAs are received by the OPR and then processed by the Enforcement Unit. Referrals come to the office through internal IRS sources, as well as from external sources such as taxpayers, state licensing authorities, the Department of Justice, and other tax professionals.

The Three-Part Screening Process

1. **Determine jurisdiction**. The OPR must first determine whether it has jurisdiction over the practitioner. The office has jurisdiction over attorneys, certified public accountants, enrolled agents and appraisers. Enrolled actuaries, while cited in the regulations, actually come under the jurisdiction of the Joint Board for Enrollment of Actuaries, an entity under the auspices of the Department of Labor and the IRS.

2. **Determine whether alleged misconduct is actionable**. Not every type of wrongdoing is a matter that should come before the OPR. For example, the OPR would not open a case on a practitioner who has been sued by a former employee for sexual harassment, or who received a series of parking tickets. The misconduct must be of a type contemplated by Circular 230. Section 10.51 defines "disreputable conduct" as including, but not limited to, certain enumerated actions. However, this should not be read as a "catch-all" provision; the conduct, even if not covered by the subsequent paragraphs in Section 10.51, should be of the same general type as the conduct described therein.

3. **Determine whether alleged misconduct is timely**. As a matter of policy, the OPR generally does not pursue allegations of which the IRS knew or should have known of the misconduct more than five years before the date upon which a proceeding can reasonably be expected to be instituted. In cases involving relatively minor allegations, the Chief of Enforcement may, in his discretion, employ an even more stringent timeliness standard.

Gathering Evidence

An enforcement attorney and a paralegal identifies and takes action to collect the appropriate types of evidence. The enforcement attorney, together with the team chief, reviews the evidence and determines if it supports the allegations of misconduct. For example, in a case involving the submission of false or misleading information (Section 10.51 (b)), the enforcement attorney likely secures the returns at issue, as well as any audit work papers or revenue agent reports. In some cases, he makes requests for information under Section 10.20 in order to develop the facts.

ISSUANCE OF ALLEGATION LETTERS

Should the IRS Issue a Letter?

After initial screening and fact finding, the OPR must decide whether to issue an allegation letter. Either the case moves forward for the issuance of an allegation letter, is held for further consideration, or is closed without action. Among the factors to consider in determining whether to issue an allegation letter are:

- The weight of the evidence,
- The framing of the charges (i.e., which sections of Circular 230 apply),
- Possible defenses the practitioner could raise,
- The range of acceptable penalties that might be appropriate if the allegations are proven true, and
- The potential impact of case (is it high-profile or likely to break new ground for the office).

The Allegation Letter

The enforcement attorney summarizes the allegations based upon the evidence provided. The allegations cite specific sections and paragraphs of Circular 230. The practitioner generally is not informed of the exact sanction that may be imposed; the letter may simply state that the OPR is considering instituting a proceeding for the practitioner's "disbarment or suspension from practice before the IRS." An appropriate sanction may reveal itself during settlement discussions, and, ultimately, must be specified in the complaint.

While the allegation letter may be sent to the practitioner at work, home, or to a post office box, the complaint must be served upon the practitioner at his last known address, as reflected on the most recent Form 1040 return filed with the IRS, pursuant to Section 10.63(a)(2) or (3). Thus, this is an appropriate time to secure the practitioner's home address.

Each enforcement attorney maintains a tickler system to monitor practitioner responses. The allegation letter states that a response is due within 30 days, but the practitioner may request an extension of time to gather evidence and/or retain a representative. Further extensions may be granted with appropriate approval.

EVALUATION OF RESPONSES, SETTLEMENT NEGOTIATIONS, AND PRE-LITIGATION PROCEDURES

The Initial Response

Affording the practitioner an opportunity to respond to the allegations before the issuance of a complaint is a "win-win" situation. It is often in the practitioner's interest to avoid a disciplinary proceeding by affirmatively responding to the allegations, and it is likewise in the interests of the OPR not to pursue allegations that are unlikely to be substantiated. The practitioner's response is evaluated according to the following factors:

- The sufficiency of the defense (taken as true)
- The persuasiveness of the defense (*i.e.*, the probability that the defense will be believed)
- The availability of documentary evidence and the credibility of witnesses that the practitioner is anticipated to utilize in his defense

OPR Reaction

The OPR sometimes conducts supplemental reviews to determine if it can rebut the practitioner's defenses before determining whether the case should be "Closed Without Action." If the practitioner's response is sufficient to overcome all of the stated allegations, the enforcement attorney issues a "Closed Without Action" letter. If the practitioner's response is sufficient to overcome some, but not all, of the allegations, the enforcement attorney contacts the practitioner or his representative by telephone and explains why the other charges remain unresolved. If the response is inadequate, the OPR matter proceeds.

Conferences

When a practitioner so requests, the OPR affords the practitioner or his representative a conference. Section 10.61(a) does not specify the manner in which the conference may be held. The enforcement attorney offers the following options to practitioners: (1) a face to face meeting with the practitioner and his representative at the OPR office in Washington, or (2) a telephone conference call with the practitioner and his representative from the respective offices of all parties.

POTENTIAL SANCTIONS

General

The OPR is required to state what sanction it is seeking when it initiates a proceeding through a formal complaint (see Section 10.62(b)). This decision by the OPR has important consequences for the case, because the administrative law judge (ALJ) will apply a heightened burden of proof ("clear and convincing evidence") to a case in which the OPR seeks disbarment or a suspension of six months or greater. The goal is to recommend a penalty that is commensurate with the misconduct at issue (i.e., the punishment should fit the crime).

Factors

Circular 230 provides no hard and fast formula for determination of the appropriate sanction in each case. Generally, the OPR looks at:

- The nature and severity of the offense(s) in question, including injury to the client, "the tax system," and the public;
- The repetitiveness of the conduct (i.e., a pattern of behavior is generally more serious than an isolated incident);
- The practitioner's prior disciplinary history, if any, with the OPR;
- Any aggravating factors (e.g., sum of money, motive, frequency) or mitigating factors (e.g., health problems, contrition) which may be present; and
- The impact that not adequately disciplining the practitioner would have on tax administration, the confidence of the practitioner community and the taxpaying public in the enforcement efforts.

ANATOMY OF A DISCIPLINARY PROCEEDING

Administrative Law Judge Proceeding

Circular 230 is not specific about the conduct of hearings. Individual ALJs may set forth particular requirements for the conduct of such proceedings, but Circular 230 proceedings typically move forward in the following fashion:

- General Legal Services (GLS) files a complaint on behalf of the director of the OPR. The complaint is filed with the chief ALJ and served upon the practitioner at his last known residential address as reflected on his 1040 return. For practical purposes, GLS serves the complaint at another place if the practitioner or his representative so requests.

- The practitioner either files a responsive pleading (such as an answer or motion to dismiss), or fails to respond, in which case GLS can move for a decision by default.
- The chief ALJ designates himself or another ALJ to preside over the case and sends out an Order of Designation to the parties notifying them of same.
- The ALJs send out a pre-hearing order, which usually requires the parties to report on the progress of settlement discussions (without disclosing the terms of such discussions to the ALJ). Should a settlement result prior to a hearing, an "acceptance letter" acknowledging receipt of the practitioner's settlement offer and accepting the practitioner's offer of consent to the sanction in question is prepared. This letter must be approved and signed by the director of OPR. If there is no settlement, the parties are usually required to exchange witness lists and copies of documentary evidence they intend to offer at the hearing.
- The parties may, in rare instances, move for leave to take the deposition of a witness in advance of the hearing. In such instances, the party must demonstrate to the ALJ that simply having the witness testify at the hearing is not sufficient, either because the witness would be unavailable at the hearing, or because having the deposition testimony in advance of the hearing is critical for the preparation of the party's case.
- Although not expressly provided for by Circular 230, the parties may move for summary judgment.
- The hearing is held in the presence of a certified court reporter. These hearings are closed to the public unless the practitioner requests that it be opened. When proceedings are opened to the public, care is taken to safeguard confidential taxpayer information from unauthorized disclosure.
- The parties may be required to submit post-hearing briefs and/or proposed findings of fact and conclusions of law. Some ALJs prefer oral closing arguments at the conclusion of the hearing.
- The ALJ issues an initial decision, first determining whether misconduct occurred and then evaluating the misconduct for determination of the appropriate sanction.

Disposition of ALJ Decisions and Processing of Appeals

Should an ALJ issue a decision authorizing any sanction at all, the practitioner has 30 days to appeal this decision to the Secretary of the Treasury. If the ALJ issues a decision dismissing the complaint, or if the sanction is considered by the OPR to be too lenient, the OPR will request that GLS file an appeal with the Secretary of the Treasury.

If there is no appeal within 30 days, the ALJ decision becomes the final agency decision. If an appeal is filed, the decision by the Secretary, or the Secretary's designee is the final agency decision. Final agency decisions can be challenged in Federal District Court, but these challenges are rare and there are very few reported decisions.

The IRS and the Department of Justice often seek injunctive relief to prevent the promotion of fraudulent and abusive tax schemes, including the promotion of frivolous return positions. The OPR looks at each injunction case involving a Circular 230 practitioner to determine whether additional action may be necessary or appropriate. Some injunctions issued by the district courts include relief that has the effect of barring practitioners from representing clients before the IRS. This may be viewed as tantamount to disbarment, making the OPR action moot. In other cases, the injunction only proscribes certain abusive practices, but still allows a practitioner to represent clients before the IRS. The findings of fact by the District Court in such a case could be cited in the OPR proceeding. Additionally, preliminary injunctions barring representation of clients before the IRS are, by their very nature, temporary, and may require OPR follow-up.

Disclosure of Result to State Licensing Authority

One initiative actively being pursued by the OPR is increased sharing of information with state licensing authorities. Notice of the fact that a practitioner has been disbarred, suspended or censured is currently published in the Internal Revenue Bulletin. As such, the fact that discipline was imposed is a matter of public record. However, absent a request by the practitioner that the proceeding be made public, the OPR does not have the ability to disclose the nature of the underlying allegations. This is frustrating to those state licensing authorities whose own rules require more information than is currently available from the OPR before determining whether to take reciprocal action. Some jurisdictions have obtained consent to disclose from the attorney or CPA, permitting the OPR to share information about the basis for the disciplinary action.

As part of the next revision of Circular 230, the OPR will propose that disciplinary proceedings be open to the public. This approach would provide greater accountability for both the OPR and practitioners, and would enable the OPR to develop a body of cases that can be used to interpret and apply Circular 230.

ENGAGEMENT LETTERS

Many legal issues between clients and tax preparers can be prevented if an engagement letter is given to the client. While it takes time to draft the proper engagement letter, there are numerous benefits to the firm. If work is being performed for multiple entities, an engagement letter should be provided to each entity. In the past, engagement letters were primarily a boilerplate one-size-fits-all letter. However, the services offered by tax professionals and accountants have grown and the engagement letter must change accordingly. At one time, there was a personal relationship between the preparer and the client. This is less likely to be the case today, and consequently, the tax preparer is more likely to find himself involved in a legal action. An engagement letter should discuss the following:

1. Confirm what the client can expect from the firm.
   - **a.** Accurate tax returns?
   - **b.** Timely returns?
2. Confirm what the firm expects from the client.
   - **a.** Completed organizer?
   - **b.** Prompt submission of information?
   - **c.** Prompt response to telephone calls?
3. List all services provided.
   - **a.** Tax preparation?
   - **b.** Electronic filing?
   - **c.** Bookkeeping?
   - **d.** Tax planning?
4. List services which are not included in the engagement.
   - **a.** Estate planning?
   - **b.** Audits?
   - **c.** Financial planning?
5. Discuss how “grey” areas of the law are handled.

6. State the length of the engagement.
   a. One year?
   b. Ongoing until written termination notice received?
7. Discuss how penalties are handled.
8. Discuss fees.
   a. Method of billing (such as hourly or by form)?
   b. Retainers?
   c. Length of time to pay after bill received?
   d. Interest assessed on late payments?
9. Discuss record retention and confidentiality.
10. Discuss how conflict of interest issues are handled.
11. Discuss how disagreements are handled.
    a. Arbitration
12. Omit certain terms from the engagement letter.
    - "We are the best."
    - "We have the highest quality staff."
    - "We go above and beyond professional standards."
    - "We guarantee the results of this engagement."
    - "Our fee will not exceed $XXXXX."

An engagement letter should be designed to meet the needs of both the client and the firm. Therefore, a one-size-fits-all approach cannot be taken. **A sample engagement letter is not included in this workbook because it would not be appropriate for all readers.** If a sample letter is desired, searching on the Internet for "tax preparation engagement letter" will generate many hits. Practitioners can often obtain sample letters or suggestions from their liability insurance carriers or professional associations.

A well-constructed engagement letter should be given to each client for his signature. This letter is then maintained in the client's permanent file.

Some practitioners have taken the approach of using a negative engagement letter. The "negative letter" is sent with the client organizer each year. The letter ends with language which says "unless otherwise notified, the firm understands the client has agreed to all of the terms in the letter."

A signed letter is much better than a negative letter. A firm may wish to format the letter as a signed letter, but include a "negative" statement. Attempts should be made to get a signature, however. The negative letter is preferable to no letter at all.

ETHICAL DILEMMA SCENARIOS — DISCUSSION AND SUGGESTIONS

SITUATION 1

Jim and Janet Ashcroft ask Charles P. Anderson, a CPA and lawyer, to represent them for an audit of their 2005 tax return. Charles did not personally prepare their return that year, but he agrees. Jim and Janet file a power of attorney designating Charles as their representative. While they are preparing for the audit, Jim tells Charles, "You know, I did make a little income off the books that year giving singing lessons to some kids in the neighborhood. We never declared that income on the return." Understandably concerned, Charles asks, "What's a little income?" Jim replies, "Oh, about $15,000." The audit appointment is scheduled for next week.

What should Charles do about this income revelation?

Issues. There are several issues in this situation.The first is whether the singing lesson income is taxable to Jim. This income is taxable.

Another issue is that Charles knows the details of the omission. Section 10.21, *Knowledge of Client's Omission*, in Treasury Department Circular 230 requires that Charles notify the client promptly that the $15,000 is taxable and advise him of the consequences of such noncompliance. If Jim refuses to report the income, and Charles presses on with representing him at the audit, he runs the risk of becoming an accomplice to his false statement. This is the case either through his silence as Jim lies in response to a direct question, or through his continuing to serve as Jim's representative at the audit despite his failure to correct an omission of which he has now been made aware.

Factors to Consider. The U.S. government is obviously affected by the failure to report income. They lose the tax revenue which should be paid on the income. Jim is affected because he committed fraud. Charles may be affected depending on how he handles the issue.

Charles should explain to Jim that he needs to "come clean" about the side income; that's the easy part. He may be able to blunt the impact with some legitimate business deductions.

Another alternative for Charles is to prepare a draft of an amended return (Form 1040X) based on this new information. Charles must ask permission from the Ashcrofts to present this information at the audit.

Appropriate Action. The appropriate action is to report the income at the audit. If Jim refuses, Charles should decline the engagement.

SITUATION 2

After their audit, the Ashcrofts fail to pay Charles for the services rendered, saying they were "disappointed" with how the audit played out (in other words, that Jim was forced to disclose the $15,000 income from the singing lessons). Charles charges only the fees to which the parties previously agreed. The Ashcrofts' 2006 tax return was prepared, but not yet filed. The return is due next week. Charles is in possession of the completed return, a P&L statement that he prepared for Jim's business, original sales receipts and equipment leases from Jim's business, and a W-2 from Janet's part-time job as a secretary.

Issues. Can Charles withhold documents from the Ashcrofts as he attempts to collect his fees?

Factors to Consider. Jim and Janet Ashcroft are affected by any nonfiling. Charles is affected by not getting paid, and may be liable for any damages to the Ashcrofts resulting from his withholding of documents. The government is also affected if the return is not filed timely and any taxes due are not paid.

Charles can insist on payment for his audit work before the return is electronically filed and indicate that he will not do so until payment is made.

Appropriate Action. Charles should not have to work for free, but the decision to return a document to a former client depends on the nature of the document. If it is necessary for the taxpayer to attach it to the tax return, the original document must be returned. If it is necessary for the taxpayer to review it in order to complete the return, the original document may be retained unless state law provides otherwise, but taxpayer must be given a copy. Work products of the practitioner, including a fully or partially completed return prepared for the client, do not have to be given to the client.

In this case, Charles need not turn over the 2006 return that he prepared, nor does he need to turn over the P&L from Jim's business, since these documents are his own work product for which he has not been paid. Review of original sales receipts will probably be necessary for the preparation of the return by someone else, but since these need not be attached to the return, copies will suffice, so long as withholding the originals is not prohibited by state law. Obviously, the Form W-2 from Janet's part-time job must be attached to the return, so the original must be given back to the Ashcrofts. See Section 10.28, *Return of Client's Records*, in Circular 230.

SITUATION 3

Ronald E. Abernathy is an enrolled agent. He is preparing a 1040 return for tax year 2007 for Sharon and Izzy Osborne, who itemize their deductions. When Ronald gets to the part about deducting charitable contributions, Izzy asks, "What do most people claim?" Ronald responds that the IRS typically does not question deductions in the range of 3–5%, but that it's the actual amount of the contributions that matter. Seizing on the numbers that Ronald just cited, Sharon replies, "That's us; put down 5%."

Issues. What should Ronald do to ensure due diligence?

Factors to Consider. The U.S. government is affected by any reduction in amount of tax actually owed. The Osbornes are affected since they may be committing tax fraud. Ronald is affected if he does not follow the procedures listed in Circular 230.

Ronald should steer the conversation back to the actual dollar amount of the contributions in order to assess how accurate Sharon's assertion really is.

Ronald can ask which organizations they gave contributions to, how much they gave, and what kind of documentation they have to back it up (e.g., canceled checks and receipts). The IRS does require receipts for individual contributions. If the Osbornes fumble around for answers to these questions, Ronald should encourage them to scale back the deduction they are claiming to that which can be documented.

Appropriate Action. The appropriate action is to file the return with deductions that can be documented. If this does not occur, Ronald may want to cancel the engagement.

SITUATION 4

Jim is a revenue officer with the IRS. He receives a power of attorney from Quentin, a practitioner, authorizing Quentin to represent a taxpayer in a collection matter. Jim sends Quentin a request for information listing 12 specific records to be submitted within two weeks, which is a reasonable time under the circumstances. Quentin calls Jim the day before the information is due, stating that he is having trouble assembling the records, and requesting a one-week extension. Jim grants the extension. The day the information is due, Quentin submits three of the items under cover of a letter stating that the taxpayer went on vacation without turning over the other records. Then, over a period of two weeks, Jim leaves five phone messages for Quentin, none of which are returned. After Jim sends Quentin a certified letter requesting the records, Quentin calls and schedules a meeting. Quentin does not appear for the meeting, but calls the next day to say that since the taxpayer had not turned over the other records, there was no point in meeting.

Issues. Has Quentin unreasonably delayed the prompt disposition of matters pending before the IRS in violation of section 10.23 of Circular 230?

Factors to Consider. The U.S. government is affected because it is not getting taxes owed to it. Jim's duties are being delayed by spending so much time on this matter.

The request for the extension was reasonable, although Quentin should not have waited until the last minute to make the request. Quentin established a pattern of delay, in that he:

- Did not notify Jim that he expected to submit fewer records than requested,
- Offered a weak excuse for submitting fewer records than requested (in view of the pending records request, he should have been aware of the taxpayer's plans),
- Ignored a number of phone messages,
- Failed to attend a scheduled meeting without a reasonable explanation, and
- Gave no indication of good faith efforts to dispose of the pending matters.

Appropriate Action. The practitioner should be sanctioned pursuant to Circular 230.

> **Caution.** The IRS may choose to disregard the power of attorney and deal directly with the taxpayer.

SITUATION 5

Allen is an Enrolled Agent. He represents two clients in connection with an IRS challenge to expenses claimed on a joint return filed in 2005. Betty and Barney are the clients and they were formerly married. Allen, concerned with a conflict of interest, informs Betty and Barney of his concerns, and fully discloses the possible conflict of interest. He advises them that his representation of them both is unlikely to negatively affect his exercise of independent professional judgment with respect to either of them.

However, after accepting the joint representation, Allen discovers an amendment to the Code that provides for a more liberal construction of the "innocent spouse rule" of IRC §6013(e). What should Allen do?

Issues. Despite Allen's full disclosure, this is a conflict of interest situation. Allen has new information which could have an enormous effect on how Betty responds to the IRS challenge.

Factors to Consider. Betty, Barney, and Allen are all affected by this situation.

In this situation, Allen may be required to argue the innocent spouse rule to the detriment of Barney. He must obtain the informed consent of each client to continue the representation.

Appropriate Action. Allen should resign from the engagement. He is in a situation where he cannot win. Regardless of what action Allen takes, he will lose one of the clients and possibly both. If during the course of representing multiple clients, the practitioner becomes aware of facts indicating that he cannot adequately represent each client's interests, the practitioner must generally withdraw from both sides. The problem cannot be cured by the practitioner simply removing himself from one side.[5]

SITUATION 6

Oscar Garcia, a professional baseball player, acquires a local sports bar during the year. The bar yields significant tax losses. On the advice of his accountant, Oscar consults with Hugh Loser, an expert in the area of passive loss rules. Oscar seeks advice regarding whether his participation in the business constitutes "material participation" under IRC §469. Hugh concludes that his involvement does meet this standard. With this information, Oscar's accountant prepares his return reflecting Hugh's advice.

Issues. Does Hugh's advice mean that he is an income tax preparer for Oscar's return?

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5. See *Devore v. Comm'r,* 963 F.2d 280 (9th Cir. 1990) (a case in which an attorney's joint representation of husband and wife, who were divorced prior to the time their tax litigation commenced, may have created a conflict of interest preventing the attorney from raising defenses on husband's behalf).

Factors to Consider. Oscar, his accountant, and Hugh are all affected by the situation. Is Hugh considered a tax preparer in this situation?

Appropriate Action. Because Hugh's advice is given about events that have previously occurred and is directly relevant to an entry on Oscar's return, Treas. Reg. §301.7701-15(a)(2) states that Hugh's advice constitutes preparation of that item.

SITUATION 7

Thad Venture, a member of an accounting firm, is engaged to prepare the corporate return of The Amber Corporation. Brock Thompson, another accountant in the same firm, has recently rendered an opinion on a financial statement of Chaos, Inc. as part of a registration statement filed with the Securities and Exchange Commission (SEC). In the course of preparing the Amber Corporation's return, Thad discovers information indicating that the SEC opinion prepared by Brock regarding Chaos, Inc. is misleading. Thad discloses this information to his partner, Brock.

Brock decides an amended statement needs to be filed with the SEC, informs the client (Chaos, Inc.), and advises the SEC. Brock explains that the information was revealed as part of a confidential disclosure which came to his attention after the statement was filed, but Brock does not disclose the identity of the Amber Corporation nor the tax return information itself.

Issues. This is a disclosure case that falls under IRC §7216(a). How much information can an accountant disclose about a client?

Factors to Consider. Both clients are affected in this situation, but the greater impact is on the accountants dealing with confidential client information. The Amber Corporation's information is shared with another accountant at the same firm for reasons not related to Amber's return preparation. Chaos, Inc. has its SEC filing corrected because of the diligence of the firm.

Example 1 of Treas. Reg. §301.7216-2(e) deals with a similar situation. The regulations conclude that the disclosure of The Amber Corporation's return information from Thad to Brock, and the use of such information by Brock in advising Chaos Inc. and the SEC of the necessity of amending their statement is not prohibited under IRC §7216(a). However, the regulation indicated that the disclosure of the Amber Corporation's return information to Chaos Inc., or the SEC would be prohibited without the consent of the Amber Corporation.

Appropriate Action. Thad and Brock acted appropriately in this situation.

SITUATION 8

Chris Hanson is a tax practitioner who specializes in tax issues related to bankruptcy. He is engaged by Paddy O'Furniture to request a ruling from the IRS holding that income from the discharge of certain debt owed by Paddy to unrelated creditors is excludable under IRC §108. Chris plans to submit a copy of Paddy's valuation report as of the date of discharge, reflecting the extent of Paddy's insolvency prior to the discharge. Before filing the ruling request, Chris learns that Paddy's valuation report fails to reflect several additional assets which would significantly reduce the amount of Paddy's insolvency prior to the discharge.

Paddy instructs Chris to file the ruling request as originally drafted, omitting the new financial information. What should Chris do?

Issues. The issue is whether Chris is using correct data to prepare Paddy's ruling request.

Factors to Consider. The U.S. government is affected if Paddy has excluded amounts from his income that are subject to tax. Paddy may be committing fraud if the valuation report is understated and Chris may be in violation of Section 10.21 if he does not advise Paddy of his concern.

Paddy has the option of reporting the correct valuation. Chris can discuss the situation with Paddy.

Appropriate Action. Chris should discuss his suspicion with Paddy. If he insists the valuation report is correct, Chris may want Paddy to give him a written record of the assets' valuation for his file. If Chris is still convinced Paddy is lying, he should decline the engagement to file the ruling request.

SITUATION 9

Mitchell Goebel consults Ron Johnson, an enrolled agent, concerning the tax consequences of making a gift of 500 shares of Apple stock, a publicly-traded corporation, to his daughter. Mitchell transferred the stock certificates to his daughter in June, when the fair market value of the stock was $120 per share. In December, when the value of the stock declined to $50 per share, Mitchell consults Ron concerning the gift tax consequences of the transfer. In general, the value of the stock on the date of the gift determines the donor's gift tax liability. Mitchell asks Ron to draft a document reflecting that the stock was transferred by gift in December, not June.

What should Ron do?

Issues. This is a documentation, timing and tax planning issue.

Factors to Consider. The U.S. government is affected if Mitchell understates the value of his gift. Mitchell is committing fraud if a document is created changing the date of the gift, and Ron may be in violation of Section 10.22 if he does not advise Mitchell of his concern.

Ron is not required to draft the document in any manner Mitchell desires. However, since he has knowledge that the date Mitchell is proposing for the document is wrong, he should question Mitchell.

Appropriate Action. Ron is clearly prohibited from drafting a document in a manner that falsely describes the date of transfer, and may be subject to criminal penalty for doing so.

SITUATION 10

Samantha Tar is a very successful CPA. She primarily has a representation practice. She was asked to represent Crazy Eddie's Electronics in connection with a protest before the IRS Appeals Office. The IRS is challenging certain deductions made by Crazy Eddie's as failing to meet the requirement of IRC §183 (the activity was allegedly not entered into for profit). Samantha discovers three cases that seem to be "on all fours" (directly on point) with the Crazy Eddie's case. Two of the cases support her position, and one case supports the government position.

Issues. Must Samantha tell the IRS about the negative impact case?

Factors to Consider. The U.S. government will be affected if it loses the case. Crazy Eddie's will also be affected if it loses the case since it will owe additional taxes, penalties, and interest.

Samantha has no responsibility to prove the case for the IRS. Her responsibility is to Crazy Eddie's.

Appropriate Action. Samantha's effectiveness in advocating her client's position is enhanced by citing all three cases to the IRS and distinguishing the adverse authority. While Samantha is not required to cite the adverse authority, she is prohibited from affirmatively misleading the IRS. Therefore, any statement in Samantha's memorandum indicating that her statement of the law is complete would subject Samantha to possible penalty. In most situations, the practitioner's effective advocacy of the client's position will be enhanced by providing the IRS with a full statement of the law.

Additionally, Samantha should notify Crazy Eddie's of the negative case. If the IRS offers to settle the case, Crazy Eddie's needs to know it could lose if the IRS found the case.

SITUATION 11

Cindy is an associate at a law firm in Chicago. She consults with Hunter, a CPA and lawyer, with respect to the tax consequences of her planned departure from the law firm for a one-year period to pursue an L.L.M. degree. Treas. Reg. §1.162-5 provides that Cindy may deduct her tuition expenses (as well as room and board) if the expense is incurred to improve or maintain her existing skills as a lawyer. Cindy stated that it is unlikely she will return to the law firm, and instead is pursuing an L.L.M. in hopes of landing a teaching job at a law school. Cindy asks Hunter to draft a "leave of absence" document to be signed by the firm, reflecting the fact that Cindy may return to the firm after her study and that the firm will keep a position open for her. Cindy believes that such a document gives her a defense if the deduction of her education expenses is challenged by the IRS.

Should Hunter draft the leave of absence document?

Issues. This is a tax planning, documentation, and taxpayer intent issue.

Factors to Consider. Cindy is affected by this situation, because pursuing an L.L.M. without the tax deductions may not be possible for her. Hunter is affected by this, because he is being asked to produce a document that may be fraudulent.

Hunter has two choices. He can refuse to write the document if he thinks that it is fraudulent, or he can question Cindy further regarding her plans following the completion of her L.L.M. to see if she may return to the practice of law.

Appropriate Action. Although Cindy hopes to find a teaching job, Hunter would be ethically permitted to draft the leave of absence document, provided Cindy retains some interest in returning to the firm. Since Cindy may decide to return to the firm if her teaching career does not materialize, the document serves a legitimate need. It protects Cindy's options in the event her plans do not develop as hoped.

SITUATION 12

Brutus is Caesar's accountant. In preparing Caesar's 2006 income tax return, Brutus negligently overstates an item creating an apparent net operating loss (NOL) available to be carried forward to the next year. In the next year, Anthony takes over the preparation of Caesar's return. Anthony has no association with Brutus or his firm. Anthony prepares Caesar's 2007 return using information presented by Caesar, including a copy of his 2006 return. Anthony is unaware of the negligent overstatement, but checks the amount of the NOL claimed on the amended returns filed for the 3-year carryback period to determine what the proper amount of the NOL for the current year should be. Anthony then files the 2007 return.

Issues. This is an issue that results from the involvement of multiple preparers. Who is responsible for the mistakes made on the 2006 and 2007 returns?

Factors to Consider. The U.S. government is affected due to uncollected taxes owed. Caesar is affected because his returns are incorrect. Brutus is affected by his own negligence, but Anthony is also affected by using Brutus's erroneous NOL.

At this point, no one is aware that a problem exists. However, if the problem is found, Caesar should certainly look to Brutus and Anthony for an explanation.

Responsibility. Because the NOL item constitutes a substantial portion of the 2007 return, Brutus is considered to be a preparer of that return. Although Anthony is also a preparer of the 2007 return, he is not subject to penalty under IRC §6694 since the understatement on the 2007 return is not due to his conduct. Brutus is subject to penalty under IRC §6694(a) with respect to both years.