

#31 AUTHORIZE A PENALTY FOR TAX RETURN PREPARERS WHO ENGAGE IN FRAUD OR MISCONDUCT BY ALTERING A TAXPAYER'S TAX RETURN

Present Law

Internal Revenue Code (IRC) § 6694 authorizes the IRS to impose a penalty when a tax return preparer has understated a tax liability on a “return or claim for refund” and the understatement is due to willful or reckless conduct.¹³¹ IRC § 6695(f) imposes a \$500 penalty on a preparer who negotiates a taxpayer’s refund check.¹³²

Reasons for Change

TAS has handled hundreds of cases involving return preparer fraud or misconduct. In the most common scenario, a taxpayer visits a preparer to get his tax return prepared, the preparer completes the return while the taxpayer is present, and the preparer alters the return after the taxpayer leaves before submitting it to the IRS. In some cases, the items of income, deduction, and credit are accurate, but the preparer alters the direct deposit routing information so the entire refund is directed to his account instead of the taxpayer’s account. In other cases, the preparer increases the refund amount and elects a “split refund,”¹³³ so the taxpayer receives the refund amount he expects and the additional amount goes to the preparer.

The Department of Justice (DOJ) may bring criminal charges against preparers who alter tax returns, but resource constraints generally preclude criminal charges except in cases of widespread schemes. In addition, the dollar amount of a refund obtained by a preparer in these cases often will determine whether the DOJ pursues an erroneous refund suit under IRC § 7405, as resources again constrain the number of suits that can be brought each year. It is therefore important that the IRS have the authority to impose sizeable civil tax penalties against preparers who alter tax returns without the knowledge or consent of taxpayers.

Under current law, the IRS has very limited authority to impose civil penalties in instances of preparer fraud. The IRC § 6694 penalty generally will not apply to either of the scenarios described above for the following reasons:

- When a preparer has altered items of income, deduction, or credit in an attempt to increase a taxpayer’s refund after the taxpayer has reviewed and approved the return for filing, the IRS Office of Chief Counsel has concluded that the resulting document is not a valid “return or claim for refund.”¹³⁴ As a consequence, the IRC § 6694 penalty does not apply.
- When a preparer has altered only the direct deposit information on the return and has not changed the tax liability, there is no understatement of tax.

In addition, it is unclear whether the IRC § 6695(f) penalty applies. The IRS and the Treasury Department have interpreted the IRC § 6695(f) penalty as applicable to a preparer who negotiates “a check (including an

131 The amount of the penalty is per return or claim for refund and is equal to the greater of \$5,000 or 75 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

132 Similarly, Section 10.31 of Circular 230 (31 C.F.R. Part 10) prohibits a tax practitioner who prepares tax returns from endorsing or negotiating a client’s federal tax refund check.

133 Taxpayers can split their refunds among up to three accounts at a bank or other financial institution. See IRS Form 8888, Allocation of Refund (Including Savings Bond Purchases). The instructions to Form 8888 specifically advise taxpayers not to deposit their refunds into their tax return preparer’s account.

134 Program Manager Technical Advice (PMTA) 2011-20, Tax Return Preparer’s Alteration of a Return (June 27, 2011); PMTA 2011-13, Horse’s Tax Service (May 12, 2003).

electronic version of a check).”¹³⁵ It is not clear whether a “direct deposit” is legally identical to an “electronic version of a check.” Therefore, when a preparer diverts a taxpayer’s refund via direct deposit but the return is otherwise accurate, it is not clear whether the preparer’s misconduct is subject to the IRC § 6695(f) penalty. Moreover, even if the penalty is applicable, the penalty amount is typically small in relation to the size of refunds that some preparers have misappropriated.

The National Taxpayer Advocate believes the IRS should have the authority to impose civil penalties on tax return preparers who engage in fraud or misconduct by altering the return of a taxpayer for personal financial gain.

Recommendations

- Amend IRC § 6694 so the penalty the IRS may assess against a tax return preparer for understating a taxpayer’s liability is broadened beyond tax returns and claims for refund by adding the words “and other submissions.”
- Amend IRC § 6695 to explicitly cover a preparer who misappropriates a taxpayer’s refund by changing the direct deposit information and increase the dollar amount of the penalty to deter preparers from engaging in this type of fraud or misconduct. To make the public fisc whole, the penalty should be equal to 100 percent of the amount a preparer has improperly converted to his own use through fraud or misconduct by altering a taxpayer’s tax return.

¹³⁵ Treas. Reg. § 1.6695-1(f)(1).