

Legislative Recommendation #31**Authorize a Penalty for Tax Return Preparers Who Engage in Fraud or Misconduct by Altering a Taxpayer's Tax Return****SUMMARY**

- *Problem:* When a corrupt tax return preparer steals from a client or from the public fisc, the government's enforcement options are limited. The Justice Department may bring criminal charges, but it lacks the resources to do so except in cases of widespread, high-dollar schemes. The alternative is civil penalties, but the law currently does not authorize meaningful civil penalties.
- *Solution:* Authorize the IRS to impose greater civil penalties in a wider range of cases.

PRESENT LAW

IRC § 6694(b) 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.¹ IRC § 6695(f) imposes a \$500 penalty (adjusted for inflation) on a preparer who negotiates a taxpayer's refund check.²

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 that the entire refund is directed to the preparer's account instead of the taxpayer's account. In other cases, the preparer increases the refund amount and elects a "split refund,"³ 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 DOJ pursues an erroneous refund suit under IRC § 7405, also due to resource constraints.⁴ 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 or misconduct. The IRC § 6694 penalty generally will not apply to either of the scenarios described above for the following reasons:

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- 1 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.
 - 2 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.
 - 3 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) (2019). The instructions to Form 8888 specifically advise taxpayers not to deposit their refunds into their tax return preparer's account.
 - 4 See Internal Revenue Manual (IRM) 21.4.5.15(6), Collection Methods for Category D Erroneous Refunds (Oct. 1, 2007) ("The erroneous refund suit is limited to amounts that exceed the litigating threshold established by the Department of Justice.").

- 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."⁵ 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. Treasury regulations have interpreted the IRC § 6695(f) penalty as applicable to a preparer who negotiates "a check (including an electronic version of a check)."⁶ Although the IRS's internal procedures currently treat direct deposits as subject to the IRC § 6695(f) penalty, the tax code and regulations do not make clear whether a "direct deposit" is legally identical to an "electronic version of a check."⁷ Moreover, even if the penalty is applicable, the penalty amount for 2022 of \$560⁸ is typically small in relation to the size of refunds that some preparers have misappropriated and does not serve as a deterrent.

The National Taxpayer Advocate recommends the IRS be given 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(b) 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 purporting to be returns."
- Amend IRC § 6695 to (i) explicitly cover a preparer who misappropriates a taxpayer's refund by changing the direct deposit information and (ii) 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 by altering a taxpayer's tax return.

5 IRS, 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).

6 Treas. Reg. § 1.6695-1(f)(1).

7 See IRM 20.1.6.5.6, Negotiation of Check – IRC 6695(f) (Oct. 13, 2021).

8 Rev. Proc. 2021-45, 2021-48 I.R.B. 764.