

NEWS ANALYSIS

Is a New Willfulness Standard at Play in Circular 230 Hearings?

By Jeremiah Coder — jcoder@tax.org

The possibility that practitioners and the IRS Office of Professional Responsibility (OPR) could soon be facing application of a new willfulness standard in litigation of alleged Circular 230 ethical violations has some in the tax community debating the standard's prospects and accompanying changes.

That debate began following a recent decision rendered by the Treasury secretary's delegate, Ronald Pinsky, in his role as appellate authority to hear appeals of Circular 230 disciplinary case decisions submitted by administrative law judges.

Gonzales

In a 2007 complaint, OPR sought to suspend Juanita A. Gonzales, an enrolled agent, from practice for 48 months under Circular 230 section 10.51(f) (now revised as section 10.51(a)(6)) for disreputable conduct stemming from five years of failure to timely file tax returns. Gonzales claimed the failure was the result of a medical condition, but she acknowledged the lateness of the returns for the tax years at issue. OPR asked for summary judgment.

Drawing on precedent from past Circular 230 disciplinary proceedings, the ALJ held that repeated failure of a practitioner to file tax returns constituted willfulness under section 10.51(f). (See *Director, OPR v. Martin M. Chandler, C.P.A.*, Complaint No. 2006-23 (Decision on Appeal, May 14, 2008).) The ALJ disregarded the enrolled agent's attempt to claim a reasonable good-faith belief that timely filing was not required, finding the requirement to be unambiguous, thus precluding any defense.

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In granting the government's summary judgment motion, the ALJ reduced Gonzales's suspension to 36 months, rather than the 48 months requested by OPR, because of sympathy for Gonzales's medical condition. Gonzales appealed the suspension — sort of.

Pinsky, the appellate authority, upheld the summary judgment based on procedural grounds. Gonzales asked for an extension of time to file an

appeal, which Pinsky granted. Several days after the extended appeal due date passed, Gonzales's counsel called OPR to announce that he would be filing a late appeal. Pinsky determined that Gonzales failed to timely file an appeal under Circular 230 because no brief had been submitted in accordance with section 10.77(a), and the appeal was dismissed as "inexcusably untimely."

But Pinsky in his written opinion also discussed the merits of OPR's actions. Agreeing with the ALJ that the repeated failure of a practitioner to timely file income tax returns constitutes a willful violation of section 10.51(f), Pinsky opined on the applicable standard of review for willfulness. Noting that there is no definition of willful in Circular 230, Pinsky said that prior OPR proceedings applied the criminal willfulness standard outlined in *Cheek v. United States*, 498 U.S. 192 (1991).

In dicta, Pinsky said, "I question whether the criminal standard is the appropriate standard to apply in the context of a civil proceeding to determine whether disciplinary action should be taken for professional misconduct." Pinsky made reference to case law from state bar disciplinary proceedings that applied a lower willfulness standard in professional misconduct cases, and he encouraged future litigation on the issue. "I invite the parties in future cases to brief what the appropriate definition for willfulness should be under Treasury Circular 230," he wrote.

The Current Standard

The standard that has controlled disciplinary cases over the past several years was outlined in *Banister* and adopted by the appellate authority at the time, David F.P. O'Connor. Like Gonzales, Joseph R. Banister faced allegations by OPR of disreputable conduct under section 10.51 for knowingly advising a taxpayer client to evade federal income taxes. (For *Director, Office of Professional Responsibility v. Joseph R. Banister*, No. 2003-2, see *Doc 2004-604* or *2004 TNT 8-14*.)

In analyzing how to properly define willful for his review, O'Connor drew on the context that the term has been given in sections 7201 to 7207 of the tax code — describing those sections as criminal provisions that "in some respects punish like conduct." (For *Director, Office of Professional Responsibility v. Joseph R. Banister*, Complaint No. 2003-02 (Decision on Appeal, June 25, 2004), see *Doc 2008-21403* or *2008 TNT 195-20*.)

In construing those same code sections, the Supreme Court set out in *Cheek* that willfulness was a "voluntary, intentional violation of a known legal duty" (citing *United States v. Pomponio*, 429 U.S. 10 (1976), and *United States v. Bishop*, 412 U.S. 246 (1973)). OPR cases since *Banister* have cited that as the presumed applicable willfulness standard.

Changing the Dynamic

Pinsky's questioning of *Cheek* as the appropriate standard could change the dynamic for practitioners who represent individuals involved in Circular 230 proceedings.

Matthew C. Hicks of Caplin & Drysdale said that over the years, some have questioned whether the criminal standard of willfulness is the appropriate standard for OPR cases. But "no one has wanted to look that gift horse in the mouth" by questioning the relevancy of *Cheek*, he said.

If OPR believed that the willfulness standard was incorrect, the office probably would have challenged it by now, Hicks said. "They haven't so far, and having the invitation just sitting out there makes things difficult for OPR," he said. The standard is important, he added, because "losing one's livelihood may not be as bad as incarceration, but it is much worse than a monetary penalty."

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Steve Johnson, a law professor at the University of Nevada, Las Vegas, currently visiting at the University of California — Hastings, said concern about the opinion may be overblown. "I'm not sure how much the difference in the verbal formulation of the willfulness standard will make in the outcome of particular cases," he said. Comparing *Banister* with the state bar case Pinsky cited, Johnson said, "You can tease out some flavor of difference, but it may be negligible in practical effect."

One possible approach to the issue would be applying the standards on separate tracks, Johnson said. While there is a common definition for willful, "it could be applied differently in different contexts," he said.

At issue in *Gonzales* was the enrolled agent's failure to file her own returns, whereas the decision in *Banister* was mainly about giving "flaky" advice to a taxpayer about interpretation of the tax laws, Johnson said. "I could imagine a looser standard applied to a practitioner's personal ethical failings rather than the practitioner's advice to a client," he said. Because one scenario is conduct based and the other is based on speech implications, a higher standard could be more appropriate in the latter context, he said.

The willfulness standard may need further examination, but it should be considered in an appropriate case down the road rather than in dicta, said Rita A. Cavanagh of Latham & Watkins LLP. One

consequence of shifting to a civil willfulness standard from the current criminal standard would be loss of the availability of a *Cheek* defense for alleged misconduct, she noted. "This may be appropriate in the context of OPR proceedings, but again, should not be dealt with by way of dicta," she said. "It deserves thoughtful and thorough consideration."

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At least one practitioner thinks moving away from the *Cheek* standard wouldn't be problematic. Richard J. Sapinski of Sills Cummis & Gross PC in Newark, N.J., told Tax Analysts that "the civil and criminal standards on willfulness are really the same once applied."

The true import of the case is not in determining which standard to apply but in providing a good-faith defense to willfulness, Sapinski said. He added that for Gonzales to have had a viable *Cheek* defense to the claim that she was willful in failing to file for five years in a row, she would have had to argue that she had no obligation to file returns in those years, rather than arguing that she did not realize that the consequences of not filing would be as severe as they proved to be.

Other Possible Changes

Another potential shift in disciplinary cases might concern reliance on state law disciplinary proceedings. In *Director, OPR v. Kevin Francis*, No. 2004-9 (Feb. 4, 2008), *Doc 2008-13212*, 2008 TNT 117-17, O'Connor specifically disclaimed that those proceedings were relevant to legal conclusions in OPR cases. "The determination of whether conduct is 'willful' should be made on the basis of Federal tax law precedents rather than on the basis of precedents interpreting similar language in state court reviews of disciplinary proceedings involving lawyers and certified public accountants," he wrote.

But Pinsky, in *Gonzales*, quoted from a California bar disciplinary case for the proposition that the willful standard in professional conduct cases could be as low as "simply a purpose or willingness to commit the act, or make the omission referred to," without any intent to violate the law.

Pinsky also hinted that if the appeal had been timely filed, he would have suspended Gonzales for the full 48 months that OPR recommended, rather than the 36 months the ALJ had given. That statement could be seen as disregarding the rules on reviewing decisions set out in Circular 230 section 10.78. Subsection (b) establishes that the appropriate standard of review for the appellate authority is

to examine the ALJ's decision for clear error regarding factual issues or mixed issues of fact and law. Only if a matter is exclusively legal in nature can the appellate authority apply a *de novo* review.

But the ALJ's determination of the length of the suspension is somewhat analogous to a district court's criminal sentence. Review of sentencing at the appellate level generally is deferential. As the D.C. Circuit stated in a recent criminal tax case, *United States v. Gus Gardellini*, No. 07-3089, "appellate courts employ an abuse-of-discretion standard and substantively review sentences only for 'unreasonableness.'"

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In that vein, Pinsky's stated desire to extend the suspension period in *Gonzales* would appear to violate the review standard establishing some measure of deference to the ALJ's findings. Tax practitioners told Tax Analysts that the extent of the dicta calls into question the perceived neutrality of the appellate authority. One practitioner who spoke on background said that once the appeal was dismissed for being untimely, "that should have been it, period."

Hicks also agreed that the *Gonzales* dicta poses problems for OPR. "Unanswered invitations are always awkward," he said.

Cavanagh said the proper exercise of appellate authority requires prudence on the part of the delegate in giving appropriate consideration to the findings and conclusions of the ALJ. "The appellate authority must show due regard for the nature of the proceeding, which should include deference to the principle of *stare decisis*, and certainly should caution against making factual findings different from the ALJ who heard the case, evaluated the documentary evidence, and determined the credibility of the witnesses," she said.

According to Cavanagh, factual findings should not be overturned except for in cases involving clear error, and any overruling of prior interpretations of the standards — given the sanctions involved and practitioners' need for clarity regarding the contours of the standards — should be done in the context of actual cases with full briefing of the parties, rather than by way of dicta.

Asked if Pinsky's desire to lengthen the enrolled agent's suspension presented any deference problems, Johnson's response was no. "As an analogy, although appellate courts are largely deferential in

reviewing sentences, on occasion, some do change the imposed sentence, and that may be an increase," he said. Pinsky's statement simply serves as a "shot across the bow" to practitioners about their conduct, he said.

Neutrality?

Kevin E. Thorn of the Thorn Law Group in Washington said there is a perception within the tax practitioner community that the appellate review of Circular 230 decisions already disadvantages the practitioner because the review is performed by an individual within the IRS Office of Chief Counsel. To avoid such negative perceptions of appellate adjudication, "perhaps appeals should be handled by the United States Tax Court or another independent party," he said.

That possibility has been discussed before. Comments submitted by the American Bar Association Section of Taxation in 2005 on OPR disciplinary procedures recommended against using Tax Court special trial judges for hearings. The ABA tax section was concerned that having the Tax Court referee ethical disputes regarding tax practitioners who might appear before it could endanger the court's independence and use up limited resources. (For the ABA comments, see *Doc 2005-24815* or *2005 TNT 236-18*.) However, Congress has not seemed worried about adding to the court's workload. In 2006 Congress added to the Tax Court's jurisdiction, giving it the authority to hear appeals of reward determinations made by the IRS Whistleblower Office.

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To establish the appellate authority as a truly independent adjudicator in Circular 230 disciplinary proceedings, the role must reside outside the IRS's jurisdiction, Cavanagh said. "OPR is part of Treasury, not the IRS; that is an important distinction that must be heeded and which OPR has been at pains to emphasize," she said. Being outside the IRS is even more crucial given reports that nearly half of OPR's referrals come from IRS field agents, she said, adding, "You can't be both inside and outside the agency."

Johnson disagreed that Pinsky's role raised conflict of interest issues. "The appellate authority's decision represents final agency action, so while it is a quasi-judicial function, it is also a statement of the

agency's position," he said. "There is nothing I see outside of the proper bounds."

Move the Role

Complaints will continue as long as any appellate authority remains nominally under IRS influence. Pinsky is subject to particular criticism because he continues to have a full-time role within the Service as assistant division counsel in the Small-Business/Self-Employed Division (SB/SE). Section 39.4.1.3(7) of the Internal Revenue Manual directs SB/SE counsel lawyers, when requested, to provide tax law assistance to General Legal Services attorneys in Circular 230 cases. Even with firewalls in place for the appellate authority role, concerns about a conflict of interest will remain.

On a broader scale, Circular 230 is a creature of Title 31, not Title 26. Ignoring the debate over why OPR is housed within the IRS, placing the appellate authority in a Treasury official outside of the IRS is good policy. It also respects the roles Congress has created by statute. When the day comes that Treasury institutes its own cadre of ALJs rather than using those of other agencies, the appellate authority should be part of that function. ■

Officials Consider Appropriateness Of 'Supersecret' Rule

By Amy S. Elliott — aelliott@tax.org

Interpretation of the so-called supersecret rule in reg. section 1.267(f)-1(c)(1)(iv) stirred up debate among consolidated return practitioners, with government officials suggesting ways the rule could be improved. The participants discussed variations of a transaction in which stock is sold at a loss, followed by a subsequent liquidation of the sold entity.

The government is considering issuing guidance on the rule, which provides that if a loss initially deferred under section 267(f) is triggered in a subsequent transaction, but the deferred loss was redetermined to be treated as a noncapital, nondeductible amount under reg. section 1.1502-13, the loss remains deferred until the selling and buying members are no longer related. (For prior coverage, see *Tax Notes*, Oct. 5, 2009, p. 24, *Doc 2009-21802*, or *2009 TNT 189-1*.)

Lawrence Axelrod, special counsel, IRS Office of Associate Chief Counsel (Corporate), noted that the language of the rule doesn't incorporate all of the consolidated return rules, just the principles of reg. section 1.1502-13. "Whether that makes any sense from a policy point of view is an entirely different question," he said. Axelrod spoke last week at a District of Columbia Bar Taxation Section program sponsored by the Corporate Tax Committee.

In one scenario considered at the event, corporation P and corporation S, which are members of a consolidated group, sit under a nonaffiliated controlled group parent. P sells 21 percent of S upstream to the parent, and S later liquidates. Axelrod said that in that example, because P owns only 79 percent of S, not 80 percent, its loss would "possibly" be accelerated. "I'm not sure that's a good answer," he said. "I don't think it's the right answer. But nonetheless it appears to be the current answer under the current regs."

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Donald Bakke, attorney-adviser in Treasury's Office of Tax Legislative Counsel, said the rule ought to be changed so that "as long as the property is in a controlled group relationship, then loss deferral