

TAX UPDATE

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Cost of Bad Practice: IRS Notice Implementing Monetary Penalties Under
Circular 230
April 24, 2007



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Notice 2007-39 Issued

The IRS has issued Notice 2007-39 to implement provisions of the American Jobs Creation Act of 2004 that authorized the IRS to impose monetary penalties on practitioners and firms under Circular 230. Previously the IRS's set of weapons to deal with the regulation of practitioners that violated Circular 230 did not include any monetary penalties.

Practice Before the IRS

Practice before the IRS is governed by code sections you won't find in the Internal Revenue Code—rather, the key provisions exist in other titles of the United States Code besides Title 26 (what we normally refer to as the Internal Revenue Code).

The definition of who is entitled to practice before the IRS is found in Title 5 of the United States Code at §500, which reads:

Sec. 500. Administrative practice; general provisions

(a) For the purpose of this section--

(1) "agency" has the meaning given it by section 551 of this title; and

(2) "State" means a State, a territory or possession of the United States including a Commonwealth, or the District of Columbia.

(b) *An individual who is a member in good standing of the bar of the highest court of a State* may represent a person before an agency on filing with the agency a written declaration that he is currently qualified as provided by this subsection and is authorized to represent the particular person in whose behalf he acts.

(c) *An individual who is duly qualified to practice as a certified public accountant in a State* may represent a person before the Internal Revenue Service of the Treasury Department on filing with that agency a written declaration that he is currently qualified as provided by this subsection and is authorized to represent the particular person in whose behalf he acts.

(d) This section does not--

(1) grant or deny to an individual who is not qualified as provided by subsection (b) or (c) of this section the right to appear for or represent a person before an agency or in an agency proceeding;

(2) authorize or limit the discipline, including disbarment, of individuals who appear in a representative capacity before an agency;

(3) authorize an individual who is a former employee of an agency to represent a person before an agency when the representation is prohibited by statute or regulation; or

(4) prevent an agency from requiring a power of attorney as a condition to the settlement of a controversy involving the payment of money.

(e) Subsections (b)-(d) of this section do not apply to practice before the United States Patent and Trademark Office with respect to patent matters that continue to be covered by chapter 3 (sections 31-33) of title 35.

(f) When a participant in a matter before an agency is represented by an individual qualified under subsection (b) or (c) of this section, a notice or other written communication required or permitted to be given the participant in the matter shall be given to the representative in addition to any other service specifically required by statute. When a participant is represented by more than one such qualified representative, service on any one of the representatives is sufficient.

(Added Pub. L. 90-83, Sec. 1(1)(A), Sept. 11, 1967, 81 Stat. 195; amended Pub. L. 106-113, div. B, Sec. 1000(a)(9) [title IV, Sec. 4732(b)(2)], Nov. 29, 1999, 113 Stat. 1536, 1501A-583.)

The IRS is given authority to regulate the practice before it under Title 5 U.S.C. section 500 by 31 U.S.C. section 330 which provides:

Sec. 330. Practice before the Department

(a) Subject to section 500 of title 5, the Secretary of the Treasury may--

(1) regulate the practice of representatives of persons before the Department of the Treasury; and

(2) before admitting a representative to practice, require that the representative demonstrate--

(A) good character;

(B) good reputation;

(C) necessary qualifications to enable the representative to provide to persons valuable service; and

(D) competency to advise and assist persons in presenting their cases.

(b) After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department, or censure, a representative who--

(1) is incompetent;

(2) is disreputable;

(3) violates regulations prescribed under this section; or

(4) with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.

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

disbarment, or censure of the representative.

(c) After notice and opportunity for a hearing to any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code of 1986, the Secretary may--

(1) provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service, and

(2) bar such appraiser from presenting evidence or testimony in any such proceeding.

(d) Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

(Pub. L. 97-258, Sept. 13, 1982, 96 Stat. 884; Pub. L. 98-369, div. A, title I, Sec. 156(a), July 18, 1984, 98 Stat. 695; Pub. L. 99-514, Sec. 2, Oct. 22, 1986, 100 Stat. 2095; Pub. L. 108-357, title VIII, Sec. 822(a)(1), (b), Oct. 22, 2004, 118 Stat. 1586, 1587.)

The notice we are talking about today deals with the language found in the last clause of §330(b), which was added by the American Jobs Creation Act of 2004.

Circular 230 contains the regulations that implement these provisions. The specific provision implementing the penalty clause is found in Sec 10.52 of Circular 230, and reads as follows:

Sec. 10.52 Violation of regulations.

(a) Prohibited conduct.

A practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service for any of the following:

(1) Willfully violating any of the regulations (other than Sec. 10.33) contained in this part; or

(2) Recklessly or through gross incompetence (within the meaning of Sec. 10.51(l)) violating Sec. Sec. 10.34, 10.35, 10.36 or 10.37.

(b) Effective date.

This section applies after June 20, 2005.

Presumably, given the notice we now have, we can add having monetary penalties

imposed to the list of sanctions found in that section. Congress appeared concerned that the lack of monetary penalties or the ability to go after the employer of the misbehaving individual made for major problems in controlling abusive practice, thus leading to the enactment of the monetary penalty provisions.

The IRS has now given some guidance on how they will make use of this tool, as well as asking for comments on additional guidance, suggesting that this notice represents an interim step towards developing a more comprehensive disciplinary rulebook to implement this provisions.

Analysis of the Notice

The Notice has a number of items worth considering. First, the IRS makes clear that this does not represent an option for practitioners facing disbarment or suspension to offer to “pay up” and receive a lighter sentence instead. While noting that money penalties may be imposed in lieu of disbarment or suspension, the notice makes clear that “monetary penalties are not, however, a ‘bargaining point’ that a practitioner may offer to avoid suspension, disbarment, or censure if these sanctions are otherwise appropriate.” From this language, the IRS appears to be making speaking just as much to its own employees who may be involved in the enforcement arena as it is to the practitioners.

Amount of Penalty

The amount of the monetary penalty is statutorily limited to the gross income received from the conduct that gave rise to the penalty. In the Notice, the IRS clarifies how this gross income will be computed:

The aggregate amount of the monetary penalty (or penalties) imposed by the Secretary for any prohibited conduct may not exceed the collective gross income derived by the practitioner and the employer, firm, or other entity in connection with such prohibited conduct. *If a single act of prohibited conduct giving rise to a monetary penalty is an integral part of a larger engagement, the amount of the penalty will be limited by the “gross income derived (or to be derived)” from the larger engagement.* In the event that the larger engagement began on or before October 22, 2004, the “gross income derived (or to be derived)” will be calculated, on a pro rata basis, to exclude amounts attributable to conduct occurring on or before October 22, 2004. In determining the amount of the monetary penalty (or penalties), the Secretary *will consider amounts that the practitioner, employer, firm, or other entity could reasonably expect to realize, irrespective of whether the amounts have actually been received.*

Note that this definition appears to greatly expand what might otherwise have appeared to be a more limited definition, allowing the IRS to “lump” the entire engagement fee into the process and to consider amounts that reasonably would have been realized, even though they may not actually have been realized.

Thus, it would appear that if there was “bad conduct” with regard to a tax return engagement, the entire fee related to the engagement (perhaps not even limited to the tax aspects of the engagement) could be imposed as a penalty. So if there was “bad act” related to a single transaction for a client that the practitioner also performed numerous other services for, it is possible the entire fee received from that client for all services performed could be the limiting factor on the penalty. Presumably, the IRS view is that the practitioner might not have gotten any of the work if he/she had not been pushing the abusive transaction. As well, it’s likely the IRS did not want to get into trying to break down how much of a billing involved the specific transaction in question or was concerned that violators would attempt to structure their engagements so as to have a minimal fee charged for any potentially risky work, and then pad up the fee for the relatively safe items.

The IRS determined that “to be derived” in the statute meant what reasonably would have been derived from the prohibited conduct, even if the IRS managed to stop the process early and therefore few fees had been collected.

The Notice does indicate that just because the IRS may impose a penalty equal to the gross fee, they can impose a penalty of a lesser amount. In determining how much to penalize an individual or firm, the IRS listed the following considerations:

In determining the amount of the penalty (or penalties), the Service will consider the level of culpability of the practitioner, firm, or other entity; whether the practitioner, firm, or other entity violated a duty owed to a client or prospective client; the actual or potential injury caused by the prohibited conduct; and the existence of aggravating or mitigating factors.

Of special interest will be the mitigating factors provisions. The IRS outlines specific items that they will consider to be mitigating factors as well as giving assurance that they do not plan to be imposing this penalty for minor issues.

Mitigating factors may include whether the practitioner, employer, firm, or other entity took prompt action to correct the noncompliance after the prohibited conduct was discovered; promptly ceased engaging in the prohibited conduct; attempted to rectify any harm caused by the prohibited conduct; or undertook measures to ensure that the prohibited conduct would not occur again in the future. In general, the Service will not impose monetary penalties in cases of minor technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct.

The mitigating factors emphasize corrective action which would be impacted by a practitioners own tax quality control system (to borrow a line from the proposed AICPA SSTS No. 9). If SSTS No. 9 is made final in a form close to the exposure draft, CPAs may need to carefully consider how their tax quality control system would react to the discovery of a potential issue in the firm, as well as noting that it would seem likely a

firm would be judged negatively if it failed to comply with its own stated procedures for dealing with such an issue. And practitioners who are not CPAs may find they will be held to a similar standard, since Circular 230 already has the “best practices” provision in Section 10.33 that, while not technically enforced as a separate violation under Circular 230 Section 10.52, is a standard the IRS expects practitioners to “aspire” to achieve. The existence of the proper attitude of “aspiration” could very well be something the IRS would consider in evaluating mitigating factors.

It’s also important to note that the IRS did give assurance they don’t want this used for mere technical violations. Again, this is a provision that likely is meant as much to give guidance to the IRS’s own personnel as it is to give some comfort to practitioners. Certainly to date the IRS’s Office of Professional Responsibility has not had a history of going overboard after minor violations, and there’s not much reason to expect that the existence of monetary sanctions will now change that.

Penalty on the Employer

The law allows for a separate (and perhaps concurrent) monetary penalty to be imposed on the employer of the individual being disciplined or other entities if certain conditions are met. Generally, the penalty may be imposed if the IRS finds that

- The practitioner acted on behalf of his/her employer, firm or other entity *and*
- The employer, firm or other entity knew, or reasonably should have know, of the prohibited conduct

For the first prong of the test, the IRS provides the following definition for “acting on behalf” of the entity:

A practitioner is considered to have acted on behalf of an employer, firm, or other entity if –

- (1) An agency relationship existed between the practitioner and the employer, firm, or other entity;
- (2) The purpose of the agency relationship was to provide services in connection with practice before the Internal Revenue Service (as defined in §10.2(d) of Circular 230), and
- (3) The prohibited conduct giving rise to the penalty arose in connection with the agency relationship.

The key test is an agency relationship existing with a purpose of providing services in connection with practice before the IRS. If that is true and “prohibited conduct” takes place, then the first prong of the test is met.

The issue then becomes whether the entity meets the knowledge test. It is a knows or should have known test, which means that intentional ignorance isn’t going to work as a

defense.

An employer, firm, or other entity knows or reasonably should know of the prohibited conduct if --

(1) One or more members of the principal management (or officers) of the employer, firm, or other entity, or one or more members of the principal management (or officers) of a branch office knows, or has information from which a person with similar experience and background would reasonably know, of the prohibited conduct; or

(2) The employer, firm, or other entity through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) did not take reasonable steps to ensure compliance with Circular 230; and one or more individuals associated with the employer, firm, or other entity, in connection with their agency relationship with the employer, firm, or other entity, engages in prohibited conduct within the meaning of section 10.52 of Circular 230 that harms a client, the public, or tax administration, or a pattern or practice of failing to comply with Circular 230.

The first prong deals with actual knowledge of the problem, or possession of information that should have lead to someone in a position of management in the firm knowing of the prohibited conduct. Note that you are your partners keeper in this regard—if you become aware of bad conduct by a partner of your firm, that knowledge can lead to a penalty against the entire firm and not just the “bad apple” partner if you decide to ignore the issue.

The second prong goes after systematic failures—that is, the firm did not take reasonable steps to ensure compliance with Circular 230. In this case, there may not be any knowledge of anyone in the firm that a problem exists, nor any evidence that has come to anyone’s attention that a problem is out there. A firm that simply did not do any monitoring or communicate to its employees the requirements of Circular 230 could find itself liable for a monetary penalty under this provision if it is found that such a failure was related to “willfulness, recklessness, or gross indifference” which lead to the problem. Should SSTS No. 9 become final in the future, it seems very possible the IRS would consider the failure of a firm to have a quality control system that its employees can explain would be seen as strong evidence of just a level of willfulness, recklessness or gross indifference to the requirements of Circular 230.

IRS Examples

The IRS does give two examples in the notice of the application of these provisions. In the first example, we deal with an attorney working for a national accounting firm. That example reads as follows:

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

Attorney A reports to the director of the firm's tax practice. The director of the firm's tax practice provides general oversight as to Attorney A. The director of the firm's tax practice was aware of the strategies that Attorney A developed, including Strategy X, although he was not necessarily familiar with the technical tax details of each strategy. The director of the firm's tax practice also knew that Strategy X generated measurable revenue for the firm.

OPR determines that Attorney A engaged in prohibited conduct in violation of Circular 230 in the creation, promotion and marketing of Strategy X. Attorney A acted on behalf of the firm because an agency relationship existed between Attorney A and the firm, and the misconduct arose in connection with that agency relationship as Attorney A worked on behalf of the firm to promote Strategy X. The firm knew or had reason to know of the prohibited conduct in this situation. The director of the firm's tax practice, who is a member of principal management of the firm, had general knowledge that Attorney A developed the tax-advantaged strategies. Alternatively, in the absence of general knowledge, the director of the firm's tax practice would need to inquire into Strategy X because it added measurably to the firm's revenue. Both Attorney A and the firm are subject to a monetary penalty.

In this example, the mere fact that the attorney did not directly represent clients before the IRS did not insulate him from a penalty, nor was the firm insulated from liability for the penalty by the fact that the director of the firm's tax practice did not know the technical details of the shelter in question. The director had a duty to inquire into the strategy because it was a significant source of firm revenue.

The second example deals with a case where an unenrolled preparer takes a number of steps to "insulate" the bad conduct from Circular 230—steps that the notice held do not work.

Example 2: Unenrolled Return Preparer B owns and operates her own firm that provides return preparation services to the public and also specializes in preparing Forms 656, Offers In Compromise. B's firm employs 10 attorneys, CPAs and enrolled agents (all practitioners) and 15 unenrolled return preparers.

B supervises and directs all of her employees. B's firm is structured in such a manner so that the first and predominant contact for clients coming in from the public is with the unenrolled return preparers. The unenrolled return preparers assist clients with preparing Forms 656 that are later submitted directly to the Service. B does not review individual Forms 656 but has provided specific instructions to her staff regarding how to complete false and misleading Forms 656 in violation of Circular 230. In order to facilitate the submission to the Service of the false or misleading Forms 656, B's procedure is to authorize one of her 10 practitioners to submit a Form 2848 on behalf of a client much later in the process, well after submission of the Forms 656 in violation of Circular 230.

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

B's firm becomes subject to the penalty even though B has unenrolled individuals submit the fraudulent forms and B herself is an unenrolled preparer and is the person who is telling other unenrolled preparers how to prepare the false forms. The fact that B "insulated" the CPAs and attorneys from the bad conduct did not help the firm when the overall engagement was looked at by the IRS. The CPAs and attorneys were involved in practice before the IRS, and their employer had committed what would be actionable violations—thus, B's firm was now subject to specific penalties under Circular 230 by what became a "bootstrap" method of the IRS being able to get into the door.

Conclusions

The IRS may be ready to begin using these provisions as an enforcement tool, and this Notice outlines the IRS's viewpoint on the use of the tool. CPAs especially should be aware that this guidance may impact the importance of the expected issuance of the tax quality control standards in proposed SSTS No. 9, and that their quality control systems may need to be designed with this guidance in mind, especially the mitigation provisions. And, as noted, non-CPAs may themselves "bootstrapped" into having to develop similar systems indirectly via Circular 230 §10.33's "aspirational" standard for best practices that could become extremely important when the IRS is evaluating whether mitigating circumstances exist.

Disciplinary Actions under Section 822 of the American Jobs Creation Act of 2004

Notice 2007-39

This Notice provides guidance to practitioners, employers, firms, and other entities that may be subject to monetary penalties under 31 U.S.C. section 330. This Notice also invites comments from the public regarding rules and standards relating to monetary penalties under 31 U.S.C. section 330.

BACKGROUND

In general, 31 U.S.C. section 330 authorizes the Secretary to regulate attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others who practice before the Service. Regulations under section 330 are promulgated in 31 CFR part 10 and are reprinted as Treasury Department Circular No. 230.

Section 822 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (the Act), amended 31 U.S.C. section 330 to expand the sanctions that the Secretary may impose for certain prohibited conduct within the meaning of section 10.52 of Circular 230 to include monetary penalties. As amended by the Act, 31 U.S.C. section 330 authorizes the Secretary to impose sanctions, including monetary penalties, against a practitioner who is incompetent or disreputable, who fails to comply with the regulations prescribed under section 330, or who, with intent to defraud, willfully and knowingly misleads or threatens a client or potential client. The Secretary is also authorized to impose monetary penalties against an employer, firm, or other entity, if the practitioner

was acting on its behalf in connection with the prohibited conduct giving rise to the penalties and the employer, firm, or other entity knew, or reasonably should have known, of the prohibited conduct.

Monetary penalties apply only with respect to prohibited conduct that occurs after October 22, 2004, the date of enactment of the Act. 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.

Monetary penalties may be imposed for a single act of prohibited conduct or for a pattern of misconduct. Monetary penalties may be imposed in addition to, or in lieu of, any suspension, disbarment, or censure of the practitioner. Monetary penalties are not, however, a “bargaining point” that a practitioner may offer to avoid suspension, disbarment, or censure if these sanctions are otherwise appropriate.

REQUIREMENTS FOR IMPOSITION OF MONETARY PENALTIES

Amount of the Monetary Penalty

The aggregate amount of the monetary penalty (or penalties) imposed by the Secretary for any prohibited conduct may not exceed the collective gross income derived by the practitioner and the employer, firm, or other entity in connection with such prohibited conduct. If a single act of prohibited conduct giving rise to a monetary penalty is an integral part of a larger engagement, the amount of the penalty will be limited by the “gross income derived (or to be derived)” from the larger engagement. In the event that the larger engagement began on or before October 22, 2004, the “gross income derived (or to be derived)” will be calculated, on a pro rata basis, to exclude amounts attributable

to conduct occurring on or before October 22, 2004. In determining the amount of the monetary penalty (or penalties), the Secretary will consider amounts that the practitioner, employer, firm, or other entity could reasonably expect to realize, irrespective of whether the amounts have actually been received.

The Secretary has discretion to impose a monetary penalty in an amount less than the amount allowed by statute. In determining the amount of the penalty (or penalties), the Service will consider the level of culpability of the practitioner, firm, or other entity; whether the practitioner, firm, or other entity violated a duty owed to a client or prospective client; the actual or potential injury caused by the prohibited conduct; and the existence of aggravating or mitigating factors. Mitigating factors may include whether the practitioner, employer, firm, or other entity took prompt action to correct the noncompliance after the prohibited conduct was discovered; promptly ceased engaging in the prohibited conduct; attempted to rectify any harm caused by the prohibited conduct; or undertook measures to ensure that the prohibited conduct would not occur again in the future. In general, the Service will not impose monetary penalties in cases of minor technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct.

The Secretary may impose separate penalties against the practitioner and against the employer, firm, or other entity for any prohibited conduct. Each separate penalty may not exceed the gross income derived by the practitioner and the employer, firm, or other entity, respectively.

Imposition of a Separate Monetary Penalty on an Employer, Firm, or Other Entity

If a practitioner acted on behalf of an employer, firm or other entity in connection with prohibited conduct, the Secretary may impose a separate monetary penalty on the employer, firm or other entity if the employer, firm or other entity knew, or reasonably should have known, of the prohibited conduct.

A practitioner is considered to have acted on behalf of an employer, firm, or other entity if –

- (1) An agency relationship existed between the practitioner and the employer, firm, or other entity;
- (2) The purpose of the agency relationship was to provide services in connection with practice before the Internal Revenue Service (as defined in §10.2(d) of Circular 230), and
- (3) The prohibited conduct giving rise to the penalty arose in connection with the agency relationship.

An employer, firm, or other entity knows or reasonably should know of the prohibited conduct if --

- (1) One or more members of the principal management (or officers) of the employer, firm, or other entity, or one or more members of the principal management (or officers) of a branch office knows, or has information from which a person with similar experience and background would reasonably know, of the prohibited conduct; or
- (2) The employer, firm, or other entity through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) did not take reasonable steps to ensure

compliance with Circular 230; and one or more individuals associated with the employer, firm, or other entity, in connection with their agency relationship with the employer, firm, or other entity, engages in prohibited conduct within the meaning of section 10.52 of Circular 230 that harms a client, the public, or tax administration, or a pattern or practice of failing to comply with Circular 230.

The following examples illustrate the above provisions:

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

Attorney A reports to the director of the firm's tax practice. The director of the firm's tax practice provides general oversight as to Attorney A. The director of the firm's tax practice was aware of the strategies that Attorney A developed, including Strategy X, although he was not necessarily familiar with the technical tax details of each strategy. The director of the firm's tax practice also knew that Strategy X generated measurable revenue for the firm.

OPR determines that Attorney A engaged in prohibited conduct in violation of Circular 230 in the creation, promotion and marketing of Strategy X. Attorney A acted on behalf of the firm because an agency relationship existed between Attorney A and the firm, and the misconduct arose in connection with that agency relationship as Attorney A worked on behalf of the firm to promote Strategy X. The firm knew or had reason to know of the prohibited conduct in this situation. The director of the firm's tax practice, who is a member of principal management of the firm, had general knowledge that Attorney A developed the tax-advantaged strategies. Alternatively, in the absence of general knowledge, the director of the firm's tax practice would need to inquire into Strategy X because it added measurably to the firm's revenue. Both Attorney A and the firm are subject to a monetary penalty.

Example 2: Unenrolled Return Preparer B owns and operates her own firm that provides return preparation services to the public and also specializes in preparing Forms 656, Offers In Compromise. B's firm employs 10 attorneys, CPAs and enrolled agents (all practitioners) and 15 unenrolled return preparers. B supervises and directs all of her employees. B's firm is structured in such a manner so that the first and predominant contact for clients coming in from the public is with the unenrolled return preparers. The unenrolled return preparers assist clients with preparing Forms 656 that are later submitted directly to the Service. B does not review individual Forms 656 but has provided specific instructions to her staff regarding how to complete false and misleading Forms 656 in violation of Circular 230. In order to facilitate the submission to the Service of the false or misleading Forms 656, B's procedure is to authorize one of her 10 practitioners to submit a Form 2848 on behalf of a client much later in the process, well after submission of the Forms 656 in violation of Circular 230.

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

When determining if a monetary penalty should be imposed on an employer, firm or other entity, the Secretary will consider factors in addition to whether the employer, firm, or other entity knew, or reasonably should have known of the prohibited conduct (or whether the employer, firm or other entity did not use reasonable efforts to ensure compliance with Circular 230). For example, the Secretary will consider the gravity of the misconduct, any history of noncompliance by the employer, firm, or other entity, preventative measures in effect prior to the misconduct, and any corrective measures taken by the employer, firm, or other entity after the prohibited conduct was discovered, including measures to ensure that future prohibited conduct does not occur.

[Additional Guidance and Request for Comments](#)

The Service may issue additional guidance regarding the application of monetary penalties, including, but not limited to, the factors that the Service should consider when evaluating all the facts and circumstances of a particular case. The Service requests comments with respect to the appropriate factors to be considered when determining whether a monetary penalty is appropriate. Comments also are requested as to factors that the Service should consider in declining to impose a monetary penalty on an employer, firm, or other entity, including the weight given to adequate procedures in place for purposes of complying with Circular 230.

Additionally, in order to develop a penalty system that best encourages compliance with Circular 230, the Service requests comments regarding mitigating circumstances to consider when determining the amount of a monetary penalty. Mitigating circumstances could be considered, for example, in varying the amount of the penalty to correspond to the seriousness of the misconduct or pattern of misconduct. Mitigating circumstances could include, but not be limited to, the immediacy of the misconduct, history of misconduct, the existence of firm procedures, and corrective measures taken after discovery of the misconduct.

Interested parties are invited to submit comments by August 13, 2007. Comments should be submitted to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2007-39), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224.

Alternatively, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. to 4:00 p.m. to: CC:PA:LPD:PR (Notice 2007-39), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Comments

Cost of Bad Practice
<http://www.edzollars.com>

Podcast of April 24, 2007
Feed <http://feeds.feedburner.com/EdZollarsTaxUpdate>

may also be submitted electronically via the following e-mail address:

Notice.Comments@irscounsel.treas.gov. Please include “Notice 2007-39” in the subject line of any electronic submissions.

DRAFTING INFORMATION

The principal author of this notice is Matthew Cooper of the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this notice contact Matthew Cooper at (202) 622-4940 (not a toll-free call).