

Recent Developments and Decisions Under Circular 230

By Laura L. Gavioli

Laura L. Gavioli examines recent developments and decisions under Circular 230.

Recent Developments at OPR

OPR's New Approach

In an effort to conserve resources while encouraging practitioner compliance, the IRS's Office of Professional Responsibility (OPR) has developed new practices for dealing with certain types of disciplinary cases. In 2009, OPR had a significant backlog of cases, and many cases were more than a year old. OPR has come up with several new programs for dealing with less serious infractions.

In less serious cases, OPR has instituted a program of sending "soft conduct" letters to practitioners. These letters inform the practitioner that the IRS is aware of the incident but will take no further action so long as the conduct is not repeated. The "soft conduct" letter has been used in compliance cases in which a practitioner corrects his or her error by filing past-due returns. The letter informs the practitioner that the IRS is aware of the wrongdoing and the correction.

OPR has also been issuing "soft 60" letters to practitioners who are not currently in compliance but who are making efforts to get back in compliance. The letter notifies the practitioner that he or she has 60 days to correct Circular 230 violations (usually failures to file his or her own return or pay taxes). Depending on the case, good-faith efforts to enter into installment agreements or offers-in-compromise may satisfy the 60-day deadline.

OPR has also instituted a "deferred discipline" program whereby practitioners who have been found to have violated Circular 230 avoid receiving a referral

to their state bar or state CPA society if they remain in compliance for five years.

In more serious cases, OPR has begun sending "pre-allegation" letters, which inform practitioners that OPR is beginning an investigation against them. If OPR decides to proceed with a case, OPR offers the practitioner a conference opportunity to discuss a possible settlement or to present evidence that would clear up the referral. If no settlement is reached, OPR will begin the normal disciplinary process.

Implementation of New Tax Preparer Standards

On January 4, the IRS announced a comprehensive new plan to regulate unenrolled tax preparers. There are currently four major facets to the new plan—(1) registration of all paid tax preparers, (2) competency testing, (3) continuing education requirements, and (4) tougher enforcement.¹

Everyone who files a federal tax return as a paid preparer will be required to register and obtain a PTIN (preparer tax identification number). While in the past, the PTIN was optional, it will now be mandatory. PTIN users also will be required to pay a user fee. Preparers will have to renew their registration every three years, and this registration renewal will involve a compliance check. The IRS released its proposed rules regarding PTINs on March 26.²

Preparers who are not attorneys, CPAs or enrolled agents will have to pass a competency test and will have to complete continuing education requirements.

In addition, the IRS plans to extend the coverage of Circular 230 to all signing and nonsigning preparers. The IRS does not view this as a significant change, since the rules already require the person most responsible for preparing a return to sign the return.

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The IRS also announced future plans to establish a database whereby the public can search to ensure that preparers have complied with the IRS's return preparer standards. The IRS also is forming a task force to assess tax preparation software and its impact on tax preparation.

Alongside these changes, the IRS has stepped up enforcement and oversight regarding return preparers. In January, the IRS sent more than 10,000 letters to preparers reminding them of their obligations to prepare accurate returns and outlining common errors. The letters went to preparers that had historically produced large volumes of erroneous returns. The IRS followed up with field visits to about 2,400 preparers that had received the letter.

This plan was the product of the IRS's six-month review of issues facing tax preparers. In particular, the ABA Tax Section and other groups had commented that the competency and continuing education requirements should not apply to licensed practitioners like attorneys and CPAs, and the plan reflects those comments. The AICPA and others have commented that the creation of "credentials" for unenrolled return preparers may be confusing to the general public.

OPR Decisions

OPR is now publishing its final disciplinary decisions on the IRS's Web site. OPR decisions can be found at www.irs.gov/taxpros/agents/article/0,,id=177688,00.html (or follow links on the IRS's Web site for "Circular 230 Tax Professionals").

Most of the reported OPR decisions involve violations of either §10.22, 10.34, 10.51 or 10.52 of Circular 230. For context, these sections generally provide that the following conduct is sanctionable:

- **Section 10.22:** failure to exercise due diligence in determining the correctness of returns filed with the IRS and of oral or written representations made by the practitioner or his/her client to the IRS
- **Section 10.34:** signing as preparer a return that does not take a position that has a realistic possibility of success on the merits, or signing a return that takes a frivolous and undisclosed tax position
- **Section 10.51:** disreputable conduct generally, including failing to file returns; evading or attempting to evade income tax (either the practitioner's own or someone else's); and knowingly, intentionally or recklessly giving a false opinion which is intentionally or recklessly misleading

- **Section 10.52:** requires that a practitioner must act willfully, recklessly or through gross incompetence to be disbarred or suspended

Willfulness Under Circular 230

Section 10.52 does not define what it means to act "willfully." Prior published disciplinary decisions have held that the standard used in *Pomponio*,³ i.e., a "voluntary, intentional violation of a known legal duty," was the correct standard.⁴

Noncompliance Cases

The vast majority of disciplinary cases involve practitioners' noncompliance—failures to file their own returns. For example, recently in *Kilduff*,⁵ OPR successfully sought a four-year suspension from practice before the IRS for a practitioner who failed to file his personal income tax returns. For six consecutive years, Kilduff either filed his personal returns late or, for one year, not at all. In many cases, Kilduff filed returns more than one year after the returns' extended due dates. Kilduff was an attorney with an LL.M. in taxation and a partner at a firm with an extensive tax controversy practice. Kilduff also had previously worked for five years for the IRS Office of Chief Counsel.

Kilduff argued that the untimely filing of his returns was not willful and was not a violation of §10.51(f). That section provides that incompetence and disreputable conduct can include "willfully failing to make a Federal tax return in violation of the revenue laws of the United States[.]" Initially, the Administrative Law Judge agreed that Kilduff had not violated this section for most of the years in question because Kilduff had eventually filed his personal returns. On appeal, Special Counsel disagreed, holding that "[f]ailing to file a return within the time requirements of Code Secs. 6072 and 6081 is in violation of the revenue laws of the United States even if the return is ultimately filed." Moreover, given Kilduff's career history and his pattern of failing to file timely returns, Special Counsel also held that this failure was willful. OPR recommended a suspension of 48 months, but Special Counsel noted that he believed the record supported complete disbarment. Special Counsel deferred to OPR in imposing the four-year suspension.

In addition, the Administrative Law Judge made a point of noting Kilduff's "apparent disinterest in, or lack of respect for, this proceeding," which was

evidenced by Kilduff's failure to timely respond to OPR's repeated correspondence and failure to file certain pleadings.

Two Rare Practitioner Victories

Recently, OPR has published two decisions in which it was unsuccessful in seeking disciplinary sanctions against attorneys. The cases present very different factual scenarios and procedural postures.

Panitz⁶

OPR unsuccessfully sought to suspend Panitz from practice before the IRS for one year related to alleged misconduct in handling taxpayers' offers in compromise. Panitz is an attorney and has practiced tax law since 1989. The conduct in question was the handling of two offers-in-compromise by a junior partner at Panitz's firm and under Panitz's general supervision. The junior partner no longer practices law.

Offer-in-Compromise for Case 1

Regarding the first case, OPR alleged that Panitz failed to disclose to the IRS in the offer-in-compromise three separate amounts that had been transferred into Panitz's firm's trust account—(1) amounts to pay the offer-in-compromise, if accepted; (2) amounts to cover anticipated state tax liabilities; and (3) amounts to pay Panitz's firm's fees and costs. OPR argued that each of these amounts should have been disclosed in the offer-in-compromise, and that the failure to do so was willful under §§10.51 and 10.52.

The Administrative Law Judge addressed all three types of funds held by Panitz's firm. First, Panitz acknowledged that the amounts his firm held to satisfy the offer-in-compromise should have been disclosed. His firm had a general policy of holding the amounts in trust while an offer-in-compromise was pending, and generally the firm would disclose this fact in a cover letter with the offer-in-compromise. The junior partner that had handled the offer-in-compromise had failed to follow these procedures. When the IRS inquired about where the funds were held, Panitz's firm readily disclosed the information and relevant documents showing the funds were held in trust. Moreover, OPR provided no evidence showing that Panitz himself knew of, authorized or otherwise bore responsibility for the omissions made by the junior partner. The Administrative Law Judge concluded that Panitz's failure to disclose the amounts held in trust for the offer-in-compromise was not willful.

Second, Panitz argued that the failure to disclose the amounts held to cover the taxpayers' anticipated tax liabilities was also not willful. The Administrative Law Judge found that the taxpayers had no current state tax liabilities, but that these liabilities were reasonably anticipated. Panitz acknowledged at the hearing that the amounts "probably should have" been disclosed in the offer-in-compromise. However, the Administrative Law Judge found that this failure was not willful because (1) the firm was acting at the client's direction, (2) the firm readily disclosed all information about the funds on request from the IRS, and (3) there was no evidence that Panitz was aware of or authorized the omissions. The Administrative Law Judge went on to discuss OPR's position:

It follows, and I find, that willfulness cannot be established by mere omission or failure to disclose information but must be evidenced by conduct from which an intent to deceive or mislead may be inferred. Thus, nondisclosure alone cannot prove a "knowing" submission of false or misleading information.

The Administrative Law Judge found significant the fact that the IRS officers handling the offer-in-compromise followed up on the initial offer and asked for many types of backup documentation. The Administrative Law Judge held that it was reasonable to infer that many taxpayers fail to provide complete information with their offers-in-compromise.

Third, OPR challenged Panitz's firm's failure to disclose amounts held in trust for attorneys' fees and costs. The IRS had no clear-cut policy regarding whether these amounts should be disclosed in an offer-in-compromise; thus, the Administrative Law Judge held that the omission of these amounts was not a willful failure to disclose. Overall, the Administrative Law Judge held that Panitz had not acted willfully in violation of Circular 230 regarding the first offer-in-compromise.

Offer-in-Compromise for Case 2

Regarding the second case, OPR alleged that Panitz had willfully failed to disclose two amounts in a client's offer-in-compromise—(1) amounts transferred to Panitz's firm's trust fund account for attorneys' fees and costs, and (2) a lump-sum workers' compensation settlement received by the firm's client. The Administrative Law Judge dispensed of the first allegation, which was similar to the allegation in case

1. Since there was no IRS policy requiring disclosure of amounts received for attorneys' fees, and no evidence that Panitz's firm misrepresented these amounts when the IRS requested information about them, the Administrative Law Judge held that the failure to disclose these amounts was not willful.

OPR also argued that Panitz had acted willfully regarding his firm's failure to disclose a client's lump-sum workers' compensation settlement. This allegation was based on the following series of events. In the initial meeting with the client, the client asked Panitz whether the IRS could collect against a lump-sum workers' compensation settlement. At that time, it was questionable whether the client had retained Panitz, and Panitz could not recall whether the client had disclosed that he had actually received such a settlement. A junior partner at Panitz's firm had prepared the offer-in-compromise, and failed to attach the required workers' compensation forms to the offer. Also, the partner failed to attach bank statements to the offer, as required.

After the offer was filed, an IRS officer followed up with requests for additional information. At that time, the junior partner responded to the IRS that the client received monthly payments to pay for living expenses, and the payments were loans from his mother. When the IRS requested additional information, Panitz and the junior partner learned that these payments were not loans, but that the client had transferred a lump-sum worker's compensation settlement to his mother for payment to him in monthly installments. Panitz and the junior partner told the client that they would have to notify the IRS, since the offer-in-compromise and collection statement were incorrect.

Panitz and the junior partner informed an IRS officer of the workers' compensation settlement *via* conference call, and asked for time to provide the correct documentation to the IRS. In the interim, a different IRS officer asked for updated financial information. Panitz responded that "there are no changes to the last financial statement[,]'" but also provided documentation of the settlement and periodic payments made by the client's mother. After reviewing this documentation, the officer sent a letter to Panitz stating that the IRS considered the settlement funds an asset for purposes of the offer-in-compromise, and that the offer was unsatisfactory. The officer requested an updated collection statement, which would include the settlement funds; asked for documentation of the client's fee agreement and billing statements with Panitz. Panitz objected to these requests; and re-

quested that the IRS reject the offer-in-compromise so that the client could appeal the decision. The officer declined to reject the offer, stating that documentation was still outstanding. In response, Panitz stated that an updated financial statement reflecting the settlement proceeds was inappropriate:

The fundamental difference of opinion in this case is whether a worker's compensation settlement that was intended as reimbursement for lost wages, and is being used as such, must all be used as part of an offer-in-compromise when the recipient is [disabled] and has no other income.

The officer then issued a summons requesting all documentation of Panitz's engagement with the client. Panitz objected to producing these documents on grounds of attorney-client privilege, and provided bank statements to show fees paid. The offer-in-compromise was rejected, and the client's appeal of the decision was denied.

Based on this series of events, the Administrative Law Judge held that Panitz's conduct was not willful in failing to disclose the lump-sum workers' compensation settlement in the client's offer-in-compromise. OPR presented no evidence that Panitz "abetted or countenanced" the client's misrepresentations in the initial offer-in-compromise. When Panitz learned of the client's misrepresentation, he took steps to correct it and to submit appropriate documentation. Regarding Panitz's later responses to the IRS officer's requests for information, the Administrative Law Judge held that Panitz could have been more clear regarding his position, but ultimately found no evidence of willfulness. Panitz clearly disclosed the existence of the settlement, but took the legal position that the settlement proceeds should not be considered an asset for purposes of the offer-in-compromise. The Administrative Law Judge questioned whether this position was "legally sound," but held that it was not so unreasonable as to constitute disreputable conduct. Because Panitz did not act willfully, the Administrative Law Judge dismissed the complaint.

Sykes⁷

Sykes successfully defended against an OPR complaint regarding tax opinions he authored for lease-stripping transactions in the 1990s. OPR sought to suspend Sykes from practice before the IRS for one year for violations of §10.22, the practitioners' duty of diligence.

The IRS had disallowed the tax benefits of the underlying lease-stripping transactions, and the taxpayers unsuccessfully challenged that decision in federal district court. The district court upheld a 40-percent gross valuation misstatement penalty against the taxpayers and held that the taxpayers lacked reasonable cause for their return positions. The court held that it was unreasonable for the taxpayers to rely on the tax opinions drafted by another law firm for a different part of the transaction, and specifically did not reach the issue of whether it would be reasonable to rely on this practitioner's opinions. Based on this decision, the Department of Justice referred Sykes's case to OPR.

The case involved two different leasing transactions—one for computer equipment and one for trucks. In a lease-stripping transaction, one entity would report the income received from a lease, and another entity would take the deductions for depreciation and rental expenses under the lease.

The practitioner at issue is a tax attorney with over 30 years' experience and an LL.M. from NYU. Sykes's law firm was retained not by the taxpayers but by an advisory firm, and the opinions covered whether the leases were "true leases" for tax purposes and the proper tax basis in the preferred stock resulting from the exchange transactions. This required an analysis of the value of the equipment over time and the expected remaining useful life of the property at the end of the lease.

Sykes was an associate at his law firm when he authored the opinions at issue. His firm selected an appraiser among four different firms, and Sykes's firm conducted its own review of the appraiser's work. Sykes's firm also had an external accounting firm review the appraisal. All concluded that the appraisal was reasonable.

Sykes's firm issued five written opinions on the various leases, and they were all "more likely than not" opinions. The opinions were all short-form opinions, meaning that they contained none of the underlying legal analysis supporting their conclusions. This was standard practice at Sykes's firm in the 1990s when the opinions were issued. Further, the taxpayers'

counsel relied on Sykes's opinions to advise their clients regarding the deductibility of rental payments under the leases. The opinions concluded that (1) the transactions were tax-free exchanges, (2) the stock received would have basis equal to the amount stated, and (3) if the stock were sold for cash in an arm's-length transaction with economic substance, gain or loss would be determined with reference to basis.

OPR's complaint primarily contended that Sykes willfully violated §10.22(a) and (c) in authoring the tax opinions.

These sections require Sykes to be diligent as to the accuracy of documents filed with the IRS and to be diligent as to the accuracy of a client's oral and written representations to the IRS. OPR built its case on the opinions themselves with little additional evidence. OPR successfully established that Sykes knew of the client's purpose in claiming significant tax benefits, knew of his professional obligations as an opinion-writer under Reg. §1.6664-4, and knew of Notice 95-53,⁸ which warned of potential problems with lease-stripping transactions. The Administrative Law Judge held that this showing was not sufficient to merit disciplinary sanctions against Sykes.

Sykes challenged OPR's complaint on several grounds. First, he argued that the complaint was time-barred. The complaint was filed in 2006, and the events of the case apparently took place in the mid-1990s. (Dates have been redacted for privacy reasons.) Sykes alleged that OPR is subject to a five-year statute of limitations under 28 USC §2462. The Administrative Law Judge declined to address this argument, which also has not been fully explored in prior OPR decisions.

Second, Sykes argued that the writing of these opinions did not constitute "practice before the IRS" within the meaning of Circular 230. The Administrative Law Judge rejected this argument, holding that §10.2(d) broadly defines "IRS practice" and that the opinions were intended to support a taxpayer's return position before the IRS.

Third, Sykes argued that OPR had failed to present clear and convincing evidence that he had violated Circular 230. The Administrative Law Judge agreed.

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§10.52 requires a finding of willfulness for suspension or disbarment, and §10.76 requires clear and convincing evidence to support an Administrative Law Judge's factual findings which result in suspension or disbarment.

The Administrative Law Judge held that OPR had not established that Sykes lacked diligence. OPR based its "lack of diligence" argument on two grounds. First, OPR argued that the use of a short-form opinion lacking legal analysis deprived the client of a fair opportunity to evaluate its decisions. Second, OPR argued that Sykes failed to make sufficient inquiries from his clients regarding their representations of profit potential and significant nontax business purposes for the transactions. The Administrative Law Judge rejected both of these arguments.

Sykes introduced evidence that short-form opinions were standard practice at the time within his own firm and in the broader tax community. He also successfully argued that no rule or regulation prohibited use of the short-form opinions at the time they were issued, and that no client had ever rejected these opinions. Further, Sykes introduced substantial evidence, including his own testimony and that of expert witnesses, that he had diligently researched all relevant legal issues supporting the opinions, including the applicability of Notice 95-53, the economic substance doctrine, and other judicial doctrines listed in the Notice. While OPR argued that the short-form opinion deprived the client of the ability to make an informed decision, OPR offered no evidence to support this contention and was left with Sykes's un rebutted testimony on this issue.

Also, OPR argued that Sykes should have altered his legal analysis due to the issuance of Notice 95-53. The Administrative Law Judge took issue with this argument, and observed that the Notice only warned of future IRS conduct. The Administrative

Law Judge held that Sykes had considered all of the judicial doctrines listed in the Notice, and that this was sufficiently diligent.

Regarding the client representations, Sykes introduced evidence that it was reasonable to rely on the representations of his client, the advisory firm, which was very well respected and a leader in the field at the time. Sykes also testified that he independently reviewed the spreadsheets showing the client's profit potential, and that he was aware of due diligence and tax opinions done by other firms in connection with the transactions. The appraisal obtained by Sykes's firm was also reasonable.

The Administrative Law Judge dismissed the complaint as not based on clear and convincing evidence of misconduct. OPR apparently did not appeal the decision, as the decision has now been published.

Conclusion

Under new leadership, OPR is making great strides in clearing its backlog of cases, improving due process for practitioners, and extending its oversight to cover all individuals who assist taxpayers in preparing returns. Practitioners should welcome these changes, which should improve the standards of practice for the federal tax bar.

ENDNOTES

- ¹ See IR-2010-1 (IRS's news release announcing the plan); FS-2010-1 (IRS's fact sheet regarding the plan).
- ² See REG-134235-08, FR Doc. 2010-6867.
- ³ *P. Pomponio*, S Ct, 76-2 USTC ¶ 9695, 429 US 10.
- ⁴ See *Director v. Banister*, Complaint No. 2003-02 (decision on appeal); *Director v. Francis*, Complaint No. 2004-9 (decision on appeal).
- ⁵ *Director v. Kilduff*, Complaint No. 2008-12.
- ⁶ *Director v. Panitz*, Complaint No. 2006-25.
- ⁷ *Director v. Sykes*, Complaint No. 2006-1.
- ⁸ Notice 95-53, 1995-2 CB 334.

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