Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200542034**

Release Date: 10/21/2005
CC:PA:APJP:B02
POSTF-119683-05

UILC: 6695.01-00, 7701.18-00

date: July 14, 2005

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subject: Application of the preparer penalty under section 6695(d)

This Chief Counsel Advice responds to your request for assistance dated April 14, 2005. This advice may not be used or cited as precedent.

ISSUES

1) Whether the "income tax return preparer" for purposes of applying the penalty under section 6695(d) is an S corporation or the sole-shareholder/owner of the S corporation who signed most of the returns.
2) Whether the penalty under section 6695(d) can be assessed when the preparer failed to produce copies of returns prepared or list of clients served pursuant to a summons and also failed to comply fully with a court order resulting from a summons enforcement hearing, which required the preparer produce copies of the bills to clients.

CONCLUSIONS

1) The penalty under section 6695(d) should be assessed against the S corporation if the shareholder is an employee of the S corporation under common law rules.

If the shareholder is not an employee, the penalty should be assessed against the shareholder directly.

2) The Service can assess the penalty against the income tax return preparer under section 6695(d) when the preparer failed to comply with a summons or court order relating to the Service's request for returns or preparer's list retained under section 6107(b).

FACTS

A Subchapter S corporation (S Corporation) is in the business of tax return preparation. S corporation has one shareholder (Shareholder) and at least one employee, the niece of the shareholder (Niece). It is unclear whether others are employed by S Corporation, as well. The Service does not know all the details pertaining to the relationship between the Shareholder and S Corporation. Shareholder has not received wages from S Corporation. S Corporation did pay wages to Niece for the services she performed for the company.

Both Shareholder and Niece have signed returns as the preparer for S corporation. Shareholder has prepared the majority of the returns that S Corporation prepared for clients. Approximately one-half of the returns Shareholder signed included the name and EIN of S Corporation. Shareholder signed the other approximate half of the returns using only her name and social security number.

A revenue agent conducted an audit of S Corporation. The Service requested the list of returns, and/or copies of returns, required to be maintained pursuant to section § 6107(b) from Shareholder for the and taxable years. Shareholder did not cooperate and the Service summoned the returns. The Service commenced an action to enforce the summons. During the enforcement action, Shareholder stated that she could not retrieve and print the requested information from her computer and was concerned about the revenue agent having the social security numbers of her client base. Therefore, the Court ordered Shareholder to produce her bills to clients. Following the enforcement action, Shareholder produced these records pertaining to approximately 400 returns, which were incomplete in some respects. The Service's computer records indicate that Shareholder and S Corporation prepared approximately 1500 returns during the years at issue. Thus, the Service assessed the penalty under section 6695(d) for the remaining approximately 1100 returns against Shareholder and S Corporation separately.

LAW AND ANALYSIS

Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with section 6107(b) with respect to such return or claim shall pay a penalty of $50 for each such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. I.R.C. § 6695(d). The maximum

penalty imposed under this subsection on any person with respect to any return period shall not exceed $25,000. Id.

Section 6107(b) requires an income tax return preparer with respect to a return or claim for refund, for a period of three years after the close of the return period, to (1) retain a completed copy of the return or claim, or retain, on a list, the name and taxpayer identification number of the taxpayer for whom the return or claim was prepared; and (2) make the copy or list available for inspection upon request by the Service.

Issue 1: Whether S Corporation or Shareholder is the preparer subject to penalty

An income tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax imposed by subtitle A or any claim for refund of tax imposed by Subtitle A. I.R.C. § 7701(a)(36)(A); Treas. Reg. § 301.7701- 15(a). In addition, the regulations under section 6107 provide the general rule that, where there is an employment arrangement between two or more income tax return preparers, the person who employs (or engages) one or more other persons to prepare for compensation any return or claim for refund (other than for the person) shall be considered to be the sole income tax return preparer. Treas. Reg. § 1.6107-1(c).

In the instant case, S Corporation employed Niece (and possibly others) to prepare tax returns. Because S Corporation employs agents or employees to prepare income tax returns for compensation, S Corporation is an income tax return preparer with respect to those returns or claims for refund for purposes of sections 6107(b) and 6695(d).

Likewise, with respect to the returns Shareholder prepared, the issue of who is subject to the section 6695(d) penalty depends upon whether S Corporation employed Shareholder. Whether S Corporation employed Shareholder is determined under common law rules applicable in determining the employer-employee relationship. See Nu-Look Design, Inc. v. Commissioner, 356 F.3d 290 (3d Cir. 2004); American Consulting Corp. v. United States, 454 F.2d 473, 477 (3d Cir. 1971). Several factors used to determine the existence of the employer-employee relationship are (1) the right to control the details of the work; (2) furnishing of tools and the work place; (3) withholding of taxes, workmen's compensation and unemployment insurance funds; (4) right to discharge; and (5) permanency of the relationship. American Consulting Corp., 454 F.2d at 477; See Treas. Reg. § 31.3121(d)-1(c)(2). Although no one factor is controlling, the most important factors is the right to control. Id. Some cases have held that where a sole-shareholder of an S corporation is the “central worker” of the corporation and performs more than minor services for the corporation, the sole-shareholder should be treated as an employee. See, e.g., Nu-Look Design, Inc., 356 F.3d 290; Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).

If facts reveal that there was an employer-employee relationship between S Corporation and Shareholder for some or all of the returns Shareholder signed, then with respect to those returns, the penalty under section 6695(d) should only be asserted against S

Corporation. If facts show that there was no employer-employee relationship for some or all of the returns Shareholder signed, then with respect to those returns, the penalty under section 6695(d) should only be asserted against Shareholder as the actual preparer. If S Corporation did not employ Shareholder, then Shareholder should be considered the preparer because she prepared the returns for compensation.

You wondered if the fact that Shareholder signed the majority of the returns was a key factor here, especially as Shareholder signed half of the returns using only her own name and EIN. Because we don't believe this action bears on the test for determining whether Shareholder is an employee, we don't believe that this fact is key to determining the applicability of the section 6695(d) penalty. We also note that the individual who prepares a taxpayer's return is required to sign the return and provide his or her taxpayer identification number. I.R.C. §§ 6109(a)(4), 6695(b), (c); Treas. Reg. §§ 301.6109-2(a)(1), 1.6695-1(b)(1). Failure to do so may result in a penalty, absent reasonable cause. I.R.C. § 6695(b), (c). If there is an employment arrangement between two or more income tax return preparers, the identification number of the employer must also appear on the return or claim. I.R.C. § 6109(a)(4); Treas. Reg. § 301.6109-2(a)(1). Similarly, failure to provide the employer identification number may result in a penalty, absent reasonable cause. See I.R.C. § 6695(c). In this case it appears that the name and EIN of the S corporation did not appear on all of the returns prepared by the shareholder. As it is not clear whether or not the shareholder was an employee of the S corporation, we do not have sufficient facts to determine if the absence of the S corporation's identification was due to an error or because there was no employment arrangement between Shareholder and S Corporation. As stated above, the key test here for purposes of section 6695(d) is whether Shareholder was an employee of S Corporation.

Issue 2: Whether the section 6695(d) penalty can be assessed

In this case, pursuant to the Court's determination at the summons enforcement action, Shareholder produced "buck slips," or bills to the clients, for approximately 400 of the estimated 1500 returns at issue. The Service assessed a penalty under section 6695(d) for each failure to provide the information with respect to the remaining approximately 1100 returns. In a subsequent e-mail, you questioned whether the section 6695(d) penalty could be asserted here where the Court ordered the employee only to produce the "buck slips" or bills to the clients and did not order the preparer to produce copies of the returns. It is unclear from the facts provided exactly why the Court ordered the bills to be produced in lieu of other records required to be maintained and produced under section 6107(b). As it does not appear from the facts that a penalty was assessed for any instance where the bills to clients were produced, we do not need to address such a situation here.

In addition, keep in mind that if, as the case develops, Shareholder establishes enough facts to prove that the failure to provide the information with respect to the taxpayer was due to reasonable cause and not due to willful neglect, then the penalty will need to be

abated with respect to each instance for which she establishes reasonable cause. See I.R.C. 6695(d).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-4940 if you have any further questions.