

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: June 02, 2005

to: Senior Counsel (Salt Lake City)
Small Business/Self-Employed
CC:SB:5:SLC

from: Chief, Branch 2
(Administrative Provisions & Judicial Practice)
CC:PA:APJP:B02

subject: Composite Returns and Section 6702

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

ISSUES

1. Whether an "Affidavit of Composite Return" ("composite return") qualifies as a frivolous income tax return subject to penalty under section 6702?
2. Whether, based on the filing of a composite return, the IRS should assess the frivolous income tax return penalty under section 6702 against the taxpayer, income tax return preparer, or both?
3. Whether a composite return satisfies the requirements for a valid return?
4. What procedures should the IRS follow when receiving a composite return?
5. Would the IRS have enough facts to justify referring an income tax return preparer who prepares a composite return for a civil injunction investigation?

CONCLUSION

1. We agree with your conclusion that a composite return qualifies as a frivolous income tax return subjecting the individual who files the purported return to penalty under section 6702.
2. The IRS should only assess the frivolous income tax return penalty under section 6702 against the taxpayer where the taxpayer's signature appears in the composite return package or where there is other evidence that the return preparer is acting as the representative or agent of the taxpayer in preparing the composite return. The IRS could likely assess either a penalty under section 6694 or section 6701 against the return preparer when assessing the section 6702 penalty against the taxpayer. The IRS, on the other hand, should assess the penalty under section 6702 against only the return preparer where the taxpayer's signature does not appear in the composite return package and where there is no other evidence that the return preparer is acting as the agent of the taxpayer in preparing the composite return.
3. We agree with your conclusion that a composite return submitted to the IRS fails to satisfy the requirements for a valid return.
4. We agree with your conclusion on this issue.
5. We agree with your conclusion that there are enough facts to justify referring the income tax return preparer for a civil injunction investigation.

FACTS

The facts as described in your February 8, 2005 memorandum indicate that the Frivolous Return Program in Ogden has started to receive packages submitted by taxpayers entitled "Affidavit of Composite Return." These packages contain numerous documents claiming that they qualify as "substitute and amended composite returns" and usually include the name, addresses, and taxpayer identification numbers of both the taxpayers and the return preparers/attorney-in-fact. They, however, show only the return preparer's address as the alleged taxpayer address for the return. The composite returns do not include information on filing status and dependents, but do contain some information which the IRS could use to calculate a tax liability. The return preparer relies on the language of the various documents and Circular 230 to assert that the return preparer is a fiduciary and that the fiduciary is actually considered to be the taxpayer.

The composite returns may contain a signature by the taxpayer on a Form 2848, Power of Attorney and Declaration of Representative, which authorizes the preparer of the composite return to represent the taxpayer. A signature of the taxpayer may also appear on another document in the composite return which purports to give the return

preparer an assignment of the tax claims and an authorization to act as the taxpayer's counsel, attorney-in-fact and personal representative with the government.

The composite return indicates it supersedes any previously filed Form 1040 and certain documents in the composite return contain a variety of arguments to support the asserted position of no taxable income. All of the arguments end up with the conclusion that the taxpayer gets a deduction equal to the amount of wages; thus, there is no taxable income.

LAW AND ANALYSIS

1. Frivolous Return Under Section 6702

We agree with your analysis of this issue.

2. Assessment of Section 6702 Penalty Against Taxpayer and/or Return Preparer

A. Assessment of Section 6702 Penalty against Taxpayer

The question presented here is who the IRS should assess the frivolous income tax return penalty under section 6702. Section 6702 provides for the assessment of a \$500 penalty against "any individual [who] files what purports to be a return but which does not contain information on which the substantial correctness of the self-assessment may be judged, or contains information that on its face indicates that the self-assessment is substantially incorrect. . . ." The section 6702 penalty should be assessed, therefore, against the individual who filed the composite return.

As a general rule, we believe that the individual subject to a section 6702 penalty is the taxpayer whose purported tax liability the purported return reflects. The statutory language of section 6702 specifically refers to the individual's "self-assessment." This "self-assessment" language indicates that Congress intended the assessment of the frivolous return penalty against the taxpayer that has incorrectly and frivolously self-assessed his or her own tax liability; thus, the taxpayer identified on the purported return is generally the individual subject to a section 6702 penalty.

The legislative history to section 6702 also supports the assessment of the section 6702 penalty against the taxpayer rather than the return preparer in most instances. Congress enacted section 6702 through section 326(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 326(a), 96 Stat. 324 (1982), in response to "the rapid growth in deliberate defiance of the tax laws by tax protestors." S. Rep. No. 97-494, at 277 (1982). The legislative history further states, "[m]any of these protestors are induced to file protest returns through the criminal conduct of others. These advisors frequently emphasize the lack of any penalty when sufficient tax has been withheld from wages and encourage others to play the 'audit lottery.'" Id. It

was anticipated, therefore, that the section 6702 penalty would act as a deterrence to the filing of frivolous returns by individual taxpayers who are persuaded to do so by other persons.

Many of the composite returns contain the signature of the taxpayer on a Form 2848 or other document within the composite return. The taxpayer by signing the Form 2848 or other document is specifically providing that the return preparer is the taxpayer's representative with respect to the composite return and authorizing the preparation of the frivolous return by the return preparer. Thus, where the taxpayer has authorized the return preparer to prepare the composite return on the taxpayer's behalf as his or her agent, the IRS should assess the section 6702 penalty against the taxpayer in accord with the language of the statute and legislative history.

Where the taxpayer did not sign any documents included in the composite return but there is other evidence that the return preparer is acting as the agent of the taxpayer in preparing the composite return, the section 6702 penalty should still be assessed against the taxpayer only and not the return preparer. The return preparer is still acting as the taxpayer's agent and the taxpayer is the individual that filed the composite return. Examples of evidence that the return preparer is acting as the agent of the taxpayer would be the inclusion of a taxpayer's private tax identification number in the composite return as well as the failure by the taxpayer to respond to a soft letter issued by the IRS.

Based on the foregoing, we conclude that the taxpayer is the individual filing the return and the IRS should assess the penalty under section 6702 against only the taxpayer when the taxpayer's name is signed on the documents filed with the IRS or where there is other evidence that the return preparer is acting as the agent of the taxpayer in preparing the composite return.

B. Assessment of Penalties Against Return Preparer

Where the IRS assesses the section 6702 penalty against the taxpayer under the above circumstances, the IRS could also assess a penalty against the return preparer under either section 6694 or section 6701.

Section 6694(a) provides if any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits, any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and such position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous, such person shall pay a penalty of \$250 with respect to such return or claim. I.R.C. § 6694(a). A return preparer who prepared a frivolous composite return is clearly acting unrealistically under the above standard and the \$250 penalty under section 6694(a) could be assessed against the preparer.

Section 6694(b) provides if any part of any understatement of liability with respect to any return or claim for refund is due to a willful attempt in any manner to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of \$1,000 with respect to such return or claim. I.R.C. § 6694(b). A preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation (as defined in paragraph (f) of this section) and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. Treas. Reg. § 1.6694-3(c). A section 6694(b) penalty, therefore, could be assessed against the return preparer if the IRS identifies a particular rule or regulation that the return preparer disregarded in preparing the composite returns. The amount of any penalty to which a return preparer may be subject under Section 6694(b) is reduced, however, by any amount assessed and collected against the return preparer under Section 6694(a) for the same return or claim. I.R.C. § 6694(b).

Section 6701 imposes a penalty upon any person who aids, procures, assists, or advises with respect to any portion of a return, claim or other document, knows or has reason to know that such portion will be used in connection with a material matter under the internal revenue laws, and knows that such portion if used, would result in the understatement of tax for another person. I.R.C. § 6701(a). In general, the amount of the penalty is \$1,000 for any tax period (or taxable event if there is no tax period). See I.R.C. § 6701(b)(1) and (3). Before the IRS can assess the section 6701 penalty for aiding and abetting, the IRS must be able to establish that the person against whom the penalty is proposed meets all three criteria set forth in section 6701(a). See Mitchell v. United States, 977 F.2d 1318, 1321-22 (9th Cir. 1992). It appears that all three criteria are met with return preparers who file composite returns; thus, the IRS could assess the \$1,000 penalty under section 6701 against them. It should be noted that the IRS may only assess a penalty on a person under either subsection (a) or (b) of section 6694 or under 6701(a), but not both. I.R.C. § 6701(f)(2).

The IRS, on the other hand, should assess the penalty under section 6702 against the return preparer only where the taxpayer's signature does not appear in the package and where there is no evidence that the return preparer is acting as the agent of the taxpayer in preparing the composite return. Assessing the frivolous return penalty against the taxpayer in those situations would be inappropriate because the taxpayer did not file the return in any sense. The return preparer acts on his or her own behalf in such circumstances and is the individual that files the composite return.

3. Composite Return as Valid Return

We agree with your analysis providing that the composite returns submitted to the IRS fail to satisfy the requirements for a valid return, but we note that the term "processable form" is a term of art that is defined in section 6611(g). Thus, we believe the use of the terms "processable" and "processing" in the issue statements and conclusions on pages

1 and 2 of your memorandum may be confusing because you are not concerned with the issue of interest on overpayments in your memorandum. We recommend that the language of the issue statements and conclusions be revised to track the language of the headings on page 9 of your memorandum.

4. Procedures for Composite Returns

We agree with your analysis of this issue.

5. Civil Injunction

We agree with your analysis of this issue.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any questions, please contact this office at (202) 622-4940.