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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE SIGNIFICANT
SERVICE CENTER ADVICE

MEMORANDUM FOR KENTUCKY-TENNESSEE ASSOCIATE DISTRICT
COUNSEL CC:SER:KYT:LOU
ATTN: PAUL J. KRAZEISE, JR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Innocent Spouse and Earned Income Credit

This Significant Service Center Advice responds to your memorandum dated July 27, 1999. Significant Service Center Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUES

- (1) Whether a tax liability arising from the disallowance of the earned income credit is subject to innocent spouse relief under I.R.C. § 6015(b).
- (2) Whether a requesting spouse who qualified for innocent spouse relief with respect to unreported income is also entitled to a restoration of the earned income credit that was disallowed because the adjustment to the joint return for unreported income caused total income to exceed the maximum amount for which an earned income credit may be claimed.

CONCLUSIONS

- (1) If an understatement of tax is due to the disallowance of an erroneous claim for earned income credit, a taxpayer is entitled under § 6015(b) to innocent spouse relief from the liability attributable to the disallowance if the understatement is not attributable to the taxpayer and the taxpayer satisfies all the conditions for § 6015(b) relief.

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(2) Where a requesting spouse qualifies for relief from liability under § 6015(b) with respect to a tax liability attributable to the disallowance of a claim for the earned income credit due to the unreported income of the other spouse, the requesting innocent spouse is not entitled to the earned income credit if the omitted income caused the joint modified adjusted gross income to trigger a complete phase out of the earned income credit.

FACTS

Taxpayers, who are married, claimed the earned income credit on their joint return. However, the joint return did not reflect all of the income of the husband. After adjusting the joint return for the omitted income of the husband, the Service determined that Taxpayer's modified adjusted gross income exceeded the maximum for claiming the earned income credit.

The wife claimed to be an innocent spouse under § 6015(b) with respect to the omitted income, and Examination agreed. As a result, the tax, penalty, and interest were abated as to her with respect to those items.

The wife now claims that because the husband is solely liable for the additional tax liability due to the omission of income, the previously disallowed earned income credit should be allowed or restored with respect to the tax liability for which she is jointly liable. You seek our views regarding whether the earned income credit is subject to innocent spouse relief under § 6015(b). Further, you seek our views regarding whether an innocent spouse under § 6015(b) is entitled to a restoration of the earned income credit previously disallowed because the adjustment on the joint tax return for understated income caused modified adjusted gross income to exceed the maximum amount for which an earned income credit may be claimed.

LAW AND ANALYSIS

Section 6015(b) provides for relief from joint liability for an electing spouse who filed a joint return, if certain conditions are met. The provisions of § 6015(b) apply to any tax liability arising after July 22, 1998, and any tax liability arising on or before July 22, 1998, remaining unpaid as of that date. The relief provided under § 6015(b) applies to all understatements of tax attributable to the erroneous items of the other (nonelecting) spouse.

For purposes of § 6015(b) the term "understatement" has the same meaning given such term by § 6662(d)(2)(A). Section 6662(d)(2)(A) provides that the term "understatement" means the excess of (i) the amount of the tax required to be shown on the return for the taxable year, over (ii) the amount of the tax imposed which is shown on the return, reduced by any rebate within the meaning of § 6211(b)(2).

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In determining an understatement under § 6662(d)(2)(A), Treas. Reg. § 1.6662-4(b)(2) provides that the amount of the tax required to be shown on the return for the taxable year has the same meaning as the “amount of income tax imposed” as defined in Treas. Reg. § 1.6664-2(b). Further, with certain exceptions not relevant in this matter, Treas. Reg. § 1.6662-4(b)(3) provides that the amount of the tax imposed which is shown on the return for the taxable year has the same meaning as the “amount shown as the tax by the taxpayer on this return,” as defined in Treas. Reg. § 1.6664-2(c).

Treas. Reg. § 1.6664-2(b) states that the “amount of income tax imposed” means the amount of tax imposed on the taxpayer for the taxable year, determined without regard to (1) the credits for tax withheld under § 31 (relating to tax withheld on wages) and § 33 (relating to tax withheld at source on nonresident aliens and foreign corporations; (2) payments of tax or estimated tax by the taxpayer ; (3) any credit resulting from the collection of amounts assessed under § 6851 as the result of a termination assessment, or § 6861 as the result of a jeopardy assessment, and (4) any tax that the taxpayer is not required to assess on the return (such as the tax imposed by § 531 on the accumulated taxable income of a corporation).

Treas. Reg. § 1.6664-2(c) provides that the “amount shown as the tax by the taxpayer on his return” is the tax liability shown by the taxpayer on his return, determined without regard to items (1) through (3) listed in the preceding paragraph. In addition, the amount shown as the tax by taxpayer on his return includes an amount shown as additional tax on a qualified amended return. Treas. Reg. § 1.6664-2(c).

In general, it can be concluded from an examination of § 6662(d)(2)(A) and the regulations under §§ 6662 and 6664 that an understatement is the amount by which the amount of income tax imposed exceeds the amount shown as the tax by the taxpayer on his return, plus or minus other adjustments not relevant in this case. Further, it can be concluded that the regulations make clear that the credits under §§ 31 and 33 as well as other items are excluded from the determination of the amount of income tax imposed and are excluded, in general, from the amount shown as the tax by the taxpayer on his return. However, the regulations do not exclude § 32 earned income credit in determining such amounts. Thus, the regulations implicitly suggest that for purposes of determining an understatement the earned income credit is to be considered in the computation of the amount of income tax imposed and the amount shown as the tax by the taxpayer on his return.

The § 32 earned income credit shown on a return should be considered in determining the amount shown as the tax by the taxpayer on his return. If the earned income credit exceeds the tax shown, without regard to such credit, the tax shown on the return for purposes of determining an understatement is a negative

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amount. Therefore, if the amount shown as the tax by the taxpayer on his return, including earned income credit, is less than the correct amount of tax, there exists an understatement for purposes of relief under § 6015(b).

The position that the earned income credit shown on the return should be considered in determining the tax understatement is also supported by § 6211, which defines deficiency. Specifically, § 6211(b)(4) provides that for purposes of determining a deficiency, any excess of the sum of the gasoline and special fuel tax credit and the earned income credit over the correct tax (without taking into account those credits) and any excess of the sum of such credits as shown by the taxpayer on his return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits), shall be taken into account as negative amounts of tax. As a result, the Tax Court deficiency procedures apply to credits allowable under §§ 32 and 34, notwithstanding that the credits reduce the net tax to less than zero. H. Rep No. 795, 100th Cong., 2d Sess. 366 (1988).

Because, as noted, a disallowed earned income credit can give rise to a tax understatement, where a tax understatement is due to the disallowance of an erroneous claim for earned income credit, a taxpayer would be entitled to § 6015(b) relief if the substantial understatement is not attributable to the taxpayer and the taxpayer met all the conditions for relief under § 6015(b). Thus, for example, where both spouses have earned income, the tax understatement resulting from the disallowance of earned income credit would be attributable to both parties, and therefore, relief under § 6015(b) would not be available. Further, §§ 6015(b) might not be available where the innocent spouse claimant knew or had reason to know of the tax understatement or significantly benefitted from the tax understatement.

The earned income credit is a refundable tax credit for eligible low-income workers, I.R.C. § 32. The credit is based on “earned income,” which includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment. I.R.C. § 32(a). Married persons must file a joint return in order to claim the credit. I.R.C. § 32(d).

The earned income credit phases out for taxpayers whose modified adjusted gross income or earned income exceeds a specified phaseout amount. The number of qualifying children, the phaseout percentage, earned income, and modified adjusted gross income dictate the level at which the earned income credit is phased out completely. I.R.C. § 32(b). Further, the earned income credit is not available to individuals with disqualified income (investment income) that exceeds a certain amount. I.R.C. § 32(i).

Where a requesting spouse qualifies for relief from liability under § 6015(b) with respect to a tax liability attributable to a disallowance of a claim for earned income

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credit due to the unreported income of the other spouse, the requesting spouse is not entitled to the earned income credit if the omitted income caused the joint adjusted modified gross income to trigger a complete phase out of the earned income credit. This is because, based on the actual joint income of the married couple, they are not entitled to the earned income credit.

If you have further questions, please call Willie E. Armstrong, Jr., at (202) 622-7920.

By: _____
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