Institute and Practitioners Bristle on Circular 230 Penalties

The Internal Revenue Service position on Circular 230 monetary penalties has generated concern and comments from the American Institute of CPAs, while the American Bar Association Tax Section intends to submit its own comments on the matter.

The penalties were announced in Notice 2007-39 earlier this year to implement Section 822 of the American Jobs Creation Act of 2004, which expanded the sanctions that the IRS can impose for certain prohibited conduct to include monetary penalties.

The IRS could have issued regulations but chose to issue a notice.

Notice 2007-39 doesn't simply apply to large firms. It affects anyone subject to Circular 230, to include attorneys, CPAs that practice federal tax, enrolled agents and actuaries. Even a one-person CPA firm would be subject to this harsh new position.

Back in 1987, the IRS did a large study of penalties, and Congress took up a number of them and enacted them. The study said that isolated instances of mere negligence should not get you into trouble, but they should only be used in egregious cases. The IRS asked for comments on the appropriate factors to be considered when determining whether a monetary penalty is appropriate.

Congress intended to add monetary penalties to the previously available sanctions which may imposed upon practitioners, such as suspension or disbarment from practice before the Treasury Department or censure. A separate penalty regime has been created with this new position. As such, the tiered approach of current Section 10.52 of Treasury Department Circular 230 provides the appropriate initial factors to consider when determining whether a monetary penalty is appropriate. The committee observed that the factors to consider in determining whether a monetary penalty is appropriate depend on the facts and circumstances of the prohibited conduct. However, it offered additional factors that it believed should be considered. Among the additional factors the committee suggested:

- The extent to which compliance with Circular 230 would be appropriately enhanced by suing monetary penalties instead of, or in addition to, other available sanctions of private reprimand, censure, suspension or disbarment from practice before the IRS;
- The extent to which a monetary penalty might be disproportionate to the misconduct;
- The nature and extent of resources assigned by a firm towards training in professional practice matters and promoting compliance with relevant professional responsibilities;
- The existence of policies and procedures furthering the professional conduct of practitioners in a firm, and to administer and enforce compliance;
- Whether prompt action was taken to correct noncompliance after the prohibited conduct was discovered;
- Measures taken to prevent a recurrence;
- The extent of injury to the client, the public, or tax administration; and,
- The frequency and duration of the misconduct, and the extent to which the conduct was intentional.

The flip side of the issue the factors that should be considered in declining to impose a monetary penalty should be governed by the principal that monetary penalties should be a last resort.

Monetary penalties should only be imposed when behavior is so egregious that other penalties are not adequate to address the behavior. That's clear from the 1987 study. Mere negligence should not get you into trouble, as long as you do not have repeated problems to the point where it becomes gross negligence. Disbarment and censure only involve Circular 230 violations that are intentional or done with gross negligence. That same framework ought to apply to monetary penalties."

The notice allows a monetary penalty on a firm, without consideration of whether the practitioner may have acted outside the scope of the agency. This inappropriately subjects a firm to a strict liability and puts a firm at unfair risk for the acts of a partner or employee acting beyond the established scope of his or her agency relationship with the firm. The IRS should decline to impose monetary penalties in such circumstances.

Moreover, when another monetary penalty has been imposed on the same behavior under the authority of another penalty provision, the IRS should decline to impose a further monetary penalty under this provision. Under the act, the aggregate monetary penalties cannot exceed the gross income derived, or to be derived, from the prohibited conduct giving rise to the penalties.

There are several instances where the amount penalized could exceed 100 percent. A practitioner could be penalized under Code Section 6694 and the same behavior could double you up under Circular 230. For example, a practitioner gives written tax advice that the outcome of a matter was more likely than not the correct treatment, then prepares and signs the taxpayer's return, reflecting the written advice, without preparing any disclosure with the return or advising the taxpayer with respect to any disclosure. The IRS then asserts that the practitioner did not have a reasonable belief that the position would more likely than not be sustained on its merits, due to recklessness.

Although the IRS may assert monetary penalties under Section 6694 or Circular 230, imposing both penalties at the same time for the same behavior would be a punitive measure that would not improve compliance with Circular 230 or be in furtherance of sound tax administration.

There is a potential 150 percent penalty here. The 50 percent is statutory, the 100 percent is under Circular 230. The right approach generally should be to look to fees paid by the client and calculate how much is attributable to bad behavior.

Meanwhile, some practitioners questioned the equity of the penalties. All practitioners should be equally affected and any fly-by-night guys that just hang out signs during tax season should be subject to Circular 230 penalties as well. Everything should be equitable between all types of preparers."

Reputable preparers worry about the quality of their product regardless of whether there'll be a monetary penalty. Reputable preparers generally have a large stable of clients and their reputation rests upon what happens to those clients and how well those returns are prepared each and every year. Reputable preparers have ethics and morals to guide them in preparing most, if not all, returns. A monetary penalty won't convince someone to act more appropriately than they would have without the penalty.