

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Lynne M. Morrison
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(EIC Office)

from: Blaise G. Dusenberry
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subject: Preparer Earned Income Tax Credit (EIC) Due Diligence Questions

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

ISSUES

1. Since the issuance of the revisions to Treasury Reg. §1.6695-2, will the IRS have the authority to continue to assert the penalty for failure to comply with I.R.C. §6695(g) against either the employee preparer or the employer preparer, based on the facts and circumstances?

2. 

3. Since the issuance of the revisions to Treasury Reg. §§1.6695-2 and 1.6107-1, who will be required to meet the recordkeeping requirement under I.R.C. §6695(g)?

CONCLUSIONS

1. The Service continues to have the authority to assert the penalty against either the employee-preparer or employer-preparer.

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2. The regulatory amendment precludes the imposition of a penalty against both an employee-preparer and employer-preparer based on the same factual situation.

3. The signing tax return preparer will be responsible for meeting the recordkeeping requirement under I.R.C. § 6695(g).

FACTS

The Service has posed a number of questions related to the due diligence requirements imposed on tax return preparers respecting the earned income credit (EIC), in light of recent regulatory amendments.

LAW AND ANALYSIS

Can the penalty for a tax return preparer's failure to meet due diligence requirements respecting the EIC apply to an employer or employee?

Prior to the revision on December 22, 2008, Treasury Reg. §1.6695-2(a) included the following language:

* * *

(a) *Penalty for failure to meet due diligence requirements.* A person who is an income tax return preparer (preparer) of an income tax return or claim for refund under subtitle A of the Internal Revenue Code with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty of \$100 for each such failure . . .

Treas. Reg. § 1.6695-2(a)(emphasis added).

The examination function of the Service has followed the practice of asserting penalties under I.R.C. §6695(g) against an employee return preparer or the employer return preparer based on the facts and circumstances of the particular case. Generally, if the employer preparer failed to educate the employee about due diligence responsibilities, maintained an attitude in the workplace that did not promote compliance, and/or failed to maintain adequate internal control and review processes, any penalties for failure to comply with the due diligence requirements would be proposed against the employer preparer. By contrast, if the employee was educated on due diligence requirements, encouraged to comply with them but nonetheless failed to adhere to the requirements, the Service imposed the penalty against the employee preparer. In most of these cases, the employee preparer signs the return.

The revised Treasury Reg. §1.6695-2(a) now states:

(a) *Penalty for failure to meet due diligence requirements.* A person who is a signing tax return preparer of a tax return or claim for refund under the Internal Revenue Code with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty of \$100 for each such failure. . . (emphasis added).

The penalty imposed for failure to meet due diligence requirements respecting the EIC must be considered in light of the Code's definitional provisions. This states, in part:

(a) In general. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund . . .

(b) Definitions –(1) Signing tax return preparer. — A signing tax return preparer is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund . . .

(2) Nonsigning tax return preparer—(i) In general. A nonsigning tax return preparer who is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund within the meaning of paragraph (b)(3) of this section with respect to events that have occurred at the time the advice is rendered . . .

Treas. Reg. §301.7701-15(b)(1)(emphasis added).

The Service has opined that due to the nature of the employer/employee relationship, the employer retains the responsibility for the overall accuracy of the return whether or not the employer signed the return as the signing tax return preparer.

Our office agrees with this assertion. The signing tax return preparer can be either an employee preparer or an employer preparer, who is a natural person. In most cases the person who is the “signing tax return preparer,” and thus has primary responsibility for the substantive accuracy of the return or refund claim will be the party affixing his signature to the return or refund claim. An individual meeting the criteria of a signing tax return preparer who fails to affix his signature to the return or refund claim, except upon showing reasonable cause for such failure, is subject to a \$50 penalty for each failure to sign, up a maximum of \$25,000 per year. Treas. Reg. § 1.6695-1(b)(1) –(4)(example 2). We also note that the final regulation implementing the preparer penalty for understatements due to unreasonable positions includes a framework that defines “preparer per position within a firm.” The regulation aims at making only one person within a firm primarily responsible for each position giving rise to an understatement. T.D. 9436.

Whether the penalty for failure to meet due diligence requirements respecting the EIC can be imposed against both an employer preparer and employee preparer?

On June 13, 2000, when I.R.C. §6695(g) was relatively new, this office provided advice on the appropriate party against whom to assert the penalty. Then Counsel expressed the view that the Service could assert the penalty against the employee preparer, the employer preparer, or both, [REDACTED]

[REDACTED]

The prior version of Treas. Reg. § 1.6695-2(a) made an “income tax return preparer” liable for the penalty if he prepared an income tax return or refund claim but failed to satisfy the due diligence requirements regarding the EIC authorized by section 32. Recent amendments to the regulation narrowed the universe of persons against whom the penalty applies. Effective for returns and refund claims filed after December 31, 2008, one must be a “signing tax return preparer” to be liable for the \$100 penalty for failing to exercise due diligence. “Signing tax return preparer,” as noted above, is the individual tax return preparer with primary responsibility for the overall substantive accuracy of the preparation of the return or refund claim. Treas. Reg. § 301.7701-15(b)(1). Other parties who participate in the preparation of a tax return or claim for refund are “nonsigning tax return preparers.” *Id.* at § 301.7701-15(b)(2).

The information accompanying the final regulations in T.D. 9436 reflects that the Service and Treasury sought to define the single person within a firm primarily responsible for the position taken that gives rise to an understatement for purposes of the section 6694 penalty. This states in part “. . . [t]he final regulations in § 1.6694-1(b)(4) provide that if the information presented would support a finding that either the signing tax return preparer or a nonsigning tax return preparer within a firm is primarily responsible for the position(s) taken giving rise to the understatement, the IRS may assess the penalty against either one of the individuals within the firm, but not both, as the primarily responsible tax return preparer. This determination will be based on all of the evidence presented and will allow for certainty regarding the identification of the

primarily responsible tax return preparer within the expiration of the period of limitations on making an assessment under section 6694(a).”

Unlike the background information associated with the regulation implementing the section 6694 penalty, the discussion of due diligence requirements respecting the EIC does not expressly state that the amendment is intended to limit application of the penalty to a single person. This can, however, be inferred by the incorporation of the definition “signing tax return preparer” into § 1-6695-2(a), which is the provision imposing the penalty.

Recordkeeping requirements under IRC §6695(g)

As noted above, the December 22, 2008 revision of Treas. Reg. §1.6695-2 asserts the penalty against a signing tax return preparer for failure to comply with the due diligence requirements of I.R.C. § 6695(g), one of which is a requirement to retain certain records. I.R.C. § 6107, which requires a tax return preparer to furnish a completed copy of a return or refund claim to his client, also contains a record keeping requirement. This states that the preparer must retain a completed copy of the return for a period of 3 years following the close of the return period. Before a December 22, 2008 revision, the regulation implementing this stated:

* * *

(b) Copy or record to be retained. —The person who is an income tax return preparer of any return or claim for refund shall —

(i)(A) Retain a completed copy of the return or claim for refund; or . . .

(c) For purposes of applying this section, in the case of —

(1) An employment arrangement between two or more income tax return preparers, the person who employs (or engages) one or more other preparers to prepare for compensation any return or claim for refund other than for the person shall be considered to be the sole income tax return preparer (emphasis added)

* * *

In the past, when an audit has been conducted on an employee tax return preparer for compliance with I.R.C. §6695(g), it has been exam practice and experience to find the records required to meet the I.R.C. §6695(g) requirements in the possession of the employer.

The December 22, 2008 revisions to Treas. Reg. §1.6107-1(b)(1) now read:

b) Copy or record to be retained. (1) A person who is a signing tax return preparer of any return or claim for refund shall—

(i)(A) Retain a completed copy of the return or claim for refund

* * *

(c) Tax return preparer. For the definition of “signing tax return preparer,” see §301.7701-15(b)(1) of this chapter. For purposes of applying this section, a corporation, partnership or other organization that employs a signing tax return preparer to prepare for compensation (or in which a signing tax return preparer is compensated as a partner or member to prepare) a return of tax or claim for refund shall be treated as the sole signing tax return preparer.

Treas. Reg. §1.6107-1(b)(i)(A) and (c)(emphasis added).

We concur in the Service’s view that the revised version of Treas. Reg. §1.6107-1 retains the general recordkeeping requirement on employers of tax return preparers.

The argument has been made to the Service that the records required to be kept pursuant to Treas. Reg. §1.6695-2, those records that support compliance with EIC due diligence, are not part of the return and are therefore not covered by Treas. Reg. §1.6107-1(b) and (c). Under this theory, the records required to be maintained by Treas. Reg. §1.6695-2 will be the responsibility of the signing tax return preparer only.

The Service opines that the definition of return for purposes of Treas. Reg. §1.6107-1 includes all documentation required to support that the return is complete and in compliance with any and all recordkeeping requirements imposed by the Internal Revenue Code. The Service states that the recordkeeping requirements under I.R.C. § 6695(g) should be considered part of the return, and that the employer will continue to be required to maintain the records if the signing tax return preparer is an employee.

In our view the signing tax return preparer required to retain a copy of the tax return or claim for refund pursuant to section 6107 and the implementing regulation is not in all instances required to also retain the records described in the EIC due diligence record retention provision.

The regulatory language of amended Treas. Reg. § 1.6695-2 does not support the imposition of the due diligence requirement of record retention against a corporation, partnership or other entity employing a signing tax return preparer, unless such employer (*e.g.* sole proprietor or individual partner) falls under the definition “signing tax return preparer.” To reiterate the definition from above, “signing tax return preparer” is confined to an *individual* tax return preparer with primary responsibility for the overall substantive accuracy of the tax return. Inanimate business entities which happen to employ signing tax return preparers are not covered by the regulation’s requirement. The background information pertaining to this regulatory amendment does not contradict the idea that only the signing tax return preparer can be liable for the penalty authorized by Treas. Reg. § 1.6695-2(a).

Section 1.6695-2's due diligence provision requires the preparer to retain: (i) a copy of the completed Eligibility Checklist or Alternative Eligibility Record; (ii) a copy of the Computation Worksheet or Alternative Computation Record; and (iii) a record of how and when the information used to complete the Eligibility Checklist (or Alternative Eligibility Record) and Computation Worksheet (or Alternative Computation Record) was obtained by the preparer, including the identity of the person furnishing the information. Treas. Reg. § 1.6695-2(b)(4). The suggestion has been made that “. . . the definition of return for purposes of Treas. Reg. § 1.6107-1 includes all documentation required to support that the return is complete and in compliance with any and all recordkeeping requirements imposed by the Internal Revenue Code.” This definition, the analysis continues, supports the conclusion that records required to be retained pursuant to the preparer due diligence requirements of section 1.6695-2(b)(4)(Eligibility Checklist, Computation Worksheet, record of how information was used to complete checklist) are encompassed in the requirement under section 1.6107-1(b)(1)(i). The latter provision requires a signing tax return preparer of any return or claim for refund to “. . . [r]etain a completed copy of the return or claim for refund . . .” Treas. Reg. § 1.6107-1(b)(1)(i).

No Code or regulatory section defines “return” broadly enough to encompass the Eligibility Checklist, Computation Worksheet and other information required by Treas. Reg. § 1.6695-2. I.R.C. § 6107(d) states that return and refund claim have the same meanings as those terms are defined in section 6696(e). I.R.C. § 6696(e) states “. . . the term “return” means any return of any tax imposed by this title” and “claim for refund” means a claim for refund of, or credit against, any tax imposed by this title.” The regulatory provision implementing section 6696, Treas. Reg. § 1.6696-1, does not expand on the terms “return” or “claim for refund” any further. Courts construing section 6696 have not attempted to expand these definitions.

I.R.C. § 6011(a) relates to tax returns, and provides:

When required by regulations prescribed by the Secretary any person made liable for any tax . . . shall make a return or statement according to the forms and regulations prescribed by the Secretary . . .

Regulations implementing this legislative mandate state, in part:

(a) *General rule.* Every person subject to any tax, or required to collect any tax, under subtitle A of the Code, shall make such returns or statements as are required by the regulations under this chapter. *The return or statement shall include therein the information required by the applicable regulations or forms.*

(b) *Use of prescribed forms.* . . . Each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included

therein. *Returns which have not been so prepared will not be accepted as meeting the requirements of the Code . . .*

Treas. Reg. § 1.6011-1(a) and (b)(emphasis added).

Courts employ the following test for determining whether a document is a tax return and thus sufficient to commence the running of the statute of limitations on assessments:

. . . First, there must be sufficient data to calculate the tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury . . .

Beard v. Commissioner, 82 T.C. 766, 777 (1984), *aff'd.*, 793 F.2d 139 (6th Cir. 1986)(*citing Florsheim Bros Drygoods Co. v. United States*, 280 U.S. 453 (1930)).

The Eligibility Checklist (or Alternative Eligibility Record), Computation Worksheet (or Alternative Computation Record) and documentation of how, when and from whom the information was obtained to complete these items are useful to someone preparing a tax return or refund claim where the EIC is claimed. These records are not, however, part of the return or refund claim itself. I.R.C. § 6696(e). Neither regulations nor the instructions associated with a 1040 (schedule EIC), 1040X (refund claim) or Form 843 require the Eligibility Checklist, Computation Worksheet and other information to be included as attachments to the tax return or refund claim filed with the Service. Treas. Reg. § 301.6402-3(a)(2)(in case of overpayment of income tax, claim for refund is made on Form 1040X Amended U.S. Individual Income Tax Return). Consequently, an individual or entity retaining a completed copy of a return or refund claim pursuant to Treas. Reg. § 1.6107-1 will not be subject to the \$100 penalty of Treas. Reg. § 1.6695-2(a) for a failure to retain the records specified in paragraph (b)(4) of this latter regulatory provision.

Please call Gerald Semasek at (202) 622-9248 if you have any further questions. This is not a toll free call.

cc: Bridget E. Tombul, Esq.