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Income tax return preparers' penalties

CHARLES M. MORGAN III
Associate Chief Counsel (Technical)
Attention: Director, Individual Tax Division

By memorandum dated May 21, 1985, you requested our formal consideration of a proposed revenue ruling (Control No. 4B9904) and revenue procedure (Control No. 5B9932). The proposed ruling holds a return preparer liable under certain facts and circumstances for the section 6694(a) penalty where a return is prepared and filed claiming a deduction for a contribution to an Individual Retirement Account and the taxpayer fails to make the contribution by the due date of the return as required by the Code. The preparer would not be liable, however, if the preparer's office practice is to make follow-up inquiries reminding the taxpayer of his obligation to make the contribution on or before the due date of the return. If the preparer is unable to ascertain from the inquiry whether the requisite contribution was made, he must notify the IRS of the potential underpayment.

ISSUE

Whether a return preparer who prepares a return claiming a deduction for a contribution to an Individual Retirement Account knowing that the contribution has not yet been made is liable for the penalty under I.R.C. section 6694(a) for the negligent or intentional disregard of rules or regulations where he does not take follow-up action to ascertain whether the contribution was made by the due date of the return.

CONCLUSION

The penalties under I.R.C. section 6694 are directed at the preparer's conduct with respect to the preparation of returns. The Code allows a taxpayer to claim a deduction for an IRA contribution even though the contribution has not yet been made when the return is filed. Hence, a return that claims this deduction is in compliance with the Code and is properly prepared. A return preparer would not be liable for the section 6694(a) penalty where the taxpayer fails to make the contribution by the due date of the return.

DISCUSSION

The definition of a return preparer under I.R.C. section 7701 (a)(36) is any person who prepares for compensation a return of tax or a claim for refund under subtitle A. Section 6694(a) provides a penalty of $100 against a return preparer if any part of an understatement of liability is due to the negligent or intentional disregard of rules or regulations. Treas. Reg. section 1.6694-1(a)(1) further provides that a preparer is not considered to have negligently or intentionally disregarded a rule or regulation if the preparer exercises due diligence in an effort to apply the rules and regulations to the information given to the preparer to determine the taxpayer's correct liability for tax. Treas. Reg. section 1.6694-1(a)(4) sets forth the "good faith" defense to the section 6694(a) penalty and provides that the preparation of a return in conflict with a revenue ruling is not a negligent or intentional disregard of the ruling if the preparer reasonably takes a position of good faith that the ruling does not accurately reflect the Code. Finally, Treas. Reg. section 1.6694-1(a)(5) provides that if the preparer presents evidence that the normal practice of the

preparer concerning the treatment of a particular credit, allowance, deduction, or item of income was not negligent and that this normal office practice was followed the preparer has satisfied his burden that he did negligently disregard a rule or regulation.

The aforementioned regulations clearly indicate that the only conduct of the return preparer regulated by section 6694(a) is conduct associated with the preparation of the return. If the preparer properly applies the rules and regulations to determine the taxpayer's correct liability, he is not negligent under section 6694(a). Once the return is properly prepared and submitted to the taxpayer, the preparer's statutory obligations cease. (Except for the preparer's obligation under section 6107 to retain the returns or a list of taxpayers for whom he prepared returns and make them available for inspection upon request.) At that point, the taxpayer assumes control over the return.

The Code allows a taxpayer to claim a deduction for an IRA contribution even though the contribution has not yet been made when the return is filed. Hence, a return claiming a deduction for an unfunded IRA contribution is correctly prepared and the preparer has not disregarded any rule or regulation. If any understatement is subsequently determined, it would not be due to the negligent preparation of the return but rather to the taxpayer's failure to make the contribution as required by the Code. The proposed revenue ruling, however, would impose an additional duty on the preparer to make follow-up inquiries to assure the taxpayer has performed his duty of making a timely IRA contribution. Such follow-up inquiries do not involve return preparation activities nor is there any rule or regulation which requires the return preparer to perform these inquiries.

We recognize that the regulations under section 6694 provide that in preparing a return, the preparer may not ignore the implications of information furnished. The fact that a taxpayer wants to claim a deduction for an IRA contribution which he intends to make should not *per se* give rise to any suspicion by the return preparer that the tax laws may be violated. The Code entitles the taxpayer to claim such deduction and thus, there is simply no factual basis to suspect that the taxpayer will not make the contribution on or before the due date of the return. We therefore believe that the preparer has not ignored the implications of any information furnished him and would not be liable under section 6694.

In *Pickering v. United States*, 691 F.2d 853 (8th Cir. 1982), the Eighth Circuit upheld the assertion of section 6694(b) penalties against a return preparer who had prepared corporate returns that contained deductions for a number of personal expenses of the company's shareholders. A bookkeeper had testified in *Pickering* that she had asked the preparer "what (the) IRS was going to say about some of our personal expenses if they ever come to audit." While the court noted that the preparer had the right to rely on the information furnished by the taxpayer, it held that the bookkeeper's statement called for further investigation and inquiry and that the preparer's failure to do so constituted willfulness. In the proposed ruling, the mere fact that the IRA contribution has not yet been made when the return is prepared does not impose a duty on the preparer to make further inquiries as in *Pickering* because the existence of this fact in no way alters the taxpayer's right to claim the deduction.

Rev. Rul. 84-18, 1984-1 C.B. 88 which holds a taxpayer liable for negligence under section 6653(a) if he fails to make an IRA contribution on or before the due date of the return provides no basis for asserting the section 6694(a) penalty against the preparer. The taxpayer is under a statutory obligation to make a timely contribution when a deduction for such contribution is claimed on his return and his failure to do so constitutes negligent conduct subject to the penalty

under section 6653(a). However, the taxpayer's negligence cannot be imputed to the return preparer because the obligations of each are not the same. While the taxpayer is required to make a timely IRA contribution, the return preparer is only required to prepare the taxpayer's return in accordance with the requirements of the Code.

The legislative history of section 6694(a) does not suggest that the preparer penalty should apply because the taxpayer is negligent under section 6653(a). While the standards for determining negligence under both sections were intended by Congress to be similar, it is still necessary to show that the preparer committed negligent acts. Here, the negligent act which occurred after the filing of the return was the taxpayer's failure to make a timely IRA contribution. The return preparer did not commit any negligent act because the return was prepared in compliance with the Code and there was no indication that the taxpayer would not make the IRA contribution as he was required to do.

If the position in the proposed ruling is adopted, the section 6694(a) penalty could also be applied in other analogous situations where the return is properly prepared but the taxpayer is required to take some subsequent action to validate the claim in the return as, for example, in the case of the sale of a personal residence. While the taxpayer is required to file Form 2119 and notify the Service as to whether or not a replacement residence has been purchased, we feel the fact that the Service receives adequate notice of a potential liability is simply not relevant to determining if an understatement on a return is due to the preparer's negligent conduct. In both cases, the taxpayer is required to perform some act subsequent to the filing of a return in order to prevent an understatement. The issue in both cases is also the same: Where the taxpayer fails to perform the necessary act, should the return preparer be liable under section 6694(a) for his failure to take follow-up action? There is no legal basis for asserting the section 6694(a) penalty on the ground that the Service did not receive adequate notice of a potential liability. The problem of adequate notice can be easily resolved by asking the taxpayer on the Form 1040 whether the IRA contribution has already been made.

In conclusion, we believe the proposed revenue ruling and revenue procedure do not comport with either the statute or the regulations and thus, should not be published.

Eliot D. Fielding
Chief, Branch 2
General Litigation Division