

Problem Return Preparers— The IRS and the Justice Department Take Aim

By *Claudia A. Hill*

Claudia Hill reviews how the IRS and the Treasury identify and pursue preparers that intentionally or, through gross negligence, facilitate noncompliance.

In early June, IRS Commissioner Doug Shulman announced¹ that by the end of 2009, he will propose a comprehensive set of recommendations to help the IRS better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers. Both taxpayers and the tax system are damaged when grossly erroneous or fraudulent tax returns enter the system.

The IRS Criminal Investigation Return Preparer Program (RPP) was implemented in 1996, and established procedures to foster compliance by identifying, investigating and prosecuting abusive return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or incompetent return preparers. This is a significant problem for both the IRS and the taxpaying public. Abusive return preparers frequently prepare bad returns for large numbers of taxpayers who, at best, are stuck with paying additional taxes and interest and at worse, depending on culpability, are subject to penalties and maybe even criminal prosecution.

Return Preparer Fraud generally involves the orchestrated preparation and filing of false income tax returns (in either paper or electronic form) by pre-

parers who may claim inflated personal or business expenses; false deductions or unallowable credits; excessive exemptions; or fraudulent tax credits. The preparers' clients may or may not have knowledge of the false expenses, deductions, exemptions and/or credits shown on their tax returns. However, when the IRS detects a fraudulent return, the taxpayer—not the return preparer—must pay the additional taxes and interest and may be subject to penalties. Since 2004, the IRS has annually released a Fact Sheet on Return Preparer Fraud as a public service warning and providing criminal investigation statistical information as well as tips for choosing a preparer.

The IRS Return Preparer Program focuses on enhancing compliance in the return-preparer community by investigating and referring criminal activity by return preparers to the Department of Justice for prosecution and/or asserting appropriate civil penalties against unscrupulous return preparers.

Dishonest return preparers use a variety of methods to formulate fraudulent and illegal deductions for reducing taxable income. These include, but are not limited to, the following:

- Preparing fraudulent Schedule C, Profit or Loss from Business
- Claiming deductions for expenses that have not been paid by the taxpayer to offset Form 1099, *Miscellaneous Income*, or income earned from outside employment
- False and inflated itemized deductions on Schedule A, *Itemized Deductions*, for medical

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and dental expenses, charitable contributions or employee business expenses

- Claiming false Schedule E, *Supplemental Income and Loss*
- Claiming false dependents
- Claiming fraudulent or inappropriate credits such as EITC or the fuel credit

INTERNAL REVENUE MANUAL §4.11.51 addresses identification of questionable return preparers through the Return Preparer Program. The Program allows for the examination of returns prepared by a particular preparer if information indicates a pattern of noncompliance exists. The examination of returns prepared by a noncompliant preparer is useful in identifying erroneous returns. The assessment of penalties on the preparer may correct the preparer's practices or force him/her to discontinue practice. A preparer program action case is a preparer penalty investigation in which clients of a questionable preparer are examined to determine whether preparer penalties and/or an injunction are warranted. The examination of a preparer's clients' returns without the express approval of the Area Director is prohibited.

SB/SE Delegation Order No. 145.7, *Authority to Request and Inspect Preparers Records*, delegates the authority to open a preparer investigation per Reg. §1.6107-1(b) to the following:

- Revenue Officers
- Revenue Agents
- Tax Auditors
- Estate and Gift Tax Attorneys
- Tax Compliance Officers

Identification of a Noncompliant Preparer

The Return Preparer Coordinator (RPC) and the Area Multifunctional Penalty Steering Committee (PSC), if one exists, gather information on Area preparers from various sources. The main source is information received from examiners through their group managers, preparer penalty records, information items and referrals from other functions.² The RPC maintains files containing information on return preparer activities. When a pattern of noncompliance is noted, action to prohibit the preparer from practicing before the IRS (if they are a CPA, EA or Attorney) will be considered.

Program action is limited to cases where information indicates that a return preparer has engaged in a widespread practice of making material errors. This conduct demonstrates intentional misconduct or

clear incompetence in preparing income tax returns. Preparer penalty consideration under Code Secs. 6694 and 6695 is required on all cases regardless of the source of the case. Consideration is more strongly indicated on RPP cases.

Reg. §1.6107-1(b) requires return preparers to make a copy of the following information available for inspection:

- Returns or claims for refund
- Records of returns and claims for refund
- Records of the individual preparer required to sign the return and claim for refund pursuant to Reg. §1.6695-1(b)

The IRS has penalty and injunctive authority to address improper income tax return preparation.³ The Internal Revenue Code provides the following penalties to stop fraudulent, unscrupulous and/or incompetent tax return preparers and abusive transaction promoters. Penalty assertion is the key enforcement vehicle for noncompliant preparers and promoters.

Income tax return preparer penalties under the following:

- Code Sec. 6694, Understatement of Taxpayer's Liability by Income Tax Return Preparer
- Code Sec. 6695, Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons
- Code Sec. 6713, Disclosure or Use of Information by Preparers of Returns

Tax shelter promoter penalties under the following:

- Code Sec. 6700, Promoting Abusive Tax Shelters, etc.
- Code Sec. 6701, Penalties for Aiding and Abetting Understatement of Tax Liability

Material advisor penalties under the following:

- Code Sec. 6707, Failure to Furnish Information Regarding Reportable Transactions
- Code Sec. 6708, Failure to Maintain Lists of Advisees with Respect to Reportable Transactions

The IRS may also pursue injunctions under the following:

- Code Sec. 7407, Action to Enjoin Income Tax Return Preparers
- Code Sec. 7408, Actions to Enjoin Specified Conduct Related to Tax Shelters and Reportable Transactions

The IRS views preparer, promoter and material advisor penalties as important tools to collect the proper amount of tax revenue at the least cost. Interestingly, while identification of the returns themselves that appear to have

been prepared erroneously may be obvious, determining who prepared the return is not always so. The IRS cannot easily keep track of the activities of paid tax preparers, nor of their compliance with tax laws, according to a new report by the Treasury Inspector of Tax Administration.⁴ Code Sec. 6695(b) permits a penalty for failure to sign return: Any person who is a tax return preparer with respect to any return or claim for refund, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim shall pay a penalty of \$50 for such failure. One of the more difficult tasks facing those who would enforce these rules is tracking down those preparers who choose not to sign returns they prepare. Further, although the IRS maintains significant information on paid preparers, the information is scattered over more than 20 record systems, and the systems are not integrated. These systems show discrepancies in identifying numbers, names and addresses. TIGTA also determined that it is difficult to match preparer information because preparers use different and multiple identifying numbers on returns: Social Security numbers, preparer tax identification numbers and employer identification numbers.

Because ongoing tax scams cause continuing harm to the U.S. Treasury and leave participants owing taxes, interest and often penalties, the government does not wait until a criminal case has been developed to take action to stop the scam.⁵ Rather, the Justice Department brings civil injunction suits to stop both the promotion of tax scams and the preparation of false or fraudulent returns. In appropriate cases, the Justice Department brings criminal charges against the promoters, preparers and scam participants to punish them for their unlawful conduct.

In the past decade, the Justice Department has sought and obtained injunctions against over 300 promoters of tax fraud schemes, including a record 71 promoters in fiscal year 2008. These injunctions have stopped promoters from selling tax evasion schemes on the Internet, at seminars or through other means. The tax scam promoters the government has sought to enjoin have cost the Treasury several billion dollars, and have had hundreds of thousands of customers. The government's results in this area are below:

- In November 2008, a federal court in California ordered Edwin Lichtig III and his firm, GSL Advisory Solutions, to stop promoting unlawful tax fraud schemes involving Individual Retirement Accounts (IRAs) that helped customers improperly avoid federal income tax on tens of million of dollars.

- In October 2008, a federal court in California ordered Scott Cathcart to stop promoting a so-called 90 Percent Stock Loan program that falsely purported to enable customers to avoid paying income tax on any capital gains, by treating the sale of appreciated stocks or other securities as a loan, in a scheme that allegedly cost the government hundreds of millions in lost tax dollars.
- In May 2008, a federal court in Florida shut down Pinnacle Quest International, which the court found knowingly sponsored "tax fraud trade shows" at offshore locations.

The Department of Justice, Tax Division, working together with the IRS, has intensified its efforts to shut down fraudulent tax return preparers and promoters of tax-fraud schemes, using both civil and criminal enforcement. Under the Tax Division's civil injunction program, the Division files a lawsuit seeking a court order that prohibits a person from engaging in certain activities (for example, to stop promoting tax-fraud schemes or preparing tax returns), or requires a person to take certain affirmative actions (for example, to provide his customer lists to the government and to mail copies of the complaint and the court order to his customers).

Two categories of fraudulent tax schemes made it to IRS's annual "Dirty Dozen Tax Scams" (see *Beware of IRS' 2009 "Dirty Dozen" Tax Scams*, IR-2009-41 (Apr. 13, 2009)).

Fraudulently claiming the fuel tax credit has been extremely popular, and a top target for IRS enforce-

Table 1. Statistical Data—Abusive Return Preparers

Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year.

	FY 2008	FY 2007	FY 2006
Investigations Initiated	214	218	197
Prosecution Recommendations	134	196	153
Indictments/Informations	142	131	135
Sentenced	124	123	109
Incarceration Rate*	81.5%	81.3%	89.0%
Avg. Months to Serve	18	19	18

* Incarceration includes confinement to federal prison, halfway house, home detention or some combination thereof.

Data Source: Criminal Investigation Management Information System

ment. The credit is available in limited circumstances for fuel purchased for off-highway business use, available only to taxpayers who operate farm equipment or other off-highway business vehicles. The equipment or vehicles must not be registered for highway uses, meaning that fuel purchased by truck drivers and companies for commercial transport does not qualify.

Typically, the preparer will fraudulently claim absurdly large credits for truck drivers by falsely reporting purchases of huge quantities of fuel, often more than the customer could have bought using all his annual income. In the past few years, the Justice Department has obtained injunctions shutting down many tax preparers who claim the bogus credits on customers' returns.

The second category employs a tax fraud scheme that uses fabricated IRS Forms 1099-OID to report fictitious tax withholding on their customers' returns and then claims refunds of huge amounts. This scheme is part of a growing trend among tax protesters to file frivolous tax returns and forms in an attempt to escape their federal tax obligations and steal from the Treasury.

Customers of such preparers who participate in this tax fraud scheme may be subject to sizeable penalties for filing returns with excessive refund claims—including a penalty equal to 20 percent of the amount improperly claimed. The penalty applies even if, as usually happens, the IRS detects the false claim and blocks a tax refund. Thus a taxpayer improperly claiming a \$2 million refund could be liable for a \$400,000 penalty as well as other penalties and possible criminal prosecution.

John A. DiCicco, Acting Assistant Attorney General for the Justice Department's Tax Division warns that "Taxpayers foolish enough to consider participating in this illegal scheme should consider that, in addition to risking criminal prosecution, they also risk incurring civil penalties that could cause them to lose their homes and their savings."⁶

"Taxpayers should steer clear of any situation involving fabricating tax forms or reporting fictitious tax withholding," said IRS Commissioner Doug Shulman. "These schemes carry a high price for promoters and for taxpayers. We aggressively pursue unscrupulous tax return preparers involved in such scams. Taxpayers should remember they are ultimately responsible for what's on their tax returns. If a promoter's sales pitch sounds too good to be true, be sure to check it out first."⁷

In the past decade, the Justice Department has obtained injunctions against more than 375 tax

return preparers and tax-fraud promoters. Information about the Justice Department's Tax Division and its efforts to enjoin tax return preparers and tax-fraud promoters is available on the Justice Department Web site.⁸

One scheme this author's office saw more than once this past filing season is illustrated by the next case. On February 13 the Justice Department announced⁹ the United States had sued a Sacramento, California, tax preparer, Chris Elmer, his firm—Associated Tax Planners Inc. (ATP)—and several members of his family associated with ATP, seeking to bar them all permanently from the tax-preparation business, the Justice Department announced today. The civil injunction suit was filed in Sacramento with the U.S. District Court for the Eastern District of California.

The complaint alleges that ATP prepares thousands of federal income tax returns for individuals and businesses each year, and repeatedly claims false or inflated business deductions. Many of the deductions are allegedly claimed as purported business expenses of sham partnerships. The complaint alleges that in many instances the defendants claimed purported partnership business losses on customers' individual tax returns regardless of whether the customers actually had a partnership or other business enterprise.

The complaint further alleges that the defendants and their customers often do not file a corresponding partnership return when the customers report partnership losses on their individual returns. The defendants also allegedly fabricate phony IRS tax identification numbers for the partnerships to conceal their sham nature.

The defendants allegedly told customers and other tax preparers that the IRS is unlikely to detect the defendants' deductions because the IRS is unlikely to audit a small partnership. Chris Elmer allegedly told one customer that this made a small partnership an ideal vehicle in which to "tuck" personal expenses as business-expense deductions.

"The public should beware of tax preparers who claim to know how to hide deductions from the Internal Revenue Service,"¹⁰ said John DiCicco, Acting Assistant Attorney General for the Justice Department's Tax Division.

To better illustrate the magnitude and type of fraudulent activities of return preparers, the following examples of abusive return preparer investigations are written from public record documents on file in

the court records in the judicial district in which the cases were prosecuted during the months of June and July 2009.¹¹

Two Alabama Women Sentenced on Federal Tax Fraud Charges

On July 22, 2009, in Montgomery, Alabama, Kwantrice M. Thornton, of Montgomery, was sentenced to 24 months' imprisonment after pleading guilty on February 4, 2008, to a one-count felony information charging her with conspiracy to defraud the United States. Felicia S. Jackson, also of Montgomery, was sentenced to 46 months' imprisonment following her February 13, 2009, guilty plea to a two-count felony information charging her with conspiracy to defraud the United States and with conspiring to defraud the United States while on release pending sentencing on the first charge. According to the plea agreement and information, in July 2006, Kwantrice M. Thornton stole from her employer, Electronic Data Systems, Inc. (EDS), in Montgomery, Alabama, Social Security numbers and dates of birth ("the identifiers") of Medicaid beneficiaries. Between August 2006 and October 2006, Thornton sold approximately 50 identifiers to a co-conspirator identified in court filings as "OM" in exchange for a total of \$1,000. In addition to these identifiers, between July 2006 and January 2007, Thornton received non-EDS-related identifiers and bank account information from other individuals and passed this information on to OM. OM provided these identifiers to other individuals, who caused the identifiers to be used to file federal income tax returns that fraudulently claimed refunds in the approximate amounts of \$6,000 to \$9,000, which were directly deposited into the bank accounts that Thornton had identified to OM. Thornton arranged for a portion of the refunds to be withdrawn from the bank accounts and provided \$2,000 to OM. Thornton originally did not charge OM for engaging in this conduct; however, Thornton subsequently required a fee of \$500 per refund paid, which she later increased to \$1,000. According to the plea agreement and information, from January to April 2005, Felicia S. Jackson was employed by Tax Tyme, loosely described as a tax preparation business operated by a Montgomery

man by the name of Tommy Jordan. Jordan was convicted at trial in January 2009, and is awaiting sentencing. Jackson testified against Jordan at that trial. Following Jordan's instructions, Jackson and another woman, Tumekia Sanders (who has also pled guilty and was previously sentenced), caused numerous federal income tax returns to be filed that claimed refunds that substantially exceeded the actual refund, if any, that the taxpayers were entitled to. This was done by manipulating the earned income credit amounts to maximize the refund associated with those returns. Jordan paid Jackson between \$400 and \$450 for each return she prepared that was filed. After Jackson pleaded guilty and was released on bond, she again participated with others in the filing of more false federal income tax returns. Because Jackson committed this criminal activity while on bond for federal criminal charges, her sentence on the second conspiracy count was enhanced.

Colorado Tax Return Preparers Sentenced to Federal Prison for Preparing over 400 False Tax Returns

On July 9, 2009, in Denver, Colorado, Loren Smith, of Broomfield, Colorado, and Curtis Duff, of Golden, Colorado, were sentenced to 24 months in prison and 23 months in prison, respectively. Each defendant was ordered to serve three years of supervised release. A hearing to determine the amount of restitution the two must pay will be in September 2009. Smith and Duff pleaded guilty in March 2009 to mail fraud and aiding and abetting in the preparation and filing of false tax returns. According to court documents, Duff and a co-conspirator owned and operated a Colorado Corporation named Windfall Tax and Financial Services ("Windfall"), located in Wheat Ridge, Colorado, whose primary business was to prepare and file amended, individual tax returns with the IRS and the Colorado Department of Revenue (CDR). Smith and Duff filed or assisted in the preparation and filing of over 400 amended tax returns with the IRS containing falsified information. The defendants also filed or assisted in the preparation and filing of over 300 amended returns with the CDR containing falsified information. As a general practice, the defendants charged

customers from 40 to 50 percent of the IRS and the CDR refund payments. As part of the scheme, the returns prepared by the defendants typically falsified the amount of the customers' charitable contributions, business expenses and business losses for a given tax year. On numerous returns, Windfall listed fictitious businesses for the taxpayers and claimed large business losses or expenses for such taxpayers as a way to generate a larger refund. After the fraudulent amended returns were created, the defendants would obtain a customer's signature on the returns without fully explaining or noting the various false entries and inflated numbers added to such returns. In a number of instances where customers questioned the legitimacy of certain figures on amended returns, the defendants misinformed such customers that the claimed deductions were legitimate and properly allowed for by IRS rules and regulations.

Return Preparer Sentenced to 51 Months for Filing Fraudulent Tax Returns

On July 6, 2009, in Louisville, Kentucky, Timothy J. Mitts, of Nanuet, New York, was sentenced to 51 months in prison, to be followed by one year of supervised release for preparing false tax returns. Mitts was convicted by a federal jury in June 2008 on 18 counts of aiding in the preparation of false federal income tax returns. According to the evidence presented at trial, Mitts prepared well over 100 fraudulent tax returns for the tax years 1997 through 2004. The returns fraudulently prepared by Mitts under reported taxes by at least \$500,000. Many of the returns were amended returns that requested refunds for taxpayers for businesses that did not exist. According to his clients, they had no idea that their returns were fraudulent. Mitts simply made up expenses, deductions, business losses, *etc.*, in order to create a refund or avoid tax liability. All of his clients stated that they relied on Mitts and simply signed the return without double checking or reviewing Mitt's work. At trial, several witnesses testified that Mitts told them he was a CPA and a former IRS fraud examiner. Mitts denied ever stating this to clients. However, trial evidence included a classified advertisement for "Timothy Mitts, CPA."

Tax Preparers Sentenced to Prison for Filing False Returns

On June 23, 2009, in Riverside, California, Matthew Carl Berry, of Rialto, California, was sentenced to nine years in prison after having been previously convicted on charges that he conspired with others to defraud the IRS and filed false personal income tax returns for the years 2001, 2002 and 2004. In addition to prison, Berry was ordered to pay \$15,418,393 in restitution to the IRS and to spend three years on supervised release following his release from prison. Matthew Berry was found guilty late last year of conspiring with his daughters, Karen Denise Berry of San Bernardino and Carla Denine Berry of Rialto, as well as with Ivan Taylor Johnson of San Bernardino and Valerie Madel Dixon of Rialto, to impede and obstruct the lawful functions of the IRS. In addition to the conspiracy charges, the jury found Berry guilty of willfully filing false income tax returns with the IRS for the 2001, 2002 and 2004 tax years.

According to court papers, Berry operated a tax business out of his residence in Rialto from as early as 1995 through 2003. Beginning in early 2000, his daughters, Karen and Carla Berry, began preparing false income tax returns at the tax business. In 2002, both Johnson and Dixon began preparing false income tax returns at the business as well. In 2004, the business relocated to a commercial building in Rialto and Matthew Berry, along with his daughters Karen and Carla Berry, formed N.C.K. Services, Inc., to operate the tax business. The false returns Berry and the other defendants prepared for clients caused losses of more than \$45 million in tax revenue to the IRS.

Previously, Karen and Carla Berry pleaded guilty before trial to various charges including conspiracy to defraud the IRS, aiding and assisting in the preparation of false tax returns and subscribing to a false tax return. Additionally, Johnson and Dixon previously pleaded guilty to charges contained in the indictment. Both Karen and Carla Berry are scheduled to be sentenced on August 31, 2009. Johnson was previously sentenced to 35 months imprisonment, to be followed by three years of supervised release, and ordered to pay restitution to the IRS in the amount of \$19,034,901. Valerie Dixon was sentenced to five years' probation, including 10 months' home detention, and ordered to pay restitution to the IRS of \$19,034,901.

States Address the Issues, Too

California is one of only three states that have formalized plans regulating return preparers. As part of its effort to address the tax gap,¹² the California Franchise Tax Board (FTB) is working to make professional practitioner misconduct unprofitable by identifying problem practitioners, auditing the returns they prepare, and assessing penalties. FTB uses modeling techniques to spot return trends,

patterns in claimed credits and overstatement of deductions on Schedules A and C. Penalties are assessed as warranted. Other FTB initiatives to identify questionable tax return preparer practices include increasing staff to verify the refundable child and dependent care expenses credit to prevent and recover fraudulent claims; verifying withholding claims to prevent and recover fraudulent claims; and participating as a member of the Federation of Tax Administrator's (FTA) Suspicious Filer Group.

ENDNOTES

¹ IR-2009-57 (June 4, 2009).

² IRM 4.11.51.3 (Oct. 1, 2004).

³ IRM 20.1.6.1 Overview of the Return Preparer, Promoter, and Material Advisor Penalties (Feb. 8, 2008).

⁴ TIGTA Report: Inadequate Data on Paid Preparers Impedes Effective Oversight (Reference Number: 2009-40-098).

⁵ DOJ Press Release, Justice Department Highlights FY 2008 Tax Enforcement Results (Apr. 13, 2009), available at www.usdoj.gov/tax/txdv09336.htm.

tax/txdv09336.htm.

⁶ DOJ Press Release, *U.S. Asks Courts in California & South Carolina to Shut Down Promoters of Allegedly Fraudulent \$39.2 Million Tax Refund Scam*, (Mar. 5, 2009), available at <http://justice.gov/opa/pr/2009/March/09-tax-190.html>.

⁷ *Id.*

⁸ See www.usdoj.gov/tax/taxpress2009.htm.

⁹ DOJ Press Release, *Justice Department Seeks to Shut Down Sacramento Tax Preparation Firm* (Feb. 13, 2009), available at www.usdoj.gov/tax/txdv09124.htm.

Firm (Feb. 13, 2009), available at www.usdoj.gov/tax/txdv09124.htm.

¹⁰ *Id.*

¹¹ These cases and more can be found at the IRS Web site, www.irs.gov/compliance/enforcement/article/0,,id=187274,00.html.

¹² California Franchise Tax Board, Tax News for Tax Professionals, *What is FTB doing about questionable tax preparers?* available at www.ftb.ca.gov/professionals/taxnews/2007/0507/0507_2.shtml.

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