Tax Practitioners Promoting Abusive Tax Shelters Are Still Able to Represent Taxpayers Before the Internal Revenue Service

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Redaction Legend:
1 = Tax Return/Return Information
MEMORANDUM FOR DIRECTOR, OFFICE OF PROFESSIONAL RESPONSIBILITY

FROM: Michael R. Phillips  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Tax Practitioners Promoting Abusive Tax Shelters Are Still Able to Represent Taxpayers Before the Internal Revenue Service (Audit # 200710041)

This report presents the results of our review of the Office of Professional Responsibility’s (OPR) actions on licensed tax practitioners that engaged in abusive tax shelter transactions. The overall objective of this review was to determine whether the OPR is effectively identifying and taking appropriate actions against those licensed tax practitioners who have employed or promoted abusive tax shelters. This audit was included as part of our Fiscal Year 2008 Annual Audit Plan under the major management challenges of Tax Compliance Initiatives and Taxpayer Protection and Rights.

Impact on the Taxpayer

The OPR plays an important role in regulating the conduct of licensed tax professionals who act as power of attorneys for taxpayers who might be involved in an audit, collection issues, or appeal of an Internal Revenue Service (IRS) determination. We found that the OPR was unaware of a significant number of licensed tax practitioners who were assessed penalties, sentenced in a criminal proceeding, or enjoined for tax shelter violations. As a result, these tax practitioners were still eligible to represent taxpayers before the IRS. Practitioner misconduct can serve to erode public confidence in the tax system and create unfortunate consequences for taxpayers relying on unscrupulous tax practitioners.

Synopsis

Abusive tax shelters are an area of concern to Congress and continue to present formidable challenges to the IRS. To address tax shelter violations and other misconduct issues, the IRS has
developed a number of strategies to ensure attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. These strategies include outreach and education to tax practitioners and IRS operating divisions related to the standards of conduct, the IRS role in enforcing the standards, and the use of disciplinary actions when appropriate.

The OPR works closely with the other IRS operating divisions to identify improper practitioner behaviors that have an impact on tax administration but generally relies on IRS employees to refer any potential practitioner misconduct. While the IRS has established a referral system for employees to report this information to the OPR, we determined the referral process was not working effectively. We found that the OPR was unaware of a significant number of licensed tax practitioners who engaged in tax shelter violations. As a result, the OPR did not initiate an investigation to determine whether any sanctions were necessary to prevent disreputable practitioners from continuing to be allowed to represent taxpayers. Specifically, the OPR was not aware of 160 practitioners assessed tax penalties, permanently enjoined by a Federal Court, or criminally sentenced for abusive tax shelter activities that caused loss to the Federal Government of approximately $34.9 million. These practitioners are still eligible to represent 9,766 taxpayers before the IRS.

During our audit, we obtained IRS data readily available outside of the OPR to identify potentially disreputable tax practitioners engaged in abusive tax shelters that had not been referred to the OPR as required. We discussed with OPR management the feasibility of OPR personnel performing similar proactive analyses to identify tax practitioners who have been assessed penalties, received a criminal sentence, or enjoined for potentially disreputable behavior. OPR management agreed that obtaining some available information from IRS systems is a sound approach; however, management stated that this would generally require extensive additional information gathering and case building that is not supported by their current resources.

**Recommendations**

We recommended that the Director, OPR, take the following actions: 1) determine whether additional disciplinary actions are warranted for the tax practitioners penalized for abusive tax shelter violations; 2) establish written procedures for controlling and reviewing case referrals on the inventory system; 3) determine whether additional disciplinary actions are warranted for the tax practitioners who were permanently enjoined for abusive tax shelter violations; 4) determine whether additional disciplinary actions are warranted for those tax practitioners sentenced for abusive tax shelter violations; 5) undertake additional outreach efforts with other IRS functions to increase awareness of the requirement to refer to the OPR licensed tax practitioners involved

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1 See Appendix IV for more detailed information.
in disreputable behavior; and 6) develop a methodology when resources become available to proactively identify licensed tax practitioners who might have engaged in disreputable activity.

**Response**

IRS management agreed with all of our recommendations. The OPR will review the identified 143 tax practitioners penalized for abusive tax shelter actions and take appropriate action. To the extent these practitioners are not within the OPR’s jurisdiction, the Director, OPR, will refer the individuals to the appropriate IRS function. In addition, the OPR is in the process of revising its Internal Revenue Manual guidelines governing the control and processing of each complaint, referral, license application, and/or renewal that is input to their information management system. Further, the OPR will also ensure that each of the nine cases involving abusive tax shelters injunctions and the eight cases involving practitioners subject to criminal prosecution are reviewed for appropriate action. If these individuals do not fall within the OPR’s jurisdiction, the Director, OPR, will refer the individuals to the appropriate IRS function. The OPR will also continue to provide awareness training to both internal and external stakeholders to ensure that licensed tax practitioners involved in potentially disreputable behavior are brought to the attention of the OPR and are appropriately sanctioned. Finally, the OPR will look to develop and sustain a more proactive model of case identification and development, as resources permit. Management’s complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.
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**Abbreviations**

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<td>CAF</td>
<td>Centralized Authorization File</td>
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<td>DOJ</td>
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Tax Practitioners Promoting Abusive Tax Shelters Are Still Able to Represent Taxpayers Before the Internal Revenue Service

Background

An abusive tax shelter is a tax transaction or scheme that shelters income from normal taxation by taking an unrealistic position. A 2006 Senate report\(^1\) included an estimate that Americans now have more than $1 trillion in assets offshore and illegally evade between $40 and $70 billion in United States taxes each year through the use of offshore tax schemes alone. Abusive tax shelters are an area of concern to Congress and continue to present formidable challenges to the Internal Revenue Service (IRS).

In the IRS’ 2005-2009 Strategic Plan, the IRS stated that it would vigorously enforce the law to stop willful noncompliance through tax shelters. One area in which the IRS has focused its enforcement is on tax practitioners who promote abusive tax avoidance transactions such as abusive tax shelters. The IRS has developed a number of strategies to ensure attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. These strategies include outreach and education to tax practitioners and IRS operating divisions related to the standards of conduct, the IRS role in enforcing the standards, and the use of disciplinary actions when appropriate. As a means of deterrence, the IRS has tools at its disposal including injunctions,\(^2\) criminal sanctions, and monetary penalties against persons who participate in or promote abusive tax shelters.

When the IRS determines that a licensed tax practitioner has participated in or promoted an abusive tax shelter, the IRS’ Office of Professional Responsibility (OPR) should be advised so it can take appropriate action.\(^3\) The OPR is responsible for regulating licensed tax practitioners who represent taxpayers before the IRS by setting and enforcing standards of competency, integrity, and conduct. The OPR provides oversight of licensed tax practitioners based on the regulations in Treasury Department Circular No. 230 (Circular 230).\(^4\) Circular 230 is the legal authorization for the OPR to institute proceedings against tax practitioners who violate these regulations. The OPR may impose disciplinary actions through private reprimand, censure (a public reprimand), suspension, or disbarment.

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2. An injunction is a writ or order from a court that enjoins or prohibits a person or group from carrying out a given action, or ordering a given action to be done. The IRS must initiate a proceeding for an injunction to be imposed against a taxpayer.
3. If an abusive tax shelter involves a non-licensed authorized representative such as an unenrolled paid preparer, then the IRS Small Business/Self-Employed Division is responsible for investigating and regulating the possible misconduct.
In September 2007, the IRS updated Circular 230 after Congress passed legislation targeting promoters and investors of abusive tax shelters. The law was designed to impose penalties for misconduct by tax shelter promoters, advisors, and investors. The current law also enables the OPR to impose monetary penalties against licensed practitioners who fail to comply with Circular 230 rules.

Over the past few years, the IRS has substantially increased the OPR’s budget and staffing to help ensure that it has adequate oversight over licensed tax practitioners. In Fiscal Year 2002, the OPR had a budget of $1.8 million and a staff of 15. By Fiscal Year 2007, the OPR had a budget for oversight of approximately $5.4 million and was authorized a staff of 58, although staffing difficulties have not allowed it to reach this maximum level.

In performing its oversight role, the OPR relies internally on IRS employees to refer to the OPR any potential practitioner misconduct identified during an examination. Referrals should be made to the OPR as soon as it appears that a practitioner might be in violation of Circular 230 regulations. The referral process is discussed in the various operating division’s policy manuals and highlighted on the OPR’s web site. The OPR informed us that when a referral is received from an IRS employee, it is evaluated to ensure that the tax practitioner is within the OPR’s jurisdiction, the referral is actionable under Circular 230, and the practitioner is representing taxpayers before the IRS. If so, the OPR opens an enforcement case and controls the case on its inventory system.

The OPR works closely with the other IRS operating divisions to identify improper practitioner behaviors that have an impact on tax administration. Both the IRS and OPR plan to use referral information to develop IRS-wide coordinated strategies to deter, detect, and address such practitioner misconduct. In Fiscal Year 2007, the OPR appointed a new Director to oversee the enforcement function. One of the Director’s first acts was to help organize an internal IRS conference to improve the level of communication of referral information.

This review was performed at the OPR in Washington, D.C., during the period October 2007 through August 2008. However, certain information needed to evaluate the OPR’s referral process was not available. Specifically, the OPR does not maintain complete information related to the number and source of referrals received. These issues are discussed in further detail in the Results of Review section. With the exception of these impairments, we conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.


6 The Internal Revenue Manual is the official source for IRS policies, directives, guidelines, procedures, and delegations of authority in the IRS.
based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.
Results of Review

The OPR plays an important role in regulating the conduct of licensed tax professionals who act as power of attorneys for taxpayers who might be involved in an audit, collection issues, or appeal of an IRS determination, especially if these licensed professionals engage in tax abuses. We determined that the OPR was unaware of a significant number of licensed tax practitioners who were assessed penalties, sentenced in a criminal proceeding, or enjoined for tax shelter violations because this misconduct may not have been referred by IRS employees as required. As a result, the OPR did not initiate an investigation to determine whether any sanctions were necessary to prevent disreputable practitioners from continuing to be allowed to represent taxpayers.

During our audit, we obtained IRS data readily available outside of the OPR to identify potentially disreputable tax practitioners engaged in abusive tax shelters that had not been referred to the OPR as required. We discussed with OPR management the feasibility of OPR personnel performing similar proactive analyses to identify tax practitioners who have been assessed penalties, received a criminal sentence, or enjoined for potentially disreputable behavior. OPR management agreed that obtaining some available information from IRS systems is a sound approach; however, management stated that this would generally require extensive additional information gathering and case building that is not supported by their current resources.

The practitioner misconduct identified constitutes only a portion of the total number of individuals assessed penalties, enjoined by Federal courts, or with criminal convictions that might be representing taxpayers. Our scope included only tax shelter abuses reported during a 3-year period. In addition, we did not review State convictions or other types of Federal Government convictions, such as those involving dishonesty, breach of trust, or a felony, that could warrant sanction by the OPR. Practitioner misconduct can serve to erode public confidence in the tax system and create unfortunate consequences for taxpayers relying on unscrupulous tax practitioners. To effectively address practitioner misconduct, we believe the OPR should reemphasize with IRS operating divisions the importance of the referral process in identifying disreputable practitioners. In addition, we believe OPR management should consider more proactive analyses, as resources become available, to minimize its reliance on referrals to identify and investigate disreputable tax practitioners. Collectively, these actions will ensure that OPR resources continue to be focused on practitioner misconduct most threatening to tax administration and reduce the risk that disreputable tax practitioners are allowed to represent taxpayers before the IRS.
Tax Practitioners Engaged in Abusive Tax Shelter Actions Are Still Able to Practice Before the Internal Revenue Service

Depending on the severity of the tax shelter offense, the IRS may assess civil penalties, pursue criminal sanctions, or request that the District Courts impose injunctions against persons involved. We found that the OPR was not aware of a significant number of licensed tax practitioners who perpetrated tax shelter abuses. The tax practitioners we identified had been penalized, enjoined, and/or convicted of promoting or practicing significant tax shelter abuses and were still able to represent taxpayers before the IRS. At the time of our audit, no disciplinary action had been taken against these practitioners, thereby allowing them to continue to represent taxpayers before the IRS.

Some practitioners assessed tax penalties for abusive tax shelter transactions are still authorized to practice before the IRS

The IRS uses penalties as a means of encouraging voluntary compliance and deterring taxpayers and tax practitioners from engaging in abusive tax shelters. IRS procedures require that an information referral be sent to the OPR when specific tax shelter penalties are assessed on licensed tax practitioners. This referral should be prepared by the IRS enforcement employee who assessed the penalty against the licensed practitioner and enables the OPR to initiate a proceeding for sanction against a practitioner who might have engaged in disreputable conduct.

We obtained information maintained on the Individual Master File7 which tracked specific tax shelter penalties assessed during Fiscal Years 2005 through 2007. During these 3 fiscal years, the IRS assessed penalties8 totaling $82.3 million for specific tax shelter violations against 1,175 individuals. We then researched the IRS Centralized Authorization File (CAF)9 to determine whether any of these individuals had represented taxpayers before the IRS. We also researched State licensing authorities to determine whether any of these persons were licensed tax practitioners.

Of the 1,175 individuals, we identified 280 that could potentially be licensed practitioners. Based on our analysis, the OPR identified and took action on 137 (49 percent) of the 280 individuals who received tax shelter penalties. For these individuals, the OPR controlled the case referral and applied sanctions for disreputable conduct where applicable.

However, we found that the OPR was not aware of a significant number of licensed tax practitioners the IRS penalized for tax shelter violations. The OPR’s inventory system contained no information on 73 (26 percent) of the 280 licensed tax practitioners. OPR management

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7 The IRS database that maintains transactions or records of individual tax accounts.
8 See Appendix V for a list of penalties.
9 A computerized system of records that houses authorization information from powers of attorney, tax information authorizations, and estate tax returns.
believed that these cases were most likely not referred to them by the applicable IRS enforcement personnel. These 73 practitioners were assessed penalties totaling approximately $1.8 million for promoting abusive tax shelters.\footnote{10} Currently, these 73 penalized licensed tax practitioners are identified on the CAF as representing 3,867 taxpayers before the IRS. These taxpayers might be unaware that their licensed tax practitioners have been identified by the IRS for tax shelter violations. This might result in the IRS assessing these taxpayers additional taxes, penalties, and interest due to the incompetence or disreputable conduct of the tax practitioner.

In addition, the remaining 70 of the 280 tax practitioners are listed on the CAF as attorneys, certified public accountants, or enrolled agents. We could not verify if the information on the CAF was correct based on our review of information maintained by State licensing agencies or the IRS’ Enrolled Agent computer system.\footnote{11} These 70 tax practitioners were assessed penalties totaling approximately $1.4 million for promoting abusive tax shelters and are currently eligible to interact with the IRS in some capacity for 4,920 taxpayers. If these 70 practitioners do not have verifiable licenses, they would not be under the jurisdiction of the OPR. Therefore, the applicable IRS function would be responsible for investigating the possible misrepresentations or potential misconduct on the part of these non-licensed practitioners.\footnote{12}

Section 10.53(a) of Circular 230 requires IRS employees to make a written report to the OPR when there is reason to believe that a tax practitioner has violated the rules in Circular 230. In performing its oversight role, the OPR relies on employees within the compliance functions to refer cases when penalties are assessed as a result of an abusive tax shelter. OPR management agreed that individuals assessed penalties for abusive tax shelters were not always referred by IRS compliance employees and stated that the penalty referral process could be problematic if the OPR is not notified when these types of penalties are assessed.

In a previous Treasury Inspector General for Tax Administration review,\footnote{13} several IRS operating divisions were contacted to evaluate their procedures and processes to ensure that appropriate cases are referred to the OPR. Although the IRS operating divisions had procedures to send referrals to the OPR, they generally did not maintain a record or list of referrals sent to the OPR. We previously reported that the OPR’s guidance is not sufficient to ensure that referrals are consistently processed. At that time, management agreed with our recommendation to develop

\footnote{10} The penalties included intentional disregard of rules and regulations, willful and reckless conduct, as well as aiding and abetting understatement of tax liability.

\footnote{11} The Enrolled Practitioner Program System is used to record and monitor individuals granted enrolled agent status by the IRS.

\footnote{12} The IRS OPR oversees the regulation of practice of attorneys, certified public accountants, enrolled agents, and other licensed professionals. If an abusive tax shelter involves a non-licensed authorized representative such as an unenrolled paid preparer, then the IRS Small Business/Self-Employed Division will investigate and/or regulate the possible misconduct.

\footnote{13} The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners (Reference Number 2006-10-066, dated March 2006).
procedures to better define which cases will be recorded on the OPR case management system and how the source, nature, and outcome of referrals will be monitored to help target outreach efforts. However, OPR management informed us in this audit that not all referrals received are recorded on their inventory system, and they are in the process of evaluating procedures for controlling and reviewing referrals. We believe that written procedures will ensure consistent case processing and adherence to requirements and assist the OPR in operating more effectively.

OPR management informed us that prior to the second quarter of Fiscal Year 2008, they were not recording on their inventory system referrals involving non-licensed practitioners or referrals in which they did not plan to open an investigation against a licensed practitioner. In addition, their current inventory system is unable to provide critical data on the source of referrals. We believe referral source information would assist OPR management in potentially identifying which IRS operating divisions have a low number of referrals and could be in violation of the referral procedures. This information could be used by OPR management to target future outreach activities to reinforce the requirement for employees to prepare written referrals identifying potentially disreputable behavior by licensed practitioners. In addition, improvements in the referral process will also positively affect the referrals of tax practitioners involved with tax-related crimes other than tax shelter issues that warrant OPR involvement.

OPR management informed us they are planning to replace their current inventory system with a new case management system in mid-2009, which should be able to provide information on the source of referrals.

**Recommendations**

The Director, OPR, should:

**Recommendation 1:** Review the 143 identified tax practitioners penalized for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

**Management’s Response:** Management agreed with the recommendation. The OPR will review the 143 identified tax practitioners penalized for abusive tax shelter transactions and take appropriate action. To the extent these practitioners are not within the OPR’s jurisdiction, the OPR will refer the individuals to the appropriate IRS function which will be responsible for investigating any potential misconduct on the part of these non-licensed practitioners.
**Recommendation 2:** Establish written procedures for controlling and reviewing case referrals for the current inventory system, as well as for the new planned inventory system, to ensure consistent case tracking and processing.

**Management’s Response:** Management agreed with the recommendation. The OPR is in the process of revising its Internal Revenue Manual guidelines governing the control and processing of each complaint, referral, license application, and/or renewal and all other OPR operations including mail processing and case referral receipt that is input to its information management system.

**Some practitioners permanently enjoined by a Federal Court for abusive tax shelter transactions are not always reviewed by the OPR**

The Department of Justice (DOJ) Tax Division uses its civil power to stop illegal tax schemes by seeking and obtaining injunctions in Federal Court. Injunctions prohibit practitioners and promoters from selling illegal tax schemes on the Internet, at seminars, or through other means. However, we identified some tax practitioners who have been enjoined by a Federal Court due to involvement in abusive tax shelter activities but still remain authorized to represent taxpayers before the IRS. Failure to identify these tax practitioners in a timely manner could have serious adverse consequences to both taxpayers and the IRS if practitioners continue to be allowed to promote, market, and sell abusive tax shelter schemes to unsuspecting taxpayers.

We obtained an IRS database extract of permanent injunctions and final judgments decreed by United States District Courts against individuals during Fiscal Years 2005 through 2007. We found that the IRS was granted permanent relief or injunctions against 48 individuals for tax shelter issues and/or abusive tax schemes. We researched State licensing authorities to determine whether any of these individuals were licensed tax practitioners under the OPR’s jurisdiction and researched the CAF to determine whether they had represented taxpayers before the IRS.

Of the 48 individuals, we identified 17 that could potentially be licensed tax practitioners. We found the OPR reviewed and applied sanctions, when applicable, for 8 of the 17 permanently enjoined licensed practitioners. However, the OPR was unaware of 9.

Seven of the 17 tax practitioners we identified are listed on the CAF as attorneys, certified public accountants, or enrolled agents. We could not verify if the information on the CAF was correct.

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14 The IRS Small Business/Self-Employed Division has a Lead Development Center that maintains a database for abusive tax transactions worked and completed.
based on our review of information maintained by State licensing agencies or IRS’ Enrolled Agent computer system. These 7 tax practitioners caused an estimated harm to the Federal Government of $13.9 million dollars and are currently eligible to represent 517 taxpayers before the IRS. If these seven practitioners do not have verifiable licenses and are not under the jurisdiction of the OPR, then the applicable IRS function should further investigate them for possible misrepresentation or potential misconduct on the part of a non-licensed practitioner.

**Recommendation**

**Recommendation 3:** The Director, OPR, should review the nine identified tax practitioners permanently enjoined for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

**Management’s Response:** Management agreed with the recommendation. The OPR will ensure that each of the nine cases involving abusive tax shelter injunctions are reviewed for appropriate action.

Some practitioners who have been convicted and sentenced for abusive tax shelter activities have not been restricted from practicing before the IRS

For those taxpayers who commit severe tax offenses, the IRS pursues criminal sanctions. Criminal Investigation Division special agents who investigate criminal offenses are required to send a referral to the OPR related to misconduct by licensed practitioners. According to Circular 230, the Director of the OPR may expedite suspension of any practitioner who, within 5 years, has been convicted of any tax-related crime, any crime involving dishonesty or breach of trust, or any felony for which the conduct involved renders the practitioner unfit to practice before the IRS. However, we identified some licensed tax practitioners criminally sentenced for tax shelter abuses who were still authorized to represent taxpayers before the IRS at the time of our audit.

Our review of the Criminal Investigation Division database for Fiscal Years 2005 through 2007 identified 40 individuals sentenced for tax shelter issues or abusive tax schemes. Of the 40 individuals, we identified 30 that could potentially be licensed tax practitioners. We found that the OPR took action to review and apply sanctions for 22 of the 30 criminally sentenced practitioners. However, the OPR was unaware of and had not reviewed 5 (17 percent) of the 30 sentenced tax practitioners. These 5 tax practitioners were engaged in tax shelter schemes that caused an estimated harm or loss to the Federal Government of $4.4 million and are representing or still eligible to represent 249 taxpayers before the IRS.

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15 The Criminal Investigation Division database extract was pulled from its Criminal Investigation Management Information System.
Three of the 30 tax practitioners identified are listed on the CAF as attorneys, certified public accountants, or enrolled agents. However, we could not verify if the information on the CAF was correct based on our review of information maintained by State licensing agencies or IRS’ Enrolled Agent computer system. These 3 tax practitioners caused an estimated harm to the Government of $10.9 million and are currently eligible to represent 261 taxpayers before the IRS. If these three practitioners do not have verifiable licenses and are not under the jurisdiction of the OPR, then the applicable IRS function should further investigate for possible misrepresentation or potential misconduct on the part of a non-licensed practitioner.

OPR management informed us that they might not always receive referrals from the Criminal Investigation Division at the point where they can initiate a proceeding for disreputable conduct against a practitioner. For example, the Criminal Investigation Division can complete an investigation involving a licensed practitioner and refer the case for prosecution to the DOJ and at the same time refer the information to the OPR. However, the OPR will generally not take action on a licensed practitioner until there is a final or decisive violation of Circular 230. Further, we determined that the OPR does not have a consistent process to follow up with the Criminal Investigation Division for referrals received once a final decision is made by the DOJ.

In our prior review, we recommended that the OPR work with other law enforcement agencies, including the DOJ, to improve the referral process by obtaining timely, relevant conviction information for tax crimes and State or Federal convictions involving dishonesty and breach of trust in a format that is useful to the OPR. OPR management agreed in principle with our recommendation, but believed they were doing all that could reasonably be done at that time. We discussed again with OPR management the feasibility of OPR personnel obtaining data readily available within the IRS to identify tax practitioners who have been assessed penalties, received a criminal sentence, or enjoined for potentially disreputable behavior. OPR management agreed that obtaining some available information from IRS systems was a sound approach; however, management stated that this would generally require extensive additional information gathering and case building that is not supported by their current resources. Given the extreme nature of the violations committed by some of the licensed tax practitioners, we believe the IRS needs to develop alternative approaches to protect tax administration and prevent further abuses.
Recommendations

The Director, OPR, should:

**Recommendation 4:** Review the eight identified tax practitioners sentenced for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

**Management’s Response:** Management agreed with the recommendation. The OPR will review the eight identified tax practitioners subject to criminal prosecution and determine whether additional disciplinary actions are warranted. If the individuals do not fall within the jurisdiction of the OPR, appropriate jurisdictional and disciplinary decisions will be made.

**Recommendation 5:** Initiate additional outreach efforts with other IRS functions to increase awareness of the requirement to refer to the OPR for appropriate action licensed tax practitioners involved in potentially disreputable behavior.

**Management’s Response:** Management agreed with the recommendation. The OPR will continue to provide awareness training to both internal and external stakeholders to ensure that licensed tax practitioners involved in potentially disreputable behavior are brought to the attention of the OPR and are appropriately sanctioned.

**Recommendation 6:** Develop a methodology, when resources become available, to perform proactive analyses of information available from other IRS functions, including the Modernization and Information Technology Services organization, the Criminal Investigation Division, and the Small Business/Self-Employed Division Lead Development Center, to identify and appropriately address licensed tax practitioners engaged in potentially disreputable activity.

**Management’s Response:** Management agreed with the recommendation. The OPR will look to develop and sustain a more proactive model of case identification and development, as resources permit.
Appendix I

**Detailed Objective, Scope, and Methodology**

The overall objective was to determine whether the OPR is effectively identifying and taking appropriate actions against those licensed tax practitioners who have employed or promoted abusive tax shelters. To accomplish this objective, we:

I. Determined the procedures and guidance for the OPR and IRS employees regarding the identification, referral, discipline, and monitoring of abusive tax practitioners/preparers.
   
   A. Reviewed Treasury Regulations [e.g., Treasury Department Circular No. 230 (Circular 230)],¹ Delegation Orders, and Revenue Procedures for tax practitioner/preparer requirements and IRS jurisdiction.

   B. Reviewed the Internal Revenue Manual for the Large and Mid-Size Business Division, Small Business/Self-Employed Division, and Criminal Investigation Division for requirements to identify and refer abusive tax practitioners/preparers to the OPR. We discussed with IRS functional employees how referrals are developed and sent to the OPR.

   C. Discussed with OPR management their current strategic priorities.

   D. Obtained workload information for the OPR that included current Business Performance Reviews, staffing information, and budgets.

II. Determined whether the OPR is effectively able to identify or investigate those tax practitioners who have been penalized for tax shelter violations.

   A. Obtained an Individual Business Master File² extract of all tax shelter and understatement of liability penalties (by IRS Master File penalty reference numbers) assessed during Fiscal Years 2005, 2006, and 2007. We determined the data were reliable by comparing and matching extracted data to online data listed on the IRS Integrated Data Retrieval System.³

   B. Identified licensed practitioners with assessed tax shelter or tax avoidance penalties during Fiscal Years 2005 through 2007 from the IRS Master File extract and

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¹ *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service* (Rev. April 2008).

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

³ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.
discussed with OPR management those tax practitioners who were penalized but were not identified by the OPR and were listed on the CAF without restrictions.

III. Determined whether the OPR is effectively able to identify or investigate those tax practitioners who have been enjoined (Civil Injunction) or convicted for employing or promoting abusive tax shelters.

A. Obtained a database extract from the IRS Small Business/Self-Employed Division Lead Development Center inventory system of individuals who were permanently enjoined for abusive tax shelter promotions, schemes, or transactions during Fiscal Years 2005, 2006, and 2007. We determined the data were reliable by comparing and matching extracted data to online Small Business/Self-Employed Division internet web site data and DOJ internet web site data.

B. Identified licensed practitioners who were enjoined for abusive tax shelter actions during Fiscal Years 2005 through 2007 and discussed with OPR management those tax practitioners who were not identified by the OPR and were listed on the CAF without restrictions.

C. Obtained a database extract from the IRS Criminal Investigation Division inventory system of individuals who were sentenced for abusive tax shelter promotions, schemes, or transactions during Fiscal Years 2005, 2006, and 2007. We determined the data were reliable by comparing and matching extracted data to online Criminal Investigation Division internet web site data and DOJ internet web site data.

D. Identified licensed practitioners who were sentenced for abusive tax shelter actions during Fiscal Years 2005 through 2007 and discussed with OPR management those tax practitioners who were not identified by the OPR and were listed on the CAF without restrictions.

**Internal controls methodology**

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the various IRS operating divisions’ policies and procedures for referring to the OPR licensed tax practitioners who were assessed penalties, enjoined, and/or sentenced for abusive tax shelter actions. We evaluated these controls by interviewing management and reviewing applicable information and documents.
Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Jeffrey M. Jones, Director
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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Actual: 8,700 taxpayers are being represented by 143 licensed or potentially licensed tax practitioners who have been penalized by the IRS for abusive tax shelter actions (see page 5).¹

Methodology Used to Measure the Reported Benefit:

To evaluate the number of tax practitioners assessed a monetary penalty by the IRS for tax shelter violations, we obtained an IRS Individual Master File² database extract of specific tax shelter assessments made during Fiscal Years 2005 through 2007. We found the IRS assessed penalties totaling $82.3 million for tax shelter violations on 1,175 individuals. We then researched the IRS CAF to determine whether any of these individuals had represented taxpayers before the IRS. We also researched State licensing authorities to determine whether any of these individuals were licensed tax practitioners. Of the 1,175 individuals, we identified 280 that could be under the OPR’s jurisdiction.

The OPR took action on 137 of the 280 individuals. However, we found that the OPR was not aware of a significant number of licensed tax practitioners the IRS penalized for tax shelter violations. The OPR’s inventory system contained no information on 73 (26 percent) of the 280 licensed tax practitioners. These 73 practitioners were penalized a total of $1.8 million for abusive tax shelter actions and are representing 3,867 taxpayers before the IRS. The remaining 70 of the 280 tax practitioners are listed on the CAF as attorneys, certified public accountants, or enrolled agents. However, we could not verify if the information on the CAF was correct based on our review of information maintained by State licensing agencies or the IRS’ Enrolled Agent computer system. These 70 tax practitioners were assessed penalties totaling approximately $1.4 million for promoting abusive tax shelters and are currently eligible to interact with the IRS in some capacity for 4,920 taxpayers.

¹To avoid double counting, we adjusted the totals for taxpayers represented by penalized practitioners (8,787 – 87 = 8,700 taxpayers).
²The IRS database that maintains transactions or records of individual tax accounts.
Type and Value of Outcome Measure:

- Taxpayer Burden – Actual: 595 taxpayers are being represented by 9 licensed or potentially licensed tax practitioners who have been enjoined for promotion of an abusive tax shelter scheme or strategy (see page 5).

Methodology Used to Measure the Reported Benefit:

To evaluate the number of tax practitioners permanently enjoined from preparing tax returns, representing taxpayers before the IRS, or from continuing a tax shelter scheme or abusive tax transaction, we obtained an IRS database extract of permanent injunctions and final judgments decreed by United States District Courts against individuals during Fiscal Years 2005 through 2007. We found that the IRS was granted permanent relief or injunctions against 48 individuals for tax shelter issues and/or abusive tax schemes. We researched the State licensing authorities to determine whether any of these individuals were licensed tax practitioners under the OPR’s jurisdiction and the CAF to determine whether they represented taxpayers before the IRS.

Of the 48 individuals, we identified 17 that could potentially be licensed tax practitioners. We found that the OPR reviewed and applied sanctions, when applicable, for 8 of the 17 permanently enjoined licensed practitioners. However, for 2 of the 17 licensed tax practitioners, the OPR was unaware that...

We also could not verify the licensing status for 7 of the 17 practitioners through the State licensing agencies maintained on internet web sites or the IRS’ Enrolled Agent computer system. However, these representatives are listed on the CAF with designations as attorneys, certified public accountants, or enrolled agents. These 7 permanently enjoined, potentially licensed practitioners caused an estimated harm to the Government of $13.9 million and are eligible to represent 517 taxpayers before the IRS.

3 The IRS Small Business/Self-Employed Division has a Lead Development Center that maintains a database for abusive tax transactions worked and concluded.
**Type and Value of Outcome Measure:**

- Taxpayer Burden – Actual: 471 taxpayers are being represented by 8 licensed or potentially licensed tax practitioners who have been sentenced for an abusive tax shelter scheme, strategy, or transaction (see page 5).¹

**Methodology Used to Measure the Reported Benefit:**

To evaluate the number of sentenced tax practitioners, we obtained and reviewed a Criminal Investigation Division database of individuals who received a final conviction and sentence for a tax-related crime during Fiscal Years 2005 through 2007. We found that 40 individuals were sentenced for tax shelter issues or abusive tax schemes. Of the 40 individuals, we identified 30 that could potentially be licensed tax practitioners. We found that the OPR took action and applied sanctions to 22 of these sentenced tax practitioners.

However, the OPR was unaware of and ultimately had not reviewed five. These 5 licensed tax practitioners were engaged in tax shelter schemes that caused an estimated harm or loss to the Government of $4.4 million and are representing or still eligible to represent 249 taxpayers before the IRS. In addition, we could not verify the licensing status for three of the tax practitioners. However, these representatives are identified on the CAF with designations as attorneys, certified public accountants, or enrolled agents. These 3 individuals caused an estimated harm to the Government of $10.9 million and are still eligible to represent 261 taxpayers before the IRS.

¹ To avoid double counting, we adjusted the totals for taxpayers represented by sentenced practitioners (510 - 39 = 471 taxpayers).
### Internal Revenue Code Practitioner Penalties

<table>
<thead>
<tr>
<th>Code Section</th>
<th>Description</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>6700</td>
<td>Promoting abusive tax shelter</td>
<td>Lesser of $1,000 or 100 percent of gross income derived from the activity.</td>
</tr>
<tr>
<td>6701</td>
<td>Aiding and abetting understatement of tax liability</td>
<td>$1,000 per person per period.</td>
</tr>
<tr>
<td>6707</td>
<td>Failure to furnish information regarding tax shelters</td>
<td>Multiple calculations.</td>
</tr>
<tr>
<td>6707A</td>
<td>Failure to disclose reportable transaction</td>
<td>$10,000/natural person or $50,000/other taxpayer.</td>
</tr>
<tr>
<td>6708</td>
<td>Failure to maintain list relating to reportable transactions</td>
<td>$10,000 per day after failure to provide list.</td>
</tr>
<tr>
<td>6694(a)</td>
<td>Understatement of taxpayer’s liability by Return Preparer</td>
<td>$250 per return or claim.</td>
</tr>
<tr>
<td>6694(b)</td>
<td>Understatement of taxpayer’s liability due to intentional disregard of rules and regulations or to willful or reckless conduct</td>
<td>$1,000 per return or claim.</td>
</tr>
</tbody>
</table>

*Source: Internal Revenue Code.*
Management's Response to the Draft Report

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Carolyn Hinchman Gray
Acting Director, Office of Professional Responsibility

SUBJECT: Draft Audit Report – Tax Practitioners Promoting Abusive Tax Shelters Are Still Able to Represent Taxpayers Before the Internal Revenue Service (Audit No. 200710041)

I have reviewed the draft report titled “Tax Practitioners Promoting Abusive Tax Shelters Are Still Able to Represent Taxpayers Before the Internal Revenue Service”. I concur with your conclusions that abusive tax shelters are an area of concern to Congress and continue to present formidable challenges to the IRS.

The OPR works closely with the other IRS operating divisions to identify practitioner misconduct that has a negative impact on tax administration. In addition, the OPR works closely with the Department of Justice (DOJ) to ensure that Tax Professionals covered by Treasury Department Circular 230 and who engage in the promotion of abusive tax shelters are identified and appropriately sanctioned. As resources are available, we will explore additional methodologies to proactively identify licensed tax practitioners who may be engaged in disreputable activity.

Attached is a detailed response outlining our corrective actions. If you have questions, please call me at (202) 622-9730 or Robert Johnson, Senior Management/Program Analyst at (202) 622-6320.

Attachment
Attachment

RECOMMENDATION 1:
Review the 143 identified tax practitioners penalized for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

CORRECTIVE ACTIONS:
The Director, Office of Professional Responsibility, will review the 143 identified tax practitioners penalized for abusive tax shelter transactions and take appropriate action. To the extent these practitioners are not within OPR’s jurisdiction, OPR will refer the individual to the appropriate IRS function which will be responsible for investigating any potential misconduct on the part of these non-licensed practitioners. OPR will also determine if any of these potentially non-licensed practitioners fall within the criminal jurisdiction of the TIGTA Office of Investigations for misrepresenting their professional status.

IMPLEMENTATION DATE:
By September 30, 2009

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility

RECOMMENDATION 2:
Establish written procedures for controlling and reviewing case referrals for the current inventory system, as well as for the new planned inventory system, to ensure consistent case tracking and processing.

CORRECTIVE ACTION:
The OPR recently completed Internal Revenue Manuals (IRMs) governing the control and processing of each complaint, referral, license application and/or renewal and all other OPR operations including mail processing and case referral receipt/input into OPR’s information management system, including both I-Trak and E-Trak. Specific IRMs were completed for Mail Processing, the Enrolled Practitioner Program, the Case Development & Licensure Branch and Enforcement Branches I and II. The IRMs are currently being reviewed by OPR’s newly appointed Information Management Coordinator and will be forwarded for approval and publishing.

IMPLEMENTATION DATE:
June 30, 2009

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility
RECOMMENDATION 3:
The Director, OPR, should review the nine identified tax practitioners permanently enjoined for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

CORRECTIVE ACTION:
The Director, OPR, will ensure that each of the nine cases involving abusive tax shelter injunctions are reviewed for appropriate action. The OPR conducted extensive liaison with the Department of Justice (DOJ) which resulted in DOJ hosting a nationwide training session for its attorneys who handle IRS injunction cases. One of the purposes of the training was to ensure that when DOJ enjoins a practitioner from "promoting tax shelters" or "preparing tax returns", the injunction language also includes a prohibition against "practicing before the IRS". The Service’s Lead Development Center (LDC) subsequently reviewed all previous injunctions against preparation to ensure that those involving practitioners also included the new injunction language. OPR will review each of these nine cases for appropriate action.

IMPLEMENTATION DATE:
September 30, 2009

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility

RECOMMENDATION 4:
Review the eight identified tax practitioners sentenced for abusive tax shelter actions to determine whether additional disciplinary actions are warranted. If the individuals do not fall under the jurisdiction of the OPR, then the Director should refer the cases to the appropriate IRS function for applicable action.

CORRECTIVE ACTION:
The Director, OPR, will review the eight identified tax practitioners subject to criminal prosecution and determine whether additional disciplinary actions are warranted. If these individuals do not fall within the jurisdiction of OPR, appropriate jurisdictional and disciplinary decisions will be made.

IMPLEMENTATION DATE:
September 30, 2009

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility
RECOMMENDATION 5:
Initiate additional outreach efforts with other IRS functions to increase awareness of the requirement to refer to the OPR for appropriate action licensed tax practitioners involved in potentially disreputable behavior.

CORRECTIVE ACTION:
The OPR continues to provide awareness training to both internal and external stakeholders to ensure licensed tax practitioners involved in potentially disreputable behavior are brought to the attention of the OPR and are appropriately sanctioned. OPR recently completed Area Reviews/Visitation of several Area PSP Offices and met with numerous Return Preparer Coordinators (RPCs) as part of a review/outreach process to evaluate and enhance the effectiveness and quality of OPR referrals. OPR personnel attend annual RPC Training events and training/liaison opportunities with LDC personnel. OPR continues to provide training involving disreputable conduct scenarios at the IRS’ Nationwide Tax Forums on an annual basis. Feedback from these presentations has been overwhelmingly positive. OPR is currently exploring options associated with the dedication of an FTE to a specialized communications position.

IMPLEMENTATION DATE:
September 30, 2009

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility

RECOMMENDATION 6:
Develop a methodology, when resources become available, to perform proactive analyses of information available from other IRS functions, including the Modernization and Information Technology Services organization, the Criminal Investigation Division, and the Small Business/Self-Employed Division Lead Development Center, to identify and appropriately address licensed tax practitioners engaged in potentially disreputable activity.

CORRECTIVE ACTION:
As resources permit, OPR will increasingly look to develop and sustain a more proactive model of case identification and development.

IMPLEMENTATION DATE:
June 30, 2010

RESPONSIBLE OFFICIAL:
Director, Office of Professional Responsibility