Chapter 5: Ethics

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Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

REGULATION OF TAX PRACTITIONERS: UPCOMING CHANGES

Circular 230 defines "practice" before the IRS as encompassing all matters connected with a presentation to the IRS or its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS.[1] This includes preparing and filing documents, corresponding, and communicating with the IRS. It also includes providing written advice regarding any entity, transaction, plan or arrangement, or any plan or arrangement having a potential for tax avoidance or evasion, and representing clients at conferences, hearings, and meetings. Circular 230 specifically states that none of its provisions may be construed as authorizing nonlawyers to practice law.[2]

All practitioners **must comply** with the requirements of Circular 230 when practicing before the IRS. Any individual who prepares or assists with the preparation of a tax return or claim for refund for compensation must have a preparer tax identification number (PTIN).[3] The Office of Professional Responsibility (OPR) may discipline practitioners who violate the rules of the circular. Disciplinary measures include public censure, suspension or disbarment from practice before the IRS, and monetary fines.[4] Other ethical standards also may apply to practitioners, such as rules of professional conduct governing lawyers and CPAs. Clients also may institute civil actions against practitioners for substandard work done on tax matters.

Note. Circular 230 provides that a person who is a tax return preparer under IRC §7701(a)(36) also is a tax return preparer subject to the rules of Circular 230.[5] The scope of this provision is unclear. For example, an accountant who advises a client about the tax treatment of a transaction on a tax return may be considered a return preparer under IRC §7701 if the issue involves a substantial tax liability. It is questionable, however, whether the accountant is a return preparer subject to the requirements of Circular 230 if they do not prepare other returns or otherwise practice before the IRS.

1. Circular 230, §10.2(a)(4).
2. Circular 230, §10.32.
3. Circular 230, §10.8.
4. Circular 230, §10.50.
5. Circular 230, §10.2.

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On September 17, 2012, the Department of the Treasury published **proposed regulatory changes** to Circular 230.[6] In the preamble to the proposed regulations, the Department of the Treasury stated that several changes were necessary, including the following.

- Eliminate the complex covered opinion rules
- Expand the requirements for written tax advice
- Broaden the rules to which firm managers must adhere to ensure Circular 230 compliance by their employees and associates
- Provide a definition of competence

This chapter addresses the proposed changes to Circular 230 as well as other key sections of Circular 230.

> **Note.** Although the discussion period for these proposed changes closed November 16, 2012, no action has yet been taken on these proposed changes at the time this chapter went to press.

REGISTERED TAX RETURN PREPARERS (RTRP) STATUS

A recent decision by the U.S. District Court for the District of Columbia invalidated the provisions of Circular 230 regulating tax return preparers, holding that the statute allowing the Treasury to regulate **representatives** who practice before the IRS does not apply to tax return preparers.[7] The decision applies to the regulations issued in 2011 that require certain tax return preparers to pass a qualifying examination, pay an annual application fee, and take a specified number of continuing education courses each year.[8] The court issued a declaratory judgment that the IRS lacks the statutory authority to promulgate or enforce its new regulatory scheme for RTRPs. The court also issued a permanent injunction barring the IRS from enforcing its registration requirements for tax return preparers. The decision does not affect the provisions of Circular 230 relating to practitioners such as lawyers, CPAs, and enrolled agents.

The IRS appealed the decision to the U.S. Court of Appeals for the District of Columbia, maintaining that the regulations are a valid interpretation of an ambiguous statute authorizing the agency to regulate tax practice. In its reply brief, the plaintiff tax return preparers argued that the district court correctly determined that the statute is unambiguous in its description of "practice" as advising and assisting persons in presenting their cases — a definition that excludes tax return preparation.[9] The tax return preparers' brief describes the RTRP regulations as an "unprecedented federal licensing scheme" that exceeds the boundaries of the statute the IRS relies upon.

> **Note.** If the district court's decision is affirmed on appeal, a new law from Congress will be required for the IRS to regulate tax return preparers. In that situation, a new statute may authorize the IRS to impose more complex, burdensome, and expensive requirements on tax return preparers.

> **Observation.** At the time this book went to press, oral arguments in connection with the injunction that now precludes the IRS from enforcing the RTRP rules were scheduled in the D.C. Court of Appeals for **September 24, 2013.**

6. Federal Register, Vol. 77, No. 180.
7. *Loving et al. v. IRS et al.,* No. 1:12-cv-00385-JEB, D.C. Cir. (Jan. 18. 2013).
8. See Regulations Governing Practice before the Internal Revenue Service, 76 Fed. Reg. 32286 (Jun. 3, 2011).
9. *Loving et al. v. IRS et al.*, No. 13-05061, D.C. Cir. (May 17, 2013).

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2013 Workbook

PTIN REGISTRATION

Although the court injunction precludes the IRS from enforcing the RTRP-related program and regulations, **the PTIN requirements remain intact** and the PTIN registration process continues to be administered by the IRS.

A PTIN may be applied for or renewed through the IRS website or using Form W-12, *IRS Paid Preparer Tax Identification Number (PTIN) Application and Renewal.* Both alternatives ask the applicant about past felony convictions, federal tax compliance, and professional credentials without any further background information being requested from the applicant. The IRS has indicated that proposals are still being considered to bolster the level of background and suitability checks through the PTIN registry, including fingerprinting.[10]

> **Observation.** Because the PTIN process must be used by all tax return preparers (including CPAs, attorneys, and enrolled agents), a PTIN suitability and background check covers all preparers.

USE OF CLIENT INFORMATION

A practitioner must promptly submit information or records properly requested by the IRS unless the practitioner has a good faith, reasonable belief that the information is privileged.[11] If the practitioner or client does not possess or control the requested records or information, the practitioner must promptly notify the IRS and provide information about the identity of anyone the practitioner believes may have possession or control of such materials.[12] Consequently, a practitioner may not simply ignore an IRS request for documents or information.

A practitioner must make a "reasonable inquiry" of a client about the possession or control of the records or information, but need not question any other person or independently verify information a client provides regarding the identity of such persons.[13] A practitioner may not interfere with a proper and lawful IRS effort to obtain records or information unless the practitioner has a good faith, reasonable belief that the record or information is privileged.[14] Upon a proper and lawful request by an IRS officer or employee regarding an alleged violation of Circular 230, a practitioner must provide information concerning the alleged violation and testify about this information in any proceeding, unless the practitioner has a good faith and reasonable belief that the information is privileged.[15]

A practitioner who knows that a client has not complied with the U.S. tax laws or has made an error or omission with respect to any return, document, affidavit, or other paper submitted or executed under such laws must promptly advise the client about the noncompliance, error, or omission.[16] This duty to advise the client of the error or omission does not require further advice regarding corrections, additional tax payments, or refund requests. In many situations, however, further advice may be appropriate.

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10. *Frequently Asked Questions: Fingerprinting Requirements.* Apr. 12, 2013. [www.irs.gov/Tax-Professionals/Frequently-Asked-Questions:-Fingerprinting-Requirements] Accessed on Jul. 11, 2013.
11. Circular 230, §10.20(a)(1).
12. Circular 230, §10.20(a)(2).
13. Ibid.
14. Circular 230, §10.20(c).
15. Circular 230, §10.20(a)(3).
16. Circular 230, §10.21.

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Note. A practitioner is not required to advise a client to make a correction, pay additional tax, or seek a refund. In many cases, the issue is moot because the statute of limitations has expired. In other situations, failure to recognize the mistaken position may affect future tax liabilities. This may be true for many estate and gift tax issues and for incorrect depreciation claims that affect the basis of property. For example, a practitioner who finds an incorrect position in a client's prior gift tax return may be required to advise the client, even though the statute of limitations has expired, if the error will change the client's future estate or gift tax liability.

A practitioner's duty is not always clear in situations in which the client refuses to correct an improper position on a prior return for an open year by filing an amended return. In some situations, the appropriate course is for the practitioner to terminate the representation.

Example 1. George consults his tax professional, Margo, about the proper reporting of a transaction for tax purposes. Margo advises him that the transactions should be reported in a specific manner. Some months later, George sends Margo a copy of the filed tax return for her records, which shows that he did not report the transactions as she advised. When Margo calls to ask about this, George informs her that he obtained a second opinion that differed from hers and decided to follow that advice.

Margo can change her advice to support the second opinion. In that case, she does not need to do anything. If that is not appropriate, she should advise George that she believes that position on his return is incorrect and about the possible consequences. If the situation is serious, she should consider terminating her relationship with George.

USE OR DISCLOSURE OF TAX PREPARATION INFORMATION

IRC §§6713 and 7216 govern the tax return preparer's use of a client's tax preparation information. IRC §6713 provides a **civil penalty** for misuse of information while IRC §7216 provides a **criminal penalty.**[17] Both penalties may be imposed for the same violation. These rules apply to any person who is in the tax preparation business or who is paid to prepare the particular tax return for which the information is obtained.[18]

The paid preparer is subject to the IRC §6713 civil penalty if that preparer either:

- Discloses the client's tax information to another party, or
- Uses the tax information for any purpose other than to prepare the return.

If the tax return preparer improperly discloses or misuses the client's tax information, the preparer is subject to a fine of $250 per improper disclosure or misuse. The maximum fine is $10,000 for any calendar year.

IRC §7216 subjects the tax return preparer to possible criminal penalties if the preparer **knowingly or recklessly** discloses or misuses the client's tax information. Under IRC §7216, the preparer may receive a criminal fine of up to $1,000 and/or be imprisoned for a maximum of one year. In addition, the preparer must pay the costs of prosecution.[19] Under this statute, violation constitutes a misdemeanor.[20]

17. Treas. Reg. §301.7216-1(a).
18. IRC §6713(a).
19. IRC §7216(a).
20. Treas. Reg. §301.7216-1(a).

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Certain disclosures are acceptable and do not violate these rules. These include the following.

- A disclosure made with the consent of the client
- A disclosure that is made pursuant to other Code provisions, including regulations
- Use of the client's tax information to update or test tax preparation software
- Providing the client's tax information to another tax return preparer in the **same firm located within the United States** for the purpose of tax preparation (and ancillary tax preparation services) for that client[21]

Note. If the preparer must disclose tax information to another employee or member of the same firm who is outside the United States, client authorization is necessary.

- Disclosure pursuant to a court order[22]

Example 2. International Accountants, Incorporated (IAI) is a large accounting firm with many U.S. and foreign offices, including offices in Chicago, New York City, and London. Jillian is a CPA who works in IAI's Chicago office and Bob is a tax attorney working in IAI's New York City office. Angela is a CPA who is employed in IAI's office in London.

Saul meets with Jillian in Chicago and furnishes her with his tax information in connection with the preparation of his 2013 tax return. In the course of working on Saul's return, Jillian needs help with determining whether Saul qualifies as a real estate professional in connection with all of the rental properties that Saul owns. She knows that Bob is an expert on the real estate professional rules because he has focused largely on these rules during 2012 and 2013 for IAI clients. Bob has even represented IAI clients in audits and in Tax Court on this issue. Bob agrees to provide her with assistance, and Jillian discloses Saul's tax return information to Bob for review and analysis. Bob addresses the real estate professional issue, completes the return for Jillian, and sends her an electronic copy that may be filed before the applicable deadline.

Because Saul's tax return information is disclosed by Jillian to another employee of the same firm located within the United States, it is not necessary to obtain Saul's consent to disclose his tax information to Bob.

Example 3. Use the same facts as **Example 2,** except that Jillian does not require Bob's expertise. Instead, after working with Saul's tax information, she notices that Saul receives pension and business income from England in addition to other sources of U.S. income. Jillian knows that the income from England must be reported on Saul's U.S. return but would like Angela to help with this aspect of Saul's 2013 return. Angela agrees to assist Jillian. Jillian discloses Saul's tax return information to Angela by sending her an e-mail of the partially completed return, showing all of Saul's tax data and a spreadsheet with the relevant information. Angela reviews Saul's tax information and sends Jillian a detailed e-mail about how to report Saul's income from England.

Even though Jillian disclosed Saul's tax information to an employee of the same firm, that employee is located outside the United States. Saul's consent is therefore required under Treas. Reg. §301.7216-3. Failure to obtain valid consent exposes Jillian to potential civil penalties under §6713 and possible criminal penalties under IRC §7216.

Note. Consent from a client must meet certain requirements in order to be valid. These requirements are discussed later in this section.

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21. Treas. Reg. §301.7216-2(c).

22. IRC §7216(b)(1)(B).

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A tax return preparer of one firm may disclose a client's tax information to a tax return preparer of **another tax preparation firm** solely for the purpose of having the second preparer complete the return. Client consent is not required as long as there is **no substantive determination** regarding the client's tax liability by the second preparer. This type of firm-to-firm disclosure is also permissible for purposes of having the second preparer e-file the return.[23]

A "substantive determination" refers to the analysis, interpretation, or application of the tax law in connection with the client's tax liability.[24]

Example 4. Brenda is a CPA and a sole practitioner. Brenda completes Glenda's tax return each year. Glenda furnishes Brenda with all required tax information in connection with the preparation of her 2013 tax return.

Glenda has substantial additional income from several different activities for the first time in 2013. Glenda materially participates in only some of these activities. Therefore, there are both "active" and "passive" forms of income. After reviewing all of Glenda's income sources, Brenda remembers that there are special grouping rules that can be used for active and passive activities, but she decides she needs some assistance in applying these rules to Glenda's new income sources for 2013.

Brenda contacts Henry, a colleague she knows well who is an EA employed by a large Boston accounting firm. Henry regularly works with the activity grouping rules and agrees to provide his expertise. Accordingly, Brenda sends Henry a fax with all of the income and expense amounts for each activity, the number of hours Glenda has participated in each activity during 2013, and other relevant tax information from Glenda's file. Henry reviews the tax information provided and advises Brenda on how to group the activities in a manner most advantageous to Glenda. Henry transmits the necessary information back to Brenda for the completion of that part of Glenda's return.

In this firm-to-firm disclosure of tax information, Glenda's consent is required because Henry's work involved a substantive determination regarding the tax liability on Glenda's return.

In a situation where one firm uses an independent contractor, the same disclosure of tax information applies.

Example 5. Leonard and Lilly are accountants and are the partners of Double L Accounting and Tax Services (Double L). To be more efficient for the 2013 tax preparation season, they decide to outsource all the e-filing of client returns to an authorized IRS e-file provider. After considering several firms that could provide this service, they choose E-FileMasters, LLC. E-FileMasters also agrees to print out any paper returns that are required and ship them to Double L.

Leonard and Lilly complete the returns for their clients and then electronically transmit the completed returns to E-FileMasters for e-filing or printing as required. Consent from Double L's clients is not necessary because E-FileMasters is not making any substantive determinations regarding the tax liability of Double L clients. The permitted disclosure also includes the necessary additional information Leonard and Lilly may need to provide to E-FileMasters in order to e-file returns.

Disclosing client tax information to another party whom the preparer hires to program, repair, maintain, or test tax preparation software is permissible:

- Only to the extent necessary for the hired party to provide their software services; and
- Only if the preparer provides the hired party with written notice providing information on the applicability of IRC §§6713 and 7216, describing the requirements and penalties of each section.[25]

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23. Treas. Reg. §301.7216-2(d)(1).

24. Ibid.

25. Treas. Reg. §301.7216-2(d)(2).

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Consent of the Client

A **knowing and voluntary** written consent of the client can be obtained as authorization to disclose or use the client's tax information for purposes other than tax preparation.[26] In order for the client consent to be valid, it must generally contain the following information.

- Names of the taxpayer and tax return preparer
- The intended purpose of any disclosure and the intended recipients of the information
- The nature of any uses of the tax information authorized
- A description of the tax return information to be used
- The signature of the taxpayer and the date[27]

Generally, if the tax return preparer indicates to the client that tax services will only be offered if the client consents, the consent is deemed involuntary and will not be valid. However, there is an exception to this rule for tax return preparers who may need to rely on the expertise of another tax return preparer to complete the client's return. In this case, the tax return preparer may make the client's disclosure consent a prerequisite to the provision of tax preparation services.[28]

The duration of the consent may be specified. However, if no duration is specified, the consent is deemed valid for one year from the date of the client's signature.[29] Consent can never be made retroactive and therefore must be obtained before the disclosure or use of client information that requires the consent.[30]

If the tax return preparer intends to use the client's tax information for the solicitation of products or services other than tax preparation services, the consent must identify the specific products or services being solicited (such as mutual funds, IRA accounts, life insurance, portfolio management, or other products or services).[31]

Note. A tax return preparer is prohibited from obtaining consent from a client that involves disclosure of the client's social security number (SSN) to a party outside the United States unless the SSN is disclosed using an adequate data protection safeguard. For further information, see Treas. Reg. §301.7216-3(b)(4). Examples of adequate data protection safeguards are found in IRS Pub. 1075, *Tax Information Security Guidelines For Federal, State and Local Agencies.*

Example 6. Use the same facts as **Example 4.** Brenda must obtain Glenda's consent before disclosing Glenda's tax return information to Henry. Assuming the consent meets all of the requirements necessary to be valid, Brenda is permitted to tell Glenda that signing the consent to disclose the information to Henry is a condition to Brenda's completion of the 2013 tax return.[32] Brenda may place this condition on her tax preparation services because she knows she may need another tax return preparer's expertise in an area that is relevant to the completion of the return. However, this is the only condition Brenda can make in connection with the consent. If Brenda places any other condition on the consent other than the provision of tax preparation (or ancillary) services, the consent will be deemed involuntary and will not be valid.[33]

26. Treas. Reg. §301.7216-3(a)(1).
27. Treas. Reg. §301.7216-3(a)(3)(i).
28. Treas. Reg. §301.7216-3(a)(1).
29. Treas. Reg. §301.7216-3(b)(5).
30. Treas. Reg. §301.7216-3(b)(1).
31. Treas. Reg. §301.7216-3(a)(3)(i)(B).
32. Treas. Reg. §301.7216-3(a)(2)(i).
33. Treas. Reg. §301.7216-3(a)(1).

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The regulations under IRC §7216 regarding disclosure and use of client tax information are lengthy and complex. Among the situations that have special use or disclosure rules are the following.

- Tax return preparer disclosure of client tax information in order to obtain legal advice
- Disclosure of tax information by fiduciaries, such as by trustees to other parties
- Disclosure or use of a client's tax information in connection with a state or local tax audit
- Use of tax information lists to solicit tax preparation business
- Disclosure of tax information due to the death of a taxpayer

Note. A detailed discussion of the rules for all of the previously mentioned situations is beyond the scope of this chapter. Practitioners with practices that involve disclosure or use of client tax return information should consult the regulations under IRC §7216.

Improper use of a client's tax return information in a manner that violates IRC §7216 constitutes disreputable conduct even without the conviction of the tax return preparer. Circular 230, §10.51, lists several items that constitute disreputable conduct. This list of items includes conviction of any criminal offense under the federal tax laws[34] or conviction of any criminal offense involving dishonesty or breach of trust.[35] Therefore, a tax return preparer violation of IRC §7216 will constitute disreputable conduct under Circular 230.[36]

Observation. The use and disclosure rules and penalties discussed previously are part of an overall regulatory structure to protect sensitive client tax information and ensure tax clients have a right of privacy in connection with the information furnished to the tax return preparer. Part of this overall structure is the Gramm-Leach-Bliley Act (GLB Act),[37] which requires tax return preparers to clearly and conspicuously advise clients about the preparer's privacy policy. For further information, see the operative regulation (16 CFR Part 313). The GLB Act is administered by the Federal Trade Commission.

DUE DILIGENCE

In accordance with §10.22 of Circular 230, a practitioner must exercise **due diligence** in ensuring correctness in the following areas.

- The preparation (or assistance in the preparation), approval, and filing of tax returns and other documents or papers relating to IRS matters
- Oral or written representations to the Treasury Department
- Oral or written representations to clients regarding IRS matters[38]

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34. Circular 230, §10.51(a)(1).
35. Circular 230, §10.51(a)(2).
36. Circular 230, §10.51(a)(15).
37. PL 106-102.
38. Circular 230, §10.22(a).

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RELIANCE ON CLIENT INFORMATION

Generally, the due diligence standard requires a practitioner to make reasonable independent inquiries to determine the accuracy and correctness of documents and representations. If reasonable inquiries are made, practitioners may avoid violating the due diligence standard by clarifying that their statements are based on current knowledge of the underlying facts. However, the standard of due diligence to which the tax practitioner is held depends on the context in which the tax practitioner's representation is made. In addition, statements made to the IRS that indicate the tax return preparer is not making a representation about the truth of the information received from the client or another party should prevent the tax practitioner from violating the due diligence standard.

Example 7. Gilda is a tax return preparer who prepared Betty's 2012 tax return, which included a Schedule C in connection with Betty's hair salon business. Gilda is on the phone with an IRS agent discussing some of Betty's business expenses for the year. Betty's utilities costs are quite high compared to last year, but Betty generally provides Gilda with an accurate summary of her expenses on a spreadsheet that Gilda uses to complete the Schedule C. When the IRS agent asks Gilda about Betty's unusually high utilities expense shown on Schedule C for 2012, Gilda responds: "I have no reason to believe that Betty overstated that expense." Gilda is not implying that she is representing the truth of the deduction amount. Such a statement may prevent violation of Gilda's due diligence requirement due to her lack of specific knowledge.

Example 8. Use the same facts as **Example 7,** except instead of a phone call with the IRS agent to discuss Betty's utilities expense, Gilda must respond to a written request from the IRS for more information. A response to a written request may require a deeper examination of the evidence and may expose a lack of prior due diligence by Gilda compared to the oral statement made by phone. Gilda should probably take steps to determine the truth of the representation made by Betty in connection with the amount of utilities expense for 2012. Contacting the client to confirm the amount or requesting the utilities invoices for the year may be necessary.

A practitioner who clarifies an oral statement or representation should then confirm the clarification through a contemporaneous memorandum or written communication to the IRS representative involved.

Example 9. Carl, an accountant, is preparing a tax return for Laura, who operates a jewelry business from her home. This is the first return he has prepared for Laura. Laura claims that she incurred a loss of $50,000 when her home was burglarized and some of her uninsured inventory was stolen. Laura has prepared a list of the items she claims were stolen, but has no independent proof of the loss (except a police report). Laura also wants to claim deductions of $5,000 for airfare, meals, and lodging relating to her trip to Italy to view the latest in European jewelry fashions.

The issue in this situation is whether Carl can rely on Laura's statements about the theft and the purpose for her trip to Italy. Her representations alone may not be sufficient. Carl should attempt to determine whether other evidence exists about the stolen items and their costs. Regarding the travel expenses, Carl should explain the substantiation requirements and the need to maintain business records.

Note. A decision by an administrative law judge to disbar a CPA was upheld on appeal because of his failure to exercise due diligence in preparing tax returns for a corporation and its husband and wife shareholders. The conduct alleged by the OPR included a failure to advise clients of potential penalties and of opportunities to avoid such penalties by making the disclosure required by Circular 230.[39] The appellate authority concluded that a great deal of evidence reflected the CPA's lack of due diligence, including evidence that it was inconceivable that the taxpayers could support their living expenses from the income reported on their returns.

39. IRS News Rel. IR-2010-82 (Jul. 7, 2010).

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RELIANCE ON WORK OF OTHERS

The proposed changes from the Department of the Treasury have not clarified the scope of the Circular 230 rule regarding a tax practitioner's reliance on the work of others.

The current version of §10.22(b) of Circular 230 states that a practitioner is presumed to exercise due diligence in relying on another person's work product if the practitioner uses reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the other person. In effect, this provision establishes a safe harbor of presumptive due diligence when a practitioner's reliance on another person's work is reasonable in the circumstances.

> **Note.** The wording of §10.22(b) of Circular 230, including the use of the term "work product," creates questions about the scope of this rule. Based on its wording, the rule seems most directly applicable to the work of a subordinate. However, because another nonemployee professional may be "engaged" by the tax practitioner, the wording suggests that this rule may also cover reliance on the work product (and perhaps statements related to that work) of another professional. The wording does not seem directly applicable to statements made to the tax practitioner by a client or others who are not engaged, supervised, trained, or evaluated. Although the proposed changes provided an opportunity to give tax practitioners more guidance and clarification about the scope of this rule, no such additional guidance was provided. Accordingly, the scope of this rule remains unclear.

It is important to note that this **safe harbor does not apply** to reliance on work product that is subject to special rules under §§10.34, 10.35, and 10.37 of Circular 230. These sections apply to the following.

- Information provided by a client relating to a position on a tax return or other document submitted to the IRS[40]
- **Covered opinions** relating to tax avoidance transactions[41]
- Certain other written advice based upon unreasonable assumptions, statements, or alleged facts[42]

Recent proposed regulations would significantly change the special rules for work product reliance under §§10.35 and 10.37 of Circular 230. The proposed rules would eliminate the current requirements for covered opinions and require only that a practitioner possess the knowledge, skill, thoroughness, and preparation for the matter the practitioner engages in before the IRS. The proposed §10.37 of Circular 230 would replace the current special rules with basic requirements applicable to all written advice a practitioner provides. A complete discussion of these proposed rules is provided later in this chapter.

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40. Circular 230, §10.34.

41. Circular 230, §10.35.

42. Circular 230, §10.37.

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BARRED ASSISTANCE AND ACTIVITIES

A practitioner may not knowingly and directly or indirectly accept assistance from any person who is currently disbarred or suspended from practice before the IRS if the assistance relates to a matter constituting practice before the IRS.[43] Practitioners also may not accept assistance from any former government employees where federal law or the provisions of §10.25 of Circular 230 would be violated.[44]

> **Note.** For further details on the federal restrictions placed on individuals who were formerly elected or employed with the executive or legislative branches or who held official office within either of these governmental branches, see 18 USC §207.

Section 10.25 also establishes detailed prohibitions and limitations regarding practice before the IRS by former U.S. government employees. These rules apply to a former officer or employee of the United States or its agencies.[45] Generally, former government employees are subject to the following restrictions.

- All former government employees are barred from representing anyone in an IRS matter if the representation would violate 18 USC § 207 or any other U.S. laws.[46]
- A former government employee who personally and substantially participated in a matter may not represent or knowingly assist any person who was a specific party to that matter.[47]
- A former government employee who had official responsibility for a matter within one year prior to termination of government service may not represent any specific party to that matter within two years after government service ended.[48]
- Within one year after government employment ends, a former government employee may not communicate with or appear before any Treasury Department employee with the intent to influence the Treasury Department employee regarding the publication, change, or interpretation of a rule for which the former employee had responsibility within one year before government service ended.[49] However, the former employee may represent a taxpayer regarding the application or interpretation of a rule if this representation is consistent with other Circular 230 rules and the former employee does not use or disclose confidential information acquired during the development of the rule.[50] A "rule" is defined as including a treasury regulation, revenue ruling, and revenue procedure.[51]

> **Note.** Former employees may always represent themselves in a federal tax matter or proceeding.

43. Circular 230, §10.24(a).
44. Circular 230, §10.24(b).
45. Circular 230, §10.25(a)(2).
46. Circular 230, §10.25(b)(1).
47. Circular 230, §10.25(b)(2).
48. Circular 230, §10.25(b)(3).
49. Circular 230, §10.25(b)(4).
50. Circular 230, §10.25(b)(3).
51. Circular 230, §10.25(a)(5).

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Generally, a member of a firm of which a former government employee is a member may not represent or knowingly assist a person who was a party to a matter in which the government employee personally and substantially participated.[52] This restriction does not apply, however, if the firm isolates the former government employee to ensure that they cannot assist in the representation. The isolation must be affirmed in a written statement, executed under oath, by the former government employee and another member of the firm acting on behalf of the firm.[53] The firm must retain the statement and provide it to the director of the OPR upon request.

Example 10. Ramona was an IRS agent until January 31, 2013, when she was terminated as a result of an IRS need to downsize due to budgetary constraints. During 2012, she was one of several agents assigned to audit restaurants in Springfield, Illinois. One such restaurant that Ramona audited in 2012 was Sal's Pizza Shop. Sal's Pizza Shop is a C corporation.

After her employment with the IRS ended, Ramona decided to establish her own tax practice in Illinois. She has been successful at obtaining new clients for tax preparation and other tax services because of her previous experience with the IRS. The owner of Sal's Pizza Shop receives a detailed examination report summarizing the results of Ramona's audit and the additional taxes due. Sal, the owner of the restaurant, contacts Ramona to see whether she is willing to represent him with an appeal. Because Ramona substantially participated in the audit of Sal's Pizza Shop, she cannot ever represent Sal's Pizza Shop with respect to the audit.[54]

Example 11. Use the same facts as **Example 10,** except instead of representation with the audit matter, Sal contacts Ramona regarding the completion of 2013 tax returns for himself and his restaurant. He explains to Ramona that he is presently seeking a new tax return preparer. Ramona can prepare Sal's personal and restaurant returns. These returns are not part of the audit matter in which she substantially participated when she was employed with the IRS.

Example 12. Use the same facts as **Example 10,** except while employed by the IRS, Ramona was not an IRS agent conducting audits. Instead, Ramona was an IRS supervisor responsible for overseeing the entire restaurant audit project that the IRS was conducting in central Illinois. She could represent Sal's Pizza Shop in the audit matter if the IRS agent under her supervision conducted the audit prior to her final year of IRS employment. If the audit of Sal's Pizza Shop was conducted and finalized before January 31, 2012, Ramona may represent Sal's Pizza Shop in the appeal. If the audit was conducted within Ramona's final year of employment, she has a 2-year waiting period after her date of termination from IRS employment before she can represent Sal's Pizza Shop. Although the Sal's Pizza Shop corporation was the specific party to the audit, the 2-year waiting period probably applies to any representation of Sal as an individual taxpayer as well.

Example 13. Use the same facts as **Example 10,** except instead of establishing her own tax practice, Ramona obtains employment with a tax preparation firm. Generally, neither Ramona nor any other member of the firm that hired her may represent Sal's Pizza Shop in the audit matter. However, if Ramona is appropriately isolated, one or more other firm members may represent Sal's Pizza Shop in the audit matter. The purpose of the isolation is to ensure that Ramona does not assist her firm colleagues with the audit representation. A statement affirming such isolation must be executed under oath by Ramona and another firm member. The affirmation must identify the firm, and Ramona and the firm must retain the written affirmation and provide it to the IRS upon request.[55]

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52. Circular 230, §10.25(c)(1).

53. Circular 230, §10.25(c)(2).

54. Circular 230, §10.25(b)(2).

55. Circular 230, §§10.25(c)(1), (2).

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FEES

Circular 230 provides rules regarding fees to which tax practitioners must adhere. There are rules regarding unconscionable fees and rules regarding contingent fees.

UNCONSCIONABLE FEES

A practitioner may not charge an **unconscionable fee** for representing a client in a matter before the IRS.[56] The term "unconscionable" is not defined anywhere in Circular 230 and there is no guidance on what steps might be taken to determine whether a fee is unconscionable. However, it is likely that the facts and circumstances of each case will be taken into account as part of the determination.

Example 14. Damien is an unenrolled agent with two years of experience as a tax practitioner who has built a thriving, growing tax practice. His client Marcel asks Damien to handle a tax refund issue. The IRS disallowed most of the business expenses Marcel claimed on his Schedule C for 2012 in connection with his part-time business. Marcel also works full time as an engineer at a large engineering and construction company. The part-time business loss provided an anticipated refund of $15,000. Marcel received a refund of only $200 due to the disallowed expenses. Marcel provided Damien with the receipts and documentation requested by the IRS. Damien contacts the IRS, sends the documentation, and obtains Marcel's additional refund amount. Damien charges Marcel $8,500 in connection with his services. Because Damien has only two years of experience and was representing Marcel with a response to a straightforward issue that did not require any complicated tax research, the fee Damien charged is likely unconscionable.

Example 15. Use the same fact as **Example 14,** except Damien is a noted tax attorney with 20 years of experience with representing clients before the IRS on tax avoidance issues. In addition, Marcel did not receive his anticipated refund because the IRS took the position that Marcel's investment in a complex tax shelter constitutes a tax avoidance scheme under the economic substance doctrine and other grounds.

Damien represents Marcel and, after successfully establishing to the IRS that Marcel's investment did not constitute investment in a tax shelter for tax avoidance purposes, Marcel obtains his refund of $15,000. Damien subsequently charges Marcel $8,500 for his services. Because Damien's representation constituted legal representation regarding a complex tax matter and he is a noted professional representing Marcel within his area of expertise, it is likely that Damien's fee would not be deemed unconscionable.

CONTINGENT FEES

Contingent fees are generally disallowed for services related to any matter before the IRS.[57] These restrictions are designed to ensure independent judgment is used by practitioners in the course of representing clients with tax issues. However, a contingent fee may be allowed for services related to the following.

- An IRS examination of or challenge to an original tax return, or an amended return or claim for refund or credit if the taxpayer filed the amended return or claim for refund within 120 days after receiving a written notice of such examination or challenge[58]
- A claim for a credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS[59]
- A judicial proceeding arising under the Code[60]

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56. Circular 230, §10.27(a).

57. Circular 230, §10.27(b)(1).

58. Circular 230, §10.27(b)(2).

59. Circular 230, §10.27(b)(3).

60. Circular 230, §10.27(b)(4).

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A fee is deemed **contingent** if it is based, in whole or in part, on whether or not the position taken on a tax return or other filing avoids challenge by the IRS.[61] This includes fees based on a percentage of a refund or of the taxes saved or otherwise dependent on a specific result. Also, a fee is contingent if the practitioner will reimburse any portion to the client if the IRS challenges a position on a tax return or other filing or if a position is not sustained.[62]

Examples of prohibited contingent fee arrangements include the following.

- The client will pay the practitioner an additional amount if the IRS does not challenge a position on the client's tax return before the statute of limitations expires.
- The client will pay the practitioner an additional amount if the position challenged by the IRS is eventually allowed by an administrative or judicial appeal.
- The practitioner will refund all or part of a fee if the IRS challenges the position on the client's return.
- The client will pay the practitioner a fee determined as a percentage of the refund requested on the client's tax return or on a percentage of a promised reduction in tax liability.

The rules in connection with contingent fees apply to all matters before the IRS, including tax planning and advice, preparing or filing returns or claims for refund or credit, and all matters connected with presentations to the IRS.[63] Examples of such presentations are preparing and filing documents, corresponding and communicating with the IRS, providing written advice regarding any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

Example 16. Paul purchased a condominium as an investment property on December 31, 2012. He purchased the property for $110,000. In late 2013, it was announced that a developer would be investing $200 million to build a major golf vacation resort on existing vacant property immediately adjacent to the building in which Paul's investment condominium is located. The developer approached Paul and offered $200,000 for the condominium. Paul accepted the offer and sold the condominium, with a closing date of December 27, 2013. Paul did not meet the 1-year holding requirement in order for the $90,000 capital gain to be reported and taxed as long term. His tax return preparer, Gus, agrees to report the gain on Paul's 2013 tax return as a long-term gain as long as Paul pays him $2,500 in April 2017 if the IRS has not challenged how the gain was reported within this 3-year limitations period. Gus's fee arrangement constitutes a contingent fee arrangement that is prohibited by Circular 230, §10.27(b).

Example 17. Steve is a CPA who agrees to prepare Megan's tax return. Steve knows that each year, Megan — a single mother — can claim exemptions for herself and her four dependent children. These exemptions provide Megan with the ability to obtain a refund of nearly all of the income tax withheld from her employment income each year. Steve also knows that Megan always obtains a substantial refund because she qualifies for an earned income credit. Steve agrees to complete Megan's return for 30% of the refund amount shown on her return. This is a prohibited contingent fee arrangement that violates §10.27(b) of Circular 230. Steve cannot charge a contingent fee to prepare a tax return.

Example 18. Use the same facts as **Example 17,** except Megan received a correspondence audit letter covering three years. She responded to the audit letter, sending in the documentation requested by the examiner. The examiner subsequently determined that she owed $12,000. Steve agrees to represent her and either request an informal conference with the examiner's manager or request an appeals conference. He agrees to represent Megan in the audit for 30% of any amount by which he can reduce the $12,000 tax liability that Megan has incurred because of the audit. This is a contingent fee arrangement that is allowed under §10.27(b)(2)(i) of Circular 230. Steve may charge a contingent fee in connection with audit representation.

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61. Circular 230, §10.27(c)(1).

62. Ibid.

63. Circular 230, §10.27(c)(2).

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In a recent decision, the U.S. District Court for the District of Columbia considered challenges to the legality of Circular 230's prohibition of contingent fees in connection with preparation and filing of refund claims with the IRS.[64] The case was brought by Ryan, LLC, a major global tax services firm and G. Brint Ryan, the firm's founder and chairman. Their complaint argues that the ban on contingent fees is invalid for the following reasons.

- The rule violates due process rights under the Fifth Amendment to the Constitution by depriving a taxpayer of the ability to obtain a refund for a tax overpayment.
- The rule infringes the right of a taxpayer to petition the government for redress of grievances under the First Amendment through a claim for refund.
- The IRS exceeded its statutory authority in promulgating Circular 230, in violation of the Administrative Procedure Act.[65]

The court dismissed the allegation of Fifth Amendment violation, holding that Mr. Ryan lacked standing to pursue this claim for denial of due process because he did not establish that the restriction on contingent fees would result in a sufficiently concrete and particularized injury to him. It also dismissed the First Amendment assertion, holding that the minor restriction on contingent fees is a constitutionally permissible limitation that does not violate the petition clause. However, the complaint regarding violation of the Administrative Procedure Act was not dismissed and the case is proceeding in the court to decide that issue.

CLIENT RECORDS

Upon a client's request, a practitioner must **promptly** return client records needed by the client to comply with the client's federal tax obligations.[66] The practitioner may retain copies of the client records. Generally, a practitioner must return client records **even if there is a dispute over fees.** However, if state law permits retention of client records if a fee dispute exists, the practitioner need only give the client the records that must be attached to the client's tax return. In that case, the practitioner must give the client reasonable opportunity to review and copy any records the client requires to comply with federal tax obligations.

Client records subject to these rules include the following.[67]

- Documents or written or electronic materials that existed when the practitioner was retained and were obtained in the course of representing the client
- Materials prepared at any time by the client or a third party that were provided to the practitioner regarding the subject matter of the representation
- A return, claim for refund, schedule, affidavit, appraisal, or other document the practitioner prepared and presented to the client regarding a prior representation if the client **requires the document to comply with current federal tax obligations**

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64. *Ryan, LLC et al. v. Lew et al.,* Case 1:12-cv-00565-RLW, (D.D.C. Mar. 29, 2013).
65. 5 USC §§701 et seq.
66. Circular 230, §10.28(a).
67. Circular 230, §10.28(b).

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CONFLICTS OF INTEREST

Circular 230 provides a general rule that a practitioner may not represent a client before the IRS if the representation involves a conflict of interest.[68] A conflict of interest exists if:

- Representation of a client will be directly adverse to another client; or
- There is a significant risk that representation of one or more clients will be materially limited by the practitioner's responsibilities to **another client, a former client, or a third person, or by a personal interest of the practitioner.**

A practitioner may represent a client despite a conflict of interest if all of the following conditions are satisfied.[69]

- The practitioner reasonably believes that competent and diligent representation can be provided to each affected client.
- The representation is not prohibited by law.
- Each affected client waives a claim of conflict of interest and gives informed consent at the time the conflict is known by the practitioner, providing written consent within a reasonable time (not to exceed 30 days).

Example 19. Lewis and Mary are limited partners in the LMN Limited Partnership, and Nathan is the sole general partner. Nathan hires Marcus to prepare the Form 1065 and Schedules K-1 for the partnership and partners. Marcus is also separately hired by Lewis, Mary, and Nathan to prepare their individual tax returns. While preparing the partnership's Form 1065, Marcus determines that a proper interpretation of the partnership agreement regarding allocations to the partners differs from the treatment of this matter in past years. In his view, the proper interpretation would provide additional income to Nathan, to the detriment of Lewis and Mary.

Marcus has a conflict of interest because:

1. His representation of one client is adverse to another client, or
2. A significant risk exists that representation of one client will be materially limited by his responsibility to another client.

It is possible to cure the conflict by obtaining informed consent from all the clients. **This should be done in writing** and the practitioner must believe that competent representation can be provided.

The practitioner must retain copies of the written informed consent for at least 36 months after the representation is concluded.[70]

Example 20. Patty and Quentin were married for all of 2011. In July 2011, Quentin began a divorce proceeding and the couple separated. In January 2012, Patty hired Debbie to prepare her 2011 tax return using a married filing jointly status. In February 2012, Quentin's attorney asked Debbie to prepare Quentin's tax return using the married filing separately status. Debbie informs the attorney about her engagement with Patty and he replies that Quentin will not sign a joint return.

This situation creates a conflict of interest because the tax liabilities of the parties will differ if their filing status changes and questions will arise about who is entitled to specific income or deduction items. The conflict may be cured by the written consent of both Patty and Quentin. However, hiring another practitioner for one of the parties may be a better course of action.

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[68] Circular 230, §10.29(a).

[69] Circular 230, §10.29(b).

[70] Circular 230, §10.29(c).

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A recent IRS news release illustrates circumstances that may result in censure or other sanctions under the conflict of interest provisions of Circular 230.[71] The facts involve an attorney who wrote several tax opinions for prospective plan participants about the qualification of a benefit plan under IRC §419A. When he wrote the opinions, the attorney had an attorney-client relationship with the plan promoter and eventually became a co-trustee of the plan. The promoter compensated the attorney during this entire period. When the IRS challenged the plan, the attorney advised and represented individual plan participants before the IRS about their individual tax disputes and continued to serve as a plan co-trustee.

The attorney never advised any of his clients about possible conflicts of interest relating to his multiple adverse representations and his personal interests, and he did not obtain their informed consents to continue the representations. The IRS concluded that the attorney created the risk, and possibly the reality, that representation of his clients would be materially limited by his responsibilities to other clients and by his personal interests. This risk arose because the attorney:

- Agreed to perform multiple services for parties who did not have mutual interests,
- Agreed to be a co-trustee of the plan,
- Accepted compensation from the promoter, and
- Represented individual plan participants in their disputes before the IRS without explaining the conflicts of interest.

Commenting on the case, OPR Director Karen Hawkins stated, "Whenever a tax practitioner represents more than one client with respect to the same transaction, that practitioner must think through the ramifications of what she or he is doing. The conflict of interest provision in Circular 230 is not a mere nicety: taxpayers who pay handsomely for tax advice and representation have a fundamental right to expect competent and diligent representation unfettered by a practitioner's responsibilities or obligations to someone else, or by the practitioner's self-interest." The fact that the sanction imposed was limited to a censure reflects the attorney's cooperation with the OPR's inquiry into his conduct, his acknowledging the violations, and his agreement to take additional tax ethics education over the next two years.

NEGOTIATION OF TAXPAYER CHECKS

Section 10.31 of Circular 230 prohibits a tax return preparer from endorsing or negotiating a refund check issued to a client by the government relating to a federal tax return.[72] **Negotiation** generally refers to the transfer of the check to another party, including a financial institution. Negotiation of a check generally requires its holder to sign the check, and that signature is an **endorsement.**

PROPOSED CHANGES TO CIRCULAR 230

The Treasury Department and the IRS have indicated a concern with a "small number of unscrupulous preparers and practitioners who attempt to manipulate the electronic refund process with the intent to defraud their clients and the IRS."[73]

Accordingly, the Treasury Department and the IRS have proposed changes that will:

- Clarify that the prohibited negotiation of checks includes any electronic negotiation or transfer, and
- Expand the prohibition to include all tax practitioners, rather than just tax return preparers.[74]

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71. IRS News Rel. IR-2012-63 (Jun. 22, 2012).
72. Circular 230, §10.31.
73. Preamble, REG-138367-06, Federal Register, Vol. 77, No. 180.
74. Preamble, REG-138367-06, Federal Register, Vol. 77, No. 180.

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The proposed changes to §10.31 would accomplish the preceding objectives. The preamble of the proposed changes indicates that a violation of this provision constitutes disreputable conduct.

Example 21. Vinny is a tax practitioner in a small town. Giovanna and Vinny are longtime friends. Giovanna meets with Vinny, her tax practitioner, to review the information she is providing to him in connection with the preparation of her 2013 tax return. She mentions to Vinny that although her 2012 return showed an overpayment that was to be refunded, she never did receive her 2012 refund from the IRS. She asks Vinny to look into this issue.

Giovanna signs a Form 2848, *Power of Attorney and Declaration of Representative,* appointing Vinny as her representative for income tax matters for 2012 and 2013. Vinny contacts the IRS about Giovanna's refund and the representative agrees that Giovanna should have received her refund and it appeared that the check was never issued. The representative indicates that the check will be mailed to Vinny's office address and that he should receive the check next week. He mentions this to Giovanna when she stops by his office to furnish him with some additional tax information before leaving on a trip to Sicily for a month. Giovanna says that it would be most helpful if Vinny could deposit her refund check in her checking account while she's gone. Vinny indicates that this would be no problem because Giovanna has her checking account at Smalltown Savings Bank, the same bank at which Vinny has his business and personal accounts.

Although everyone at the bank knows that Vinny is Giovanna's tax practitioner, Vinny suggests that Giovanna write a note giving him express permission to deposit the check into her account, and Giovanna does so. A week later, while Giovanna is in Sicily, her refund check arrives in Vinny's office. Vinny brings the check to Smalltown Savings Bank. The teller takes the check from Vinny and deposits it into Giovanna's account as he requests.

Arguably, Vinny has violated the §10.31 prohibition against endorsing or negotiating a client check. Although Vinny did not endorse the check, the deposit of the check constitutes a negotiation of that check. Vinny may argue that he took care to obtain Giovanna's express written permission to deposit the check into her account. However, §10.31, as drafted, provides no such exception; it is unclear whether express permission from the client actually prevents the tax practitioner from violating the rule.

STANDARDS FOR TAX RETURNS AND OTHER DOCUMENTS

Both the Code and Circular 230 provide standards to which tax return preparers must adhere with respect to the accuracy of a tax return. The following two provisions are most relevant.

- IRC §6694
- Circular 230, §10.34

IRC §6694(a) imposes a tax return preparer penalty if the preparer prepares a return (or refund claim) that understates tax liability due to an **unreasonable position** that the preparer knew (or reasonably should have known) about.[75] An unreasonable position is a position for which there is:

- No substantial authority,[76] or
- No adequate disclosure **and** reasonable basis.[77]

75. IRC §6694(a).

76. IRC §6694(a)(2)(A).

77. Treas. Reg. §1.6694-2(d).

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2013 Workbook

SUBSTANTIAL AUTHORITY

Only the following sources of law, IRS guidance, and other information are considered to be sources that provide substantial authority.

- The Code and other statutes
- Tax regulations (proposed, temporary, and final regulations)
- Tax treaties and underlying treaty regulations
- Explanations of treaties from the Treasury Department and other official explanations
- Court cases
- Congressional intent
- The Joint Committee on Taxation blue book
- Private letter rulings
- Technical advice memoranda issued after October 31, 1976
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- IRS press releases, notices, announcements, and other administrative pronouncements[78]

Substantial authority exists for how the tax return preparer treated an item on a return if the weight of authorities in support of that treatment is substantial in relation to the weight of contrary authority.[79] How much weight an authority has depends upon the type of authority, how relevant the authority is to the tax return preparer's position, and how persuasive that authority is.

> **Note.** For further guidance on what constitutes substantial authority, see Treas. Reg. §1.6662-4(d).

ADEQUATE DISCLOSURE AND REASONABLE BASIS

Generally, a tax return preparer makes adequate disclosure of a position or item on a return if it is shown on a properly completed Form 8275, *Disclosure Statement*. This form must be attached to the return or amended return.[80] If the position is contrary to a regulation, Form 8275-R, *Regulation Disclosure Statement,* is used instead of Form 8275.[81]

> **Note.** Special disclosure rules exist for recurring items, carrybacks and carryovers, and pass-through entities. See Treas. Reg. §1.6662-4(f) for further guidance on adequate disclosure in these areas.

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78. Treas. Reg. §1.6662-4(d)(3)(iii).
79. Treas. Reg. §1.6662-4(d)(3)(i).
80. Treas. Reg. §1.6694-2(d)(3) and §1.6662-4(f)(1).
81. Treas. Reg. §1.6694-2(d)(3).

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There is no guidance that provides a clear definition of "reasonable basis." However, guidance does indicate that the reasonable basis standard may be met in instances that would not meet the stronger substantial authority standard.[82] Merely having an arguable claim is not sufficient for meeting the reasonable basis standard.[83] A reasonable basis exists if the position is based on one or more of the sources of information constituting substantial authority, provided that those authorities are sufficiently relevant and persuasive on the tax return preparer's position.

Note. Using adequate disclosure and reasonable basis as grounds for reducing the penalty does not apply if the penalty arises from a tax shelter position or item. Similarly, the substantial authority ground for a penalty reduction does not apply to tax shelter positions or transactions.[84]

AMOUNT OF THE PENALTY

Under IRC §6694(a) the amount of the tax return preparer's penalty is the greater of:

- $1,000, or
- Half of the income received by the tax return preparer from the client regarding the advice rendered in connection with the unreasonable position taken and the preparation of the return.[85]

REASONABLE CAUSE AND GOOD FAITH EXCEPTION

The tax return preparer may avoid an IRC §6694(a) penalty if they can show that, under all the facts and circumstances, the understatement was due to reasonable cause and that the tax return preparer acted in good faith. Factors considered in this determination are:

- Whether the tax provision involved was complex, uncommon, or highly technical such that a competent preparer reasonably could have made a similar error;
- Whether the error was an isolated error as opposed to part of a pattern of errors made by the tax return preparer;
- Whether the understatement is relatively immaterial in amount;
- The preparer's normal office practices; and
- Whether the preparer relied on the advice of others or relied on generally accepted practices.[86]

Note. For further guidance on the above factors that may help the preparer establish reasonable cause and good faith, see Treas. Reg. §1.6694-2(e).

WILLFUL OR RECKLESS CONDUCT

Under IRC §6694(b), if the tax return preparer's conduct represents a willful attempt to understate the client's tax liability or involves reckless or intentional disregard of tax rules and regulations, the penalty is substantially increased. For this type of conduct, the penalty is the greater of:

- $5,000, or
- Half of the income received by the tax return preparer from the client regarding the advice rendered in connection with the unreasonable position taken and the preparation of the return.

82. Treas. Reg. §1.6662-3(b)(3).
83. Ibid.
84. IRC §6662(d)(2)(c).
85. IRC §6694(a)(1).
86. Treas. Reg. §§1.6694-2(e)(1)–(6).

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A tax return preparer willfully attempts to understate tax liability if the preparer disregards information furnished by the taxpayer or others.[87] Reckless or intentional disregard for tax rules and regulations occurs when the preparer takes a position on a tax return that is contrary to a tax rule or regulation that the preparer either knows about or is reckless in not knowing about. Such recklessness exists when the tax return preparer makes little or no effort to determine whether a rule or regulation exists under circumstances which substantially deviate from the conduct of a reasonable tax return preparer.

Example 22. Francine is Greg's tax return preparer.[88] Greg sold a large residential property in 2013 and pays Francine $10,000 to research the various tax issues related to the sale of the property, including whether he is entitled to claim any principal residence exclusion under IRC §121. Based on Francine's hourly rate, $5,000 of the $10,000 can be reasonably allocated to her research on the IRC §121 issue, $3,000 can be reasonably attributed to her preparation of Greg's return, and the remaining $2,000 is allocable to other issues that needed to be researched that are unrelated to the property sale or return preparation.

Francine decides that Greg should claim an exclusion under IRC §121 even though her thorough research shows that he did not meet both the necessary ownership and use tests required to claim this exclusion. The IRS subsequently challenges the IRC §121 exclusion and assesses an IRC §6694(b) penalty against Francine. Because $8,000 ($5,000 for the IRC §121 research and $3,000 for the preparation of the return) was the relevant fee amount received by Francine for IRC §6694 penalty purposes, Francine's IRC §6694(b) penalty is the greater of $5,000 or $4,000 (half of $8,000). Francine's penalty is therefore $5,000.

Example 23. Use the same facts as in **Example 22,** except that Francine did not know about the required ownership and use tests under §121 and did not bother to research the Code or regulations to find out about those tests. Her conduct represents recklessness under IRC §6694(b) and she is liable for the same penalty.

Note. The reasonable cause and good faith exception that the tax return preparer may use to avoid the IRC §6694(a) penalty does not apply to an IRC §6694(b) penalty.

Anti-Stacking Provision

If a tax return preparer's conduct results in both an IRC §6694(a) penalty and an IRC §6694(b) penalty, the §6694(b) penalty is reduced by any §6694(a) penalty amount. This prevents the same conduct from triggering a maximum penalty under both IRC §§6694(a) and (b).[89]

TAX RETURN PREPARER AND FIRM LIABILITY

If a firm has a preparer who is an employee, partner, member, shareholder, or other equity holder who becomes liable for a penalty under either IRC §6694(a) or §6694(b), the firm is **also** subject to the penalty if:

- One or more of the firm's principal management members or officers participated in the prohibited conduct or knew of the conduct;
- The firm failed to provide reasonable, appropriate procedures for the review of the position taken on the return that led to the understatement; or
- The firm willfully or recklessly disregarded such review procedures or disregarded such review procedures through gross indifference.[90]

87. Treas. Reg. §1.6694-3(b).

88. This example is adapted from Treas. Reg. §1.6694-1(f).

89. Treas. Reg. §1.6694-3(f).

90. Treas. Reg. §1.6694-2(a)(2) and Treas. Reg. §1.6694-3(a)(2).

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If a firm and an individual tax return preparer are both liable for either an IRC §6694(a) or §6694(b) penalty, the total penalties that may be assessed by the IRS are as follows.

- Against the individual tax return preparer, the greater of $1,000 for an IRC §6694(a) penalty ($5,000 for an IRC §6694(b) penalty) and half of the amount of compensation related to return preparation and advice or research that led to the position resulting in the understatement; and
- Against the firm, an amount of penalty not in excess of half of the firm's compensation from the client attributable to the individual preparer's advice and the firm's return preparation.[91]

OBLIGATIONS UNDER CIRCULAR 230

The obligations imposed on the tax practitioner by Circular 230, §10.34, incorporate many concepts from the IRC §6662 accuracy-related penalty and its underlying regulations.

Signing Tax Returns and Advising Clients

Under §10.34(a) and (b), a tax practitioner cannot sign a return or refund claim or advise a client on a position if the practitioner knows or should know that the return or advice takes a position that:

- Lacks reasonable basis,
- Is an unreasonable position, or
- Is a willful attempt to understate tax liability.

> **Note.** An unreasonable position for purposes of this rule is a position lacking substantial authority. An unreasonable position is one that also lacks adequate disclosure and a reasonable basis. The meanings of "substantial authority," "adequate disclosure," and "reasonable basis" under this rule are the same as under the regulations for the IRC §6662 accuracy-related penalty.[92]

In order to violate this Circular 230 rule, the tax practitioner must willfully act recklessly or be grossly incompetent in signing the return or providing the type of advice prohibited. A pattern of conduct may be used to show the tax practitioner's willful disregard, recklessness, or grossly incompetent conduct.

> **Observation.** The PTIN registry provides the OPR with the ability to focus on returns prepared by a specific tax return preparer. This may provide an effective mechanism for the OPR to establish a pattern of conduct.

Advising Clients on Other Documents

Section 10.34(a) of Circular 230 addresses practitioner obligations with respect to tax returns and refund claims, and §10.34(b) prohibits a tax practitioner from advising a client to submit any other document to the IRS for the purpose of delaying the administration of federal tax laws. In addition, a tax practitioner cannot advise a client to submit a document that takes a frivolous position.

Similarly, advice cannot be given that directs a client to submit a document taking a position that demonstrates an intentional disregard of a tax rule or regulation. However, this rule does not preclude a tax practitioner from advising a client to submit a document to the IRS for the purpose of making a good faith challenge to a rule or regulation.

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91. See Treas. Reg. §1.6694-1(f)(3).

92. Circular 230, §§10.34(a)(1)(i)(B), (ii)(B); IRC §6694(a)(2).

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Advising Clients about Penalties

If a tax practitioner has provided advice to a client regarding a position on a return (or other submitted document) or has signed that return (or other document), the tax practitioner must inform the client of any likely penalties in connection with the position taken.[93]

In addition, the client must be advised of the ways in which the penalties may be avoided through disclosure and be told of any adequate disclosure requirements that apply to that position.

> **Note.** The concept of adequate disclosure in §10.34(c) is the same as the adequate disclosure concept for the IRC §6662 accuracy-related penalty.

Reliance on Client Information

A tax practitioner can rely in good faith on information provided by the client and use that information to take a position on a tax return or other document. The tax practitioner does not need to independently verify the client's information.[94] However, the practitioner must make reasonable inquiries if the information from the client appears incorrect, incomplete, or inconsistent with another important fact or assumption.[95]

Example 24. Marina is preparing Gordon's tax return for 2013, which includes Gordon's Schedule C for his plumbing business. Each year, Gordon provides Marina with a comprehensive spreadsheet showing his business income and expenses. In the course of completing Gordon's 2013 Schedule C, Marina reviews his Schedule C for 2012, using it for reference. She notices that the business income amount Gordon indicated on his 2013 spreadsheet is substantially lower than the 2012 income amount. She also notices that Gordon's 2013 expenses are significantly higher. Marina should contact Gordon to make additional inquiries about the correctness of the amounts provided and what changes took place with respect to the operation of the business in 2013 that resulted in lower income and higher expense amounts. This is necessary because the information for 2013 seems inconsistent with the information for 2012.

OTHER DOCUMENTS

Circular 230 also sets forth standards for practitioners relating to positions their clients take on documents submitted to the IRS other than tax returns.[96] Under these rules, a practitioner may not advise a client to do either of the following.

1. Submit a document, affidavit, or other paper to the IRS that takes a frivolous position
2. Submit a document, affidavit, or other paper to the IRS if:
   a. The purpose is to delay or impede administration of the federal tax laws;
   b. It is frivolous; or
   c. It contains or omits information in a manner that demonstrates intentional disregard of a rule or regulation, unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation

93. Circular 230, §10.34(c).

94. Circular 230, §10.34(d).

95. Ibid.

96. Circular 230, §10.34(b).

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COVERED OPINIONS AND WRITTEN ADVICE

Section 10.35 of the current version of Circular 230 outlines the requirements for **covered opinions.** Section §10.37 provides the practitioner with the requirements for all other written tax advice.

> **Note.** Written tax advice includes emails and other forms of electronic communication.

A covered opinion is generally **written advice** from a tax practitioner concerning:

- A **listed transaction** that the IRS has identified as a tax avoidance transaction, or
- Any plan or arrangement that has **tax avoidance** as its principal purpose.[97]

> **Note.** The various types of tax avoidance transactions that the IRS considers to be listed transactions are found at **www.irs.gov/Businesses/Corporations/Listed-Transactions---LB&I-Tier-I-Issues.**

The rules regarding covered opinions are complex. The Treasury Department indicates that considerable effort by practitioners is necessary to determine whether written advice to a client is subject to the covered opinion rules of §10.35 of Circular 230.[98]

Extensive requirements apply to covered opinions.[99] For example, under the current covered opinion rules, a practitioner must generally show the following items and analysis within the actual covered opinion.

- All the facts that the practitioner considers to be relevant in connection with the covered opinion
- The application of the law to those facts
- A conclusion regarding the likelihood that the taxpayer will prevail on the merits with respect to each federal tax issue considered in the opinion[100]

In addition, under current rules, when the practitioner evaluates the significant federal tax issues within a covered opinion, the practitioner is prohibited from taking into account the possibility that a tax return will not be audited or that an issue will not be raised on audit. The practitioner is also prohibited from taking into account the possibility that an issue will be resolved through settlement if it is raised.[101]

Section 10.37 of the current version of Circular 230 addresses the requirements for tax advice other than covered opinions. It states that the practitioner may not provide written advice that:

- Is based on unreasonable factual or legal assumptions,
- Unreasonably relies on the representations of the taxpayer or other person,
- Does not consider all relevant facts that the practitioner knows or should know,
- Takes into account the possibility of an audit or that a particular issue will be raised if an audit occurs, or
- Takes into account the possibility that an issue will be resolved through settlement if that issue is raised.

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97. Circular 230, §10.35.
98. Preamble, REG-138367-06, Federal Register, Vol. 77, No. 180.
99. Ibid.
100. Circular 230, §10.35(c).
101. Circular 230, §10.35(c)(3).

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All facts and circumstances are taken into account in determining whether the tax practitioner has complied with these rules.[102] Moreover, if the tax practitioner knows (or has reason to know) that the written advice will be used by someone else to market or promote a tax avoidance scheme, a heightened standard of care will be used to assess the practitioner's compliance with these rules.[103]

PROPOSED CHANGES TO CIRCULAR 230

The Treasury Department notes that practitioners have attempted to exempt advice from the covered opinion rules through the use of disclaimers without regard to whether the use of a disclaimer is appropriate.[104] Practitioners have raised the issue that this practice discourages compliance with the relevant ethical requirements because some practitioners believe that they are free to disregard the standards regarding written tax advice if they include a disclaimer.

The Treasury Department wants to eliminate these cumbersome rules. Heightened awareness about the ethics concerning tax advice and the IRS's success with combating abusive tax avoidance schemes contribute to the Treasury Department's decision to propose the elimination of the covered opinion rules.[105]

In addition to eliminating the covered opinion rules, the proposed rules seek to revise §10.37 and provide a new standard for written tax advice. The revised version differs from the current version in several respects. The proposed version of §10.37 has three substantive parts that address the following areas.

- Requirements for written advice
- Reliance on advice of others
- Standard of review in ascertaining whether the practitioner complied

In addition to some changes to the rules and their application to the practitioner, the revised version of §10.37 provides the practitioner with substantially more guidance and greater clarity on the rules that must be complied with in connection with written advice.

Requirements for Written Advice

The proposed rule consists of §10.37(a), which outlines the proposed requirements for written advice. The current version of §10.37 prohibits the practitioner from rendering written advice if the practitioner does not consider all the facts known (or that the practitioner should have known) relevant to the federal tax issues involved in the advice. The proposed rule requires the practitioner to reasonably consider all relevant facts that the practitioner knows or should know. In addition, the proposed rule states that the practitioner must use reasonable efforts to identify facts relevant to each federal tax matter addressed in the advice.

> **Note.** The proposed rule, which uses the concept of reasonableness in the requirements noted, may be less severe than the previous prohibition, which did not consider the practitioner's reasonableness depending on how the IRS applies the rule to the practitioner's conduct.

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102. Circular 230, §10.37(a).

103. Ibid.

104. Preamble, REG-138367-06, Federal Register, Vol. 77, No. 180.

105. Ibid.

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In addition, although the proposed rule still prohibits the practitioner from considering the probability of an audit or that a matter will be raised in an audit, the proposed rule allows the practitioner to consider the probability of resolution by settlement if an issue is raised.

> **Observation.** The proposed change regarding consideration of a settlement will mean that a practitioner may provide written advice with a view toward the settlement of a tax issue.

The proposed regulations would eliminate the current rule under §10.35 that requires that a practitioner's written advice specifically describe the relevant facts (including assumptions and representations), the application of the law to the facts, and the practitioner's conclusion about the law and the facts. In place of this formalistic rule, the extent to which these factors should be set forth in the written advice would be determined from the **scope of the engagement** and the **type** and **specificity of the advice** the client seeks. Under the revised standard of review, a practitioner may consider these factors in determining the scope and content of the written advice. Unlike the current rule, a practitioner's compliance with Circular 230 **would not** depend on whether each factor is addressed, but **would** be determined from all the facts and circumstances.

Reliance on the Advice of Others

Proposed §10.37 provides the practitioner with additional guidance in connection with the reliance on information from the taxpayer or other person. This additional guidance is found in proposed §10.37(b).

Under the proposed regulations, a practitioner may rely on the advice of another practitioner only if the advice is reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is **not** reasonable if the practitioner knows or should know that the other practitioner:

- Rendered an opinion that should not be relied on,
- Is not competent or lacks the necessary qualifications to provide the advice, or
- Has a conflict of interest.[106]

Although the current rule states that the tax practitioner must not provide written advice if the practitioner unreasonably relies on the representations of the taxpayer or others, the proposed rule serves to provide the practitioner with further guidance on what is reasonable and unreasonable. In addition, the competence of the other person from whom the information is received by the tax practitioner is a factor that will be considered under the proposed rule.

Standard of Review

Although §10.37 of the current version of Circular 230 provides for a heightened standard of review when written advice is used to promote or market a tax avoidance arrangement, it does not provide any further guidance on the important subject of the standard against which the practitioner's actions are assessed to determine whether that practitioner complied. Accordingly, proposed §10.37(c)(2) preserves this heightened standard in tax avoidance situations. Moreover, proposed §10.37(c)(1) provides additional clarification on the standard of review used to ascertain whether the practitioner has complied with the standards for written tax advice for situations that do not involve tax avoidance.

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106. As defined in Circular 230, §10.29.

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In evaluating whether a practitioner complied with the Circular 230 requirements for written advice, the IRS will apply a reasonableness standard, considering all facts and circumstances, including the scope of the engagement and the type and specificity of the advice involved.[107] If the practitioner knows, or has reason to know, that the advice will be used or referred to by another person (other than a firm member) in promoting, marketing, or recommending to taxpayers a partnership or other entity, investment plan, or arrangement that has a significant tax avoidance or evasion purpose, a heightened standard of review will apply to determine whether the practitioner complied with the requirements for written advice. The higher standard applies because the practitioner's lack of knowledge about the taxpayer's circumstances creates a greater risk of noncompliance.

Under the current rules regarding covered opinions, the practitioner is obligated to disclose within the written advice the actual facts relevant to the federal tax issues addressed, show the application of the tax law to those facts, and state the specific conclusions. Under the proposed rules, the degree to which the practitioner is obligated to disclose facts and the law's application to the facts and conclusions is based, in part, on the **type** of the advice sought by the client and the **scope** of the practitioner's representation. The type of advice and the scope of representation are specific factors that will be taken into account along with all other facts and circumstances in determining whether a tax practitioner has complied with the written advice requirements.

Note. Written tax opinions are requested by taxpayers in connection with a variety of transactions. The proposed changes to Circular 230 may simplify the preparation of these opinions in the following ways.

- Eliminating the requirements to include disclaimers in emails and other writings
- Eliminating the requirement to separately state facts and law and reach a conclusion on each significant tax issue
- Allowing a practitioner to rely on the advice of another practitioner if that reliance was reasonable and in good faith under the facts and circumstances

PROCEDURES TO ENSURE FIRM COMPLIANCE

The current version of §10.36 of Circular 230 is structured as follows.

- §10.36(a) addresses compliance procedures associated with **covered opinions.**
- §10.36(b) outlines the compliance procedure rules regarding **tax return preparation and the preparation of other documents.**

Generally, members of a firm's management who have the principal authority and responsibility to oversee a firm's practice in these two areas have a Circular 230 oversight obligation. These managers have an obligation to take reasonable steps to ensure that the firm has adequate procedures in place for all employees to comply with Circular 230 in these areas.

Observation. A sole practitioner is treated as a "firm."

107. Proposed §10.37(c) of Circular 230.

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TAX RETURNS AND OTHER DOCUMENTS

A practitioner who has the principal authority and responsibility for overseeing a firm's practice of preparing tax returns, refund claims, or other documents for submission to the IRS must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees to comply with Circular 230.[108] Disciplinary action may be imposed on a supervising practitioner who does one of the following.

- Through willful disregard, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures in effect, allowing an employee of the firm to engage in a pattern or practice of failing to comply with Circular 230
- Knows or should know that an employee of the firm engaged in a pattern or practice that does not comply with Circular 230, and does not take prompt action to correct the noncompliance

Note. For purposes of the current version of §10.36, "employee" includes members of a firm and associates.[109]

PROPOSED CHANGES TO CIRCULAR 230

Because the proposed changes to Circular 230 include the elimination of the covered opinion rules (discussed previously in this chapter), the proposed version of §10.36 no longer includes the section specifically addressing covered opinions. Accordingly, the current version of §10.36(a) will be eliminated. The proposed version of §10.36 is drafted to create manager obligations with respect to employee compliance for all sections of Circular 230.[110]

In addition, the manager is subject to discipline if the manager does one of the following.

- Willfully, recklessly, or through gross incompetence fails to take reasonable steps to ensure that adequate compliance procedures are in place
- Knows or should know that an individual employed by the firm is engaging in a pattern or practice that is noncompliant with Circular 230 and willfully, recklessly, or through gross incompetence fails to take prompt, corrective action

Observation. The proposed version of §10.36 clarifies that a manager of the firm with oversight responsibility violates §10.36 if reasonable steps are not taken to develop and implement compliance procedures for employees. This is the case even if an employee does not engage in a noncompliant practice. However, wording within the proposed changes suggest that the failure to take such reasonable steps requires something more than **negligence.**

108. Circular 230, §10.36(b).

109. Circular 230, §10.36.

110. Proposed §10.36 of Circular 230.

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The **firm manager** who violates §10.36 is subject to the same disciplinary measures that exist for a practitioner violation of other provisions of Circular 230. These disciplinary measures include the following.

- Censure
- Suspension
- Disbarment
- Monetary fine

A **suspension** is a temporary removal of the tax practitioner's ability to practice before the IRS. **Disbarment** refers to the permanent removal of the practitioner's ability to practice before the IRS. A Circular 230 **censure** is a public reprimand for noncompliant behavior. Censures, suspensions, and disbarments are published in the Internal Revenue Bulletin and include the practitioner's name, city, state, and professional designations. The various IRS sanctions are discussed in more detail later in this chapter.

RULES REGARDING PRINCIPAL MANAGEMENT

Another source of possible firm management liability arises from regulations. Under Treas. Reg. §1.6694-2(a)(2), a firm may have liability issues if the principal management (or principal officers) of the firm, or a branch office, participated in or knew of the conduct in question and:

- Failed to provide reasonable and appropriate procedures for review of the position subject to the penalty; or
- Disregarded its reasonable and appropriate review procedures through willful disregard, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate) in formulating advice or preparing a tax return or refund claim.

Principal management is defined under Treas. Reg. §1.6694-2(a)(2) and IRS Notice 2007-39.[111]

IRS Notice 2007-39 states that the IRS may impose monetary penalties against an employer, firm, or other entity if a practitioner was acting on its behalf and knew, or reasonably should have known, about the prohibited conduct in question.

A practitioner is deemed to act on behalf of an employer, firm, or other entity if the following conditions are met.

- An agency relationship existed.
- The purpose of the agency relationship was to provide services in connection with practice before the IRS.
- The conduct in question arose in connection with the agency relationship.

An employer, firm, or other entity knows or reasonably should know about prohibited conduct if:

- Members of the principal management (or officers) of the employer, firm or other entity, or branch office knows of the conduct, or has information from which a person with similar experience and background would reasonably know; **or**
- Through willfulness, recklessness, or gross indifference did not take reasonable steps to ensure compliance with Circular 230; **and**
- Individuals associated with the employer, firm, or other entity, in connection with their agency relationship, engaged in prohibited conduct that harmed a client, the public, or tax administration, or engaged in a pattern or practice of failing to comply with Circular 230.

111. IRS Notice 2007-39, 2007-20 IRB 1243.

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Example 25. Albert is a tax specialist who develops standardized tax planning strategies at the headquarters of a national accounting firm. Albert has discretion over his day-to-day work product, rarely supervises other professionals at the firm, and does not deal directly with clients. He works directly with the firm's attorneys, accountants, and support staff across the country to market a new Tax Strategy X, but he is not specifically identified as a representative of the clients or firm. Albert reports to the director of the tax practice, who has general knowledge about Tax Strategy X and knows that it generates significant revenue for the firm.

After an examination of their clients in connection with Tax Strategy X, the IRS determines that Albert's conduct regarding Tax Strategy X is prohibited by Circular 230. The IRS also concludes that Albert acted on behalf of the firm because an agency relationship existed between him and the firm, and the misconduct arose in connection with that agency relationship because Albert worked on behalf of the firm to promote Tax Strategy X. The firm knew or had reason to know of the prohibited conduct in this situation. The director of the tax practice had general knowledge that Albert developed the tax-advantaged strategies. Alternatively, in the absence of general knowledge, the director of the tax practice would need to inquire into Tax Strategy X because it added measurably to the firm's revenue. Both Albert and the firm are subject to a monetary penalty.

CONDUCT

Disreputable conduct, not competence, is the focus of the numerous examples provided under §10.51 of Circular 230. There are 18 examples provided under §10.51, but only one of the examples mentions competency. Section 10.51(a)(13) refers to ". . . engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws." This section provides a definition of "reckless conduct" but offers no guidance on the subject of competence.

Part C of Circular 230 describes conduct for which the Treasury Department may sanction a practitioner and establishes the penalties that may apply.[112] Under these rules, a practitioner may be censured,[113] suspended, or disbarred from practice before the IRS under the following conditions.

- The practitioner is shown to be **incompetent or disreputable.**[114]
- The practitioner willfully fails to comply with the regulations in Circular 230.[115]
- The practitioner **recklessly or through gross incompetence** violates the requirements for tax return or document preparation, covered opinions, compliance, and written opinions set forth in Circular 230.[116]
- The practitioner, with an intent to defraud, willfully and knowingly misleads or threatens a client or a prospective client.

The Treasury Department also may impose monetary sanctions on practitioners and their firms in addition to, or in lieu of, censure, suspension, or disbarment of either the practitioner or the firm.[117]

112. Circular 230, §§10.50–10.53. Section 10.53 provides rules governing the receipt and use of information from IRS agents concerning a practitioner's conduct.

113. Defined as a public reprimand under Circular 230, §10.50.

114. Within the meaning of Circular 230, §10.51.

115. Circular 230, §10.52(a)(1).

116. Circular 230, §10.52(a)(2).

117. Circular 230, §10.50(c).

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INCOMPETENCE OR DISREPUTABLE CONDUCT

The type of incompetence or disreputable conduct for which a practitioner may be sanctioned includes, but is not limited to, the following.

- Being convicted of a criminal tax offense
- Being convicted of a criminal offense involving dishonesty or breach of trust
- Being convicted of any felony involving conduct that renders the practitioner unfit to practice before the IRS
- Giving, or participating in giving, information that is known to be false or misleading to the Treasury Department or to any federal tax tribunal (For this purpose, "information" includes facts or other matters in testimony, tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or written or oral statement.)
- Soliciting employment as prohibited under §10.30 of Circular 230, intentionally using false or misleading representations to deceive a client or prospective client to procure employment, or intimating that the practitioner can improperly obtain special consideration or action from the IRS
- Willfully failing to make a required federal tax return or willfully participating in evading, or attempting to evade, any assessment or payment of federal tax

Note. An appellate authority sustained the OPR's decision to disbar a tax attorney from practice before the IRS for 48 months because the attorney did not file one federal tax return and filed another five returns late. Commenting on the decision, OPR Director Karen Hawkins noted that, "Professionals who demonstrate a lack of respect for our tax system by failing to meet their own tax filing obligations should not expect to retain the privilege to practice before the IRS."[118]

- Willfully assisting, counseling, encouraging, or suggesting that a client or prospective client violate any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade or not pay federal taxes
- Misappropriating or failing to properly or promptly remit funds received from a client to pay taxes or other obligations due to the United States
- Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any IRS officer or employee through threats, false accusations, duress or coercion, special inducement, or promise of an advantage, or by bestowing any gift, favor, or thing of value
- Being disbarred or suspended from practice as an attorney, CPA, public accountant, or actuary by any state, territory, or possession of the United States or any federal court, agency, body, or board
- Knowingly aiding and abetting another person to practice before the IRS during the suspension, disbarment, or ineligibility of that person
- Engaging in contemptuous conduct in practice before the IRS, including abusive language, known false accusations or statements, or the circulation or publication of malicious or libelous matter

118. IRS News Rel. IR-2010-27 (Mar. 4, 2010).

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- Knowingly, recklessly, or through gross incompetence giving a false opinion, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on tax questions, including opinions that reflect or result from one of the following
  - A known misstatement of fact or law
  - Assertion of a position known to be unwarranted under existing law
  - Counsel or assistance in conduct known to be illegal or fraudulent
  - Concealment of matters required by law to be revealed
  - Conscious disregard of information indicating that material facts expressed in the opinion or offering material are false or misleading
- Willfully failing to sign a tax return when required by federal tax laws, unless the failure is due to reasonable cause and not willful neglect
- Willfully disclosing or using a tax return or tax return information in a manner not authorized by the Code, contrary to the order of a court, or contrary to the order of an administrative law judge in a disciplinary proceeding instituted under §10.60 of Circular 230
- Willfully failing to file on magnetic or other electronic media when required by federal tax laws, unless the failure is due to reasonable cause and not willful neglect
- Signing or willfully preparing all or substantially all of a tax return or claim for refund when the practitioner does not possess a current or valid PTIN or other identifying number
- Willfully representing a taxpayer before an officer or employee of the IRS when the practitioner is not authorized to do so

RECKLESS AND GROSSLY INCOMPETENT CONDUCT[119]

For purposes of the sanction rules, **reckless conduct** is a **highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care** that a practitioner should observe under the circumstances.

In determining whether a practitioner acted knowingly, recklessly, or through gross incompetence, a **pattern of conduct** is taken into account. Gross incompetence includes grossly indifferent conduct, grossly inadequate preparation, and consistent failure to perform obligations to the client.

PROPOSED CHANGES TO CIRCULAR 230

The proposed regulations provide a new, general competence rule for practitioners.[120] Under this rule, a practitioner must possess the necessary competence to engage in practice before the IRS. This rule is meant to clarify that a practitioner may be sanctioned under Circular 230 for lack of competence in practicing before the IRS.

Competency has been defined to include four elements that a tax practitioner must have when engaged in practice before the IRS. These elements are as follows.

- Knowledge
- Skill
- Thoroughness
- Preparation

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119. Circular 230, §10.51(a)(13).

120. Proposed §10.35(a) of Circular 230.

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Example 26. Carson is a petroleum engineer and a single taxpayer. His new tax practitioner, Jane, is preparing Carson's 2013 tax return. In addition to the amount on Carson's Form W-2, Carson has income from several Schedules K-1 from gas and oil entities. Jane determines that Carson's total income is about $256,000 for 2013. Because Carson is a petroleum engineer, she treats all of the income from the Schedules K-1 as active income for Carson. In addition, because she notices that this is how his previous tax practitioner completed the return last year, she concludes that the Schedule K-1 income is not investment income for Carson and completes the return for him on that basis.

Jane has failed to complete Carson's return with competence. She should know that she must ask Carson relevant questions about each entity for which a Schedule K-1 is issued to determine whether each source of income constitutes net investment income (NII), which is subject to a 3.8% Medicare tax. She must ask Carson questions regarding whether the entities constitute a "trade or business" under IRC §162 and about his material participation in each one of those activities. It is quite possible that she has understated Carson's NII and has subjected him to potential penalties and interest on the unreported, unpaid NII tax liability for 2013.

Jane's completion of the return constitutes "practice before the IRS" and she did not exhibit the necessary skill, knowledge, thoroughness, or preparation needed in order to complete the return with respect to Carson's 2013 NII tax liability.

Note. If a tax practitioner relies on information from another person when preparing written tax advice, the proposed changes require the practitioner to assess the **competence** of that person. This is necessary in order for the practitioner's reliance to be reasonable. This aspect is discussed earlier in this chapter in the section regarding the requirements for written tax advice. This is another area in which the concept of competence has been introduced by the proposed changes to Circular 230.

DISCIPLINARY PROCEEDINGS UNDER CIRCULAR 230

Part D of Circular 230 sets forth detailed rules governing the disciplinary proceedings that must be initiated to sanction a practitioner for prohibited conduct related to practice before the IRS. These rules, contained in sections 10.60 through 10.82, include extensive procedural requirements.

Section 10.82 describes the requirements applicable to initiate an **expedited suspension** of a practitioner. These requirements have been reconsidered by the Treasury Department, and proposed regulations under §10.82 were recently issued to expand the circumstances that would permit this sanction to apply.

EXPEDITED SUSPENSION

Expedited suspension proceedings may be initiated by the IRS when the tax practitioner has engaged in conduct that justifies suspension from practice before the IRS. Expedited suspension proceedings may be brought within five years of the date a complaint is served to a practitioner who engaged in the following types of conduct.

- Had a license to practice as an attorney, CPA, or actuary suspended or revoked for cause (except failure to pay a professional licensing fee) by any state, territory, or possession of the United States or any federal court, agency, body, or board[121]
- Was convicted of any crime under title 26 of the U.S. Code, any crime involving dishonesty or breach of trust, or any felony involving conduct that renders the practitioner unfit to practice before the IRS
- Violated conditions imposed in connection with a censure or suspension from practice[122]

121. Circular 230, §10.51(a)(10).

122. As authorized by Circular 230, §10.79(d).

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- Was sanctioned by a court in a civil or criminal proceeding relating to a taxpayer's tax liability or to the practitioner's own tax liability, for one of the following
    - Instituting or maintaining proceedings primarily for delay
    - Advancing frivolous or groundless arguments
    - Failing to pursue available administrative remedies

Under §10.82 of Circular 230, the IRS may initiate expedited proceedings to suspend a practitioner from practice before the IRS. A practitioner served with a complaint under this section must file an answer requesting a conference within 30 days after receipt.[123] If no answer is filed or conference requested, the practitioner may be suspended immediately after the 30-day period. A requested conference must occur no sooner than 14 calendar days after the date the answer must be filed, unless the practitioner agrees to an earlier date. The practitioner may be represented at the conference by an authorized representative. A practitioner who is determined to be in violation of §10.82 or fails to appear may be immediately suspended from practice.[124]

Observation. Expedited proceedings always apply to suspension. The expedited procedure does not apply to censure, disbarment, or monetary fine.

Note. The OPR prevailed in an agency appeal against a CPA who challenged the 36-month length of his suspension in an expedited proceeding brought after he pled guilty to a tax misdemeanor. The appellate authority concluded that serious aggravating factors supported the longer suspension, including the CPA's lack of concern about telling the truth in sworn testimony in the criminal and disciplinary proceedings and his lack of remorse. OPR Director Karen L. Hawkins commented that, "Convicted practitioners can expect OPR to continue its aggressive use of the expedited suspension procedures in Circular 230 to quickly and efficiently remove them from practice for the taxpaying public's protection."[125]

A suspension under §10.82 begins on the date a written notice of suspension is issued. It remains in effect until the earlier of the date the suspension is lifted by the IRS for any reason or by an administrative law judge or the Secretary of the Treasury in an administrative proceeding under §10.60 of Circular 230.[126]

A practitioner who is suspended under the expedited proceeding rules may make a request, within two years of the date the suspension began, asking the IRS to issue a complaint under §10.60. This will result in a hearing to ensure that the expedited suspension was appropriate. The IRS must then issue a complaint within 30 days of receiving the request.[127] A new hearing for the practitioner will occur if the practitioner was suspended without a conference under the expedited suspension rules.

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123. Circular 230, §10.82(c).

124. Circular 230, §10.82(e).

125. IRS News Rel. IR-2011-48 (Apr. 25, 2011).

126. Circular 230, §10.82(f).

127. Circular 230, §10.82(g).

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Example 27. William is a CPA who has been Lenny's tax advisor and preparer for many years. Each year, the preparation of Lenny's tax return involved the preparation of a Schedule C, *Profit or Loss From Business,* for each of Lenny's three businesses (an automobile collision shop, a cement business, and a tavern). Lenny was charged and convicted of money laundering in 2009. The district attorney's office also charged William as an accessory to Lenny's money laundering crimes. As a result of William's subsequent conviction in January 2010, his CPA license was revoked by the governing body within his state. The OPR issued a 30-day letter to William in April 2010 initiating an expedited suspension procedure against him. William did not respond to the letter and his default led to his expedited suspension effective June 1, 2010.

William's attorney was successful in obtaining an acquittal upon appeal in early 2013, establishing that William did not have the knowledge required to be an accessory to Lenny's crimes. As a result, William's CPA license was reinstated in March 2013. Under §10.82(f) of Circular 230, William's suspension may be lifted by one of the following.

- The IRS, if the IRS determines that William is no longer a tax practitioner who has had his CPA license revoked
- An administrative law judge, at a reinstatement conference (which William must request within two years of the date of his suspension)[128]

William had to request a reinstatement conference before June 1, 2012 (two years after the June 1, 2010, effective date of his suspension).[129] Because it is too late to request the conference, he can simply advise the OPR that the original grounds for expedited suspension did not exist due to his acquittal. William's acquittal should be a strong argument in favor of his reinstatement as a tax practitioner.

Observation. The 2-year deadline from the effective date of the expedited suspension may not be long enough for the practitioner to rectify errors or issues with the circumstances that originally provided the grounds for expedited suspension. This leaves the practitioner without the ability to request a reinstatement conference in front of an administrative law judge.

PROPOSED CHANGES TO CIRCULAR 230

The proposed changes to Circular 230 will extend the expedited disciplinary procedures to practitioners who willfully failed to comply with their **federal tax filing obligations.**[130] This provision restates a former proposed rule issued in 2006[131] that was not finalized because of practitioner concerns that the rule would erode due process rights.[132] The proposal has been reissued because the IRS continues to encounter practitioners who demonstrate unfitness to practice by repeatedly failing to comply with their own tax obligations.

The new proposed regulations would permit expedited action against practitioners who engage in a specified pattern of willful disreputable conduct that is demonstrated by noncompliance with their federal tax obligations. The expedited procedure would be limited to cases in which the practitioner's **pattern of willful disreputable conduct** is established by one of the following actions.

- Failure to file an annual federal tax return during four of five tax years immediately before the expedited proceeding is instituted
- Failure to file a return required more frequently than annually during five of seven tax periods immediately before the expedited proceeding is instituted

128. Circular 230, §10.82(b).

129. Circular 230, §10.82(g).

130. REG-138367-06; proposed §10.82(b)(5) of Circular 230.

131. See Federal Register, Vol. 71, No. 26.

132. See Federal Register, Vol. 72, No. 186.

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> **Observation.** Failure to file tax returns by practitioners is an area of increasing IRS focus. For a more detailed discussion of this subject and recent IRS action in this area, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Compliance Target Areas.

The practitioner also must be noncompliant with a tax filing obligation when the notice of suspension is served.

The proposed regulations do not permit expedited proceedings against practitioners who have not **paid** their federal tax obligations. The preamble to the proposed rules notes that this position responds to practitioner concerns that expedited suspension is inequitable when a failure to pay is caused by circumstances the practitioner cannot control. Expedited suspension is considered appropriate, however, for practitioners who do not meet their basic tax filing obligations for extended periods. The Treasury Department maintains that practitioners who engage in a repeated pattern of nonfiling demonstrate a high level of disregard for the federal tax system and a level of willfulness sufficient to be sanctioned under Circular 230. Prompt sanctions are deemed appropriate because practitioners who demonstrate such disregard for the federal tax system are unfit to represent others who make a good faith attempt to comply with their own federal tax obligations. Expedited action is considered necessary in these situations to prevent harm to these taxpayers and to the federal tax system.

Under the current §10.81, a disbarred practitioner must wait five years to apply for reinstatement. No similar rule applies to reinstatement of a practitioner suspended under the expedited procedures of §10.82. A proposed change under §10.81 would make these rules consistent by applying the same 5-year time period for reinstatement applications made by disbarred and suspended practitioners. In both cases, the IRS will not grant reinstatement unless it is satisfied that the petitioner is not likely to engage in prohibited conduct and that reinstatement is not contrary to the public interest.

Additional changes in the proposed regulations include the following.

- To begin an expedited suspension, the IRS would issue a "show cause order" instead of a "complaint" and the practitioner would submit a "response" instead of an "answer."[133] These terminology revisions do not change the expedited suspension procedures or the required contents of documents but are designed to make §10.82 easier to understand and to distinguish the expedited suspension procedures of §10.82 from the general procedures for instituting sanctions under §10.60.
- Proposed §10.82(g) clarifies that a practitioner subject to an expedited proceeding may demand a complaint under §10.60 and that the demand must specifically refer to the suspension action under §10.82.
- The current rule of §10.82(g) that allows the IRS only 30 days to issue a complaint after receiving the practitioner's demand for a complaint would be extended to 45 days by the proposed regulations.

133. Proposed §10.82(c) of Circular 230.

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