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MEMORANDUM FOR: SUE SOTTILE
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SUBJECT: Changes to Due Diligence Requirements of I.R.C.
§ 32(c)(1)(C)(i) as Amended by the Economic Growth and
Taxpayer Relief Reconciliation Act of 2001 (EGTRRA)

This memorandum addresses your request for guidance dated April 17, 2002, and received in our office on May 20, 2002.

ISSUES

1. If a paid preparer is told that no one other than the taxpayer is claiming a qualifying child for Earned Income Credit (EIC) purposes, does that satisfy the due diligence requirements of I.R.C. § 6695(g)?
2. If two taxpayers wish to claim the EIC for the same qualifying child, is the paid preparer responsible for applying the tie-breaker rules before the return is filed?

CONCLUSION

1. A paid preparer satisfies the due diligence requirements of I.R.C. § 6695(g) and the implementing regulations if that preparer relies upon information the taxpayer provides and neither knows, nor has reason to know, that the information is incorrect or incomplete. The preparer must make reasonable inquiries if the information furnished to the preparer appears to be incorrect, inconsistent, or incomplete.
2. A paid preparer is responsible for applying the tie-breaker rules. Whenever the preparer knows, or has reason to know, that more than one taxpayer is seeking

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to claim the EIC for the same child, the preparer will be subject to a penalty for violating the due diligence requirements of section 6695(g) and the implementing regulations if the preparer prepares a return for a taxpayer other than the taxpayer entitled to the EIC under the tie-breaker rules.

BACKGROUND

Section 6695(g) was added by section 1085(a)(2) of the Taxpayer Relief Act of 1997. Pub. L. 105-34, 11 Stat. 788, 955 (1997). Section 6695(g) imposes a \$100 penalty for each failure by an income tax return preparer to meet the due diligence requirements set forth in regulations prescribed by the Secretary.

Treasury Regulation § 1.6695-2(b) provides that the return preparer must satisfy the following due diligence requirements to avoid the penalty under I.R.C. § 6695(g): (1) complete Form 8867, "Paid Preparer's Earned Income Credit Checklist" or other alternative eligibility record; (2) compute the credit on appropriate worksheets or otherwise record computation of the credit; (3) have no knowledge, or reason to know, of an incorrect credit claim; and (4) retain records for three years, including a record of the person furnishing information on which the claim was based. The Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (2001), made several changes affecting EIC, including changes to rules regarding who may claim a qualifying child for EIC purposes, that will take effect for tax years beginning after December 31, 2001. Because of these changes, Form 8867 will need to be revised to assist in determining a taxpayer's eligibility to claim the EIC.

DISCUSSION

Reliance on Taxpayer Statements

The due diligence requirements of I.R.C. § 6695(g) and the implementing regulations require the return preparer to complete an eligibility checklist (Form 8867) and to compute the credit on the basis of information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer. Treas. Reg. § 1.6695-2(b)(1)(ii) and (b)(2)(ii). Thus, the regulations contemplate that return preparers will rely, and are entitled to rely, on information that taxpayers provide them. Although Form 8867 has not yet been revised, we believe that the form should direct return preparers to determine whether any other taxpayer for whom the child is a qualifying child is actually claiming the child for EIC purposes. In conformity with the section 6695(g) regulations, we believe that return preparers may rely upon statements of taxpayers in making that determination, so long as the return preparer does not know or have reason to know that the statement is incorrect, inconsistent or incomplete.

If the return preparer has knowledge, or reason to know, that a statement is incorrect or incomplete, then due diligence will not be satisfied. Treasury Regulation § 1.6695-2(b)(3) provides "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." Therefore, if a taxpayer provides a return preparer with information that appears to be incorrect, inconsistent, or incomplete with respect to whether another person was claiming the child, the return preparer would have to make reasonable inquiries to clarify the matter before preparing a return claiming the EIC. If the return preparer does not clarify the information or decline to prepare the return if the information cannot be clarified, then the preparer would be subject to a penalty for relying on the information.

Note that, in situations where a preparer knows that a taxpayer's EIC claim is inconsistent with another taxpayer's claim of the same qualifying child, the preparer may not make inquiries that reveal the fact that another taxpayer has claimed the child. Section 7216 imposes restrictions on the disclosure of information provided in connection with the preparation of income tax returns. The implementing regulations for section 7216(a) provide that a return preparer may use tax return information obtained from the one taxpayer in the preparation of another taxpayer's return only in limited circumstances. If the first taxpayer is related to the other taxpayer, the first taxpayer's tax interest is not adverse to the second taxpayer's tax interest in the information, and the first taxpayer has not prohibited such disclosure, the regulations allow disclosure. Treas. Reg. § 301.7216-2(b). Because the competing claims to the same qualifying child are adverse, this exception would not allow a preparer to make a disclosure to one taxpayer of information learned in preparing the return of another.

As a result of the restrictions of section 7216, the preparer would have to be cautious in phrasing any inquiries so as not to reveal return information of the first taxpayer to the second taxpayer. If apparent inconsistencies cannot be resolved without revealing return information, the preparer should decline to prepare the return. Disclosing return information protected under section 7216 is subject to both civil and criminal penalty. I.R.C. §§ 6713 and 7216.

Application of Tie-Breaker Rules

If a qualifying child can be claimed by more than one taxpayer, the taxpayers may choose among themselves who may claim the child. I.R.C. § 32(c)(1)(C). If more than one taxpayer wishes to claim a qualifying child, the taxpayer entitled to make the claim is as follows: the parent, if one taxpayer is a parent; the taxpayer with the higher adjusted gross income (AGI), if neither is a parent; the parent that the child lived with longest during tax year, if both taxpayers are parents and they do not file jointly; the parent with the higher AGI, if child lived with both parents the same length of time during the tax year. I.R.C. § 32(c)(1)(C).

If a taxpayer desires to claim the EIC and that taxpayer's return preparer knows, or has reason to know, that another taxpayer with a superior right to claim the child has already done so, or intends to do so, the return preparer may not prepare the return

without being subject to a penalty. Due diligence requires that a return preparer may not know or have reason to know that an EIC claim is incorrect. Treas. Reg. § 1.6695-2(b)(3). Of course, a return preparer may prepare a return where a taxpayer has a superior right to claim a qualifying child even when the preparer knows, or has reason to know, that a taxpayer with an inferior claim has already claimed the child.

We believe that this conclusion is accurate even if the preparer prepared the prior return with the inferior claim. A return preparer's knowledge or reason to know should be judged as of the time the preparer completes preparation of a taxpayer's return. If, at the time he prepares an inferior claim, the preparer completes the eligibility checklist and does not know or have reason to know that a superior claim has been or will be made, then the preparer has not failed to exercise due diligence simply because a superior claim is filed.

cc: Karin Loverud
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