

NEW YORK STATE BAR ASSOCIATION TAX SECTION

**COMMENTS IN RESPONSE TO NOTICE 2007-39
CONCERNING MONETARY PENALTIES FOR CERTAIN
PROHIBITED CONDUCT UNDER CIRCULAR 230**

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EXHIBIT A -- Possible Revision of Section 10.52

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The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Treasury Department under 31 U.S.C. section 330(a) ("Section 330"). The Secretary is also authorized to discipline a representative who is incompetent, is disreputable, violates regulations prescribed under Section 330, or, with intent to defraud, willfully and knowingly misleads or threatens a person being represented (or a prospective person to be represented).² The regulations promulgated under Section 330 have long been known as "Circular 230."³

Prior to enactment of the American Jobs Creation Act of 2004 (the "2004 Act"), Public Law No. 108-357, Section 330 provided for two possible sanctions -- suspension from practice before the Treasury Department and disbarment from such practice.

¹ The principal drafters of this Report were Ellen S. Brody, Elliot Pisem, and Bryan C. Skarlatos. Substantial contributions were made by Diana L. Wollman. Helpful comments were received from Patrick Gallagher, David Miller and Michael Schler.

² Section 330(b).

³ 31 C.F.R. sections 10.0 through 10.93. Section 10.50(a) restates the Secretary's authority to impose discipline in these cases, section 10.51 contains examples of incompetence and disreputable conduct, and section 10.52 contains standards of culpability relevant to determining whether a practitioner will be sanctioned for violation of a Circular 230 regulation ("willfully" in the case of certain regulations, and "recklessly or through gross incompetence" in the case of others). Unless otherwise indicated, all "section" references in this Report are to the Circular 230 regulations.

The 2004 Act amended Section 330 in several significant ways. First, the 2004 Act expanded the disciplinary sanctions that could be imposed under Section 330 to include "censure" (*i.e.*, a public reprimand) and a "monetary penalty," which may be in addition to, or in lieu of censure, suspension, or disbarment, but may not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Second, the Secretary was authorized to impose a "monetary penalty" on an employer or other firm or entity on whose behalf a representative who engaged in sanctionable conduct had acted, if such employer, firm, or entity knew or reasonably should have known of such conduct. Finally, the 2004 Act "confirmed" the authority of the Secretary to impose standards applicable to rendering of certain written tax advice.

The amendments made by the 2004 Act became effective for actions taken after the date of amendment.

On April 23, 2007, the Internal Revenue Service (the "Service") issued Notice 2007-39 (the "Notice") in which the Service provided guidance regarding the "monetary penalty" provisions of the 2004 Act and requested comments with respect to appropriate factors to be considered when determining whether a monetary penalty is appropriate, factors that the government should consider in declining to impose a monetary penalty on an employer, firm, or other entity, and mitigating circumstances to consider when determining the amount of a monetary penalty. This Report attempts to respond to that request for comments.⁴

⁴ The Tax Section has provided extensive comments on prior revisions to Circular 230. *See, e.g.*, NYSBA Report on Proposed Amendments to Circular No. 230 (July 31, 2000), NYSBA Report on Proposed Modifications to Circular No. 230 (July 25, 2001), NYSBA Comments on Issues Relating to Circular 230 (February 14, 2003), NYSBA Comments on Proposed Circular 230 Amendment (May 24, 2004), NYSBA Report on Circular 230 Regulations (March 3, 2005), and NYSBA Report on Circular 230 (May 1, 2006).

I. RATIONALE FOR IMPOSING A MONETARY PENALTY

Any evaluation of the factors to be considered in determining whether and how to impose a monetary penalty should take into account the purpose of the monetary penalty. In providing a reason for the new monetary penalty, the legislative history of the 2004 Act says only that "[u]se of these sanctions is expected to curb participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards."⁵ Proper implementation of monetary sanctions can provide the Treasury Department with a powerful new weapon to deter prohibited conduct. Actions by practitioners that do not warrant a censure, suspension or disbarment can now be disciplined through monetary penalties alone. Moreover, the threat of a monetary penalty may deter some tax practitioners for whom censure or suspension from practice before the Treasury Department is, for whatever reason, not significant. In other cases, a monetary penalty may be added to another penalty to make the sanction more painful. The existence of a monetary penalty gives the Treasury increased flexibility which allows it to fashion an appropriate sanction for a broader range of prohibited conduct.

II. WHEN IS A MONETARY PENALTY APPROPRIATE?

A. When Is Any Penalty Appropriate?

The question of what factors should be considered in determining whether a monetary penalty is appropriate raises the more general question of when is any penalty appropriate. Section 10.52 of Circular 230 contains the standards for imposing the sanctions of censure, suspension or disbarment and provides that such sanctions may be imposed for willful violations of certain regulations and for recklessly or through gross incompetence violating other

⁵ See H.R. 4520, Conference Agreement for the 2004 Act at 395, citing Sec. 622 of the House Bill and Sec. 414 of the Senate Amendment.

regulations. We believe that monetary penalties should be treated no differently than other sanctions under Circular 230. Further, we believe that the basic rules governing the imposition of the monetary penalty should be set forth expressly in the text of the regulations. To that end, we recommend that section 10.52 be amended to include monetary penalties and that the same standards of willfulness, recklessness and gross incompetence be applied to monetary penalties. We have drafted proposed revisions to section 10.52 to incorporate these and other comments suggested below.⁶ Our proposed draft of section 10.52 is attached hereto as Exhibit A.

B. What is the Relationship of the Monetary Penalty to the Other Available Sanctions?

Once it is determined that a practitioner has violated the appropriate standard of conduct, the issue of which sanction to impose should be addressed in the broader context of the three other sanctions available to the Secretary and where the monetary penalty fits within the hierarchy of those sanctions. The Notice states that monetary penalties may, under Section 330, be imposed in addition to, or in lieu of, suspension, disbarment, or censure. We agree that it is appropriate for the government to have discretion to impose the monetary penalty in isolation or in combination with other sanctions as needed to match the sanction with the severity of the violation. However, the Notice does not indicate whether the government views monetary penalties, standing alone, as being more or less onerous than any of the other sanctions.

In some circumstances, the potential harm to the reputation of a practitioner from a public censure would be a more severe punishment than payment of a monetary fine. In these instances, the long-term reputational damage of a public censure can impact on the future

⁶ Clarifying and conforming changes to section 10.51, which articulates varying standards of culpability for several forms of "disreputable conduct," may also be appropriate. Conforming changes to several other sections of Circular 230 would be required as well.

livelihood of the practitioner significantly more than a one-time monetary penalty, and this factor, where it is present, should be taken into account in determining the sanction to be imposed.⁷ Conversely, in the case of tax practitioners who never appear before the Service, censure, suspension, or even disbarment may be less of a deterrent, and a monetary penalty may be the only sanction that matters.

We are split as to whether the name of a practitioner on whom a monetary penalty has been imposed should always be disclosed to the public. Some of us believe that the name of the practitioner should always be disclosed. Others of us believe that the government should have the discretion to impose a non-publicized monetary penalty in less egregious cases.

We suggest that the regulations explicitly state that a monetary penalty can be imposed as the sole sanction, or censure, suspension or disbarment can be imposed as the sole sanction, or any combination can be imposed. The regulations also should identify the factors to be considered in imposing a sanction, which factors should include the nature and circumstances of the violation and the history and characteristics of the individual being punished, as well as the need for the sanction. Our proposed revisions to section 10.52 contains a list of these factors modeled, in part, after 18 U.S.C. section 3553(a), which sets forth the factors to be considered for purposes of determining an appropriate criminal sentence.⁸ See Exhibit A.

⁷ In some cases, this may properly lead to the conclusion that a monetary sanction, standing alone, is an insufficient penalty for a particular violation, while, in cases involving less egregious behavior, it may lead to the conclusion that only a monetary penalty, and not censure, is appropriate.

⁸ Our proposed revisions to section 10.52 address the general standard for imposition of the monetary penalty on individuals as well as employers, firms and other entities, rules regarding the maximum amount of a monetary penalty, factors to be considered in determining the appropriate sanctions, and an effective date provision. This report also comments on other aspects of the Notice, and we suggest that such comments be incorporated in a revised notice that provides guidance regarding the new monetary penalty.

While it is relatively easy to list factors indicating that a more or less severe sanction is appropriate, it is much more difficult to determine how to weigh these factors in particular cases and to ascertain whether any punishment should be imposed and, if so, of what magnitude. The fact-intensive nature of this inquiry does not lend itself to the promulgation of black-letter rules.⁹ Thus, once it has been determined that a violation has occurred, we believe that the Office of Professional Responsibility (“OPR”) should be able to take into account all the facts and circumstances in setting a punishment, including mitigating and aggravating factors that cannot necessarily be anticipated at the time rules are drafted (including, if appropriate, the “interests of justice”). However, some reasonable level of guidance should still be provided that can set “benchmarks” for dealing with real world cases. Guidance could be provided in a variety of ways. Several examples could be added to Circular 230, or an accompanying notice, describing particular fact patterns and the punishment that would likely be appropriate in each of them.

In addition, the Service should consider regular publication of reasoned decisions in disciplinary matters by OPR.¹⁰ The body of published decisions would help practitioners understand when and how sanctions will be imposed. In the case of a published decision where only a monetary penalty was imposed, see the discussion earlier in this part II.B concerning whether the practitioner’s name should be disclosed or expurgated; however, even if the

⁹ IRS Chief Counsel Donald L. Korb stated that “It is our objective here to apply common sense,” in discussing the 2004 amendments to Circular 230 regulations at a Practising Law Institute conference on June 16, 2005, 2005 TNT 118-6, June 21, 2005.

¹⁰ Although OPR regularly publishes lists of the names of individuals who have been disbarred, suspended, and censured, no description of the violations committed by these individuals is published. *See, e.g.*, Announcement 2007-72; 2007-33 IRB 373.

practitioner's name were expurgated, a description of the violation and the penalty could be published.

The Notice states that the Service will not generally impose a monetary penalty for "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." It is not clear to us, however, whether this is meant to suggest that some other penalty (possibly censure) would be appropriate in such cases. In our view no penalty should be imposed for a minor violation of the regulations where there is little or no injury and little likelihood of repeated similar misconduct.

The Notice also states that "[m]onetary penalties are not . . . a 'bargaining point' that a practitioner may offer to avoid suspension, disbarment, or censure if these sanctions are otherwise appropriate." We concur; a practitioner should not be able to avoid a well-justified censure, suspension, or disbarment by making a large cash payment. (Similarly, the government should not attempt to compel the payment of monetary penalties by threatening practitioners with more serious sanctions.) On the other hand, the process of "plea bargaining" has a long history as a means of resolving disciplinary matters, and we are reluctant to suggest anything that would limit the flexibility to resolve disciplinary matters potentially involving "hazards of litigation" on a compromise basis. If improper "bargaining" is found to be occurring, consideration could be given at that time to amending section 10.61 to prevent the imposition of monetary proceedings without a full proceeding on the matter.

C. When Should Monetary Penalties Be Imposed on a Practitioner?

As noted above, we believe that monetary penalties, without disclosure, may properly be considered more or less onerous than censure. In the case of truly egregious

conduct, monetary penalties may be appropriate in addition to censure, suspension or disbarment.¹¹ However, monetary penalties should not be imposed in every single case as a matter of course, but rather only after a careful consideration of the facts and circumstances. The imposition of monetary penalties is intended to deter certain behavior and was not simply intended as a “revenue raiser”.

The Internal Revenue Code (the “Code”) now contains a panoply of provisions imposing various monetary penalties on tax practitioners for a wide range of improper conduct. We believe that monetary penalties relating to a single violation should not generally be sought against a practitioner under both Circular 230 and the Code.

III. WHEN SHOULD THE GOVERNMENT IMPOSE A MONETARY PENALTY ON AN EMPLOYER, FIRM, OR OTHER ENTITY?

Section 330 authorizes the imposition of a monetary penalty on an employer, firm, or other entity "if it knew, or reasonably should have known, of such conduct [giving rise to a penalty by a practitioner acting on behalf of such employer, firm, or other entity]." The Notice properly restricts such liability to situations in which the employer, firm, or other entity, through willfulness, recklessness, or gross indifference, did not take reasonable steps to ensure compliance with Circular 230. We do not believe that penalties should be imposed on an employer that learns of misconduct by an employee after the fact and takes reasonable steps to mitigate the effect of the violation and ensure compliance in the future.

It still must be determined, however, who at the firm has to know or reasonably know of the conduct. The managing partner? The head of the tax department? The partner in

¹¹ Obviously, monetary penalties should be imposed in case of additional violations by individuals who have already been disbarred from practicing before the Service.

charge of ensuring compliance with Circular 230 by establishing appropriate procedures as required under section 10.36? We believe section 10.36 provides a framework regarding firm liability that can be used in this context. Accordingly, we recommend that there be a safe harbor from sanctions for any firm that can show that it has taken reasonable steps to ensure adequate procedures for purposes of complying with Circular 230. Further, a firm that can show that it uses "best practices for tax advisors" as set forth in Section 10.33(b) should generally be relieved of any monetary sanction. Additional examples, including some illustrating when sanctions will not be imposed on a firm, even though there may have been violations by particular employees or partners, would be extremely helpful in this area.¹²

The Notice asks for comments "as to factors that the Service should consider in declining to impose a monetary penalty on an employer, firm or other entity." We are concerned that this question suggests that monetary penalties are automatically assessed against an employer, firm, or other entity, unless the Service declines to impose such a penalty. The imposition -- or even assertion -- of any sanction under Section 330 and Circular 230 is a serious matter that can affect the reputation and financial wellbeing of an employer for years to come. Moreover, in many aspects of tax practice, the Service and practitioners are frequently, and properly, in an adversarial relationship. For these reasons, OPR has been set up outside of the Service, to provide both the reality and the appearance of impartial decisionmaking, and it should

¹² We also recommend certain changes to the first example in the Notice. The example states that Attorney A engaged in prohibited conduct in connection with the marketing of tax planning strategies, but without specifying what that conduct was. The facts in the example should be clarified to eliminate the incorrect (and, we believe, unintended) inference that marketing and refining an off-the-shelf tax planning strategy is inherently prohibited conduct. Indeed, without knowing the nature of the prohibited conduct, it is hard to know how the firm in that situation would have known or reasonably should have known of it. Finally, the example finds it relevant that the strategy added "measurably" to the firm's revenue. With sufficient effort, almost any contribution to a firm's revenue, whether large or small, can be measured. If a duty of inquiry is to be imposed on firms, it should be with respect to "material," rather than "measurable," increases in revenue.

not be suggested that it is within the Service's discretion to impose or to decline to impose a penalty without reference to specific standards of conduct and culpability set forth in the regulations.

IV. WHAT IS THE APPROPRIATE AMOUNT OF A MONETARY PENALTY?

We are concerned that the Notice suggests that the Service views the maximum amount of monetary penalty authorized by Section 330 -- the gross income derived (or to be derived) from the conduct giving rise to the penalty -- as presumptively the proper amount of monetary penalty, from which the Service will depart only in its discretion.¹³ Just as there is no reason to presume that a monetary penalty will be imposed, there is similarly no reason to presume that the maximum monetary penalty is appropriate. OPR should bear the burden of demonstrating the appropriateness of any penalty, taking into account all relevant facts and circumstances, including the relative dollar amounts of the maximum statutory penalty as compared to the tax liability involved in the misconduct being punished. The gross income derived from the engagement thus should merely set a cap on the monetary penalty that may be imposed. Several issues are presented in computing the amount of this cap.

A. How Should "Gross Income" Be Measured?

The statute expressly states that the "penalty shall not exceed the gross income derived (or to be derived) *from the conduct giving rise to the penalty...*" However, the Notice provides that, if the prohibited conduct giving rise to the 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.*" Thus, the Notice contains more expansive language

¹³ In the words of the Notice, "The Secretary has discretion to impose a monetary penalty in an amount less than the amount allowed by statute."

than the statute by referring to “the larger engagement” as opposed to the “conduct giving rise to the penalty.”

The idea of including all income from “the larger engagement” appears to be derived from the Regulations defining "material advisors" under section 6111 of the Code. In the material advisor regulations, however, the "total fees" are relevant only in determining whether or not an individual is a "material advisor," and the penalty imposed for failure to comply with the underlying substantive rules is generally a fixed dollar amount. In the Circular 230 case, including all income from the larger engagement increases the potential dollar amount of the penalty itself. We recommend that the regulations follow the statutory language. A monetary penalty should not be computed by reference to work done by corporate, real estate, or other "business" lawyers on transactions that would have gone forward, often in exactly the same manner, independent of the conduct prohibited by Circular 230. On the other hand, where a transaction would not have occurred but for a tax goal that involves Circular 230-prohibited conduct, the fees attributable to the non-tax work on the transaction would generally be included in measuring the maximum amount of a monetary penalty.

To address these issues, we suggest that the Notice be modified to provide that the amount of the penalty be limited by the gross income derived (or to be derived) from the prohibited conduct and any services that are directly attributable to the prohibited conduct. Whether services are “directly attributable” to prohibited conduct would incorporate a “but for” test of causation such that income from other services would be included in computing the penalty only if the other services would not have been provided but for the prohibited conduct. In this way, the amount of penalty would still be tied directly to the prohibited conduct. Examples could be given to illustrate when particular services are directly attributable to

prohibited conduct. For instance, if a general practice firm markets an abusive tax shelter transaction and fifty percent of its fee is reasonably allocable to the tax advice and fifty percent of its fee is reasonably allocable to setting up entities in a tax haven jurisdiction to effect the transaction, then we believe that the fees for the setting up the entities would be directly attributable to the prohibited conduct because the fees would not have been earned but for the prohibited conduct. In contrast, if a practitioner drafts a tax opinion that violates section 10.35 regarding a transaction that would have occurred regardless of the prohibited conduct, then the non-tax fees for structuring and implementing the transaction are not directly attributable to the prohibited conduct and should not be included in determining the amount of the penalty.

Guidance also should be provided regarding application of monetary sanctions when little or no gross income is derived by the practitioner from the prohibited conduct. Would the sanction simply shift to other available penalties (censure, suspension, disbarment) when there is no fee (or the fee is not deemed sufficient to constitute a penalty)?

Another important issue is how the Secretary should determine amounts that the practitioner or firm “could reasonably expect to realize, irrespective of whether the amounts have actually been realized.” Is this intended to cover amounts that have been billed but not yet collected? What about amounts that were written off by the practitioner and never actually billed to the client or amounts that can never be collected as the client is suing the attorney for malpractice? We recommend that the penalty be limited to amounts that the practitioner has actually collected or reasonably expects to receive.

Other issues also arise regarding the computation of the gross income of a particular practitioner who works for a firm or other entity. It may be virtually impossible to measure the gross income of a tax practitioner who is either an employee or a partner in a law or

accounting firm that is derived from any specific engagement or any specific incident of misconduct. Whether the practitioner is an employee on a set salary or a partner whose share of the profits varies based on many factors, the fees derived from the conduct may have virtually no bearing on the total compensation of the practitioner. Some sort of proportion based on hours devoted to the engagement or similar factors would result in rough justice at best.

Furthermore, care must be exercised to ensure that the imposition of a monetary penalty on an employer, firm, or other entity does not result in an improper multiplication of penalties. This can occur in a number of ways. First, because the monetary penalty is capped at the gross income derived from the conduct, a firm that received a fee from a client for services performed by an employee or independent contractor ("service provider") and then remitted a large portion (or even all) of that fee to the service provider as salary or other compensation could be penalized the full amount of the fee, even though a penalty in the same amount was also being imposed on the service provider. In such a case, the sum of the penalties imposed on the firm and the service provider should not exceed the amount collected, or reasonably expected to be collected, from the client. Second, as noted above, section 10.36 already requires certain practitioners who oversee a tax practice to take reasonable steps to ensure that all practitioners in the firm comply with section 10.35. It would not be proper to penalize such an overseeing practitioner twice -- once, under the rules as they existed before the 2004 Act, for the practitioner's own violation of section 10.36, and then again under the new rules for employer liability.

B. Effective Date Issues.

With respect to conduct that occurred both before and after the effective date of the statute, the monetary penalty should be calculated only on fees attributable to services rendered after the effective date of the statute.

V. WHAT MITIGATING CIRCUMSTANCES SHOULD BE CONSIDERED?

The Notice lists numerous mitigating factors, including whether the practitioner or firm 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 addition to these factors, the government should consider the history of misconduct by the practitioner and/or firm, the level of experience of the practitioner, the appropriateness of firm supervision over the practitioner, the actions taken by the firm to educate the practitioners regarding the rules and regulations, and the sophistication of the client with respect to tax matters. The existence and degree of harm to the public as opposed to a particular client should also be considered in determining whether to impose a penalty and the amount of any such penalty.

The existence of mitigating factors is part of the larger analysis of the overall culpability of the practitioner which, as described above, is a fact intensive inquiry that must be determined case by case.¹⁴ Thus, the best approach is for future guidance to state that all relevant mitigating factors will be considered and that the burden of their proof is on the practitioner. This would help ensure that any appropriate mitigating factors will be brought to the attention of the government before sanctions are imposed.

¹⁴ In some cases, aggravating factors, such as participation in the marketing of an abusive transaction will be present, and such factors should be taken into account as well.

EXHIBIT A

Possible Revision of Section 10.52 (marked to show changes from current regulation)

§10.52 Violation of regulations.

- (a) *Standards for imposing sanctions.* A practitioner may be subjected to a monetary penalty, censured, or suspended or disbarred from practice before the Internal Revenue Service for any of the following:
- (1) Willfully violating any of the regulations (other than §10.33) contained in this part.
 - (2) Recklessly or through gross incompetence (within the meaning of §10.51(l)) violating §§10.34, 10.35, 10.36 or 10.37.
- (b) *Employers, firms or other entities.* If a practitioner acts on behalf of an employer, firm or other entity in connection with conduct that is prohibited by the regulations contained in this part, then such employer, firm or other entity may be subjected to a monetary penalty if (i) the employer, firm or other entity knew, or reasonably should have known, of such conduct or (ii) after learning of the conduct, does not take reasonable steps to mitigate the effect of the violation and to ensure future compliance with such regulations.
- (c) *Maximum amount of monetary penalty.* The amount of any monetary penalty imposed on a practitioner shall not exceed the gross income derived (or reasonably expected to be derived) by the practitioner from the conduct giving rise to the penalty. The amount of any monetary penalty imposed on a practitioner's employer, firm or other entity shall not exceed the gross income derived (or reasonably expected to be derived) by such employer, firm or other entity from the conduct giving rise to the penalty.
- (1) A person that has paid a monetary penalty under 26 U.S.C. §§6694, 6700 or 6701 shall not be subject to a monetary penalty under these regulations for the same conduct.
- (d) *Factors to be considered in determining the appropriate sanction.* The Secretary shall consider all appropriate factors in considering the appropriate sanction or sanctions to be imposed pursuant to subsection (a) of this section or §10.51 including the following:
- (1) The nature and circumstances of the violation and the history and characteristics of the practitioner or employer, firm or other entity, including –
 - i. The level of culpability of the practitioner, employer, firm or other entity;

- ii. Whether the practitioner, employer, firm or other entity violated a duty owed to a client or prospective client;
 - iii. The actual or potential injuries caused to a client, prospective client or the Government by the prohibited conduct; and
 - iv. The existence of aggravating or mitigating factors.
- (2) The need for the sanction imposed –
- i. To reflect the seriousness of the violation, promote respect for the law and provide just punishment for the violation;
 - ii. To adequately deter future prohibited conduct; and
 - iii. To protect the public.
- (e) Monetary penalties. Monetary penalties can be imposed as the sole sanction or in combination with other sanctions.
- (f) *Effective date.* This section applies after June 20, 2005.