

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

Present Law

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 then 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,"¹²³ so the taxpayer receives the refund amount he expects and the additional amount goes to the preparer.

IRC § 6694 authorizes the IRS to impose a penalty where a preparer has understated a tax liability on a "return or claim for refund" when the understatement is due to willful or reckless conduct.¹²⁴ However, 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."¹²⁵ As a consequence, the section 6694 penalty does not apply.

By contrast, when the preparer has altered only the direct deposit information on the return, the resulting document is treated as a valid "return or claim for refund." However, the penalty still does not apply because there is no understatement, as the return is otherwise accurate.

IRC § 6695(f) imposes a \$500 penalty on a preparer who negotiates a taxpayer's refund check.¹²⁶ The IRS and Treasury have interpreted this penalty to apply to a preparer who negotiates "a check (including an electronic version of a check)."¹²⁷ It is unclear, however, whether an "electronic version of a check" is legally identical to a direct deposit. Thus, 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 section 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.

Reasons for Change

While the Department of Justice (DOJ) may bring criminal charges against preparers who alter tax returns, resource constraints generally preclude criminal charges except in the case 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

123 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.

124 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.

125 PMTA 2011-20, *Tax Return Preparer's Alteration of a Return* (June 27, 2011); PMTA 2011-13, *Horse's Tax Service* (May 12, 2003).

126 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.

127 Treas. Reg. § 1.6695-1(f)(1).

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.

If the penalty amount is equal to the amount by which a preparer has benefited (*i.e.*, a 100 percent penalty), the public fisc would be made whole.

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 "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 improperly converted to his own use through fraud or misconduct by altering a taxpayer's tax return.