REPORT #747

TAX SECTION

New York State Bar Association

Proposed Amendments to 31 CFR Part 10 (Circular 230)

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New York State Bar Association

January 11, 1993
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R (IA-20-92)
Room 5228
Washington, D.C. 20044

Re: Proposed Amendments to 31 CFR Part 10 (Circular 230)

Ladies and Gentlemen:

In general, we think the Treasury is to be commended for its conclusions (1) that the standard of conduct expected of practitioners who prepare returns is the "realistic possibility" test of Code section 6694 which imposes penalties upon tax return preparers, and (2) that the standard of discipline applied to those who fail to meet this standard of conduct is that the failure must be due to willfulness, recklessness or gross incompetence. Therefore, a problem with the proposed version of Circular 230-that imposition of the section 6694 penalty might automatically trigger a disciplinary action-has been dealt with. A return preparer who fails to meet the realistic possibility (or one-in-three) test will not be disciplined under the new rule unless his or her failure was willful, reckless, or grossly incompetent. We believe that the new regulations draw a reasonable line between safeguarding rights of practitioners on the one hand and safeguarding the fisc on the other.

However, we are concerned about the proposed change which would impose new limitations on contingent fees for return preparation. Proposed new section 10.28(b) would prohibit such contingent fees except for preparing claims for refund and only “if the practitioner reasonably anticipates, at the time the claim is filed, that the claim will be denied by the Service and subsequently litigated by the client.” The proposed change is explained as reflecting Treasury's fear “that permitting contingent fees for tax return preparation would undermine voluntary compliance by encouraging return positions that exploit the audit selection process.”

First, we recommend that the definition of “contingent fee” be made more explicit. At present, the only definition is contained in the last sentence of proposed new section 10.28(b):

> A contingent fee includes a fee that is based on a percentage of the refund shown on a return or a percentage of the taxes saved, or that depends on the specific result attained.

The word “includes” strips this definition by example of most of its utility. We recommend that the explanatory sentence be changed to read substantially as follows:

> For this purpose a contingent fee is a fee based entirely or principally upon a percentage of the refund shown on a return or a percentage of the taxes saved, or that depends upon the specific result obtained.

A further problem is the scope of what constitutes return preparation. The definition of a return preparer in the regulations

under section 7701(a)(36) as amplified by Treas. Reg. § 301.7701-15 includes any person other than the actual return preparer who renders advice which is directly relevant to the determination of the existence, characterization or amount of an entry on a return or claim for refund. While subsection (a)(2)(i) of the regulation provides an exception for a person who renders advice relating to the consequences of contemplated actions (i.e. prospective advice) as opposed to advice relating to events which have already occurred, the language of subsection (a)(l) suggests, that even prospective advice to a taxpayer can cause the advice giver to be classified as a return preparer if the advice is comprehensive enough to make the preparation of the return or refund claim largely a “mechanical or technical matter”. Thus, the definition of a return preparer may very well include any practitioner who advises a client regarding the structuring of a transaction or, at the very least, require a highly subjective analysis of the weight and effect of the practitioner's advice before a determination can be made as to whether he or she falls within the definition. Therefore, as presently drafted, Circular 230 would appear to prohibit the charging of a contingent fee based on the tax outcome of a particular transaction, even where the advice given did not include a recommendation as to how the transaction was to be reported, if at all, on the taxpayer's return, if the conclusion on how to report the transaction is determined by the advice. We believe that such a restriction on contingent fees is overbroad and unworkable since advice, whether direct or inferential, about the reporting of the transaction will usually be only a small part of the overall analysis, and should not prevent the practitioner from making a contingent fee arrangement with the client Therefore, the contingent fee limitation should be restricted to a contingent charge for the actual preparation of a tax return without regard to the nature or content of transactional advice given to the taxpayer.

Finally, we are well aware that only a very small percentage of returns, including refund returns, are examined and we can appreciate the concern of Treasury and the Internal Revenue Service that permitting tax return preparers to charge contingent fees for such work as preparing individual income tax returns reflecting refunds, as most do, might well reduce compliance. The low examination coverage is surprising and disappointing to us. If taxpayers become aware that a bogus claim for refund is very likely to be granted automatically without being reviewed by any person, such claims are bound to proliferate. The analogy of “stealing candy from a baby” at first blush seems apposite, except that even a baby may scream. We strongly suggest that Internal Revenue Service should take whatever actions are necessary so that a majority of claims for refund are reviewed before they are granted.

The Circular's exception for refund claims is unrealistic. Consistent with the Service's administrative practice, many claims that initially are denied by the Service are settled with the taxpayer prior to any litigation. Thus, except in the few cases in which the Service has announced a no compromise position, there is no reason why a practitioner would anticipate that a claim having some reasonable basis would be “litigated”. Indeed, based upon the statistics discussed in the preceding paragraph, it seems doubtful that any taxpayer could anticipate that a claim that did not involve a substantial amount of money would even be reviewed, let alone denied Finally, a reasonable expectation of examination test is so subjective that it is very difficult to apply. While examples might clarify and reduce misunderstandings, their use might encourage noncompliance by illustrating examination standards.

Although we have been unable to reach any firm consensus on the issue, we generally believe that the Service's fears about contingent fees for return and claim preparation should be allayed if it is reasonably certain that a claim for refund prepared by someone whose fee depends upon the claim's allowance is likely to be scrutinized by a Service employee in the examination process. In this context, all amended returns should be given the same treatment as those which constitute claims for refund.

Therefore, we suggest that a contingent fee for the preparation of a claim for refund or amended return be allowed if the claim or amended return contains a sufficient notification to the Internal Revenue Service that the preparer is charging a contingent fee. Appropriate wording could be placed on the particular form to implement this “check the box” suggestion.

If, as we hope, you find that our recommendations have merit, we will be glad to work with you in effectuating them.

Sincerely yours,

John A. Corry
Chair

cc: Honorable Shirley D. Peterson
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