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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR CANDICE V. CROMLING
EARNED INCOME CREDIT PROGRAM MANAGER

FROM: Lewis J. Fernandez
Deputy Assistant Chief Counsel (Income Tax & Accounting)
CC:DOM:IT&A

SUBJECT: Preparers' Due Diligence Requirements

This is in response to your request for advice dated March 3, 2000. You asked us to answer several questions regarding a Service employee obtaining documents from a return preparer during an earned income credit (EIC) due diligence audits. We have coordinated our answers with the General Litigation Division and the Disclosure Division of Chief Counsel.

Issues

1. Whether a Service employee conducting an EIC due diligence audit on a return preparer is required to provide the return preparer with a summons for any information required to conduct the audit.
2. May a return preparer rely on the tax advice privilege under § 7525 of the Code in refusing to provide information required to conduct an EIC due diligence audit?
3. How should a return preparer treat conflicting information received from two taxpayers with regard to filing returns or claims for refund claiming the EIC?

Conclusions

1. A Service employee conducting an EIC due diligence audit does not have to provide a summons to a return preparer to examine the preparer's books, papers, records, or other data which may be relevant or material to the inquiry of the return preparer's potential liability for a preparer due diligence

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penalty under § 6695(g) of the Code. See § 7602(a)(1).

2. A return preparer cannot rely on the tax advice privilege under § 7525 of the Code for purposes of refusing to provide information requested by a Service employee during an EIC due diligence audit.
3. A return preparer is subject to the penalty under § 6695(g) of the Code if the preparer has knowledge, or reason to know, that any information used by the return preparer in determining eligibility for, and the amount of, the EIC is incorrect. Thus, a return preparer should not prepare a return or claim for refund claiming the EIC that the preparer knows or has reason to know is based on incorrect information.

Analysis

Issue 1

Section 6695(g) of the Code provides that any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Service by regulations with respect to determining eligibility for, or the amount of, the credit allowable by § 32 (earned income credit) will pay a penalty of \$100 for each failure.

Section 1.6695-2T of the Temporary Regulations requires preparers of returns or claims for refunds claiming the EIC to: (1) complete the Eligibility Checklist (Form 8867, Paid Preparer's Earned Income Credit Checklist, or such other form as may be prescribed by the Service, or otherwise record in the preparer's files the information necessary to complete the Eligibility Checklist; (2) complete the computation Worksheet (Earned Income Credit Worksheet contained in the Form 1040 instructions, or such other form as may be prescribed by the Service), or otherwise record in the preparer's files the computation and information necessary to complete the Computation Worksheet; (3) have no knowledge, and have no reason to know, that any information used by the preparer in determining eligibility for, and the amount of, the EIC is incorrect; and (4) retain the taxpayer's signature, the Eligibility Checklist and the Computation Worksheet (or alternative records), and a record of how and when the information used to determine eligibility for, and the amount of, the EIC was obtained by the preparer.

Additionally, § 1.6695-2T(c) of the regulations provides that a return preparer can avoid the penalty under § 6695(g) of the Code if the return preparer can demonstrate to the satisfaction of the Service, that, considering all the facts and circumstances, the preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements,

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and the failure to meet the due diligence requirements with respect to the particular return or claim for refund was isolated and inadvertent.

Section 7216(a) of the Code provides that any income tax return preparer who knowingly or recklessly discloses any information furnished to him for, or in connection with, the preparation of any such return, or uses any such information for any purpose other than to prepare, or assist in preparing, any such return, is guilty of a misdemeanor, and, upon conviction thereof, will be fined not more than \$1000 penalty and/or imprisonment for not more than 1 year.

Section 7216(b)(1)(A) of the Code provides that the restrictions on disclosure contained in § 7216(a) do not apply if such disclosure is pursuant to any other provision of the Internal Revenue Code. Section 7216(b)(3) further provides that the restrictions on disclosure contained in § 7216(a) do not apply if such disclosure or use of information is pursuant to a regulation under this section. The implementing regulations indicate that § 7216(a) does not apply to the disclosure of return information provided such disclosure is pursuant to any other provision of the Code or regulations thereunder. See § 301.7216-2(a) of the regulations. Additionally, § 301.7216-2(b) provides that a return preparer may use tax return information obtained from one taxpayer in the preparation of another taxpayer's return if the taxpayers are related, the taxpayers' interests are not adverse, and the taxpayer who provided the information has not prohibited disclosure of the information.

Under § 6695(g) of the Code and § 1.6695-2T of the regulations, an income tax return preparer has an affirmative duty to retain certain required records and to demonstrate that the due diligence requirements are routinely followed. Also pursuant to those section, an income tax return preparer is liable for a \$100.00 penalty for each failure to comply with the due diligence requirements with respect to determining eligibility for, or the amount of, the earned income credit allowable under § 32.

Under § 7602(a)(1) of the Code, the Service is authorized to examine any books, papers, records, or other data which may be relevant to certain specifically identified purposes. One such purpose is that of "determining the liability of any person for any internal revenue tax." The revenue agent's investigation of the return preparer for potential liability under § 6695(g) falls squarely within this purpose. Consequently, the revenue agent is authorized under § 7602(a)(1) to examine the records that § 6695(g) requires the preparer to retain. It is not necessary for the revenue agent to first issue a summons before examining these records. The Service's authority to examine books, papers, records, or other data exists separately from the Service's authority to summon such records under § 7602(a)(2). In fact, it is the Service's policy that information such as that sought by the revenue agent should be obtained informally, without serving a summons.

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See IRM Summons Handbook 109.1, Chapter 1.4(1). Thereafter, if the records are not produced voluntarily, the Service can compel compliance by summoning the records and, if needed, the preparer's testimony.

Furthermore, § 7216(b)(1)(A) of the Code and § 301.7216-2(a) of the regulations provide that the restrictions on disclosure do not apply to the disclosure of return information provided such disclosure is pursuant to any other provision of the Code or regulations thereunder. Accordingly, when a return preparer complies with the requirements of § 1.6695-2T, the return preparer does not violate the disclosure restrictions in § 7216 by virtue of providing information to the Service without a summons during the EIC due diligence audit.



Issue 2

Section 7525 of the Code provides that with respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney will also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

Analysis of this issue requires the Service to first determine whether the individual return preparer in question is a federally authorized tax practitioner under § 7525(a)(3)(A), which defines the concept as individuals authorized under federal law to practice before the Service if such practice is subject to federal regulation under Title 31 U.S.C. § 330. Assuming the individual qualifies as a federally authorized tax practitioner, then the pertinent issue is whether the communications between the return preparer and the taxpayer would be privileged if they had occurred between an attorney and a taxpayer. We note that the attorney-client privilege does not apply to communications made to prepare a return or a refund claim because such services are accounting services, not legal services. United

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States v. Frederick, 182 F.3d 496 (7th Cir. 1999) and United States v. Davis, 636 F.2d 1028 (5th Cir. 1981). We perceive little distinction between the information required by a § 6695 due diligence inquiry and any other information solicited by a preparer to properly prepare a return. Accordingly, by analogy to Frederick and Davis, we conclude that the privilege under § 7525 does not apply to the communications between a preparer and a taxpayer required by § 6695.

Issue 3

To avoid the due diligence penalty under § 6695(g) of the Code, the return preparer must have no knowledge, or reason to know, that any information used by the preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect. The preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete. See § 1.6695-2T(b)(3) of the regulations. Thus, if the return preparer receives conflicting information from two different taxpayers, the return preparer has an affirmative duty to request verification from both taxpayers to determine which information is correct and only file a return with the information the return preparer does not know or have reason to know is incorrect. The return preparer will be subject to the penalty under § 6695(g) if the preparer files a return or claim for refund claiming EIC based on information the return preparer knows or should know is incorrect.

In addition, under § 301.7216-2(b) of the regulations, a return preparer may not disclose information obtained from one taxpayer to another taxpayer or use information obtained from one taxpayer on another taxpayer's return, unless the taxpayers are related, the taxpayers' interest in the information is not adverse to one another, and disclosure is not prohibited by the taxpayer. If related taxpayers provide conflicting information to a return preparer, the taxpayers' interest in the information may be adverse to one another. If this is the case for information relating to a return or claim for refund claiming the EIC, the return preparer may not disclose the conflicting information or use the information provided by one taxpayer on the return of the other taxpayer.

If you have any questions or concerns regarding this response, please contact Brad Taylor at (202) 622-4940.

cc: National Director,