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Loving: Who Can The IRS Regulate?

Law360, New York (December 06, 2013, 11:51 AM ET) -- A recent change to the regulations governing practice before the Internal Revenue Service, commonly known as “Circular 230,”[1] is under attack.

In 2011, the IRS amended Circular 230 to regulate hundreds of thousands of tax return preparers who were not already covered by Circular 230 as attorneys or CPAs. The government describes these new regulations as of “exceptional importance to the administration of the tax laws.” But in January, the district court in Loving v. Internal Revenue Service[2] granted declaratory and injunctive relief to the plaintiffs, concluding that the IRS lacked the authority to issue or enforce the new regulations. The government appealed and the D.C. Circuit heard oral arguments on Sept. 24. Observers described the circuit court as skeptical of the government’s arguments; some predicted that the court would affirm the decision. The court’s ruling will have a significant effect on the IRS and tax return preparers and could have implications for other practitioners.

There have been three major revisions to Circular 230 in the last 30 years. In 1984, the IRS established standards for tax opinions used in promoting tax shelters. In 2004, the IRS revised and expanded those standards, creating a complex web of detailed procedures addressing different types of opinions. In 2011, the IRS established the new standards for tax return preparers. New requirements for registration, a certification test, and continuing education apply only to those return preparers who do not fit within any of the other categories of practitioners.[3]

The 1984 and 2004 revisions were aimed at protecting the government. The IRS believed that some attorneys and CPAs had crossed the boundary from responsibly and ethically advising their clients to encouraging and enabling abusive tax evasion. The 2011 revision, on the other hand, was aimed at protecting both the government and taxpayers. Congressional testimony identified tax return preparation as an issue in the late 1990s. Beginning in her 2002 annual report and continuing since then, National Taxpayer Advocate Nina Olson described significant problems for the government and for taxpayers caused by incompetent or unscrupulous tax return preparers. Several studies and audits of tax return preparers have substantiated those concerns. After lengthy review, the IRS proposed the revisions to Circular 230 in 2010 and finalized them in 2011.

The District Court’s Decision

The court focused on the meaning of the statute authorizing the IRS to regulate practitioners, 31 U.S.C. § 330(a):

> Subject to section 500 of title 5, the Secretary of the Treasury may—
> (1) regulate the practice of representatives of persons before the Department of the Treasury; and
> (2) before admitting a representative to practice, require that the representative demonstrate--
> (A) good character;
> (B) good reputation;
> (C) necessary qualifications to enable the representative to provide to persons valuable service; and
> (D) competency to advise and assist persons in presenting their cases.

The court focused on “presenting their cases” and interpreted that as a definition of the “practice of representatives.” The court concluded that filing a tax return does not constitute “presenting a case,” as there is no dispute with the IRS at the time of filing the return. Disputes arise only later, during the examination and appeals processes. The court found further support for its conclusion in the broader statutory context. The Code includes specific penalties targeted at conduct surrounding return preparation as well as authority in Section 7407 to enjoin return preparers who engage in certain conduct. The court concluded that regulation of return preparers under Circular 230 would be inconsistent with this “comprehensive scheme” targeting problems with tax return preparation. Further, Circular 230 does not contain all of the safeguards that the statutory scheme includes.

Was Loving Correct?

The appellate briefs by, or in support of, the government argue that the statute is ambiguous and therefore the IRS’s interpretation of the scope of their regulatory authority must be given deference. The income tax has evolved from a system that affects only a few Americans to one that affects most of us. The IRS necessarily relies on taxpayers to report their own income and tax liability, and only a small percentage of returns are ever audited. That makes the competency and ethical behavior of return preparers critical. Additionally, the Code includes a significant number of nontax policies and government assistance programs, many of which use refundable tax credits. In 2012, over 82 percent of individual income tax returns resulted in the payment of a refund. Thus, the original tax return really is a “claim” or “case” presented to the government, in a way it wasn’t 50 years ago, and fits within paragraph (a)(2)(D) quoted above.

In my opinion, the interpretation of “case” can and should be logically extended even beyond tax returns that claim refunds. The district court limited “case” to disputes during the examination and appeals stages. Realistically, however, taxpayers and their advisers and return preparers are preparing for such disputes before that point. They seek either to avoid the dispute, by not claiming questionable tax benefits on the return, or to evaluate their arguments for claiming those benefits. The tax return may never be challenged, but they are preparing for the very real possibility of such challenges.

This interpretation is analogous to the work product privilege afforded documents prepared in anticipation of litigation. Work product may apply even before there is any prospect for litigation. For example, in Wells Fargo v. United States[4], the court concluded that the taxpayer anticipated litigation when it prepared the recognition and measurement step of its FIN 48 analysis of its uncertain tax positions. Similarly, taxpayers and their advisers and return preparers often will be anticipating and preparing for audits and appeals long before the tax return is filed.

Although the district court did not discuss the question, the appellees in Loving also raise the question of whether return preparers are “representatives” within the meaning of the statutory language quoted above. The appellees argue that return preparers do not have legal authority to act for the taxpayer, as an agent. This interpretation might limit “representatives” to those with a Form 2848 power of attorney, which authorizes the representative to perform certain acts for the taxpayer. Although this argument has some logic, ultimately it is not entirely persuasive. The term “representative” can be and has been used more broadly. Certainly many attorneys and CPAs advise clients without ever obtaining such a power of attorney but nevertheless are considered to be representing their clients.

Neither “case” nor “representative” in the authorizing statute is enough to unambiguously foreclose the Circular 230 regulation of return preparers. Ambiguity is enough to require the court to defer to the IRS interpretation of its own authority.[5] While one might debate the wisdom of such regulation as a matter of policy, it lies within Treasury’s authority to regulate practice before the IRS. The circuit court should reverse.

Possible Impact on Other Practitioners

However, if the circuit court upholds the district court, that might also call into question other aspects of Circular 230. Subpart B, dealing with “Duties and Restrictions Relating to Practice Before the Internal Revenue Service,” includes many provisions that apply (or could apply) prior to the examination and appeals stage and even if the practitioner has no formal authority to act as an

agent.

For example, section 10.21 imposes a duty to advise the client concerning the consequences of any noncompliance, error or omission, including those in a return. Section 10.22(a) requires due diligence in preparing or assisting in the preparation of returns. Section 10.34(a) establishes standards for signing, or advising a client to take a position, on not only a claim for refund but also an original tax return. All of these provisions, in addition to the requirements for registration, testing, and continuing education, would be vulnerable under the district court's interpretation of the statute.

More importantly, sections 10.35, 10.36 and 10.37 — which account for almost half of Subpart B — provide requirements concerning written advice. The largest, section 10.35, explicitly does not apply to post-filing advice. The content of, and history of amendments to, Circular 230 show that assistance before the return is filed was a greater concern than post-filing representation during examination and appeals. It would be difficult if not impossible to identify a distinction, based on the language of paragraph (a) of the statute, between return preparation and prefiling tax advice. If preparation of a tax return is not "presenting a case," neither is prefiling written advice. If the return preparer is not a "representative," neither are tax advisors without a formal power of attorney.[6]

The IRS might be authorized to regulate prefiling written advice by 31 U.S.C. § 330(d), enacted in the American Jobs Creation Act of 2004:

> Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

But the legislative history for the AJCA, enacted 20 years after Circular 230 was first amended to regulate tax opinions, suggests Congress interpreted "presenting a case" broadly:

> The House bill also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.[7]

If the circuit court affirms Loving, that may mean that paragraph (a) does not authorize regulation of tax opinions either. If paragraph (d) is the only authority for regulating tax opinions, the IRS might have to amend Circular 230[8] to eliminate the regulation of not only return preparation but also most written advice. Most written advice does not concern transactions with "a potential for tax avoidance or evasion."

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[1] The current version is available online at http://www.irs.gov/pub/irs-pdf/pcir230.pdf.

[2] 917 F. Supp.2d 67 (D.D.C. 2013).

[3] Circular 230 already included similar requirements for enrolled agents and enrolled retirement plan agents. Circular 230 has no such requirements for attorneys or CPAs, who are subject to similar requirements by their state, or enrolled actuaries, who are regulated by another federal board. Although some return preparers are regulated by their state, the vast majority are not.

[4] 112 A.F.T.R.2d (RIA) 5380 (D. Minn. 2013).

[5] City of Arlington v. Federal Communications Commission, 133 S. Ct. 1863 (2013).

[6] The return preparer, however, at least is required to sign the tax return. The tax advisor who provides pre-filing written advice generally is not required to notify the IRS of her involvement.

[7] 108 H. Rpt. 755, at 395 (emphasis added).

[8] In late 2012, the IRS issued proposed regulations simplifying the 2004 standards for written advice. The IRS may be waiting to finalize those proposed regulations until the Circuit Court rules in Loving.