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PENALTIES FOR TAX RETURN PREPARERS

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## PENALTIES FOR TAX RETURN PREPARERS \*

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### ABSTRACT

Proposals by the government to introduce a system of penalties for tax agents responsible for tax return preparation resulted in considerable concern, particularly from the profession, and they have been put on hold for the time being. The issue of return preparer penalties has been addressed in by the Steering Committee of the National Review of Standards for the Tax Profession which released its discussion paper in December 1993.

Similar issues have arisen in the United States where a system of return preparer penalties have been introduced. The purpose of this paper is to consider the need for a system of penalties in the light of existing remedies at common law, under the Income Tax Assessment Act and Taxation Administration Act, the proposals contained in the National Review discussion paper, and the US experience.

There are some sobering lessons from the US experience and it is hoped that the Australian authorities will learn from the US experience and not ultimately adopt an approach of administrative expediency at the expense of fairness to return preparers.

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## 1.0 INTRODUCTION

In recent times, a number of issues relating to professional standards and regulatory arrangements have gained prominence, coincident with the movement towards a taxation system based on self assessment principles. The steady increase in the number of taxpayers seeking assistance from tax agents in order to fulfil their income tax return preparation obligations (70.75% of individual tax payers in 1992<sup>1</sup>) indicates a growing need to ensure that the services provided by tax agents meet community expectations and that sanctions are in place for a failure to do so.

Early consultations relating to the passage of the *Taxation Laws (Self Assessment) Act 1992* (SAA) saw the Government put forward a proposed regime of tax agent penalties, to coincide with the revised schedule of penalties for understatements of tax which the SAA introduced.

This proposal was met with much criticism and concern from the tax profession. Moreover, many tax agents raised concerns regarding the extent and nature of their duties and responsibilities under a system of self assessment.

In response to these concerns, particularly concerns from tax agents relating to proposed penalties for tax agents, the Government decided to put on hold such proposals.

The purpose of this Paper is to examine the need for and desirability of establishing a system of penalties for tax agents. The focus of the Paper is on the return preparation function of registered tax agents rather than that of providing taxation advice.

Similar issues have arisen in the United States (U.S.), where a system of return preparer penalties has been introduced. Much can be learned from the U.S. experience, both in terms of understanding the threshold issues and, more importantly, in appreciating some of the pitfalls which similar Australian rules may contain. Accordingly, an examination of the system of return preparer penalties in the U.S. will also be made.

The approach of the Paper will be to consider these issues in three parts:

- the need for a system of tax agent penalties, specifically:
  - the current position of tax agents under the *Income Tax Assessment Act 1936* (ITAA) and *Taxation Administration Act* (TAA); and
  - the current position of tax agents at common law.
- the proposals contained in the Discussion Paper released by the Steering Committee of the National Review of Standards for the Tax Profession (the Discussion Paper).
- the US experience relating to return preparer penalties.

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<sup>1</sup>The Annual Report of the Commissioner of Taxation 'Towards a World Class Administration', AGPS, Canberra, 1992

## 2.0 THE EXISTING POSITION

The Discussion Paper notes that the relationship between tax agent and taxpayer is one whereby the agent provides certain agreed services for a fee. "In providing these services, the agent is in a position of trust and has a duty of care. If the professional fails to discharge properly this duty there are legal remedies available to the client. One such remedy is the right of clients to sue for damages arising from a tax professional's negligence."<sup>2</sup>

Tax agents currently enjoy a statutory monopoly in respect of charging a fee for preparation of income tax returns conferred by section 251L(1) of the ITAA. In addition under section 251O, only registered agents can advertise as such.

## 2.1 INCOME TAX ASSESSMENT ACT

Section 251K allows the Tax Agents' Board (the Board) power to cancel or suspend a tax agent's registration in certain circumstances. Suspension or cancellation is mandatory in the case of an agent who commits an offence against sections 8P, 8T or 8U of the TAA (sub-section 251K(1)). The minimum period of suspension under this sub-section is three months.

Under sub-section 251K(2) the Board may suspend an agent's registration if it is satisfied that returns prepared by that agent are false in any material particular, that the agent has been guilty of misconduct, that the agent is not a fit and proper person to prepare income tax returns and transact business on behalf of taxpayers.

Prior to 1 November 1988 the Board only had power to cancel registration. By Act No 78 of 1988 sub-section 251K(2) was amended to allow for suspension as an alternative to cancellation.

Section 251N(1) imposes a fine of \$1,000 for allowing person other than employee to prepare an income tax return or objection or conduct business in respect of an income tax matter on the agents behalf. Sections 251N(2) and (2A) impose penalties of \$1,000 for allowing employee not under supervision or control of an agent to prepare income tax returns or objections.

Section 251M provides at sub-section (1):

*If, through the negligence of a registered tax agent, or of a person exempted under section 251L, a taxpayer becomes liable to pay a fine or other penalty, any additional tax or any interest under section 170AA or 207A, the registered tax agent, or the person, as the case may be, shall be liable to pay to the taxpayer the amount of that fine or penalty, additional tax or interest, and that amount may be sued for and recovered by the taxpayer in any court of competent jurisdiction.*

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<sup>2</sup> Discussion Paper p. 24



One of the difficulties with section 251M is that it is not clear whether the negligence of the tax agent needs to be the *sole* reason for the penalty or fine. In the absence of a provision allowing for apportionment of liability it would seem that the section will not apply if the agent's negligence is only one of a number factors.<sup>3</sup>

*"This provision seemingly adds little to the right to sue for damages which exists under common law. In any event, a requirement that in order to obtain redress the aggrieved client sue the tax agent directly, with all the costs, risks and distress this often entails is hardly user friendly. Perhaps not surprisingly, even where there is evidence to support a lawsuit, few aggrieved clients choose this course of action."*<sup>4</sup>

Sub section (2) of section 251M goes on to emphasise that the section does not exonerate the taxpayer. Thus the taxpayer is primarily liable for the penalty in the first instance. The introduction of "self assessment" has not altered the position of section 251M. Indeed the revised penalty regime implemented with effect from 1 July 1992 makes the taxpayer vicariously liable for the culpable errors of tax agents acting on their behalf.

In the Explanatory Memorandum accompanying the SAA it was stated that where a tax shortfall arises ... "through an inadvertent error or honest mistake of the tax agent in circumstances where reasonable care has been exercised (eg a transposition error by a staff member, that shortfall would not attract a penalty." It has been suggested however that this may not be the case given the decision in *Walker v Hungerford* <sup>5</sup> where it was found that the agent could not rely on the accuracy of the information provided by the taxpayer. The burden of proving that the error was inadvertent or honest lies with the agent and is an onerous one.<sup>6</sup>

Liability under section 251M can therefore arise if tax agents don't check accuracy of records maintained by taxpayers. Agents should thoroughly review records and supporting documentation. It has been suggested that preparation of engagement letter spelling out the extent of the work to be performed by the agent in terms of verifying the supporting documentation in order to protect against any subsequent questions or doubts about either the quality or amount of work.<sup>7</sup>

Concern has been expressed that taxpayers will attempt to transfer burdens of self assessment to tax agents and that "higher standards of care imposed on agents and increased exposure to section 251M actions may drive some agents out of the industry. Professional indemnity premiums are almost certain to rise."<sup>8</sup>

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<sup>3</sup> CCH Federal Tax Reporter

<sup>4</sup> The Discussion Paper p.86

<sup>5</sup> *Walker v Hungerford* (1988) 88 ATC 4920

<sup>6</sup> Gordon Cooper "Liability: Self Assessment and the Tax Agent" Taxation in Australia July 1992

<sup>7</sup> Les Nethercott & M Webb "Self Assessment: Implications for Corporate Taxpayer and Agent" Charter Feb 1991

<sup>8</sup> Butterworths Weekly Tax Bulletin Issue 39, 1992 para 74

A disturbing case in this regard was recently heard by the Supreme Court of New South Wales.<sup>9</sup> There, a tax agent who omitted critical information from a client's return resulting in a substantial liability on discovery by the Commissioner following an audit, was held to be liable for damages under section 251M, and although the court recognised that the taxpayers were guilty of contributory negligence, this is not available as a defence to a claim under section 251M.

## 2.2 TAXATION ADMINISTRATION ACT

Section 8K(1) of the TAA makes it an offence to make a statement to a taxation officer that is false or misleading in a material particular, or to omit from a statement any matter or thing without which the statement is misleading. The penalties for an offence under section 8K are specified in section 8M.

An offence under section 8K(1) can be committed by a person other than the taxpayer, for example a tax agent acting on behalf of a taxpayer. The decision in *Graspas v Unger* (D.F.C. of T) 86 ATC 4588 indicates that a tax agent will not be guilty of an offence under section 8K(1) if the misstatement in question forms part of a return signed by the taxpayer. In that case, where an agent made false claims in a return which the taxpayer signed without knowledge of them, a majority of the High Court noted that the ITAA provides for a tax agent to prepare a return (sections 165, 251J(3) and 251K(2)), but that taxpayer actually *makes* the return by signing it and furnishing it to the Commissioner. (Section 161(1)). That case involved the former section 230 as it applied prior to 1984, however "[i]t would seem that the same reasoning would be applicable in the context of section 8K."<sup>10</sup>

Under section 5 of the *Crimes Act* 1914 "any person who aided, abetted, counselled or procured or was in any way directly or indirectly, knowingly concerned in, or party to, the commission of an offence against section 8K(1), would be deemed to have committed the offence and would be punishable accordingly. Thus a person *other* than the person who actually makes the statement may be guilty of an offence against section 8K(1)." <sup>11</sup> The Australian Taxation Office (ATO) offers as an example of this the situation where a tax agent includes information provided by the taxpayer, both parties knowing that it is false and misleading.<sup>12</sup>

Under s 8K(2) it is a defence if the person prosecuted proves that he or she did not know *and* could not reasonably be expected to have known that the statement in question was false or misleading. The standard of proof required to establish this defence is on a balance of probabilities. The defence provided by section 8K(2) is not satisfied merely by proving a lack

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<sup>9</sup> *Pech & Anor v Tilgals & Anor* (1994) 94 ATC 4206

<sup>10</sup> *supra* n.3

<sup>11</sup> *supra* n.3

<sup>12</sup> Income Tax Ruling No. 2246

of knowledge; the person must also prove that he or she could not reasonably be expected to have known that the statement was false or misleading.

Section 8N makes it an offence for a person to *recklessly* make false or misleading statements and section 8P makes it an offence for a person to *knowingly* make a false or misleading statement to a taxation officer etc. As is the case with section 8K, a person other than the taxpayer may be guilty of an offence under section 8N or section 8P. The penalties for an offence under section 8N and 8P are prescribed by section 8R.

It is an offence under section 8X to hinder or obstruct another person in the exercise of the other persons power in relation to a taxation law. The maximum penalty in the case of an individual is \$2,000 or imprisonment for 6 months or both. In particularly serious cases for example where violence has been used, action may be taken under section 76 of the *Crimes Act* 1914. Further consideration of the *Crimes Act* is beyond the scope of this paper.

Income Tax Ruling IT 2246 outlines the ATO's prosecution policy and states at paragraph 11.1:

*The Australian Taxation Office expects the highest standards of conduct from tax agents. It is clearly in the public interest that should such persons abuse their position of trust they should be prosecuted. Delinquent tax agents can have a serious impact on the proper administration of taxation laws because of the large numbers of returns, objections etc submitted through them.....*

## 2.3 COMMON LAW

The taxpayer may seek common law redress from the return preparer in contract or in the tort of negligence. The return preparer/taxpayer relationship is always contractual, though the contract may be either written or oral. In the case of an unwritten contract, either party, or both, may be unaware that a contract has been entered into.

Until about ten years ago the question whether concurrent liability lay in both contract and in tort could not be answered with any certainty. Recently there has been authority to support the argument that insofar as certain professions are concerned, for example accountants and auditors,<sup>13</sup> there is concurrent liability, in Australia at least, in both tort and contract. Some texts<sup>14</sup> assume that in Australia concurrent liability now exists on a general basis.

Suing in tort may be preferable for the taxpayer. In contract the limitation period commences when the contract is breached, and the resultant damage may not be immediately obvious; in tort the limitation period starts when the damage is discovered. In addition the assessment of damages may be more advantageous to the plaintiff tax payer in a tort action.

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<sup>13</sup> *Hungerfords v Walker* (1990) 171 CLR 125, *Arthur Young & Co v WA Chip & Pulp Co* [1989] WAR 100

<sup>14</sup> F. Trindade & P. Cane *Law of Torts in Australia* (1993), p 369 J.G. Fleming *The Law of Torts in Australia* (1992), p 186

Where there is a written contract, there may be a term specifically excluding or limiting liability in tort. If valid, any such term will be recognised by the courts.

A question to be answered in all cases, whether framed in contract or in tort, or both, is whether or not the return preparer has carried out the work competently. In the tort of negligence this comprises the negligence or breach element (i.e. has the defendant fallen below the required standard of care?); in contract it refers to the term, express or implied, that the work is to be carried out with reasonable care.

### 2.3.1 CONTRACT

#### EXPRESS TERMS

Where there is a written contract there may be a term outlining the standard of work required of the return preparer. This may be specific, detailing either a higher or lower standard than is generally acceptable. When determining whether or not the return preparer has breached the contract the courts will apply the standard provided for by the relevant term in the contract.

Where the express terms of the contract specify a lower than usually acceptable standard, the courts, while paying due regard to what is mutually agreed between the parties as evidenced by the written contract before them, may take into account the position of the plaintiff taxpayer when the contract was made. In certain very limited circumstances the courts may invalidate such a term and may make their own assessment of what the standard should be

<sup>15</sup>

It is more likely that a term relating to the required standard of work will be phrased in generalities such as "reasonable care" or "due diligence". The courts then have to look to the same considerations as they would when there is no express term, or when it is the standard of care in negligence that is being determined. This is discussed more fully below (see 2.3.2.2).

#### IMPLIED TERMS

Where the written contract contains no reference to the required standard, or where there is no written contract <sup>16</sup> the courts will imply a term that "reasonable" care should be taken. What satisfies this requirement varies from case to case and is covered in detail later (see 2.3.2.2).

### 2.3.2 TORT

The elements of an action in the tort of negligence are:

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<sup>15</sup> e.g. in N.S.W. by virtue of the *Contracts Review Act* 1980 N.S.W.

<sup>16</sup> *Hawkins v Clayton* (1988) 164 CLR 539 per Deane J at 570.

- a) that the defendant, here the return preparer, owes the plaintiff taxpayer a duty of care, (the duty of care);
- b) that the defendant has failed to conform to the required standard of care (the standard of care);
- c) that there has been material damage to the plaintiff (damage). The damage is the cost to the taxpayer of the penalty paid as a result of the return preparer's negligence; and
- d) that there is a reasonably proximate connection between the defendant's conduct and the resulting injury (causation and remoteness). This is not a problem in the taxpayer/return preparer relationship.

### 2.3.2.1 DUTY OF CARE

Fleming<sup>17</sup> defines the duty of care as "...an obligation, recognised by law, to avoid conduct fraught with unreasonable risk of danger to others." The history of the duty concept shows that the courts have always envisaged that there be a closeness between the parties, a relationship elegantly crystalized in Lord Atkin's "neighbour" speech in *Donoghue v Stevenson*<sup>18</sup> An attempt in the English courts to broaden the scope of liability in the late nineteen seventies was shortlived<sup>19</sup>.

Where the "damage" suffered by the plaintiff is personal injury or damage to property the courts generally have no difficulty in finding that a duty of care exists because the nature of the damage shows that there must have been at least a physical closeness between the parties at some point.

### DUTY OF CARE - NEGLIGENT MISSTATEMENT CASES:

Traditionally the courts have been reluctant to compensate for pure economic loss i.e. where the negligent act causes no personal injury or damage to property and the loss is a financial one only.

Pure economic loss is often caused by negligently given advice or information (a "negligent misstatement"). The plaintiff loses on the basis that there is no duty of care owed by the defendant to that plaintiff because their relationship is not sufficiently close enough. The reasoning for this reluctance to impose a duty of care is the fear of opening the floodgates to all manner of claims for financial loss. This is best expressed by Cardozo CJ in his much quoted speech beloved by accountants and auditors everywhere:

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<sup>17</sup> *Supra* n 14. p 135

<sup>18</sup> [1932] A.C. 562 at 580

<sup>19</sup> Per Lord Wilberforce in *Anns v Merton LBC* [1978] AC 728 at 751-752, overruled by *Murphy v Brentwood DC* [1991] 1 AC 398. The *Anns* 'duty' concept was increasingly out of favour in the English courts prior to 1991, and never adopted in Australia.



"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.....liability for negligence if adjudged in this case will extend to many callings other than an auditor's." <sup>20</sup>

Despite this the courts have cautiously moved towards finding liability in some instances. This was foreshadowed by the English House of Lords case of *Hedley Byrne & Co v Heller & Partners* <sup>21</sup>. In this case the plaintiff ultimately lost because of a disclaimer. Their Lordships made it clear, however, that they saw no reason why the defendant should not be liable for carelessly given advice that caused the plaintiff economic loss, providing the parties were sufficiently close, in a "special relationship", and the advice was given in circumstances where it should have been evident that the plaintiff would rely on it.

Since 1964 the question of when a duty of care arises in economic loss cases has been at the cutting edge of current developments in the law of negligence. The Australian High Court has found such a duty to exist in *MLC v Evatt* <sup>22</sup> and *L Shaddock & Associates Pty Ltd v Parramatta City Council* <sup>23</sup> where it was said that there is no distinction between the giving of advice and the giving of information. No duty was found to exist in *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act* <sup>24</sup> and in the English House of Lords case of *Caparo Industries v Dickman* <sup>25</sup>.

Recent negligent misstatement cases in the lower courts in Australia indicate that perhaps judges are having difficulty applying the principles propounded in the cases above when deciding whether a duty of care is owed. In *R Lowe Lippman Figdor & Franck v AGC (Advances) Ltd* <sup>26</sup> the Appeal Division of the Supreme Court in Victoria allowed an appeal in an action where an auditor had been held liable for negligent misstatement. Similarly the Queensland Full Court in *Westpac Banking Corporation v Potts & Anor* <sup>27</sup> reversed the trial judge's decision that the bank's officer had been negligent in the way he had given an opinion; special leave to appeal to the High Court has been refused.

Rolfe J, however, in the NSW Supreme Court case *Columbia Coffee & Tea Pty Ltd & Anor (Donyoke Pty Ltd) v Churchill & Ors t/a Nelson Parkhill* <sup>28</sup> expressed doubts about the actual findings of fact and the proper inferences to be drawn from the facts <sup>29</sup> in the *R Lowe Lippman*

<sup>20</sup> *Ultramares Corp. v Touche* 174 NE 441 at 444 (N.Y. 1931).

<sup>21</sup> [1964] AC 465.

<sup>22</sup> (1968) 122 CLR 556, a decision reversed on appeal to the Privy Council, see [1971] AC 793.

<sup>23</sup> (1981) 150 CLR 225.

<sup>24</sup> (1986) 162 CLR 340.

<sup>25</sup> [1990] 2 AC 605.

<sup>26</sup> (1992) Aust Torts Reports 81-165.

<sup>27</sup> (1992) Aust Torts Reports 81-166.

<sup>28</sup> (1992) 10 ACLC 1,659.

<sup>29</sup> *ibid.* at p 1,665.

decision. In *Columbia Coffee Rolfe J* found that a duty of care existed between the auditors and Donyoke, but Donyoke lost because there was no causal connection between the breach and the alleged damages.

The most recent case is *Esanda Finance Corp v Peate Marwick Hungerfords*,<sup>30</sup> a South Australian Supreme Court decision. The dependant in this case sought to have certain paragraphs in the plaintiff's Statement of Claim struck out: these paragraphs raised a plea of negligence and the dependant argued that no reasonable cause of action was disclosed as the plaintiff had not alleged any intention on the part of the dependant to induce the plaintiff to act in reliance on the account.

The trial judge Bollen J., found for the plaintiff on the basis that:

*"One cannot say in black and white that an auditor is always or is never liable to a third party. I think it appropriate that this case should go forward "on negligence" to evidence. My "interlocutory conclusion" is that Mr Gray [counsel for the defendant] has not quite made good his submission that "intention to induce" must be pleaded to sustain a plea of negligence of the type suggested in this action. I think that proximity is the basis for such a plea in negligence."*<sup>31</sup>

The defendant's appeal to the Full Court of the South Australian Supreme Court was successful, King CJ, Millhouse and Olsson JJ unanimously finding that for a successful plea in negligence of this type there should be an intention to induce before a duty of care is owed by the dependant to the plaintiff:

*"The mere plea of assumption of responsibility (based on general audit standards) is simply not enough. In absence of a plea of facts amounting to an intention on the part of the defendant to induce the plaintiff to act on the faith of the audit certificate or the existence of some other specific type of circumstance.....the claim for negligent misstatement cannot succeed. It is patently untenable."*<sup>32</sup>

In finding for the defendant the court approved the *R Lowe Lippman* decision and disapproved of Rolfe J's decision in *Columbia Coffee*.

An application for special leave to appeal to the High Court in *R Lowe Lippman* was struck out by consent. Given the facts of the case it is a pity that it did not reach the High Court so the situation regarding duty of care for negligent misstatement might be clarified at the highest level.

As far as the relationship between the return preparer and the taxpayer is concerned, because there is always going to be a contract between the parties, there is sufficient proximity between them for a duty of care to be owed. The return preparer will be aware that the

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<sup>30</sup> (1994) Aust Torts Reports 81-265

<sup>31</sup> (1993) Aust Torts Report 81-243 at 62,513

<sup>32</sup> *supra* n.30, per Olsson J at 61,165

taxpayer is relying on the return preparer's advice/information in filling in the return. The only way to avoid the duty is by an explicit disclaimer.

### 2.3.2.2 STANDARD OF CARE

This element of the tort of negligence is relevant also to the discussion of the required standard in a contract where there are no express provisions or the express provisions are framed in general terms (see above 2.3.1), as the same matters are considered.

The required standard of care is reasonable care. Reasonable care is determined by objective standards ....

*"in other words, the appropriate standard is not that which the defendant could have reached, but rather the standard which the law says should have been reached"*<sup>33</sup>. As Fleming<sup>34</sup> points out "This means that individuals are often held guilty of legal fault for failing to live up to a standard which as a matter of fact they cannot meet." ....

In certain instances the law does allow the particular circumstances of the defendant to be taken into account. This is relevant in the context being examined because "skill" is one such circumstance. Where the defendant, a return preparer for example, holds him/herself up as having a special skill, completing tax returns on behalf of others, the defendant's work will be judged in comparison with the standard of competence expected of a reasonable return preparer, **not** how the reasonable man in the street would prepare a tax return, nor what this defendant regards as a reasonable standard.<sup>35</sup>

Expert evidence is called by both sides to illustrate what is a reasonable standard of competence in that profession or calling. Where there are regulations governing a profession, whether the regulations are imposed by the profession itself or by statute, the courts usually regard these as a minimum standard. Failure to conform will almost certainly mean the defendant has not reached the required standard of care, conformance does not necessarily mean the defendant has not been negligent.

The same applies to compliance with custom and accepted standards. Quite early on the High Court made it clear that compliance with accepted standards would not necessarily exonerate the defendant from liability<sup>36</sup>. The bulk of cases in this area concern medical practitioners. A recent High Court case, *Rogers v Whitaker*<sup>37</sup>, succinctly states in a strong unanimous judgment the present position in Australia. The respondent/plaintiff, Whitaker, successfully sued the appellant/defendant ophthalmic surgeon for negligence in failing to inform her of a risk involved in the surgery undertaken. At issue was not

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<sup>33</sup> Trindade & Cane, *supra* n 14. p 411.

<sup>34</sup> *supra* n 14. p 106.

<sup>35</sup> see *Pech & Anor v Tilgals & Anor* *supra* n 9 Per Dunford J at p 4,211

<sup>36</sup> *Mercer v Commissioner for Road Transport* (1937) 56 CLR 580.

<sup>37</sup> (1992) Aust Torts Reports 81-189.



negligent treatment, "[t]here is no question that the appellant conducted the operation with the required skill and care"<sup>38</sup> but negligence in the advice given to help her determine whether or not to undergo the operation. The High Court distinguished between treatment and advice: "However, the factors according to which a court determines whether a medical practitioner is in breach of the requisite standard of care will vary according to whether it is a case involving diagnosis, treatment or the provision of information or advice".<sup>39</sup>

It is submitted that the comments in the above case as to the standards expected of professionals in the non diagnosis/treatment area have ramifications for all professions, not just medical practitioners. In *Rogers v Whitaker* it is said:

*"In Australia, it has been accepted that the standard of care to be observed by a person with some special skill or competence is that of the ordinary skilled person exercising and professing to have that special skill. But, that standard is not determined solely or even primarily by reference to the practice followed or supported by a responsible body of opinion in the relevant profession or trade"*<sup>40</sup>.

The Court cited with approval the decision of King CJ in *F v R*:<sup>41</sup>

*"The ultimate question, however, is not whether the defendant's conduct accords with the practices of his profession or some part of it, but whether it conforms to the standard of reasonable care demanded by the law. That is a question for the court and the duty of deciding it cannot be delegated to any profession or group in the community"*<sup>42</sup>.

Cases involving the professional negligence of accountants and auditors illustrate that once the plaintiff has shown that a duty of care is owed, the courts seem to expect a very high, and in some instances (as auditors may well bleat) an unrealistically high, standard of care<sup>43</sup>. The recently reported<sup>44</sup> out of court settlement of a record \$136m to be paid by the auditors KPMG Peat Marwick, without admission of liability, to the Victorian Government over the audit of the Tricontinental group accounts reveals just how hesitant that profession is to risk taking their chances in court.

In conclusion it may be said that the standard of care that the courts will require in a professional relationship is best set out in King CJ's quote above: i.e. *"That is a question for the court and the duty of deciding it cannot be delegated to any profession or group in the community"*<sup>45</sup>.

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<sup>38</sup> *supra* n 34. per Mason CJ, Brennan, Dawson, Toohey and McHugh JJ at p 61,674.

<sup>39</sup> *ibid.* p 61,677.

<sup>40</sup> *ibid.* p 61,676

<sup>41</sup> (1983) 33 SASR 189.

<sup>42</sup> *supra* n 38. at p 194.

<sup>43</sup> See for example *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN(NSW) 29 (\$1.5m damages awarded against the auditors), *Cambridge Credit Corporation v Hutcheson* (1985) 9 ACLR 545 ((\$145m awarded against the auditors, reduced to \$20m in a 1988 settlement agreement), *Hungerfords v Walker*, *supra* n 13.

<sup>44</sup> *The Australian*, January 26 1994.

<sup>45</sup> *supra* n 39.

At present where there are no standards for return preparers, while the court will note the evidence of fellow professionals in determining the requisite standard of care, the court itself will ultimately decide what is a reasonable standard in the circumstances. It is unlikely that this will alter even if the Government does bring in some form of statutory regulation.

## 2.4 CONSUMER PROTECTION LEGISLATION

There are implications under Part V of the *Trade Practices Act* (1974) Cth, and the mirror legislation passed in the various States, but it is beyond the scope of this paper to consider these further.

## 3.0 THE NATIONAL REVIEW

### 3.1 BACKGROUND

The move towards self assessment in income tax started in early 1980's; as one commentator notes "when the tax office began to clear away the debris of the tax schemes of the '70's."<sup>46</sup>

In 1984 the ATO established a task force to review the assessment process. The conclusion of this review was the decision to move towards a system of self assessment. The move has been somewhat chequered to date and prior to the establishment of the National Review of Standards for the Tax Profession (National Review) seemingly paid little heed to the role of agents in the process.

Indeed the much publicised Reform of the Australian Taxation System emerging from the 1985 Summit did not address the role of the tax profession and the 1986 "self assessment" amendments to the Income Tax Assessment Act did not alter the actual process of lodgment and assessment.

In a paper on the Ethics of tax practice, Hill referred to an address to the ASCPA's in Perth in September 1989 by Trevor Boucher. The then Commissioner put forward the "crazy idea" that penalties arising from the incorrect statement of the taxpayer's position should be borne by the agent, who would have to insure against the risk. The market would determine premiums based on the reliability of the agents and premiums would of course be factored into the agent's fee. Mr Boucher noted that this would achieve a measure of certainty for the taxpayer, and agents would be able to charge higher fees to cover the risk. The ATO would be able to exercise some degree of quality control over agents. Mr Hill queries the validity of

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<sup>46</sup> Ken Spence in a paper presented to the Taxation Institute of Australia's State Convention in South Australia 1990.

the idea proposed by Mr Boucher, stating that the burden of uncertainty would merely be camouflaged.<sup>47</sup>

The self assessment environment is indeed a minefield and entails a considerable culture shift on the part of the tax profession. Tax agents are no longer just required to prepare returns on a "lets see if the ATO buys it" basis, they are now required to ensure that the taxpayer's position is reasonable arguable.

### 3.2 THE REVIEW

At the Tax Liaison group meeting of 15 July 1992 the Australian Taxation Office (ATO) Draft Project Proposal on Standards relating to Tax Agents was tabled. The Taxation Institute of Australia then lodged a written submission and set of revised terms of reference. The final terms of reference incorporated most of Taxation Institute suggestions. The National Review was announced by the Commissioner 29 September 1992 as a co-operative project between Australian Taxation Office and representatives of the tax profession.

One commentator notes that the Commissioner will not be bound by any recommendation of the Steering Committee. Indeed he expects that the Commissioner will favour regulation of the industry by legislation."<sup>48</sup>

The Steering Committee of the National Review issued its final discussion paper on 20 December 1993. The paper contains 82 recommendations of which 69 were unanimously supported by committee members and 13 were supported by a majority.

*"This Review represents the first detailed re-consideration of the regulatory regime set in place fifty years ago. Given the profound changes in that time to tax law and the technology of tax collection, the impact upon taxpayers and tax professionals alike of the progression towards self assessment, the increasing role of tax agents in the taxation system and the general trend towards less regulation of business by government, it is overdue."*<sup>49</sup>

#### 3.2.1 PENALTIES

On the question of penalties the Steering Committee notes that existing penalties need to be reviewed to ensure that their quantum is appropriate and also to expand the spectrum to encompass failure to exercise reasonable care. In the event that disciplinary rules are codified, penalties will be required to deal with any failure to comply with them. The issue of

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<sup>47</sup> *ibid*

<sup>48</sup> Jim Momsen, quoted in Taxation in Australia Vol 27 Issue 6 "Current Topic: The Profession"

<sup>49</sup> Discussion paper p.16

whether such disciplinary rules are appropriate and if so what they should encompass will not be canvassed in this paper.

The Steering Committee expressed considerable concern over the issue of taxpayers being vicariously liable for penalties arising due to a failure by a tax agent to exercise reasonable care. It notes that it is fundamental to a system of self assessment that taxpayer who exercises reasonable care should not be penalised.

The vicarious liability provisions were referred to by the government as an "interim measure" in the Explanatory Memorandum:

*"The ATO, in conjunction with tax professional representative bodies is looking at whether tax agent penalties or some other form of registration of tax agents is appropriate, and if so, the level of those penalties or the form of registration. Pending that review, and as an interim measure designed to protect revenue, the Bill maintains the current position that a taxpayer is liable for penalties for shortfalls caused by the culpable conduct of a tax agent in dealing with the taxpayers affairs."*

The Steering Committee has suggested that there ought not to be separate standards for registered agents and for self preparers. For taxpayer reasonable care involves compliance with record keeping, full and honest disclosure to agent and conformity with advice given by agent. The Committee uses the term "safe harbour" to describe the desirable position where a taxpayer is absolved from penalty if he or she relies on an agent and that agent does not exercise reasonable care. The "safe harbour" concept will also have application if an agent is reckless or intentional disregard. The onus is on the agent to elicit required information from the taxpayer.

The "safe harbour" will not protect a taxpayer from penalties where the position adopted is not reasonably arguable. In the Steering Committee's opinion taxpayers must bear ultimate responsibility for the content of returns, as is the current situation. Advice from an agent should in no way give immunity from penalties.

The Steering Committee suggests that for an agent to exercise reasonable care he or she must inform clients of their obligations and entitlements and penalties, ask questions reasonably expected to draw out all information and exercise due professional care and competence in preparing a return based on information provided. Tax Agents must be able to assume that the client is honest. The onus of proof is on the tax agent if accused of a failure to exercise reasonable care.

### **3.2.2 THE TAX AGENT'S BOARD**

The Steering Committee noted the unsatisfactory situation whereby the current Tax Agents' Boards are operating in each state independently of one another. The Committee's view is

that there should be a national board with power to consider and rule on complaints about agents, with power to discipline and make order for restitution. Any separate avenue for recovery of damages is cumbersome, costly and inefficient. The proposed system would be more accessible and cost effective than a common law damages claim. It would also provide taxpayers with an incentive to go to registered agents to have their returns prepared as opposed to unregistered return preparers.<sup>50</sup>

In respect of the imposition of penalties, the Steering Committee noted that the ATO is simultaneously prosecutor, judge and jury. It recommends that if an agent has not exercised reasonable care, the matter should go to some form of independent tribunal. Reasonable care for a tax agent refers of course to the process by which the return is prepared and not its content which, as previously noted, should remain the responsibility of the taxpayer.

### 3.2.3 COMPETENCE

Much has been said about the rapidly changing environment in which tax agents operate and the difficulties faced by them in keeping abreast of legislative and administrative developments. Indeed "...the [tax] adviser owes to his client and himself a duty to be up to date and diligent in his role. There is an obligation on the profession as a whole and the professional bodies to assist agents to keep up to date."<sup>51</sup>

The Steering Committee noted concern that agents don't keep up to date. In the US enrolled agents are required to undertake 72 hours of continued professional education ever 3 years. A majority of the Steering Committee recommended some 30 hours per annum of which 15 tax specific.

It is incumbent on registered tax agents to provide a high quality of service to taxpayers and a regime of statutory penalties is one way of achieving this. As noted by one commentator however, "even if this doesn't eventuate, agents may well be vulnerable to negligence suits brought by clients for not having adequately researched a reasonably arguable position."<sup>52</sup>

## 4.0 THE UNITED STATES EXPERIENCE

### 4.1 INTRODUCTION

In this part of the Paper, the United States experience relating to professional standards for tax professionals and return preparers will be examined. The United States experience is instructive for two main reasons:

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<sup>50</sup> The Steering Committee has recommended that agents need only register if fees for return preparation exceed a threshold amount, suggested to be \$3,000.

<sup>51</sup> D Graham Hill *Ethics of Tax Practice* paper presented to a workshop Decision Making in the Australian Tax System. "Published by the Australian Tax Research Foundation, Sydney 1985

<sup>52</sup> Gordon Cooper, quoted in *Taxation in Australia* Vol 27 No. 7.

1. Early consultations relating to the passage of SAA saw the Government put forward a proposed regime of tax agent penalties, to coincide with the revised schedule of penalties for understatements of tax which the SAA introduced.<sup>53</sup> This proposed regime of tax agent penalties was substantially the same as the United States regime of return preparer penalties.

While the Government decided to put on hold such proposals pending the completion of the review, it is clear that the Government intended to base any penalty regime for tax agents on the United States system, which is not surprising, given that the revised schedule of penalties for understatements of tax which the SAA introduced was essentially transported from the United States regime.

Accordingly, it is instructive to examine the United States experience, both in terms of appreciating the threshold issues relating to such penalties and, more importantly, in appreciating likely pitfalls which similar Australian rules may contain.

2. Even if the final standards for the tax profession which are introduced in Australia are not the same as are in place in the United States, much can be gained from examining tax ethics in the United States because the field has been developing far longer in that country than in Australia.

## 4.2 STANDARDS IN THE UNITED STATES - AN OVERVIEW

There are standards of practice for all tax practitioners in the United States. To give the ensuing discussion some structure, these will be considered under the following headings:

1. TAX COURT RULES

The Tax Courts have set down special rules for those appearing in those Courts. However, an examination of these rules is beyond the scope of this Paper as the rules are unlikely to be strictly relevant to appearances before Australian Courts exercising their tax jurisdiction.

2. TREASURY RULES

Those practising before the Internal Revenue Service ("IRS") must abide by rules adopted by the Treasury Department (see below).<sup>54</sup>

3. RETURN PREPARER PENALTIES

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<sup>53</sup> See *The Treasurer, A Full Self Assessment System of Taxation - A Consultative Document*, (Canberra: AGPS, 1990), paras. 7.5-7.7, pp. 30-31.

<sup>54</sup> See Circular 230 and Audit Technique Handbook for Internal Revenue Agents.



The *Internal Revenue Code* (US) 1986, as amended ("the Code") contains provisions imposing penalties on tax return preparers (see below).

### 4.3 TREASURY RULES

The Treasury Department has been given statutory power to adopt disciplinary standards for practitioners appearing before it.<sup>55</sup> Regulations, which are commonly referred to as Circular 230, have been issued by the Secretary of the Treasury.<sup>56</sup>

Circular 230 sets out the following:<sup>57</sup>

- Rules for eligibility to practice before the IRS.
- The duties and restrictions for those practising.
- The rules on discipline for violating the regulations.

The Australian rules may develop in a similar vein, as the Discussion Paper recommends the establishment of a formal code of practice for taxpayers' agents.<sup>58</sup> The Discussion Paper further recommends that as part of this Code there be established 'disciplinary rules' setting out the minimum acceptable professional standards of conduct, breaches of which could give rise to disciplinary action and/or sanctions.<sup>59</sup> Hence, if these recommendations are adopted, we may see rules similar to those contained in Circular 230.

However, unlike Australia, a person preparing tax returns in the United States does not need to meet eligibility requirements.<sup>60</sup> Only when a matter is presented to the IRS in relation to a client's problem does one need to be enrolled.<sup>61</sup> However, unenrolled tax return preparers are still regulated by other provisions of the Code.<sup>62</sup> The Australian position in this respect is unlikely to change as evidenced by the Discussion Paper which clearly states that:<sup>63</sup>

*"We conclude the public interest is best served by retaining a mandatory registration regime for taxpayers' agents, with set eligibility criteria ..."*

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<sup>55</sup> 31 USC 330.

<sup>56</sup> 31 CFR 330.

<sup>57</sup> Circular 230, section 10.1.

<sup>58</sup> Discussion Paper, Chapter 5, Recommendation 11, page 94.

<sup>59</sup> *Id.*, Chapter 5, Recommendation 12 (ii).

<sup>60</sup> S. Ross, "Ethics for Tax Practitioners", (1993) *Australian Tax Research Foundation Research Study No. 18*, p. 33.

<sup>61</sup> Circular 230, section 10.2(a).

<sup>62</sup> See B. Wolfman, J.P. Holden and K.L. Harris, *Standards of Tax Practice* (Chicago, Ill., CCH, 1991), para. 117.011.

<sup>63</sup> Discussion Paper, Executive Summary, page 9.

Circular 230 sets out eleven rules<sup>64</sup> defining the standard of behaviour. Examples include:

1. A practitioner has a duty to notify a client upon discovery of an error or failure to comply with the tax laws.
2. A practitioner has a duty to exercise due diligence in the preparation of documents and the submission of oral and written statements to the IRS.
3. A practitioner has a duty to not unreasonably delay the prompt disposition of any matter before the IRS.

Violation of any of these rules can lead to a practitioner being suspended or barred from practising before the IRS. Other bases for such action include incompetence, disreputable conduct (see below), a violation of the statute and regulations, or wilfully and knowingly misleading or threatening a client with the intent to defraud.<sup>65</sup> Three examples of conduct considered "disreputable" are:

1. Knowingly giving false or misleading information, or participating in the giving of such information, to the IRS, or making false or misleading statements to a client with the intent to procure employment.
2. Wilfully failing to file a federal tax return or evading (or attempting to evade) taxes.
3. Giving a false opinion on questions arising under the federal tax laws, knowingly, recklessly, or through gross incompetence.

Finally, any wilful violation of Circular 230 may result in disbarment or suspension.<sup>66</sup>

#### **4.4 PENALTIES RELATING TO RETURN PREPARERS**

The following discussion relating to return preparer penalties will be considered in two dimensions:

- (A) United States professional standards.
- (B) United States legislation (the return preparer penalty provisions).

#### **4.5 UNITED STATES PROFESSIONAL STANDARDS**

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<sup>64</sup> Circular 230, section 10.21-10.33.

<sup>65</sup> 31 USC section 330(b) and Circular 230, section 10.50.

<sup>66</sup> Circular 230, section 10.51.



Both the American Bar Association ("ABA") and the American Institute of Certified Public Accountants ("AICPA") have issued ethical standards in relation to tax return preparation and advice. In response to concerns that previous standards had become too lax, both professional bodies substantially revised their standards for taking a tax return position.

In 1985, the ABA modified its previous position by requiring that lawyers have a "good faith belief" that the position taken in a tax return has "some realistic possibility of success if the matter is litigated."<sup>67</sup>

In 1988, the AICPA followed the ABA by adopting a requirement of a "good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged."<sup>68</sup>

The "realistic possibility of success" standard adopted by the ABA and AICPA was subsequently codified by the *Omnibus Budget Reconciliation Act* of 1989 ("OBRA") in revised section 6694.<sup>69</sup>

The new standard has met with a mixed reception from practitioners and their respective professional bodies. A task force of the ABA's Tax Section commented on the implications of the new standard stating that it "measurably elevates what had come to be widely accepted as the minimum ethical standard."<sup>70</sup> Other commentators have suggested that the "realistic possibility of success" standard is a lower adversarial based standard which allows the assertion of any "non-frivolous" position on a tax return.<sup>71</sup>

In conclusion, there is no doubt that both professional tax bodies in the United States want some kind of standard of ethical behaviour to be maintained. The problem which the professional bodies in the United States face, as will the Australian professional bodies, is if the respective bodies adopt a low standard then the Government will intervene.

## 4.6 UNITED STATES LEGISLATION

### 4.6.1 OVERVIEW

In the United States regime, broadly there are two sets of penalties:

1. penalties for understatements of tax - these apply to taxpayers; and

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<sup>67</sup> ABA Committee on Ethics and Professional Responsibility, Formal Opinion 85-352 (1985).

<sup>68</sup> AICPA Federal Taxation Executive Committee, *Statements on Responsibilities in Tax Practice* ("SRTP") (1988 Rev.). The SRTPs were again revised slightly in 1991 and Interpretation 1-1 on the realistic possibility standard was issued in December 1990.

<sup>69</sup> See Gardner, Willey and Woehlke, "The Realistic Possibility Standard", 22 *The Tax Adviser* 279 (May 1991).

<sup>70</sup> See (1985) 39 *Tax Law* 635, p. 638.

<sup>71</sup> See B. Wolfman, J.P. Holden and K.L. Harris, *supra* note 57, para. 214.02

2. return preparer penalties - these apply to preparers of tax returns.

#### 4.6.2 PENALTIES FOR UNDERSTATEMENT OF TAX

Many of the concepts contained in the recently introduced Australia regime of penalties for understatements of tax<sup>72</sup> have been transported, either directly or indirectly, from the United States system.

While a detailed consideration of the penalties for understatements of tax under the US regime is beyond the scope of this Paper, a brief mention of the regime is warranted to appreciate the interaction with the return preparer penalties, which will be discussed in some detail.

Under the present regime, only two penalties effectively apply to underpayments of tax in the US:

- (A) a uniform accuracy-related penalty - section 6662; and
- (B) a fraud penalty - section 6663.

##### (A) THE ACCURACY-RELATED PENALTY

By way of overview, section 6662 of the Code imposes a penalty equal to 20% (40% in the case of a gross valuation misstatement) on (1) underpayments attributable to negligence *or* disregard of rules or regulations, and (2) substantial understatements of income tax.<sup>73</sup> Section 6662 also includes penalties on valuation misstatements, pension liability overstatements, and gift or estate tax undervaluations. Together, the five components of the 20% penalty covered by section 6662 are referred to as the combined accuracy-related penalty.

##### (B) THE FRAUD PENALTY

The fraud penalty, which is imposed at a rate of 75%, applies to the portion of an underpayment attributable to fraud.<sup>74</sup>

##### (C) STANDARDISED EXCEPTIONS

Standardised exception criteria are applicable to all accuracy-related penalties - thus no penalty is imposed under the accuracy-related or fraud penalties if it is shown that (i) the

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<sup>72</sup> *Taxation Laws Amendment (Self Assessment) Act 1992* ("SAA").

<sup>73</sup> In the Australian regime, the basic rate structure rises from 25% (for example, disregarding a private ruling) to 75% (for an intentional disregard of the law). However, it should be noted that these are the "basic" parameters and the rate imposed can drop to as little as 2% and rise to as high as 90%.

<sup>74</sup> Section 6663(a).

taxpayer had reasonable cause for an underpayment, and (ii) the taxpayer acted in good faith.<sup>75</sup>

Other exceptions apply to the individual penalties however these are beyond the scope of this Paper.

#### 4.6.3 RETURN PREPARER PENALTIES

This following discussion should be read in conjunction with Appendix 1.

The return preparer penalties can be considered under two main provisions:

##### SECTION 6694(A)

This provision provides for the imposition of a \$ 250 penalty on a tax preparer who knew (or reasonably should have known) about any undisclosed tax return position that results in the understatement of tax liability and that does not meet the realistic possibility standard as defined in the final section 6694 regulations.

##### SECTION 6694(B)

This provision imposes a \$ 1000 penalty if there is any understatement of tax liability derived from a wilful attempt to understate tax liability or due to reckless or intentional disregard of IRS rules or regulations.

#### 4.6.4 INTERRELATIONSHIP BETWEEN SECTION 6694(A) AND SECTION 6694(B)

Any penalty imposed under section 6694(b) is reduced by the amount of any penalty imposed under section 6694(a) for the same return.<sup>76</sup> Therefore, if a penalty is imposed under section 6694(a) and (b) for the same return, the maximum penalty will be \$ 1000 (\$ 250 imposed under section 6694(a) and \$ 750 under section 6694(b)).

Finally, the regulations take the view that a preparer can be subject to a section 6694(b) penalty even though he meets the requirement to avert a section 6694(a) penalty. Some have commented that this leads to the highly questionable result that conduct which passes muster under section 6694(a)<sup>77</sup> may nevertheless be subject to the section 6694(b) penalty, which in turn is generally reserved for more culpable (that is, reckless or intentional) behaviour.<sup>78</sup>

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<sup>75</sup> Section 6664(c), reg. 1.6664-4.

<sup>76</sup> Reg. 1.6694-3(g).

<sup>77</sup> To pass muster under this provision, the "realistic possibility" standard must be met.

<sup>78</sup> See B. Wolfman, J.P. Holden and K.L. Harris, *supra* note 57, para. 5005.05.

#### 4.6.5 RATES OF PENALTY

Reference should be made to Appendix 1 for an illustration of the types of behaviour that results in penalties being imposed under sections 6694(a) and (b).

As mentioned, the penalties under the provisions are either \$ 250 or \$ 1000. While many may believe that such small penalties would not operate as effective deterrents, such action could have wider implications as it could result in the tax practitioner being suspended or disbarred from practice before the IRS.<sup>79</sup> Furthermore, the practitioner would have the expenses of defending any action brought under the section and the cost of any additional disciplinary proceedings.<sup>80</sup>

#### 4.6.6 THE REGULATIONS

On 31 December 1991 (the eve of a new tax return filing season), the IRS issued final regulations under section 6694 in an attempt to clarify the new provisions. At the same time, final regulations were issued under sections 6662 and 6664 dealing with accuracy-related penalties on taxpayers (see previous discussion for summary of penalties).

Return preparers would be well served to understand how both sets of regulations may apply to cause aggressive tax return positions to generate two sets of penalties, **both** of which effectively may be borne by the hapless return preparer - his own penalty, as well as his client's penalty under section 6662, which in some situations the preparer may choose to reimburse under the threat of malpractice or other litigation by his disgruntled client.<sup>81</sup>

In addition, numerous violations of the return preparer penalties will likely constitute violation of Circular 230 (*supra*), which may lead to disbarment or suspension of practice before the IRS, as well as referral to appropriate state licensing bodies for possible revocation of the preparer's professional licence.<sup>82</sup>

### 4.7 THE SECTION 6694(A) PENALTY

#### 4.7.1 OVERVIEW

The following discussion should be read in conjunction with Appendix 2.

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<sup>79</sup> See S. Ross, *supra* note 55, p. 56.

<sup>80</sup> *Ibid.*

<sup>81</sup> S. Banoff, "Final Regulations on Return Preparers' Penalties: IRS Refuses to Deal, Preparers' Fears Prove to be Real/Penalty Roulette - Roll the Wheel/Who Knows how the Courts will Feel?", *Taxes*, March 1992, p. 138.

<sup>82</sup> *Ibid.*

If any part of an understatement of liability relating to a return of tax or claim for refund of tax under the Code is due to a position for which there was not a "realistic possibility of being sustained on its merits", any person who is a preparer with respect to such return or claim for refund who knew or reasonably should have known of such position is subject to a penalty of \$ 250 with respect to such return or claim for refund.<sup>83</sup>

There are three exceptions to the imposition of this penalty:

1. Where a favourable written determination has been obtained for the taxpayer.
2. Where there has been adequate disclosure of a non-frivolous position.
3. Where reasonable cause and good faith has been shown for the position taken.

The operation of the penalty as well as the exceptions listed will be presently considered.

#### 4.7.2 THE REALISTIC POSSIBILITY STANDARD

As can be observed, to avert a penalty being imposed under section 6694(a), one must satisfy the "realistic possibility" standard. The regulations explain in some detail the requirements relating to the standard. A number of issues and criticisms arise from that explanation and they shall be considered presently.

#### QUANTIFICATION OF STANDARD

The regulations adopt the highly controversial position that the realistic possibility standard can and should be quantified. The regulations state that a position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has **approximately a one in three, or greater, likelihood of being sustained on its merits** (the realistic possibility standard).<sup>84</sup>

In making this determination, the possibility that the position will not be challenged by the IRS (for example, because the taxpayer's return may not be audited) is not to be taken into account.<sup>85</sup>

The regulations' definition of realistic possibility wrongly creates a quantitative one-in-three standard as the "watershed" test. Many commentators asked that the one-in-three definition be eliminated because of the difficulty in assessing the likelihood of a position being

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<sup>83</sup> Section 6694(a), Reg. 1.6694-2(a)(1).

<sup>84</sup> The approximately one-in-three standard was first promulgated in Notice 90-20, and received criticism from preparers, accounting societies and bar associations.

<sup>85</sup> Reg. 1.6694-2(b)(1).

sustained on the merits.<sup>86</sup> The quantified standard was reportedly retained to prevent erosion of the standard - the reasoning being based on the argument "If we don't put some percentage in there, how do we prevent the standard from eroding."<sup>87</sup>

Others expressed this sentiment by stating that the overriding concern in this area was the need for a benchmark to measure success from, despite the difficulty in quantifying this possibility.

Hence it was not surprising to see the Preamble to the final regulations stating that "a numerical benchmark helps prevent erosion of the standard and other definitions suggested by commentators would not provide any more meaningful guidance."

Notwithstanding this defence, many were vociferous in pointing out the likely absurdity of applying the one-in-three definition in the real world. A typical criticism in this regard is the comment by the ABA's Civil Penalties Task Force:<sup>88</sup>

*"In litigation over the penalty, for example, if the practitioner against whom the penalty is asserted is able to produce another practitioner willing to testify, 'I think this position had about a one-in-three chance of prevailing,' what is the Service's response? Is it to put on a witness who says, 'I think it had less than a one-in-three chance of prevailing'?"*

*"Who is right? Could either side really find a qualified witness who, in good faith, could assess the odds of winning a fairly close case in litigation? Will a district judge be able to tell? What kind of analysis could he put in an opinion? Will that opinion be of any precedential use in future penalty proceedings? The definition proposed by the Service will result in arbitrary and unexplainable decisions. Further, it will be difficult for a decision to have much precedential impact unless the court fashions rules not included in the regulation."*

Further technical problems exist with the realistic possibility standard.

First, the regulations give no hint as to who is "a person knowledgeable in the tax law." Second, as to the benchmark of "a reasonable and well-informed analysis by a person knowledgeable in the tax law", it is unclear what constitutes such an analysis or what authorities would be required to be known in order to make a well-informed analysis." And then practical issues arise, such as how many return preparers can devote the necessary time and resources to perform a "reasonable analysis" of all potentially applicable authorities?

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<sup>86</sup> T.D. 8382, Preamble, "Section 6694(a) Provisions-1. 'One-in-Three' Definition of the Realistic Possibility Standard."

<sup>87</sup> See "Witness at IRS Hearing Complain About Provision of Preparer penalty Rules", *BNA Daily Tax Reporter* (No 107) G-9 (June 4, 1991).

<sup>88</sup> Accord: ABA Section on Taxation Civil Penalties Task Force Letter dated June 3, 1991, to IRS Commissioner Fred T. Goldberg, Jr., re: Comments Concerning Proposed Regulations Under Code Sections 6662, 6664 and 6694 of the Internal Revenue Code of 1986 ("ABA Task Force Letter").



And then how many of those who do have the necessary time and resources can make an expert evaluation that the odds of success are "approximately one-in-three or higher"?

Furthermore, it seems clear that CPAs and other experienced tax professionals do not limit themselves to the restrictive sources listed as "authority" under the regulations in determining whether the realistic possibility standard is satisfied. The question then is how does one obtain a "reasonable and well informed analysis by a person knowledgeable in the tax law" without considering the same sources and authorities otherwise referred to?

Third, how does one evaluate "success on the merits" at the administrative level? And what does "being sustained" mean? Does it require full concession by a field or appellate agent? Apparently, some appellate officers and agents use a rough rule of thumb that they generally will not concede a case in its entirety unless the taxpayer has at least an 80 per cent chance of winning in court.<sup>89</sup>

If this is the case then it is far more difficult to achieve the level considered sufficient to avert the penalty than if the case had gone to court, as success in court merely requires being correct more likely than not - that is, convincing the court that the taxpayer's position is better than that of the IRS (for example 51 per cent to 49 per cent).

#### ANALYTICAL APPROACH TO APPLICATION OF STANDARD

The regulations<sup>90</sup> state that the method of analysing whether the realistic possibility standard is satisfied is the same analysis to be used for purposes of determining whether substantial authority is present, in order to avert the Section 6662(b)(1) penalty.<sup>91</sup>

One factor in this analysis is the **weight** of valid authorities. The regulations state that old-IRS-generated authority may be accorded very little weight, as compared to more recent authority.<sup>92</sup>

Many have criticised this stating that the regulations wrongly conclude that new authority that is contrary to previously issued authority causes the latter to cease to be authority.<sup>93</sup> In such situations, it is contended that the reversal should only **diminish** the weight of earlier authority; it should not cause the earlier authority to lose its status as authority altogether.<sup>94</sup>

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<sup>89</sup> See S. Banoff, *supra* note 76, p. 158.

<sup>90</sup> Reg. 1.6694-2(b)(1).

<sup>91</sup> Reg. 1.6662-4(d)(3)(ii).

<sup>92</sup> *Ibid.*

<sup>93</sup> See S. Banoff, *supra* note 76, p. 162.

<sup>94</sup> *Id.* 163.

## TYPES OF AUTHORITY

The final regulations retain the much criticised position that tax return preparers can rely only on a limited list of types of authority to satisfy the realistic possibility standard. Consequently, return preparers and tax advisors cannot use many types of authorities which could be used in a court action to win the case. The final regulations acknowledge that the IRS's intransigence is based on administrative ease for IRS enforcement.<sup>95</sup>

Many have submitted that the position in the regulations should be rejected and that the types of authority which count for the purposes of new Section 6694(a) should be the same as the broad list previously applicable to the reasonable basis standard under former section 6694(a).<sup>96</sup> Reasons for retaining such a broad interpretation include:<sup>97</sup>

- (1) There was no Congressional intention to change the types of authority applicable to return preparers when section 6694(a) was changed.
- (2) The narrowing of the types of authority upon which return preparers can rely flies in the face of their professional rules of practice.

The importance of having a single standard for preparers is self-evident: preparers should not be subjected to sanctions and penalties by the IRS if the preparers' actions are consistent with thoughtfully developed and appropriate professional standards of behaviour.<sup>98</sup> Congress implicitly recognised the need for comparable standards, and explicitly directed the IRS and Treasury to draft the penalty rules in conjunction with professional standards.<sup>99</sup> Despite this, the final regulations are **more restrictive** than professional standards, in many respects.

As mentioned, in certain situations, the Service has chosen to deviate from professional standards because of "administrative convenience" or to avoid "erosion of the standard." However, there is no indication in the statute or legislative history that Congress allowed the IRS, on the basis of convenience, to make the standards more strict or burdensome than imposed by the professions.<sup>100</sup> This important difference in philosophy underlines many of the problems in the US regime.

- (3) The narrowing of the types of authority upon which preparers can rely ignores the way in which thousands of preparers practice. In other words, the restrictive definition of valid authorities in the regulations excludes many types of authority

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<sup>95</sup> T.D. 8382, Preamble, "Section 6694(a) Provisions-2. Authorities."

<sup>96</sup> See S. Banoff, *supra* note 76, p. 159.

<sup>97</sup> *Ibid.*

<sup>98</sup> *Id* 155.

<sup>99</sup> *Ibid.*

<sup>100</sup> *Id* 156.



which tax preparers commonly consider in determining the potential outcome of taking a particular reporting position.

In summary, critics have recommended that the narrow definition of authority contained in Reg. 1.6694-2(b)(2) should be rejected.

#### 4.7.3 EXCEPTION 1: WRITTEN DETERMINATION

Return preparers can protect themselves from penalty in cases where the taxpayer whose return they are preparing has obtained a favourable written determination. In such a situations, the realistic possibility standard for the taxpayer's preparer will be considered to have been satisfied for the purposes of section 6694(a).<sup>101</sup>

#### 4.7.4 EXCEPTION 2: ADEQUATE DISCLOSURE

The regulations provide that the section 6694(a) penalty will not be imposed on a preparer if the position taken is not frivolous and is adequately disclosed in accordance with the regulations.<sup>102</sup>

The regulations define a "frivolous" position as one that is "patently improper."<sup>103</sup> This definition has been criticised as being potentially too broad because, *inter alia*, it does not take the preparer's subjective belief as to the merits of his position into consideration.<sup>104</sup>

Commentators suggested that the definition of a "frivolous" position should be changed to require that the position be both patently improper and knowing advanced in bad faith, or that a frivolous position be defined as "not litigable."<sup>105</sup>

The Service's response is that the "patently improper" definition was used because it represents an objective standard: thus, neither the good nor the bad intentions of a preparer are relevant to a determination of whether that position is frivolous. The IRS also rejected the "not litigable" standard because, if adopted, it would place preparers who are not attorneys at a disadvantage in assessing the effectiveness of disclosure in relation to preparers who are attorneys.<sup>106</sup>

As a result of the IRS position, a preparer who is not negligent (but is stupid) and who prepares a return in good faith nonetheless will be subjected to section 6694(a) penalties, even

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<sup>101</sup> Reg. 1.6694-2(b)(4).

<sup>102</sup> Reg. 1.6994-2(c)(1).

<sup>103</sup> Reg. 1.6994-2(c)(2).

<sup>104</sup> See S. Banoff, *supra* note 76, p. 147.

<sup>105</sup> *Id* 163.

<sup>106</sup> T.D. 8382, Preamble, "Public Comments General Provisions--6. Definition of 'Frivolous'."

for a position he or she adequately discloses, if the position is patently improper.<sup>107</sup> Thus, a preparer could be found to have taken a frivolous position unknowingly.

#### 4.7.5 EXCEPTION 3: REASONABLE CAUSE AND GOOD FAITH ("RCGF")

A statutory exemption to the section 6694(a) return preparer penalty exists if "reasonable cause" exists for the understatement and the preparer acts in "good faith."<sup>108</sup>

The regulations list five factors to be considered; however, the list is not all-inclusive. The RCGF factors are:<sup>109</sup>

- (1) the nature of the error causing the understatement;
- (2) the frequency of errors;
- (3) the materiality of errors;
- (4) the preparer's normal office practice; and
- (5) the reliance (or lack of reliance) on the advice of another preparer.

There are a number of criticisms in relation to the RCGF exception.

First, the regulations contain no illustrations to help in determining when the RCGF factors are present, thus creating considerable uncertainty as to when the penalty will not be imposed.

Second, in establishing the RCGF exception, the valid list of authorities which may be referred to is restrictive (see above). It would appear that, at a **minimum**, the reliance by return preparers on secondary sources (including well-reasoned treatises and articles) should be treated as sufficient to constitute RCGF on the part of the preparer, in order to avert the penalty.<sup>110</sup> After all, the burden of proof is on the preparer to establish RCGF,<sup>111</sup> which presumably would include establishing the validity of the secondary source.

Finally, the regulations do not permit preparers to avoid the section 6694(a) penalty by reliance on another preparer in the same firm. As discussed earlier, one of the factors in determining whether the RCGF exception applies to a section 6694(a) penalty is whether the signing preparer relied in good faith on the advice of another preparer who the first preparer had reason to believe was competent to provide the required advice.

However, a preparer may **not** rely on the advice of an individual associated with the same firm as the preparer. Thus a signing preparer working at a firm does not satisfy this RCGF

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<sup>107</sup> See S. Banoff, *supra* note 76, p. 163.

<sup>108</sup> Reg. 1.6694-2(d).

<sup>109</sup> Reg. 1.6694-2(d)(1)-(5).

<sup>110</sup> See S. Banoff, *supra* note 76, p. 162.

<sup>111</sup> Reg. 1.6694-2(e)(2).

factor unless he hires and consults an advisor **outside** his firm. In relation to the Australian regime, the Discussion Paper merely states that registered taxpayers' agents are not to be held liable to disciplinary action for acting upon the advice of a qualified accountant or lawyer with expertise in the area in question, without specifying whether this advice must be third party advice or can be in-house.<sup>112</sup>

The US position causes a practical problem for medium and large firms, who have the resources in-house to give reliable advice, rather than hire outside professionals to provide the same advice. Conversely, this position may result in increased revenues for tax law specialists, whose fees as specialists will no doubt raise the cost to the public for tax return preparation.

Further, in order to rely on this factor of the RCGF exception, the signing preparer has the burden of showing he had reason to believe that the other (advising) preparer "was competent to render such advice."<sup>113</sup> The practical difficulty here is how does the preparer prove he had such "reason to believe?" The regulations offer no help.

## 4.8 THE SECTION 6694(B) PENALTY

### 4.8.1 OVERVIEW

The following discussion should be read in conjunction with Appendix 3.

If any part of an understatement of liability relating to a tax return or claim for refund under the Code is due to either (i) a wilful attempt in any manner to understate the liability for tax by a preparer of the return or claim for refund, or (ii) any reckless or intentional disregard of rules or regulations by any such person, then such preparer is subject to a penalty of \$ 1000 with respect to such return or claim for refund.<sup>114</sup>

### 4.8.2 LIMB 1: WILFUL UNDERSTATEMENT

A preparer is considered to have wilfully attempted to understate tax liability if, in a wrongful attempt to reduce the tax liability of the taxpayer, the preparer disregards information furnished by the taxpayer or other persons. For example, if a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is subject to the penalty. Similarly, if a taxpayer states to a preparer that the taxpayer has only two dependants, and the preparer reports six dependants on the return, the preparer would be subject to the penalty.<sup>115</sup>

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<sup>112</sup> Discussion Paper, Chapter 8, Recommendation 44, page 98.

<sup>113</sup> Reg. 1.6694-2(d)(5).

<sup>114</sup> Section 6694(b), Reg. 1.6694-3(a)(1).

<sup>115</sup> Reg. 1.6694-3(b).

Further, the penalty for wilful understatement applies regardless of the source of the information. Thus, the client, a reporting entity issuing an information return, or even a less direct source such as a newspaper report of a substantial court judgement or a lottery winning, could provide the correct information.<sup>116</sup>

Finally, unlike the other return preparer penalties, no method of adequate disclosure is authorised for a preparer who wilfully attempts in any manner to understate tax liability so as to incur a penalty under section 6694(b)(1).

#### 4.8.3 LIMB 2: RECKLESS OR INTENTIONAL DISREGARD

A preparer will be subject to a \$ 1000 penalty if the preparer takes a position that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation.

A preparer is reckless if he makes little or no effort to discover the rule or regulation in a situation in which a reasonable preparer normally would research the issue.<sup>117</sup> In the specific language of the regulations, the preparer will be considered reckless if there is a "substantial deviation" from a reasonable preparer's "standard of conduct."<sup>118</sup>

#### 4.8.4 RULES OR REGULATIONS

The regulations define the term "rules or regulations" widely to include the provisions of the Code, temporary or final regulations issued under the Code, and revenue rulings or notices issued by the IRS and published in the Internal Revenue Bulletin.<sup>119</sup>

Commentators criticised the inclusion of revenue rulings in the regulations (and no doubt would also criticise the addition of notices in the regulations) as being treated as "rules" because (1) a revenue ruling does not constitute a rule under the *Administrative Procedure Act* and (2) a revenue ruling is only the contention of one party and is not subjected to the give-and-take of a public comment process.<sup>120</sup>

#### 4.8.5 EXCEPTIONS TO THE PENALTY

The exceptions to the penalty for reckless or intentional disregard of rules or regulations depend on the type of authority being disregarded.

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<sup>116</sup> J. C. Gardner, S. L. Willey, J.A. Woehlke, "The Final Return Preparer Regulations", *The Tax Adviser*, April 1992, pp. 211-212.

<sup>117</sup> *Id* 212.

<sup>118</sup> Reg. 1.6694-3(c)(1). Diligence is implicit in this standard of being a reasonable preparer.

<sup>119</sup> Reg. 1.6694-3(f).

<sup>120</sup> T.D. 8382, Preamble, "Section 6694(b) Provisions—2. Rules or Regulations."

### POSITION CONTRARY TO A "RULE"

If the position taken is contrary to a "rule" (but not a regulation), a preparer can avoid the penalty if the position contrary to the rule is (i) not frivolous and is (ii) adequately disclosed.<sup>121</sup>

### POSITION CONTRARY TO A "REGULATION"

In the case of a position being taken contrary to a regulation, a preparer can avoid the penalty if the position contrary to the rule is (i) not frivolous and is (ii) adequately disclosed **and** (iii) the position must represent a good faith challenge to the validity of the regulation.<sup>122</sup>

### POSITION CONTRARY TO A "REVENUE RULING OR NOTICE"

In the case of a position being taken contrary to a revenue ruling or notice, a preparer can avoid the penalty if (i) the position is not frivolous and is adequately disclosed **or** (ii) he does not disclose the position, but the position taken has a realistic possibility of being sustained on its merits.<sup>123</sup>

## 5.0 CONCLUSION

The final regime of return preparer penalties in the US represents a unique process which commenced prior to 1989, which involved roundtable discussions, task forces and input from representatives of the IRS, Treasury, advisory groups, practitioner groups and Congress. During the time that all the groups participated in the design and passage of the legislation, the product was correctly heralded as a major improvement and much-needed reform of a myriad of inconsistent and often overlapping penalties.<sup>124</sup>

Once the regulations were released, much comment and criticism was received from practitioners, academics, firms and several professional bodies, including the ABA and AICPA. Many feared that the rules could cause practical problems for preparers and in their relationships with their taxpayer clients, which problems arise in large part because of Treasury's desire for administrative convenience.<sup>125</sup>

Such fears proved to be real in the US experience; the preamble to the final regulations recites several instances where the Government turned a deaf ear to preparers' suggestions or

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<sup>121</sup> Reg. 1.6694-3(c)(2).

<sup>122</sup> Reg. 1.6694-3(c)(2).

<sup>123</sup> Reg. 1.6694-3(c)(3).

<sup>124</sup> See S. Banoff, *supra* note 76, p. 169.

<sup>125</sup> *Id* 139.

complaints. One commentator has stated that the IRS and Treasury appear to have rejected more comments than they accepted; without the advice and consent of Congress, they have made administrative determinations which favour the IRS (for example, for reasons of administrative ease) at the expense of fairness to return preparers.<sup>126</sup>

As a result some have stated that many return preparers may find themselves:<sup>127</sup>

*"playing penalty roulette; they may "roll the wheel" to take their chances in the audit (and enforcement) lottery, rather than take a conservative position or disclose an aggressive position. Flying in the face of final regulations is not for the faint of heart; if such positions are discovered by the IRS on audit, penalties are likely to be imposed."*

Whether the courts will uphold the more controversial aspects of the regulations is hard to say. In the meantime, a related problem for practitioners is what to do in the meantime, given that court decisions relating to some aspects of the regulations may be some time away.

In any event, any journey through the courts will be long, arduous and expensive, and one which will leave many practitioners with substantial uncertainty for many years to come - clearly an unsatisfactory situation.

The professional community in the US has reacted in two ways:

1. Some have taken an ostrich-like stance to the penalty rules; burying their heads in the sand. This group sees this method as more expeditious in the short-term rather than changing the way they provide tax advice.
2. However, many other practitioners have become concerned, particularly now the regulations have become finalised. Some think that "when a gallows is erected in the town square, it may well be that someone is planning a hanging."<sup>128</sup> Playing penalty roulette may not lead to capital punishment, but paying penalties and potential malpractice liability and facing potential disbarment from IRS practice certainly leads to punishment of capital!<sup>129</sup>

Thus it can be seen that there are some sobering lessons to be learned from the US experience.

Interestingly, the National Review seems to be unfolding in a similar fashion to the US regime - however, it is still early days as the Review is still in the consultative phase.

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<sup>126</sup> *Id* 170.

<sup>127</sup> *Id* 139.

<sup>128</sup> Raby, "A Gallows in the Town Square? Recent Cases Involving the New Preparer Penalty Regulations", 54 *Tax Notes* 573 (3 February 1992).

<sup>129</sup> See S. Banoff, *supra* note 76, p. 170.

It is hoped that the Australian authorities will learn from the US experience and adopt a true consultative stance, taking heed of comments and constructive criticism which will no doubt now be forthcoming with the release of the Discussion Paper.

Sceptics would argue that the consensus approach to the Review has already started to crack as the Discussion Paper was released without clearance by any of the bodies represented on the Review's Steering committee. However, in the Caveat to the Discussion Paper, the Committee recognised that each of the bodies may agree or disagree with part or all of it<sup>130</sup> - one only hopes that the Committee does not reject more comments than they accept.

One also hopes that the Committee will not make administrative determinations which favour the ATO (for example, for reasons of administrative ease) at the expense of fairness to return preparers. One thing remains sure - time will tell.

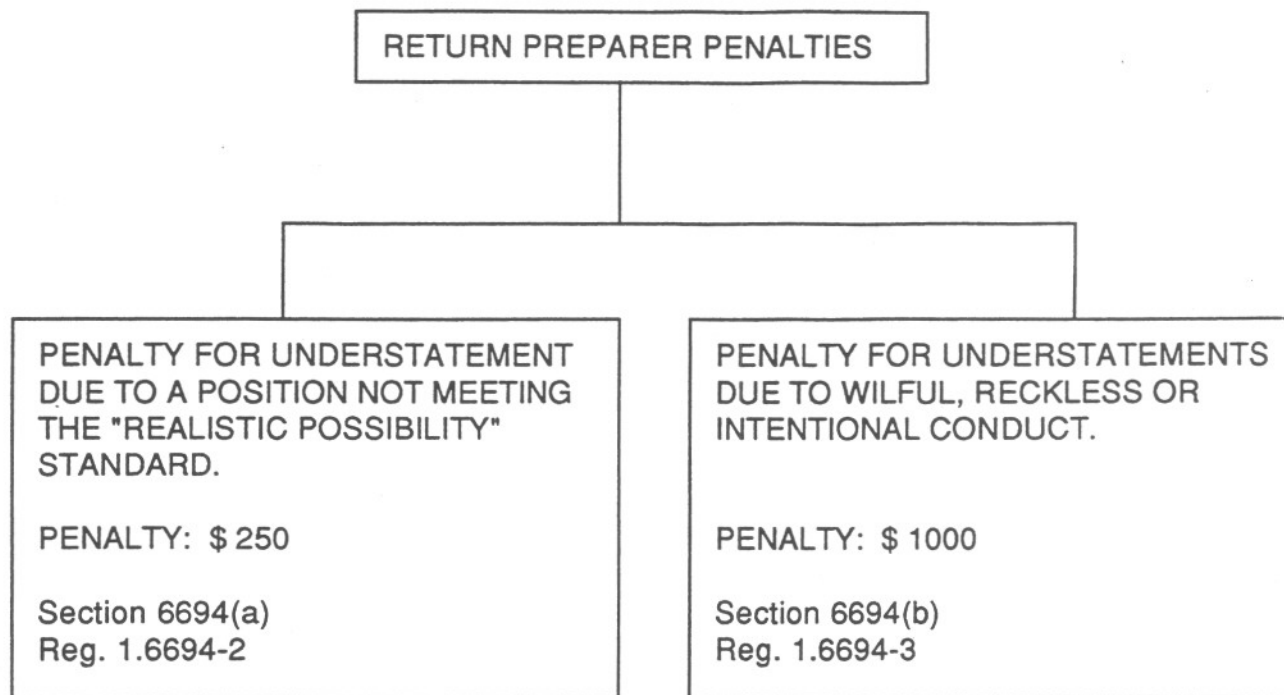
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<sup>130</sup> Discussion Paper, Caveat, p. 3.



## APPENDIX 1 - OVERVIEW OF RETURN PREPARER PENALTIES IN THE UNITED STATES REGIME

**NOTE:** All section references herein are to the *Internal Revenue Code* (US) 1986, as amended, or to the Treasury regulations promulgated thereunder.



	TYPE OF BEHAVIOUR	PENALTY	SECTION
1	Negligent disregard of rules or regulations	\$250	6694(a) **
2	Position that does not have a "realistic possibility" of being sustained on its merits	\$250	6694(a)
3	Frivolous return position (even if disclosed)	\$250	6694(a)
4	Wilful attempt to understate tax liability	\$1,000	6694(b)(1)
5	Intentional disregard of rules or regulations	\$1,000	6694(b)(2)
6	Reckless disregard of rules or regulations	\$1,000	6694(b)(2)
	** subsumed in the definition of "realistic possibility" of being sustained on the merits.		



**APPENDIX 2 - PENALTY FOR UNDERSTATEMENT DUE TO A POSITION NOT MEETING THE "REALISTIC POSSIBILITY" STANDARD**

**NOTE:** All section references herein are to the *Internal Revenue Code* (US) 1986, as amended, or to the Treasury regulations promulgated thereunder.

PENALTY FOR UNDERSTATEMENT  
DUE TO A POSITION NOT MEETING  
THE "REALISTIC POSSIBILITY"  
STANDARD.

PENALTY: \$ 250

Section 6694(a)  
Reg. 1.6694-2

**EXCEPTIONS**

FAVOURABLE WRITTEN  
DETERMINATION  
OBTAINED FOR THE  
TAXPAYER:

Reg. 1.6694-2(b)(4)

ADEQUATE DISCLOSURE  
OF A NON-FRIVOLOUS  
POSITION:

Reg. 1.6694-2(c)(1)

REASONABLE  
CAUSE AND GOOD  
FAITH:

Reg. 1.6694-2(d)

**APPENDIX 3 - PENALTY FOR UNDERSTATEMENTS DUE TO WILFUL, RECKLESS, OR INTENTIONAL CONDUCT**

**NOTE:** All section references herein are to the *Internal Revenue Code* (US) 1986, as amended, or to the Treasury regulations promulgated thereunder.

