



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

October 5, 2007

Ms. Linda Stiff
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments in Response to IRS Notice 2007-39, on the Application of Monetary Penalties in
Disciplinary Procedure under Section 822 of the American Jobs Creation Act of 2004

Dear Acting Commissioner Stiff:

Enclosed are comments in response to IRS Notice 2007-39, on the application of monetary penalties in disciplinary procedure under section 822 of the American Jobs Creation Act of 2004. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink that reads "Stanley L. Blend".

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
Anita Soucy, Attorney Advisor, Department of the Treasury
Michael R. Chesman, Director, Office of Professional Responsibility, Internal Revenue Service
Deborah A. Butler, Associate Chief Counsel, Internal Revenue Service
Matthew Cooper, Associate Chief Counsel, Internal Revenue Service

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**ABA SECTION OF TAXATION
COMMENTS IN RESPONSE TO IRS NOTICE 2007-39,
2007-20 I.R.B. 1243 (APRIL 23, 2007), ON THE
APPLICATION OF MONETARY PENALTIES IN DISCIPLINARY
PROCEDURES UNDER SECTION 822 OF
THE AMERICAN JOBS CREATION ACT OF 2004**

The following comments (“Comments”) in response to Notice 2007-39 are submitted on behalf of the American Bar Association Section of Taxation (the “Section”). The Comments have not been approved by the House of Delegates or Board of Governors of the American Bar Association, and therefore should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Linda Galler, Chair of the Section’s Standards of Tax Practice Committee’s Task Force on Notice 2007-39 Comments. Substantive contributions were made by Rochelle L. Hodes, Bryan C. Skarlatos, Kevin E. Thorn, Ronald M. Wiener, and Peter S. Wilson. These Comments were reviewed by Mona L. Hymel, Chair of the Standards of Tax Practice Committee. These Comments were further reviewed by Scott D. Michel of the Section’s Committee on Government Submissions and by Kathryn Keneally, the Council Director for the Standards of Tax Practice Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients that could be affected by the principles addressed by these Comments or may have advised clients in the application of said principles, and all could be affected in their capacity as practitioners, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Persons:	Linda Galler	Mona L. Hymel
Phone:	(516) 463-5895	(520) 621-3838
Fax:	(516) 463-4800	(520) 621-9140
E-mail:	Linda.Galler@hofstra.edu	hymel@law.arizona.edu

Date: October 5, 2007

Executive Summary

On April 23, 2007, the Internal Revenue Service (the “Service”) issued Notice 2007-39, 2007-20 I.R.B. 1243 (the “Notice”), to provide guidance to practitioners, employers, firms, and other entities that may be subject to monetary penalties under 31 U.S.C. § 330 as added by Section 822 of the American Jobs Creation Act of 2004. These Comments are submitted in response to the request for comments contained in the Notice.

We respectfully submit the following Comments:

1. The substance of Notice 2007-39 should be incorporated into Circular 230.
2. The rules, when finalized, should provide more certainty as to when monetary penalties will apply and should clarify that such penalties will be used only to redress Circular 230 misconduct.
3. The combined maximum penalty for misconduct should be limited to 100 percent of fees or gross income regardless of the authority under which the penalty is asserted. Alternatively, referrals to the IRS Office of Professional Responsibility (“OPR”) under section 6694¹ should be not be mandatory, but discretionary.
4. Monetary penalties should apply only to employers, firms, or other entities that engage in providing tax services or advice to others.
5. The rules, when finalized, should incorporate the exact language from the statute with regard to calculating the maximum amount of penalty. The basis for separately determining the maximum monetary penalty to be imposed on each practitioner and (if applicable) on each employer, firm, or entity should be clearly articulated.
6. The rules, when finalized, should clarify when and how mitigating factors listed in the Notice should or must be taken into account, and how such mitigating factors will influence the final determination of a case.
7. The rules, when finalized, should include the procedures that OPR will follow in determining and imposing monetary penalties.
8. Example 2 should be clarified to set forth explicitly facts sufficient to establish when a practitioner has violated Circular 230.

¹ Unless otherwise indicated, all references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”).

Comments

A. Background

The Secretary of the Treasury (the “Secretary”) is authorized by 31 U.S.C. § 330 to regulate the practice of representatives before the Department of the Treasury. The rules promulgated by the Secretary pursuant to this statutory provision are contained in Circular 230.² Under section 10.50 of Circular 230, the Secretary may censure, suspend or disbar from practice before the Service a practitioner³ who is incompetent, disreputable, fails to comply with Circular 230, or who, with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. In addition, the OPR has sometimes privately reprimanded practitioners for conduct that has been determined not to warrant more serious discipline.

Section 822 of the American Jobs Creation Act of 2004 (the “Jobs Act”),⁴ enacted on October 22, 2004, expanded in two ways the sanctions that the Secretary may impose pursuant to its statutory authority. First, the Jobs Act expressly permits the Secretary to censure practitioners. Second, the Jobs Act permits the Secretary to impose a monetary penalty as a sanction. If a practitioner is acting on behalf of an employer, firm, or other entity, the Secretary may impose a monetary penalty on the employer, firm, or other entity if it knew, or reasonably should have known, of the conduct. A monetary penalty may not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative.

B. Discussion

1. Relationship of the Notice to Circular 230

Both Circular 230 and the Notice were promulgated pursuant to 31 U.S. § 330, and the Notice covers the same subject matter as Circular 230, § 10.50. We recommend that the substance of the Notice and any additional guidance be incorporated directly into Circular 230. Doing so would resolve ambiguities as to the relationship between sanctions imposed under Circular 230 and sanctions imposed under the Notice. Moreover, while we recognize that immediate guidance on the use of monetary penalties is desirable if the OPR is beginning to exercise its authority, the process of publishing regulations is essential to ensure due process in the creation of a disciplinary standard. As with other changes to Circular 230,

² 31 C.F.R. subtitle A, part 10 (2007).

³ While the statute refers to “a representative,” Circular 230 refers to “a practitioner.” *See, e.g.*, Circular 230, § 10.2. These Comments adopt the nomenclature of Circular 230, as does Notice 2007-39, 2007-20 I.R.B. 1243. We note, however, that the statutory term “representative” may connote an individual or firm who provides services to another, suggesting that a corporation that employs a tax professional to work on the corporation’s own tax matters could not be subject to monetary penalties under the Notice, even if the in-house professional him/herself might be subject discipline under Circular 230.

⁴ Pub. L. No. 108-357, 118 Stat 1418 (2004).

such procedures have heretofore been used to modify standards. Because the addition of a monetary penalty significantly alters matters already covered in regulations, we believe that it would be appropriate for guidance to be issued in the form of proposed regulations and, if immediate implementation is necessary or desired, simultaneously issued in the form of temporary regulations.⁵

If the Notice and related future guidance are ultimately incorporated into Circular 230, then the provisions of Part D (section 10.50 *et seq.*) should be revised to cover representatives acting under the authority of Circular 230, § 10.7. Such a revision would provide for uniform application of the monetary penalty while extending to these representatives the same procedural rights as “practitioners.” (Such a change also might necessitate modifications to Rev. Proc. 81-38, 1981-2 CB 592, which sets the standards for limited practice without enrollment.)

2. When Should the Monetary Penalty Apply?

The statute permits the OPR to impose monetary penalties in lieu of or in addition to other sanctions under Circular 230. Given this broad authority, we urge the government to provide more certainty as to when monetary penalties will apply. For example, a monetary penalty in lieu of other sanctions under Circular 230 might be appropriate, regardless of conduct, where a practitioner, employer, firm or other entity is indifferent to the consequences of other Circular 230 sanctions.

Overall, the history of OPR and its predecessors demonstrates a judicious use of sanctions against practitioners who do not comply with the requirements of Circular 230. Determining whether public or private sanction is appropriate has been a function of the agency, with the practitioner having the ability to challenge the agency determination through an administrative hearing process and ultimate court review. We urge OPR to continue applying sanctions under Circular 230 by determining the appropriateness of the sanction given the misconduct. The addition of the monetary penalty should not be viewed by OPR as an extension of penalties assessable under the Code, nor should the monetary penalty be used as a bargaining chip by OPR or the Service during an action against the practitioner. Proceedings under Circular 230 have always been initiated and conducted separate and apart from Code-based proceedings and that practice should be continued. Just because a monetary sanction is similar to a civil penalty under the Code, it should not become the sanction of choice merely because this form of compliance tool is convenient for the Service to impose. Therefore, we urge OPR to impose monetary penalties only to redress Circular 230 misconduct and to avoid using the monetary penalty as a default or an automatic “add-on” to other sanctions and Code-based penalties.

⁵ Under section 7805(e), temporary tax regulations issued after November 20, 1988 expire unless they are replaced by final regulations within three years. The effect of this provision is to encourage the government to seek post-effective date comments on temporary regulations. We believe that the policies and procedures set forth in the Notice likewise should “sunset” unless the customary notice and comment procedure is followed.

3. Relationship between Monetary Penalties and Section 6694

The Internal Revenue Manual presently requires a referral to OPR in all cases in which a return preparer penalty is assessed under section 6694. IRM ¶ 20.1.6.2.1. Recent amendments to section 6694(a) significantly raise the standards for return preparation, extend the penalty to all types of tax returns, and increase the penalty to a maximum of 50 percent of the income derived (or to be derived) by the preparer with respect to the return or refund claim.⁶ These changes may result in an increase in incidences of assertion of the section 6694(a) penalty and, consequently, may increase the incidences of mandatory referrals to OPR. Many of these referrals could be based on confusion about the new standard, inadvertent oversight, or relatively minor infractions.

Mandatory referrals of section 6694(a) penalties to OPR potentially could expose practitioners to a combined penalty well in excess of fees or income actually received from providing services with respect to a tax return or refund claim: a maximum 50 percent section 6694(a) penalty plus a maximum 100 percent monetary penalty under Circular 230. Nothing in the legislative history indicates that Congress intended or even considered the “stacking” of these penalties when section 6694(a) was amended. Given these circumstances, we recommend promulgation of a rule limiting the combined maximum penalty for the same misconduct to 100 percent of the fees or gross income derived by the practitioner from such misconduct. In the alternative, the Service should revise the mandatory referral rule in the Internal Revenue Manual to make referral of a section 6694(a) penalty within the discretion of the examiner, or to limit mandatory referral to OPR to the willful and reckless preparation penalty under section 6694(b). In any event, we urge OPR to maintain its focus on serious practitioner misconduct of the sort that causes significant harm to clients, the public, or the tax system, and not to get “bogged down” in trying to measure the percentage level of support for tax return positions taken or recommended by practitioners.⁷

4. Application to Persons Not Engaged in Tax Practice

Consistent with Circular 230, the Notice applies to “practitioners” and to employers, firms, or other entities on whose behalf a practitioner may have acted. While the Notice does not contain a definition, the term, “practitioner” is defined in Circular 230, §10.3, as an attorney, certified public accountant, enrolled agent, enrolled retirement plan agent, or enrolled actuary. Neither Circular 230 nor 31 U.S.C. § 330 limit the application of monetary penalties to activities involving the representation of another taxpayer. Thus, the Notice could be interpreted to permit the assessment of a monetary penalty against a company for whom a practitioner is employed as an in-house tax adviser. If a practitioner engages in prohibited conduct in connection with such employment, the employer may be subject to monetary penalties (if it knew or reasonably should have known of the prohibited conduct). We are

⁶ Small Business and Work Opportunity Tax Act of 2007, § 8246, Pub. L. No. 110-28, 121 Stat. 112 (May 25, 2007).

⁷ See Circular 230, § 10.52(a) (sanctions imposed only for willful, reckless, or grossly incompetent acts).

concerned that assessment of a penalty under these circumstances exceeds Treasury’s authority under 31 U.S.C. § 330 to “regulate the practice of *representatives of persons* before the Department” (emphasis added).

Moreover, if it is determined that the monetary penalty is applicable to firms or entities that are not in the business of rendering tax services or advice to others, then such firms or entities face the same “stacking” of penalties problem discussed *supra* with respect to the section 6694 penalty. In this case, a taxpayer could be subject, for a single act, to taxpayer penalties (*e.g.*, section 6662) in addition to monetary penalties under the Notice (or Circular 230). We, therefore, recommend that the rules, when finalized, clarify that monetary penalties apply only to employers, firms, or other entities that engage in providing tax services or advice to others.⁸

5. Calculating the Monetary Penalty

The statute⁹ and Notice are inconsistent with respect to calculating the maximum amount of a penalty. Where the statute provides that a “penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty,” the Notice states that “[t]he aggregate amount of the monetary penalty (or penalties) imposed by the Secretary for any prohibited conduct may not exceed the collective gross income derived by the practitioner and the employer, firm, or other entity in connection with such prohibited conduct.” This discrepancy raises a number of issues.

The Notice’s use of the phrase “in connection with such prohibited conduct” could be construed as encompassing a greater amount of gross income than the statutory phrase “derived from the conduct.” We recommend that the rules, when finalized, use the statutory language to avoid any misunderstanding on this point.

The Notice’s description of the maximum amount of the penalty by reference to the “collective gross income derived by the practitioner and the employer, firm, or other entity” does not seem to contemplate the necessity of determining separately the maximum amount of the penalty that may be imposed on (a) the practitioner whose misconduct has resulted in the violation of Circular 230 and (b) the employer, firm, or other entity. We believe it is important that the rules, when finalized, require OPR to set forth clearly the basis for separately determining the maximum monetary penalty that may be imposed on each practitioner and (if applicable) on each employer, firm, or entity.

The rules, when finalized, also should be clarified to state explicitly that in applying the principle that the aggregate amount of penalties imposed on a practitioner and all sanctionable parties may not exceed the gross income derived by them from the sanctionable misconduct, gross income determined to have been derived by the practitioner from a

⁸ Such an approach would be consistent with Reg. §301.7701-15(d)(2), which excludes from the definition of “preparer,” for purposes of the section 6694 penalty, an individual acting as an officer, general partner, or employee of another person.

⁹ Section 822 of the Jobs Act.

sanctionable party will be subtracted from the gross income determined to have been derived by the latter. For example, if Firm X receives \$10,000 from a third party as its gross income from sanctionable misconduct of Practitioner A, and if A is determined to have received \$1,000 from X as A's share of such gross income, the total monetary penalty imposed on A may not exceed \$1,000 and the total monetary penalty imposed on X may not exceed \$10,000, but the combined monetary penalties imposed on X and A should not exceed \$10,000.

Even where there is no basis for sanctioning any person other than a misbehaving practitioner, difficult questions may be posed in determining the gross income derived by the practitioner from the conduct giving rise to the monetary penalty. For example, if he or she is a member of a firm or other organization, and if the fees derived from the misconduct are paid to that entity, it may be extremely difficult to determine what portion of his or her gross income is derived from the misconduct, even if the misconduct was not part of a larger engagement (an issue discussed below). For example, if the practitioner is compensated by the entity on the basis of a fixed annual dollar amount of compensation, there may be many cases where there is no readily determinable basis for calculating his or her share of the fees from any particular project (especially if the sanctionable misconduct constituted a relatively small portion of his or her work for the firm during the period for which his or her compensation was paid). There are a number of approaches that could be taken to dealing with this issue, including determining the gross income paid to the practitioner for the sanctionable misconduct on the basis of time spent on that misconduct compared with total time spent during the relevant compensation period. This determination would be much easier if the misbehaving practitioner is compensated on the basis of a percentage of income earned by the firm from all work done by him or her during some specific period of time or on a project by project basis. In general, we believe that a detailed facts and circumstances analysis will have to be applied in many, if not most, cases, and therefore we recommend that the rules, when finalized, be clarified to acknowledge this specifically.

Further, if a monetary penalty is imposed with respect to conduct that is part of a larger representation, it is unclear how OPR will determine the "gross income derived (or to be derived) from the conduct giving rise to the penalty." For example, if a law firm represents a party to a merger or acquisition and provides its client with legal advice and services on all (*i.e.*, tax and non-tax) aspects of the transaction, the fees collected by the firm reflect payment for non-tax services as well as for tax services. Moreover, the fees received for the tax services may be attributable in part to services other than the prohibited conduct. If a practitioner is sanctioned only for conduct related to all or a portion of the tax services provided in connection with the transaction, the maximum penalty should be limited to fees allocable only to sanctionable tax services. We interpret the statutory language, which limits monetary penalties to gross income "from the conduct giving rise to the penalty" as both supportive of our recommendation and inconsistent with the Notice, which may be read to permit the maximum monetary penalty to be measured by fees from non-sanctionable conduct provided as part of a "larger engagement." Because we recognize that it may be difficult to allocate gross fees from a larger engagement between tax and non-tax services, particularly where fees are not based strictly on billable time, we recommend that the rules, when finalized, state explicitly that OPR will make a good faith determination as to the

portion of the gross income attributable to the prohibited conduct and provide the practitioner the right to contest and appeal such determination.

If, at the time a monetary penalty is imposed, there is a possibility that the practitioner or other entity could receive additional gross income from the prohibited conduct, it is not clear from the statutory language how the maximum amount of the monetary penalty is to be determined. The Notice states, “In determining the amount of the monetary penalty (or penalties), the Secretary will consider amounts that the practitioner, employer, firm or other entity could reasonably expect to realize, irrespective of whether the amounts have actually been received.” The quoted language in the Notice could be interpreted to permit the Secretary to impose a maximum penalty based on an estimate of amounts that might be received in the future regardless of whether such amounts are ever actually received. Therefore, we recommend eliminating this ambiguity by stating clearly that the penalty can never exceed amounts actually received, taking into account amounts received both before and after the time the penalty is imposed.¹⁰ We further recommend setting forth procedures to assure that any monetary penalty based on possible future gross income from the prohibited conduct can lawfully and practicably be collected by the government.

The Notice gives OPR “discretion to impose a monetary penalty in an amount less than the amount allowed by statute.” This sentence could be construed as a presumption that the maximum amount of the penalty permitted by the statute will be imposed in each case unless OPR exercises discretion to impose a monetary penalty in a lesser amount. We believe that this is not a correct or appropriate interpretation of the statutory language. Rather, we believe that the determination as to whether a monetary penalty should be imposed in a particular case and, if so, the amount of such penalty, should be made after taking into account all relevant facts and circumstances regarding both the nature and impact of the prohibited conduct and the relevant characteristics of the practitioner or entity under whom the monetary penalty is to be imposed.¹¹

6. Mitigating Factors

While the Notice lists mitigating factors that may be considered by OPR in evaluating potential violations of Circular 230 and determining the amount of a monetary penalty, the Notice does not clarify when and how mitigating factors should or must be taken into account. For example, will OPR evaluate the mitigating factors listed in the Notice only when an allegation involves a written opinion, or will mitigating factors be considered in other types of potential violations, such as misrepresentations before the Service or

¹⁰ The rules, when finalized, also should clarify the method of calculating “gross income derived (or to be derived)” in situations where a practitioner or firm returns to the client all or part of the fees received, whether such a return results from a preexisting agreement between the practitioner or firm with the client, or from litigation or threatened litigation.

¹¹ This recommendation is consistent with our prior recommendation made on June 6, 2006, when we commented on Proposed Amendments to Circular 230, promulgated on February 3, 2006. In those comments, we recommended that the following language be added to section 10.50 of Circular 230: “The sanctions imposed by this section shall in all cases bear a reasonable relationship to the conduct subject to sanction, taking into account all relevant facts and circumstances.”

allegations of fraud or false advertising? Likewise, the Notice fails to discuss how mitigating factors will influence the final determination of a case, particularly with relation to how monetary penalties will be considered. We believe that additional guidance on how OPR will evaluate preventative and corrective actions taken by a practitioner, firm or other entity would be appropriate. For example, if OPR finds that the conduct under investigation promptly ceased and that corrective actions were immediately taken, guidance should be provided as to whether or under what circumstances the actions taken by the practitioner or entity will reduce the amount of the monetary penalty (or other sanctions) to be imposed or will avoid the imposition of a monetary penalty (or other sanctions) altogether.

Further, the Notice does not specify how or whether the mitigating factors will be applied differently to practitioners or firms or other employers. For instance, most of the mitigating factors listed in the Notice appear to apply more closely to the types of corrective actions that firm management or a corporate tax department could make in regard to changing its current policies or procedures, as opposed to a solo practitioner or small firm. Indeed, it would be very difficult for an individual practitioner to take decisive corrective action against himself and then discipline himself. We therefore recommend formulating separate lists of mitigating factors specifically applicable to individual practitioners and to firms or other entities. Possible mitigating factors applicable to individuals might include the length of time the practitioner has been in practice or the practitioner's role (senior or supervisory versus junior staff) on the engagement team. An additional mitigating factor applicable to both entities and individuals could be the extent, if any, of the entity's or practitioner's prior contributions to sound tax administration and professionalism.

7. Procedural Safeguards

The Notice was issued under the authority of 31 U.S.C. § 330, not under the Code. Therefore, the procedures that OPR will follow in determining, imposing, and collecting monetary penalties are not in the Code. Consistent with our recommendation that these rules be incorporated into Circular 230, section 10.50, we recommend that the rules, when finalized, specifically state that the same rules and procedures in Subpart D of Circular 230 (section 10.60, *et seq.*) that otherwise apply for disciplinary proceedings will be used to determine and impose monetary penalties. Alternatively, we recommend that guidance be issued on what procedures and safeguards will apply, and under what authority OPR will seek to collect monetary penalties. Furthermore, assuming that the Circular 230 procedures apply, we recommend that section 10.76 of Circular 230 expressly state that the Secretary bears the burden of proving the facts necessary for the imposition of a monetary penalty, including the calculation of the income on which the penalty is based, by a preponderance of the evidence and that the taxpayer bears the burden of proving any mitigating circumstances by the same preponderance of the evidence.

8. Clarification of Example 2 in the Notice

We commend the Service for including examples in the Notice. Examples are helpful to practitioners in complying with the Notice's requirements, and we encourage more examples, particularly to clarify the matters discussed above. It is in this spirit that we

comment on Example 2. Example 2 in the Notice is intended to describe the application of monetary penalties in a situation where false and misleading Forms 656 were submitted by a firm that employed both practitioners and non-practitioners. The example states that the non-practitioner employees were instructed to submit false and misleading Forms 656 to the Service. The example also states that the firm's principal had established a procedure for "one of her 10 practitioners to submit a Form 2848 on behalf of a client much later in the process, well after submission of the Forms 656." Although the example implies that the practitioners employed by the firm knew or had reason to know that they were participating in the giving of false or misleading information to the Service in violation of Circular 230, this fact is not expressly stated. Because we believe that a violation of Circular 230 by a practitioner must be established in order for OPR to impose a penalty on an entity on whose behalf the practitioner's conduct was performed, we recommend that the examples be clarified to set forth explicitly facts sufficient to establish a violation of Circular 230 by the practitioners involved.¹²

¹² Similarly, while Example 1 states that the practitioner violated Circular 230, no specific violation is identified. We recommend clarifying Example 1 to eliminate the implication that advice on any transaction that will reduce tax (which is enough to satisfy the definition of tax shelter under section 6662) will result in a violation of Circular 230.