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# Why Regulate Tax Return Preparers?

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## Comment

# Why Regulate Tax Return Preparers?

## I. INTRODUCTION

The American system of taxation has progressed to a state of complexity that, at times, bewilders even the most competent professional. Taxpayers are, or at least think they are, in need of assistance in the preparation of their income tax returns and seek the aid and consultation of "tax experts" on an ever-increasing basis. Traditionally, Certified Public Accountants ("C.P.A.s") and attorneys have fulfilled this function but since the early 1960s the commercial return preparation business has seen a tremendous growth.<sup>1</sup>

The increase in the number of nonprofessional preparers of tax returns has not occurred without substantial criticism. The controversy has reached almost all aspects of the nonprofessional's practice including his competence, ethical standards, misuse of confidential information,<sup>2</sup> false and misleading advertising<sup>3</sup> and actual

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1. Harless, *Taxpayer Assistance and the Tax Practitioner*, 1973 TAX ADVISER 4, 5 [hereinafter cited as Harless].

2. INT. REV. CODE of 1954 § 7216 [hereinafter cited as CODE] now imposes a penalty for the illegal disclosure of information derived from a customer's tax return. The maximum penalty is \$1,000, one year in prison or both.

3. On June 30, 1971, the Federal Trade Commission issued proposed complaints against both H & R Block, Inc. and Beneficial Corporation and its affiliates. As to H & R Block, Inc.:

The proposed complaint alleged that contrary to the firm's TV and radio commercials and printed advertisements: (1) it does not reimburse the taxpayer for all payments he is required to make in addition to his initial tax payment if the additional payment results from an error made by it in preparing the tax return; and (2) it does not provide representation by persons qualified and certified by, and enrolled to practice before, IRS to their customers in instances where their tax returns are audited.

The complaint added that H & R Block provides to its wholly owned subsidiary, J. B. Grossman, Inc., certain data culled from tax returns.

Proposed Complaints, File No. 712 3433 [1970-1973 Transfer Binder] TRADE REG. REP. ¶ 19,677, at 21,724 (FTC June 30, 1971).

Beneficial Corporation was charged with similar misrepresenta-

fraud. The Internal Revenue Service's ("Service") primary quarrel with the organized return preparation industry has been with its false and misleading advertising tactics.<sup>4</sup>

Early in 1972, the Service began a campaign against certain commercial tax return preparers it suspected were engaged in the preparation of fraudulent returns. During 1972, the Service made more than 3,000 undercover contacts.<sup>5</sup> One-third of these the Service had reason to believe were preparing improper returns. The other two-thirds involved preparers who employed false and misleading advertising, or who otherwise appeared questionable.

More than 60 per cent of the returns prepared for Service employees in undercover capacities revealed improprieties.<sup>6</sup> Because of the improprieties disclosed and abuses of the type the FTC has acted on, it would appear the regulation of the income tax return preparation industry is imminent. Congressman John S. Monagan, chairman of the Legal and Monetary Affairs Subcommittee on Government Operations, at the beginning of hearings on H.R. 7590 stated:

[It is] apparent that the mushrooming tax return preparation industry, which is estimated to have 200,000 participants, is basically unregulated and while the majority of them, I am sure, govern themselves by the highest standards of ethics, some are perpetrating a fraud on the U.S. Treasury, a great disservice to the American taxpayer.<sup>7</sup>

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tion and false advertising.

The proposed complaint alleged the firms' TV and radio commercials and printed advertising misrepresent that they will provide an "instant refund" when they prepare the returns of taxpayers to whom a refund is owed by the Internal Revenue Service. In reality, it is alleged their "instant tax refund" is a personal loan and the recipient is required to pay finance charges and other costs for it.

Further allegations in the complaint are that the firms falsely advertise that: (1) they will reimburse the taxpayer for any payments he may be required to make in addition to his initial tax payment if the additional payments result from an error made by them in preparing the tax return; (2) their personnel are especially trained and unusually competent in preparing tax returns and giving advice; and (3) their customers receive a demonstrably greater percentage of refunds than the tax paying public at large.

Proposed Complaints, File No. 712 3580 [1970-1973 Transfer Binder] TRADE REG. REP. ¶ 19,677, at 21,724 (FTC June 30, 1971).

The former firm later consented to the cease and desist order of the Federal Trade Commission. Consent Order, File No. 712 3433 [1970-1971 Transfer Binder] TRADE REG. REP. ¶ 19,884 at 21,893 (FTC Dec. 29, 1971).

4. Harless, *supra* note 1, at 5.

5. *Id.* at 6.

6. *Id.*

7. *Hearings on H.R. 7590 Before the Subcomm. on Legal and Monetary*

While Congress did not pass H.R. 7590, a similar bill is now pending. The pending bill, S. 1046,<sup>8</sup> would require licensing of preparers and permit the Secretary of the Treasury to establish the standards for licensing.

For one to evaluate the recent proposals, he must know the present restrictions. Consequently, this article will consider existing Internal Revenue Code of 1954 ("Code") provisions which restrict or regulate preparers, and professional ethics which govern the actions of attorneys and C.P.A.s. Then analyses of the recent proposals made by the commercial return preparation industry, the Service and the American Institute of Certified Public Accountants ("A.I.C.P.A.") will be made. Furthermore, the article will consider the American Bar Association's ("ABA") position on these different proposals.

## II. CODE PROVISIONS AFFECTING PREPARERS

The Code contains a series of provisions which impose both civil and criminal penalties for noncompliance with tax statutes. The most formidable of the civil penalties, section 6653(b),<sup>9</sup> imposes a penalty equal to 50 per cent of the underpayment for fraud by a taxpayer.

Although the line between tax evasion and tax avoidance is often hard to draw, evasion has been considered to be synonymous with fraud<sup>10</sup> and implies the intentional underpayment of taxes

*Affairs of the House Comm. on Government Operations, 92d Cong., 2d Sess. 1 (1972).*

8. S. 1046, 93d Cong., 1st Sess. § 6021 (1973).

9. CODE § 6653 provides:

### FAILURE TO PAY TAX

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME OR GIFT TAXES.—If any part of any underpayment (as defined in subsection (c) (1)) of any tax imposed by subtitle A or by Chapter 12 of Subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(b) FRAUD.—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a). In the case of a joint return under section 6013 this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

10. Note, *Civil Tax Fraud Liability for the Preparer of Another's Return*, 54 IOWA L. REV. 345, 348 (1968).

legally due. Avoidance, on the other hand, is associated with the legal reduction of one's tax liability. Evasion involves the attempt to knowingly portray transactions and events so as to gain favorable tax treatment when, in reality, a different disposition would be in order if all facts were properly disclosed. Avoidance involves planning transactions to comply with the Code and yet result in a lower tax.

Another distinction between the civil fraud penalty and the other civil penalties embodied in the Code is the burden of proof required. To impose the civil fraud penalty, the Commissioner must prove by clear and convincing evidence that the taxpayer intended to knowingly underpay his taxes,<sup>11</sup> whereas in the assessment of a deficiency there is a presumption that the Commissioner is correct.<sup>12</sup> In other words, the taxpayer must have the necessary scienter before the civil fraud penalty may be imposed. In many respects, the elements of a civil fraud case are similar to the common law offense of fraud.<sup>13</sup>

The 50 per cent civil fraud penalty is computed on the basis of the amount of underpayment.<sup>14</sup> In order to compute this penalty, a return must have been filed. The penalty is assessed on the amount of underpayment on the timely filed return<sup>15</sup> and it has been held that the deficiency cannot be reduced by late payments.<sup>16</sup>

Assuming that the elements of the civil fraud case are present, how may the taxpayer rebut the Commissioner's assertion? If a third party has prepared the taxpayer's return, the taxpayer generally will have a valid defense to a civil fraud penalty if he is able to meet five criteria. These criteria are:

- 1) the taxpayer must act in good faith; 2) he must make sufficient disclosures of the facts to permit counsel to judge fairly the problems at hand; 3) solution to the tax questions must be within the scope of the matters on which counsel is giving advice or rendering an opinion; 4) counsel must act in good faith; and 5) counsel must be reasonably competent on which advice is asked.<sup>17</sup>

The taxpayer is primarily liable for the tax return, however, and if he fails to fully comply with one of the requirements, for ex-

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11. *Id.* at 349.

12. *Id.*

13. *Id.* at 348.

14. CODE § 6653(c) (1).

15. *Id.* If the taxpayer neither files a return nor pays any tax, he will be subject to the penalties provided in CODE § 6651.

16. Rev. Rul. 56-54, 1956-1 CUM. BULL. 654; Joseph N. Roman, 25 P-H Tax Ct. Mem. 419, *aff'd*, 235 F.2d 730 (4th Cir. 1957).

17. Note 10 *supra*, at 350-51.

ample withholding relevant facts from the preparer, he will be unable to avoid the penalty.<sup>18</sup>

The civil fraud penalty applies only to the taxpayer. It is the most severe of the civil tax penalties embodied in the Code.<sup>19</sup> Regardless of any bad faith, misleading advertising, incompetency or negligence, no civil penalty is provided for the tax return preparer in the Code. A criminal sanction does exist;<sup>20</sup> but, because of the burden of proof and disparity between the fee received by the preparer and the magnitude of the potential penalty, it has been imposed in only the most blatant cases.

The penalties for criminal fraud are understandably more onerous than those for civil fraud. The Code provides that any person who is guilty of criminal fraud "shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$5,000, or imprisoned more than three years, or both, together with the cost of prosecution."<sup>21</sup> The line between civil and criminal tax fraud is indeed a difficult one to draw. The real difference, as one author has stated, is "that a civil case ripens into a criminal case when it has that elusive but additional ingredient of insidiousness

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18. *E.g.*, *Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969); *Burrell v. Commissioner*, 400 F.2d 682 (10th Cir. 1968); *Fabacher v. United States*, 17 Am. Fed. Tax R.2d 401 (D. Miss. 1965).

19. Other penalties include: (1) CODE § 6653(a) imposes a penalty equal to 5% of the underpayment for negligence; (2) CODE § 6651(a)(1) imposes a 5% per month penalty, with a maximum of 25% of the deficiency, for failure to file a return; (3) CODE § 6651(a)(3) levies a penalty equal to 6% per annum of the deficiency when the return is filed and the tax due is not paid or an additional assessment is not paid within 10 days.

20. CODE § 7206 provides:

**FRAUD AND FALSE STATEMENTS**

Any person who—

(1) **DECLARATION UNDER PENALTIES OF PERJURY.**—Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) **AID OR ASSISTANCE.**—Willfully aids or assists in, or procures, counsels or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; or

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$5,000, or imprisoned not more than 3 years, or both, together with the costs of prosecution.

21. CODE § 7206.

that enables the Government to prove its case beyond a reasonable doubt."<sup>22</sup> The criminal sanction is in no way dependent upon the size of the deficiency; rather, it is based solely upon the violation.

Section 7206(2) imposes the criminal fraud penalty, *inter alia*, on "any person who . . . wilfully aids or assists in . . . the preparation . . . of a return . . . which is fraudulent or false as to any material matter . . ."<sup>23</sup> At present, this is the only statutory constraint on income tax preparers.<sup>24</sup> Because it has been imposed too sparingly, a statutory penalty for lesser offenses by the preparer is also needed.

Because of the burden of proof which the government must meet—guilty beyond a reasonable doubt—indictments have been issued for only the most flagrant violations. In *Hull v. United States*,<sup>25</sup> a C.P.A. was convicted of aiding and abetting, under section 7206(2), the filing of false returns when he knowingly included as a business expense an amount for commissions which he knew had not, and never would be, paid. In another example of an obvious fraud, *Hedrick v. United States*,<sup>26</sup> the C.P.A. involved masterminded the whole scheme. The taxpayer attempted to deduct stock distributed to certain officers and key employees as compensation, when, in actuality and to the knowledge of the C.P.A., the officers and employees had been fully compensated and the stock distribution was no more than a stock dividend, a nondeductible item. Although the preparer in *Hedrick* was the individual who designed the fraudulent scheme, the case does stand for the proposition that in an aiding and abetting case, the professional may receive a more severe penalty than the taxpayer because of the professional's superior knowledge and higher standard of care.<sup>27</sup>

The Code provides no redress against the grossly incompetent, negligent, misleading or unethical preparers. The Service has embarked, however, upon a campaign against unscrupulous preparers. Although the results are incomplete and inconclusive, the government investigated 418 individual preparers in the 1972

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22. *Moore v. United States*, 360 F.2d 353, 355 (4th Cir. 1966), *citing Beck, When Avoidance: When Evasion*, 18 N.Y.U. INST. ON FED. TAX 1093, 1104-05 (1960).

23. CODE § 7206(2).

24. CODE § 6653 has no civil counterpart for preparers.

25. 356 F.2d 919 (5th Cir. 1966).

26. 357 F.2d 121 (10th Cir. 1966).

27. Other examples of fraud by practitioners include: *United States v. Barnes*, 313 F.2d 325 (6th Cir. 1963); *United States v. Herskovitz*, 209 F.2d 881 (2d Cir. 1954); *Newton v. United States*, 162 F.2d 795 (4th Cir. 1947); *United States v. Edwards*, 230 F. Supp. 881 (D. Ore. 1964); *Fulton v. Commissioner*, 14 T.C. 1453 (1950).

calendar year and obtained convictions or guilty pleas in 127 cases.<sup>28</sup> All of these cases were brought under section 7206(2) and it is felt that the majority of return preparers will be unaffected by these actions. Only the most flagrant violators are prosecuted and because of the higher burden of proof and the nature of the offense, a felony, the provision will not have a sufficient deterrent effect.

### III. OTHER RESTRAINTS ON PROFESSIONALS

Two groups of professionals, attorneys and C.P.A.s, are engaged in the preparation of income tax returns. In addition to the section 7206(2) restrictions, standards have been imposed by the two professions. The attorney has held the stature of a professional since the middle ages and he is expected to be a leader in establishing ethical standards to govern the bar's conduct. Although the C.P.A. was not recognized as a professional until the twentieth century, he also has promulgated rules of conduct.

The ABA Code of Professional Responsibility is not concerned directly with the practice of law as related to tax matters. Little doubt remains, however, that its standards govern the attorney whether he be litigating a case, representing a client before the Service or preparing a client's income tax return. The Code of Professional Responsibility speaks directly to the attorney's competence when it states:

28. The following summary of tax practitioner cases was obtained from the Internal Revenue Service.

**Calendar Year 1972**  
**Summary Of Tax Practitioner Cases As Of 3-1-73**

| Region         | Cases Pending |                  |                       |               |                           | Legal Actions          |             |                            |                       | TOTALS     |
|----------------|---------------|------------------|-----------------------|---------------|---------------------------|------------------------|-------------|----------------------------|-----------------------|------------|
|                | Open Cases    | Regional Counsel | Department of Justice | U.S. Attorney | Complaints (Not Arrested) | Arrests (Not Indicted) | Indictments | Convictions or Guilty Plea | Acquittals Dismissals |            |
| North-Atlantic | 3             | 4                | 1                     | 2             | 1                         | 4                      | 6           | 6                          | 0                     | 27         |
| Mid-Atlantic   | 18            | 1                | 0                     | 6             |                           | 0                      | 28          | 9                          | 1                     | 63         |
| Southeast      | 13            | 1                | 1                     | 1             |                           | 8                      | 16          | 27                         | 4                     | 71         |
| Central        | 0             | 4                | 0                     | 3             |                           | 2                      | 8           | 9                          | 0                     | 26         |
| Midwest        | 29            | 6                | 1                     | 2             |                           | 4                      | 8           | 21                         | 3                     | 74         |
| Southwest      | 15            | 1                | 0                     | 5             |                           | 10                     | 18          | 21                         | 2                     | 72         |
| Western        | 4             | 6                | 0                     | 13            |                           | 1                      | 24          | 34                         | 3                     | 85         |
| <b>TOTALS</b>  | <b>82</b>     | <b>23</b>        | <b>3</b>              | <b>32</b>     | <b>1</b>                  | <b>29</b>              | <b>108</b>  | <b>127</b>                 | <b>13<sup>1</sup></b> | <b>418</b> |

1. Four acquittals and nine dismissals.



Employment should not be accepted by a lawyer when he is unable to render competent service . . . .<sup>29</sup>

Because of his vital role in the legal profession, a lawyer should act with competence and proper care in representing clients. He should strive to become and remain proficient in his practice and should accept employment only in matters which he is or intends to become competent to handle.<sup>30</sup>

[A] lawyer generally should not accept employment in any area of law in which he is not qualified . . . .<sup>31</sup>

A lawyer shall not

- (1) Handle a legal matter which he knows or should know that he is not competent to handle, without associating with him a lawyer who is competent to handle it.<sup>32</sup>

Law, like many other disciplines today, tends to require specialization. If an attorney specializes in some area of law other than taxation and has not kept current with tax developments, he no doubt would be subject to disciplinary proceedings if he were to undertake a client's tax work without doing a substantial amount of research. Although seldom done in practice, attorneys have an ethical duty to report any incompetence of this nature of other attorneys to the local disciplinary committee.<sup>33</sup>

In preparing a tax return or representing a client before the Service, an attorney may resolve areas of conflict in his client's favor,<sup>34</sup> but he must never forget that even though it may be an adversary setting,<sup>35</sup>

[i]n all cases, with regard to both the preparation of returns and negotiating administrative settlements, the lawyer is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively either by misstatements or by silence or by permitting his client to mislead.<sup>36</sup>

A lawyer may not advance spurious or frivolous claims in the client's behalf. The Code of Professional Responsibility states:

- (A) In his representation of a client a lawyer shall not:

. . . .

- (2) Knowingly advance a claim or defense that is unwarranted under existing law, except that he may advance such claim or defense if it can be supported by good faith argu-

29. ABA CODE OF PROFESSIONAL RESPONSIBILITY EC 2-30 (1970).

30. *Id.* EC 6-1.

31. *Id.* EC 6-3.

32. *Id.* DR 6-101.

33. *Id.* EC 1-4.

34. *Id.* EC 7-3.

35. See Paul, *The Lawyer as a Tax Adviser*, 25 ROCKY MT. L. REV. 412, 430 (1953).

36. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 314 (1965).

ment for an extension, modification, or reversal of existing law.

.....

(7) Counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent.<sup>37</sup>

Ethical standards established by the legal profession, then, should effectively restrain undesirable behavior. The Code of Professional Responsibility speaks to the attorney's competence and his duties not to mislead and not to represent a client that is attempting to mislead or perpetrate a fraud. Additional regulation of the tax bar by statute should be unnecessary.<sup>38</sup>

The other professional engaged in tax practice, the C.P.A., also has established professional standards by which he is governed. Unlike the attorney, however, the C.P.A. is usually an *independent* expert who issues financial statements on which the public relies. Noting this distinction, one author has stated the general rule as:

[I]t does not seem appropriate to say that a C.P.A. acts as an advocate in tax practice. He must, in the opinion of the ethics committee, observe the same standards of truthfulness and integrity as he is required to observe in any other professional work. This does not mean, however, that [he] may not resolve doubt in favor of his client as long as there is a reasonable support for his position.<sup>39</sup>

These general professional standards prohibit concealment,<sup>40</sup> participation in fraud<sup>41</sup> and the preparation of a return when he knows or should know that the client is concealing information.<sup>42</sup> The accounting profession's standards with respect to the disclosure of a client's intention to commit a crime are analogous to those of the ABA.

Attorneys and C.P.A.s who are enrolled to practice before the Department of the Treasury must abide by the mandates of Treasury Circular 230. This circular requires that every attorney must conduct his practice in an ethical and professional manner, and it is his duty to observe the ABA canons of ethics. Agents other than lawyers must follow the ethical standards of the accounting profession. In accepting a card which evidences their right to practice before the Service, enrolled agents also agree to a num-

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37. ABA CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102 (1970).

38. The attorney no doubt fears disbarment more than the imposition of a civil penalty for the former deprives him of his very livelihood.

39. J. CAREY & W. DOHERTY, *ETHICAL STANDARDS OF THE ACCOUNTING PROFESSION* 78 (1966).

40. *Id.* at 30.

41. *Id.* at 87.

42. *Id.* at 84.

ber of additional requirements embodied in Treasury Circular 230 which include the following:

**Information to be furnished.—(a) To the Internal Revenue Service.**—No attorney, certified public accountant, or enrolled agent shall neglect or refuse promptly to submit records or information in any matter before the Internal Revenue Service, upon proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, or shall interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service or its officers or employees to obtain any such record or information, unless he believes in good faith and on reasonable grounds that such record or information is privileged or that the request for, or effort to obtain, such record or information is of doubtful legality.<sup>43</sup>

**Knowledge of client's omission.**—Each attorney, certified public accountant, or enrolled agent who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client is required by law to execute in connection with such matter, shall advise the client promptly of the fact of such noncompliance, error, or omission.<sup>44</sup>

**Diligence as to accuracy.**—Each attorney, certified public accountant, or enrolled agent shall exercise due diligence:

(a) In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(b) In determining the correctness of oral or written representations made by him to the Internal Revenue Service; and

(c) In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the Internal Revenue Service.<sup>45</sup>

Some authors have indicated that these requirements may impose a higher standard on the attorney representing a client before the Service.<sup>46</sup> In other words, an attorney would be required to make a fuller disclosure of all relevant facts than otherwise would be necessary in a civil non-tax case. This double standard, however, disappears when the dispute reaches the litigation stage in either the Tax Court or a federal district court.<sup>47</sup>

The ethical standards established by both professions should deal effectively with the preparer guilty of fraud. If convicted,

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43. Treas. Cir. 230 § 10.20 (a), 1966-2 CUM. BULL. 1171, at 1178.

44. Treas. Cir. 230 § 10.21, 1970-2 CUM. BULL. 644.

45. *Id.* at § 10.22.

46. Note 35 *supra*, at 429-30.

47. *Id.* at 430.

an attorney would be disbarred<sup>48</sup> and a C.P.A. would lose his license to practice. Ethical standards are not as effective, however, when dealing with the negligently prepared return or an incompetent preparer. It already has been stated that lawyers have a duty to report other attorneys' incompetence, but this is seldom done in practice. Because few if any ethical violations of this nature are reported, and many more such violations are never revealed to fellow attorneys, the local disciplinary committee is unable to enforce effectively the ethical standards. A similar situation exists in the accounting profession. Some authorities have pointed to the malpractice suit as an effective governing force but, because such suits are only brought when a substantial sum is involved, the potential liability is more of a theoretical consideration than one affecting routine activities. Additionally, the attorney or C.P.A. handling large or complex tax matters is generally an individual eminently qualified who has earned the respect of the client. Essentially, then, supposed controls over professionals in preparing occasional or small returns are largely illusory.

#### IV. NONPROFESSIONAL PREPARER

The majority of criticism related to tax return preparers has been directed at the nonprofessional group. Much, but not all, of this criticism is justified in light of the advertising tactics employed by some and the misrepresentation, incompetency and fraud practiced by others.

To understand the scope of the problem, one first must consider who may enter the field of tax return preparation. Virtually anyone may label himself a "tax expert" and begin preparing returns for a fee.<sup>49</sup> No special education is required by law. Regulations promulgated in Treasury Circular 230 are binding only upon those who practice before the Department of the Treasury—generally attorneys, C.P.A.s and enrolled agents who have successfully completed a written examination. Very few nonprofessionals are enrolled agents and therefore they are not bound by the mandates of Treasury Circular 230. The only other formal requirement established by the Code is that anyone preparing a return for a fee must sign it<sup>50</sup> and, of course, the fraud provision of section 7206 (2) is applicable to the nonprofessional.

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48. The conviction of a felony would constitute an act discreditable to the profession.

49. Commissioner Walters has cited some of the off-season occupations of preparers as including a travel agency operator, a railroad checker, an insurance agency, a proprietor of a variety store, an employment security specialist, a minister, a teacher, a factory worker and a realtor.

50. CODE § 6065.

The nonprofessional preparer most often is concerned with small wage earner returns. These are generally quite simple and little training or education is required to properly complete them. Because of the ease of entry into the field and lack of formal educational requirements, a large portion of the self-labeled tax experts are no more than technicians. On many of the returns he prepares, the nonprofessional is qualified because of the simple nature of the return. When the nonprofessional encounters a complex return or an unusual item, however, he may be unqualified and unable to competently prepare the return unless he conducts extensive research. Even with a great deal of research, which he most likely is unable to conduct because of his lack of education or training, he may be unable to relate one Code section to another and applicable case law. All too often, he refuses to recognize his incapacities and, if he does, in even fewer cases does he relate this limitation to his customer. The result is an ill-advised taxpayer.

Closely related to the nonprofessional's competence is his practice of false and misleading advertising. This in no way implies that all such individuals engage in this practice, but only that those who do are not subject to adequate legal restraints. The Federal Trade Commission ("FTC"), an entity not known for its aggressiveness, has on occasion issued a cease and desist order to some of the most flagrant violators.<sup>51</sup> The Service has attempted to police this area by having its field agents issue warnings to offenders and, in many instances, voluntary compliance has been experienced.<sup>52</sup> For those who do not comply voluntarily, however, no legal restraints are available unless the FTC acts.

What little restraint existing for the professional because of the malpractice suit is virtually nonexistent for the nonprofessional. With the majority of these returns being prepared for less than \$25, few find it worth the money or effort to file suit. This situation enables the unscrupulous nonprofessional to increase his business and appease his clients by preparing their returns without further research even if required and without further inquiry of them when the facts so demand. The virtual nonexistence of the malpractice remedy also enables the nonprofessional to increase business and appease clients by taking deductions or failing to report income which he knows is not authorized by the Code. When a deficiency is later imposed by the Service, the preparer, because of his seasonal business, is often difficult to locate. If last year's campaign against unscrupulous preparers is any indication of a trend in the industry, legislation obviously is needed.

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51. See note 3 *supra*.

52. Harless, *supra* note 1.

## V. RECENT PROPOSALS

Prompted by abuses in the tax return industry, the Service, the legal profession, the accounting profession and various nonprofessional preparers have voiced their opinions about regulations or restrictions needed to prevent the present problems. The thrust of these proposals is directed generally at the commercial preparer but, due to the inadequacy of other controls in certain areas, the professional should not be exempted. A comparison of these proposals and positions taken by the various interested groups will reveal the inadequacy of some, impracticality of others, and utility and effectiveness of still others.

S. 1046, the pending bill previously mentioned, is basically a licensing proposal. It would 1) require all preparers of more than 25 returns per year to be licensed, unless the preparer is an attorney, a C.P.A., a licensed Public Accountant, or an enrolled agent; 2) authorize the Secretary of the Treasury to establish standards for licensing—including the preparation and conducting of examinations; 3) require the preparer to sign each return he prepares and indicate his license number; and 4) require the preparer to file an annual information return listing all clients for whom returns were prepared. The proposed bill fails to correct some of the problems existing in the industry already discussed. The proposals of the various concerned groups have used this bill as a starting point and have added their views and criticized those of other groups in relation to it.

## A. Commercial Return Preparers' Proposals

The commercial return preparation industry favors a system of registration or licensing in order to prevent the abuses already discussed and to eliminate the unscrupulous preparer.<sup>53</sup> Henry W. Block, president of H & R Block, Inc., the largest nonprofessional return preparer, expressed his views in the following proposals:

1) Registration should be required from any person, firm or corporation preparing ten or more income tax returns for compensation in any one year;

.....

3) No individual, partnership or corporation may be registered if, in the case of an individual, that person, or in the case of a partnership, any partner, or in the case of a corporation, any of its officers or directors, has been convicted of a felony within the past ten years.

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53. Simonneti, *Regulation of Tax Return Preparers—It's On the Way*, 1972 TAX ADVISER 346, 347 [hereinafter cited as Simonneti].

6) The registration application form must indicate the qualifications of the party to prepare tax returns. In the case of a partnership or corporation, there must be filed with the registration application information concerning the training of its tax preparers.

7) Each registrant must notify his customers that in the event of the customer's return being audited, the registrant will accompany the customer to the Internal Revenue Service or to the appropriate state agency to explain how the return was prepared.

....

9) A tax return preparer should be prohibited from advertising the fact that he is a registered tax return preparer.<sup>54</sup>

Mr. Block's registration or licensing proposal is very controversial. Registration or licensing has been opposed in theory by the Service, the ABA's tax section and the A.I.C.P.A.<sup>55</sup> These entities are concerned with the licensing proposal's practicality and utility. The proposal would require standards for the issuance of licenses. Such standards would more than likely evaluate the applicant's competence, character and method of practice. Unless licenses were limited to individuals with a certain educational background, examinations would be necessary if the Service were to meaningfully inquire into the applicant's competence. A great deal of additional manpower would be required to administer a licensing system and Congress has not indicated it would authorize such manpower.

The Service has summarized its position by stating that it neither has the manpower nor money to police effectively such a licensing system. Former Commissioner Walters stated:

Even if we were to have a licensing or registration system, it is obvious that we could not have a single form of license or registration to cover the preparer of a simple wage-earner return and also a complex business return. Furthermore, it would presumably be necessary to re-examine the qualifications and character of preparers at regular intervals. In our opinion, this would consume too much manpower needed for revenue compliance work.<sup>56</sup>

If the funds and manpower were available, a comprehensive licensing system would result in more competent and reliable service to the American taxpayer. If the tax return preparation industry were limited to those individuals admitted to practice before the Service, for instance, the Service would have an effective control of return preparers and the practices they employ, since they

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54. *Hearings on H.R. 7590 Before the Subcomm. on Legal Monetary Affairs of the House Comm. on Government Operations*, 92d Cong., 2d Sess., 80-81 (1972).

55. Simonneti, *supra* note 53, at 347-48.

56. *Id.* at 348.

would be governed by the mandates of Treasury Circular 230. The increased competence of preparers under such a system would be dramatic, but this increase would not result without considerable costs to the taxpayer. Not only would additional funds and manpower be required to police the licensing system, but preparers' fees also would rise substantially. One must consider the additional costs and whether the desired benefits could justify such an expenditure. Some authors believe the taxpayer deserves nothing less<sup>57</sup> and that the increased costs could be viewed as a cost of collecting the tax.

Even if Congress were willing to appropriate the necessary funds, the Service or whoever would be charged with the responsibility, would have a difficult task in establishing different types of licenses. As former Commissioner Walters pointed out, "[I]t is obvious that we could not have a single form of license or registration to cover the preparer of a simple wage-earner return and also a complex business return."<sup>58</sup> Categories would have to be established and it would be necessary to preclude those licensed to do the simpler returns from preparing the more complex. A licensing system which would provide for numerous classes of licenses probably would be impractical and require a disproportionate amount of Service supervision.

Other criticisms of the licensing proposal are related to the availability to the Service of the identities of those for whom preparers have completed returns. If the Service has reason to believe that an individual may be preparing fraudulent or improper returns, it would have no practical way of determining how many improper returns were prepared by him. The Service must be able to locate all returns prepared by an individual in order to effectively police the return preparation industry. Without the equivalent of an annual information return submitted by preparers, or similar information stored in computer memory banks, the Service will be unable to recall readily all returns prepared by a certain preparer. This the ABA and A.I.C.P.A. believe is a serious shortcoming since the Service would have a heavy burden in setting and maintaining the standards of competency and ethics of registered preparers unless it had available a means by which to check the performance of an individual preparer.

Mr. Block's other proposals appear to have little merit. If a licensing system is to be more than a rubber-stamping of licenses, the Service would have to be aware of the licensees' qualifications

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57. Wright, *Federal Tax Administration and the Small Taxpayer*, 6 J. LAW REFORM 529, 541 (1973) [hereinafter cited as Wright].

58. Note 56 and accompanying text *supra*.



and the third proposal would be unnecessary. The seventh proposal, requiring the preparer to notify clients that he will accompany them to the Service if their return is audited, has been used by at least one commercial return preparer as an advertising gimmick. Until the FTC issued a cease and desist order,<sup>59</sup> this company gave the impression that its preparers would legally represent the taxpayer before the Service. In reality, the preparers could not practice before the Service and they seldom accompanied the taxpayer to the district conference. The value of the commercial preparer accompanying the taxpayer is indeed questionable, and compelling such attendance should not be required. The ninth and final proposal, prohibiting advertising that one is a licensed preparer, is illusory. If only licensed preparers are allowed to prepare returns, the preparer will have no need to make or gain any advantage from making such an advertisement.

## B. Service's Proposals

The Service has favored legislation and regulations which would both penalize and identify the incompetent or unscrupulous preparer. Former Commissioner Walters summarized these proposals as:

- 1) Establish a statutory penalty on the preparer of 10 to 25% of the deficiency in tax caused by a preparer who knowingly understates income or overstated deductions, exemptions, credits, etc. . . .
- 2) Authorize the Government to apply directly to the U.S. District Courts for injunctions to prevent further preparation of returns by preparers who consistently prepare false or deficient returns. . . .
- 3) Establish a penalty of, say, \$5 for each return which is not signed by a preparer. . . .
- 4) Require each preparer to furnish an annual information return listing all of the taxpayers, and their identification numbers, for whom returns have been prepared. . . .
- 5) The Service would design model courses and course materials and make them available to appropriate schools and universities who conduct courses open to preparers and the general public.<sup>60</sup>

The first proposal would be analagous to the present civil fraud penalty of section 6653 (b) except that it would apply to the preparer of the return rather than the taxpayer. This proposal would provide a penalty for fraudulent conduct that did not warrant the time-consuming procedures involved with a criminal prosecution under section 7206 (2). However, the provision requires the preparer to *knowingly*, understate income or overstate deductions. If

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59. See note 3 *supra*.

60. Harless, *supra* note 1, at 7-8.

the Service is able to prove this intentional act, it probably also could obtain a conviction under the present provisions. In order to combat more fully the evils at which the proposal is aimed, the sanction also should include a penalty for the preparer's negligence. With such a provision, courts would not be required to play the word-games of asking whether the incompetent preparer was merely grossly negligent or willingly overstated deductions or understated income. In the case of an incompetent preparer, this is often a difficult distinction to make, but the Service should be empowered to impose a monetary reprimand in either situation.

The Service's second proposal has been severely criticized by some authors<sup>61</sup> for having little utility. Because of court congestion in many areas of the country, it would be long after the filing season before any case was heard on the merits. Few district court judges would be willing to grant such an injunction without at least a preliminary argument on the merits. After the filing season when the case is finally heard, the issue would be moot. Additionally, the proposal would require a showing of consistently preparing false returns. This is analogous to the "first bite" rule. As a whole, criticism of this proposal's utility appears to be justified.

The fourth proposal, requiring an annual information return, has received the approval of both the ABA and the A.I.C.P.A. It is designed to fulfill one of the shortcomings of the registration proposal in that it would permit the Service quick access to all returns prepared by an individual. It would appear that this requirement would be applicable to both the professional as well as the commercial return preparer. As preparers are already obligated to sign the returns they prepare,<sup>62</sup> no objection should be voiced when a list of all returns prepared for the year also is required. Once the Service has such a list, it can use its data processing capabilities to determine more readily the unscrupulous and negligent preparers. When auditing a return and uncovering improprieties, an agent could check to see whether the particular preparer had made errors of that type on other returns and, if so, forward the information to the Intelligence Division. Once identified, the punitive provisions of the Code could come into play.

### C. A.I.C.P.A.'s Proposals

The Tax Division of the A.I.C.P.A. has gone on record as favoring the basic proposals advanced by the Commissioner with the following additions:

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61. Wright, *supra* note 57, at 642-43.

62. CODE § 6065.

- 1) Negligence penalties should be imposed on tax return preparers.
- 2) A monetary penalty should be imposed for each return prepared by a tax return preparer who engaged in misleading advertising.
- 3) Copies of all returns prepared by tax return preparers should be retained for a period of three years. Also, preparers should give a copy of each return prepared to the taxpayer.
- 4) The I.R.S. should expend its publicity programs to inform taxpayers about the responsibilities of tax return preparers and to caution taxpayers to engage only qualified preparers.<sup>63</sup>

The imposition of a negligence penalty, as suggested by the A.I.C.P.A., could be a meaningful complement to the civil fraud penalty proposed by the Commissioner. It would enable the Service to invoke legal sanctions on the incompetent or careless preparer. In many instances, it appears that this situation is more prevalent than the actual intent to defraud as required in the Commissioner's proposed civil fraud penalty for preparers. If properly drafted, a negligence penalty also could cover the situation where the preparer knows or has reason to know the client or customer is not telling the whole truth. A preparer then should have a duty to inquire; if he is unable to satisfy himself that the customer probably is disclosing all of the pertinent facts, he should refuse to complete the return. Such a provision should apply to all preparers, including the professional since the professional who prepares only an occasional return or only wage earner returns is not otherwise effectively controlled.

Critics of the negligence penalty state that it merely would shift the enforcement burden to the courts, as opposed to the Service under a licensing system.<sup>64</sup> Accordingly, rather than increase the appropriations and manpower of the Service, Congress would have to make a similar increase in manpower and appropriations for the federal courts. One must realize, however, that under the A.I.C.P.A. proposal, the Service could apply this penalty on a selective basis—as it now does with the returns it selects for audit. Also, it is hoped that the establishment of a substantial amount of case law on this issue would provide a sufficient deterrent so that the number of additional cases actually going to trial would be manageable. A very large proportion of preparers will no doubt plead guilty or *nolo contendere*,<sup>65</sup> which also would tend to diminish the associated court congestion.

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63. Simonneti, *supra* note 53, at 348.

64. Wright, *supra* note 57, at 542.

65. This assumption is based on the fact that the total penalty per preparer will not be large enough to justify an extended trial and defense

Few would contend that a negligence penalty could attain the same objectives as a comprehensive and well-managed licensing system. Rather, such a penalty would be intended to bolster the Service's arsenal and provide a specific Code section for charging the negligent or grossly incompetent preparer. The selective application of a negligence penalty by the Service probably would be sufficient to rid the tax return preparation industry of the unscrupulous and most incompetent individuals, and to discourage other like individuals from entering the field. Additionally, a negligence penalty has a greater chance of acceptance since, at the present, it is probably an almost insurmountable task to convince Congress and the American taxpayers to support the type of licensing system that would be necessary, or to contend with the increased governmental control.

The proposal that the Service expand its publicity program need not take the form of a legislative directive. It appears that nothing would preclude the Service, if it so desired, to initiate such a program on its own. This past year the Service has placed its major emphasis on dispelling taxpayer misconceptions and fears of the task of preparing his return. It has established toll-free information lines where taxpayers may call and request answers to tax questions. Internal Revenue agents are available at local offices to assist in preparing returns and answering questions. It would appear that the suggestion by the A.I.C.P.A. would be a logical sequence to this program and is consistent with numerous statements by the Service that it has nothing against preparers in general and recognizes that they provide a useful service, except when they are engaged in false or misleading advertising practices, or other abuses already discussed.<sup>66</sup>

## VI. CONCLUSION

Due to the lack of effective controls, unscrupulous and incompetent individuals are able to engage in the business of preparing income tax returns. In the words of Congressman Monagan "a great disservice to the American taxpayer"<sup>67</sup> is being permitted. The most effective way of countering this problem is to: 1) establish a civil fraud penalty for the preparer as suggested by

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on the part of the preparer when the prosecution has sufficient evidence to warrant a conviction. On the other hand, the penalty should be large enough to have a deterrent effect and thus not be regarded as simply another business expense by the preparer.

66. Harless, *supra* note 1.

67. Note 7 and accompanying text *supra*.

Commissioner Walters, 2) require each preparer to furnish an annual information return listing all taxpayers for whom returns were prepared, 3) establish a negligence penalty for preparers—including a provision whereby the preparer would have a duty to inquire where the facts so demand, and 4) conduct a campaign to educate the American taxpayer that he is primarily responsible for his tax return and so he should rely on only “competent” preparers.

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