August 24, 2018

Internal Revenue Service
CC:PA:LPD:PR (REG-103474-18)
Room 5207
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations on Tax Return Preparer Due Diligence Penalty under Section 6695(g) (REG-103474-18; 7/18/18)

Members of the Taxation Section of the California Lawyers Association ("CLA") are pleased to submit these comments on proposed regulations under IRC § 6695(g), Tax Return Preparer Due Diligence Penalty under Section 6695(g).

These comments were prepared by Kevan P. McLaughlin, Chair of the Taxation Section's Tax Procedure & Litigation Committee, Brian M. Katusian, Vice Chair of the Taxation Section's Income & Other Taxes Committee, and Matthew D. Carlson, member of the Taxation Section of the CLA. They were reviewed by Annette Nellen, Special Advisor to the Taxation Section, and Veronica Long, Chair of the Taxation Section's Income & Other Taxes Committee; both members of the CLA Taxation Section. These comments represent the individual views of the authors who prepared them, and do not represent the position of the CLA or the Taxation Section.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or firm or the organization to which such member belongs has been engaged to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

We appreciate your consideration of these comments. If you would like to discuss these issues further, please feel free to contact Kevan P. McLaughlin at (858) 678-0061 or kevan@mclaughlinlegal.com; or Patrick Martin at (619) 515-3230 or patrick.martin@procopio.com.

Sincerely,

Patrick Martin
Chair, Taxation Section of the California Lawyers Association

cc:
The Honorable David J. Kautter, Acting Commissioner, Internal Revenue Service
The Honorable William M. Paul, Acting Chief Counsel, Internal Revenue Service
Elizabeth Chirich, Attorney, IRS Office of Chief Counsel
Marshall French, Attorney, IRS Office of Chief Counsel
Adrienne Griffin, Attorney, IRS Office of Chief Counsel

CALIFORNIA LAWYERS ASSOCIATION

SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS ON TAX RETURN PREPARER DUE DILIGENCE PENALTY UNDER SECTION 6695(g) SEC. 1.6695-2 (REG-103474-18; 7/18/18)

I. Summary of our Recommendations

The authors respectfully believe that the proposed regulation does not sufficiently address the following areas:

a) The impact of a return preparer's preexisting personal or professional knowledge about their taxpayer clients.

b) Adequate guidance on the "isolated and inadvertent" exception.

c) Sufficient guidance on the "contemporaneous" standard for documenting questions and responses thereto.

d) The lack of guidance regarding the scope and depth of a tax preparers inquiries.

e) Concerns with IRS Form 8867.

DISCUSSION

II. Background

Originally enacted as part of the Taxpayer Relief Act of 1997, IRC § 6695(g) began as a $100 penalty on preparers who failed to comply with certain due diligence requirements when preparing return(s) that claim Earned Income Tax Credits ("EITC") under IRC § 32.

On December 22, 1997, the IRS published Notice 97-65. Therein the IRS first set out four specific due diligence requirements a preparer must satisfy. On December 21, 1998, temporary regulations relating to the due diligence requirements were published, which became final on October 17, 2000. The four due diligence requirements imposed on preparers since then have been: (1) complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist*; (2) complete the Earned Income Credit Worksheet, as contained in the Form 1040 instructions or record the preparer's computation of the credit, including the method and information used to make the computation; (3) to not know or have reason to know that any information used by the preparer in determining eligibility for, and the amount of, the EIC is incorrect and make reasonable inquiries when required, documenting those inquiries and responses contemporaneously; and (4) to retain, for three years from the applicable date, the Form 8867, the Worksheet (or alternative records), and the record of how and when the information used to determine eligibility for, and the amount of, the EIC was obtained by the

preparer, including the identity of any person furnishing information and a copy of any document relied on by the preparer.

The IRC § 6695(g) penalty remained at $100 per return until 2011 with the passage of the United States-Korea Free Trade Agreement Implementation Act (P.L. 112-41), which increased the penalty to $500 per failure to exercise due diligence. The penalty later became indexed to inflationary increases as a result of the Tax Increase Prevention Act of 2014 (P.L. 113-295) and the addition of IRC § 6695(h).

The Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) extended the application of the IRC § 6695(g) penalty and due diligence requirements to the child tax credit of IRC § 24 and the American opportunity tax credit of IRC § 25A. The Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA)) extended the penalty and due diligence requirement to any return where the taxpayer claims head of household filing status as defined under IRC § 2(b).

On July 18, 2018, a proposed regulation to amend portions of the previously temporary regulation at Treas. Reg. 1.6695-2T was released (REG-103474-18). Although the proposed Treas. Reg. § 1.6695-2 primarily addresses the impact of the expanded scope of IRC § 6695(g) to cover head of household filing status, the authors are taking this opportunity to address those proposed changes and related matters under IRC § 6695(g), the regulations and the relevant tax form.

The proposed Treas. Reg. § 1.6695-2(b)(3) contains a knowledge requirement that is substantially identical to current temporary Treas. Reg. § 1.6695-2T(b)(3). The proposed regulation adds head of household filing status as one of the due diligence items, and further incorporates it into the examples, but otherwise the knowledge requirement appears to remain unchanged from the temporary regulation.

A draft of Form 8867, *Paid Preparer's Due Diligence Checklist*, for 2018 was released on July 26, 2018 (https://www.irs.gov/pub/irs-dft/f8867--dft.pdf).

III. Comments

A. Preexisting Knowledge and Positive versus Negative Focus

First, the proposed regulation addresses the knowledge requirement, already substantially identical to current Treas. Reg. § 1.6695-2T(b)(3), in that:

> *The tax return preparer must not know, or have reason to know, that any information used by the tax return preparer in determining the taxpayer's eligibility to file as head of household or in determining the taxpayer's eligibility for, or the amount of, any credit described in paragraph (a) of this section and claimed on the return or claim for refund is incorrect. The tax return preparer may not ignore the implications of information furnished to, or known by, the tax return preparer, and must make reasonable inquiries if a reasonable and well-informed tax return preparer*

knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete. The tax return preparer must also contemporaneously document in the preparer's paper or electronic files any inquiries made and the responses to those inquiries.

As a general preliminary comment, we note that it may be more helpful to create a more workable standard for proposed Treas. Reg. § 1.6695-2(b)(3) to define the requisite level of knowledge in positive terms rather than negative, because it is generally difficult to prove a negative.

By way of example, the general knowledge standard could be modified to a standard akin to:

"The tax return preparer must verify that all information provided to the tax return preparer by the taxpayer and used by the tax return preparer in determining the taxpayer's eligibility for, or the amount of, any credit described in paragraph (a) of this section and claimed on the return or claim for refund is correct to the best of the tax return preparer's knowledge, and that no information provided to the tax return preparer by the taxpayer and used by the tax return preparer is incomplete, or inconsistent with other information provided to the tax return preparer by the taxpayer."

This would provide a more clear and workable standard for the tax return preparer, as the tax return preparer could feasibly list each qualifying component for the applicable IRC § 6695(g) status or credit, list the corresponding information relied upon for each component, and list any inconsistent information (if any), consistent with the requirement that the tax return preparer contemporaneously document "inquiries" made and the responses to those inquiries. In other words, if a tax return preparer is going to be contemporaneously documenting inquiries (as required by proposed Treas. Reg. § 1.6695-2(b)(3)), the tax return may as well also document information provided and relied upon by the tax return preparer in determining status or credit eligibility, and in the process determine whether any inconsistent information may contradict or otherwise undermine the information provided and relied upon by the tax return preparer.

The proposed regulation lacks guidance regarding what, if anything, a return preparer can do with their preexisting knowledge.

In practice the issue arises in two scenarios. First, the return preparer has a preexisting personal relationship with the taxpayer. This is particularly prevalent in tight ethnic communities. For example, a preparer may know that the parents or other relatives of a child are deceased because of prior social interactions with the particular child's aunt. When the aunt later asks the preparer to help file her taxes, the preparer would have the preexisting personal knowledge and may not think to make, or document, any additional inquiries about the qualifying child, *i.e.*, where are the child's parents? Furthermore, even if the preparer did think to ask the question, social insensitivity may prevent them from actually doing so.

The second scenario involves the preparer providing non-tax services and having some professional knowledge spillover. For example, a preparer may know that the parents or other relatives of a qualifying child are deceased because they assisted in designating the qualifying child as the aunt's life insurance beneficiary as part of their larger professional offerings, or helped the qualifying child register a vehicle at the aunt's address. When the child's aunt later asks the preparer to help file her taxes, the preparer would already have preexisting professional knowledge and may not think to make any further inquiries. And even if they did think to make additional inquires, perceived professional incompetence may prevent them from actually doing so.

In either event the return preparer does not know, nor has any reason to know, the information about the aunt claiming the qualifying child is incorrect. To the contrary, the preparer knows the information to be correct, either through personal or professional interactions with the aunt. Nevertheless, proposed Treas. Reg. § 1.6695-2(b)(3)(i) requires prepares to make additional inquires "if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete." In either of these two scenarios it is quite possible a reasonable and well-informed tax return preparer, based on the objective standard that the proposed regulation utilizes, would conclude that the aunt claiming a qualifying child was incomplete without knowing the status of the child's parents. Thus, without guidance, the preparer is left in an incredibly difficult situation.

In late 2016, Treas. Reg. § 1.6695-2T attempted to address some of these concerns with examples. First, Treas. Reg. § 1.6695-2T(b)(3)(ii), Examples 1 and 2, suggested that if a preparer has "information from other sources," they may be able to use that knowledge to satisfy the (b)(3) knowledge requirement. The examples continued by providing a situation where the preparer gains the requisite knowledge from preparing the taxpayer's return in a prior year. Similarly, Example 4 suggested that a preparer can maintain the requisite knowledge from preparing someone else's tax returns. In the second situation the preparer did not need to make additional inquiries because the status of the taxpayer as a dependent of another was made clear in preparing the latter's return.

That guidance continues in the proposed Treas. Reg. § 1.6695-2T(b)(3)(ii) with Examples 2 and 4; however, they do not provide as strong of guidance as is needed upon further review because both use imputed knowledge from the tax preparation practice itself. Upon review both Examples 2 or 4 are acceptable because there should be sufficient contemporaneous information to meet the (b)(3) knowledge requirement in somebody's tax preparation file. Nevertheless, preparers remain concerned regarding personal or professional knowledge that is acquired outside the tax return preparation context. Additional guidance is therefore needed, without which preparers will continue to struggle with how to handle preexisting personal or professional knowledge which would otherwise satisfy the underlying concern over their due diligence.

B. Isolated and Inadvertent Standard

Since Notice 97-65, the IRS has allowed a return preparer to avoid an IRC § 6695(g) penalty if they can, to the satisfaction of the IRS, demonstrate that their "normal

office procedures are reasonably designed and routinely followed to ensure compliance," and the breach of the due diligence standard was "isolated and inadvertent" (Treas. Reg. § 1.6695-2(d)).

Unfortunately, the terms "isolated" and "inadvertent" are not defined terms, nor are they frequently used in the tax lexicon. Does "isolated" mean the breach of the due diligence standards happened just once, or was it more than once, but not a constant or regular failure and part of a larger pattern? Similarly, does "inadvertent" refer to accidental, negligent, or willful conduct? Are tax preparers to infer guidance, for example in Treas. Reg. § 1.6694-2(e)(2), applies for purposes of IRC § 6695(g)?

The litigious problem of these exact undefined terms has been seen, for example in *NJN Sys., Inc. v. Sunoco, Inc*., 95 F. Supp. 3d 1330, 1333 (M.D. Fla. 2015), *aff'd* 646 Fed. Appx. 915 (11th Cir. 2016), where the parties grappled with defining a Florida statute's affirmative defense and the terms "isolated and inadvertent." Similarly, in *Heritage Residential Care, Inc. v. Div. of Lab. Standards Enf't*, 120 Cal. Rptr. 3d 363, 370 (Cal. App. 6th Dist. 2011), much discussion was had in analyzing the definition of the word "inadvertent," as used in Cal. Lab. Code Ann. § 226.3, where the court ultimately settled on a meaning of "unintentional," "accidental," or "not deliberate." However, without further guidance these questions plague preparers and may invite costly, and potentially disparate, answers when applied by different IRS personnel.

We submit that a solution may already exist by moving away from the "isolated and inadvertent" standard towards more well-familiar precedent. At their core isolated and inadvertent address concerns over frequency and intent. These concerns are also addressed in IRC § 6694. Under IRC § 6694(a), a preparer can be penalized for a particular position if they know or have reason to know that it was unreasonable. Section § 6694(b) also penalizes a preparer, but for whose conduct is willful or a reckless, intentional disregard. Importantly, IRC § 6694(a) penalties may be abated if "it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith," whereas IRC § 6694(b) penalties cannot.

By comparing the knowledge element of Treas. Reg. § 1.6695-2T(b)(3), the isolated and inadvertent exception of Treas. Reg. § 1.6695-2(d), and IRC §§ 6694(a) and (b), great similarities regarding culpability exist with IRC § 6694(a). This is important, because unlike Treas. Reg. § 1.6695-2(d), the regulations associated with IRC § 6694(a)(3) list and detail six factors for consideration to determine whether a tax preparer is entitled to the "reasonable cause" or "good faith" defense: (1) the nature of the error; (2) the frequency of the errors; (3) the materiality of the errors; (4) the preparer's normal office practice; (5) reliance on the advice of another preparer, and (6) reliance on administrative or industry practices (Treas. Reg. § 1.6694-2(e)).

Therefore, adopting the "reasonable cause and good faith" exception in Treas. Reg. § 1.6694-2(e), and moving away from the current "isolated" and "inadvertent" standard, is desired. In the alternative, additional guidance regarding the meaning of these terms is needed to enhance preparer's knowledge of their rights and responsibilities.

C. Contemporaneous Standard

Proposed Treas. Reg. § 1.6695-2(b)(3) also requires that the tax return preparer "contemporaneously document in the files any inquiries made and the responses to those inquiries" as a part of the knowledge requirement, which is apparently triggered only when "a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete."

In some instances, a tax return preparer will make adequate inquiries, but for various reasons the documentation thereof is incomplete, unavailable, or otherwise compromised. However, even in the absence of contemporaneous documentation, the return preparer did in fact make all of the requisite inquiries and received all the requisite responses thereto. Thus, we believe that a tax return preparer should be permitted to present other forms of evidence to demonstrate these inquiries during a return preparer investigation, including testimony from a knowledgeable person or persons. While it may be appropriate to require certain inquiries when a return preparer is confronted with potentially incorrect information, where the return preparer has in fact made these inquiries and has received seemingly accurate information in response, there should exist a defense to the penalty.

Similarly, a return preparer should be entitled to illustrate facts through documentation, even if not maintained contemporaneously, as a defense to the penalty. Where a return preparer obtains evidence to corroborate that the preparer did not know or have reason to know that any information is incorrect, the return preparer should be permitted to offer such evidence as a defense to the penalty.

Example 5 listed in proposed Treas. Reg. § 1.6695-2(b)(3) provides a fact pattern proposing that the return preparer must obtain contemporaneous documentation even where it appears that no incorrect, inconsistent, or incomplete information has been furnished with regard to the taxpayer's relationships to his niece and nephew. Proposed Example 5 is not consistent with the proposed knowledge requirement. The knowledge requirement of proposed Treas. Reg. § 1.6695-2(b)(3) provides that the return preparer must not know or have reason to know that any information is incorrect; that the return preparer must not ignore the implications of information furnished to or known by the return preparer; and that the return preparer must make reasonable inquiries when confronted with seemingly incorrect, inconsistent, or incomplete information.

However, proposed Example 5 provides no trigger to request contemporaneous documentation in the event that no incorrect, inconsistent, or incomplete information has been provided regarding the taxpayer's relationships to his niece and nephew. To the contrary, the taxpayer has informed the return preparer that his niece and nephew lived with him for part of the 2017 tax year, but the fact pattern does not describe any potentially conflicting information. We suggest modifying Example 5 slightly to provide some indication of potentially incorrect information, such as a later statement by the taxpayer to the return preparer that he was an only child or a similar fact that would raise questions as to whether the taxpayer had a niece and nephew.

D. Scope

Proposed Treas. Reg. § 1.6695-2(b)(3) sets forth the applicable degree of knowledge that a tax return preparer must have with respect to a taxpayer's eligibility to file as head of household as well as a taxpayer's eligibility for other IRC § 6695(g) covered credits.

With regard to inquiries that the tax return prepare must make, proposed Treas. Reg. § 1.6695-2(b)(3) provides: "The tax return preparer may not ignore the implications of information furnished to, or known by, the tax return preparer, and must make reasonable inquiries if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete." But no guidance is offered as to the lengths to which a tax return preparer must go in making "reasonable inquiries" or in "not ignoring" information "known by" the tax return preparer.

Section 6695(g) requires tax return preparers "… to comply with due diligence requirements imposed by the Secretary by regulations …" Exercising due diligence often-times entails following a due diligence checklist. The Service has, in fact, developed Form 8867, *Paid Preparer's Due Diligence Checklist*, consistent with the concept of there being reasonable and finite due diligence steps that tax return preparers should undertake to satisfy due diligence requirements. And by definition due diligence contemplates some level of completion, i.e., when the adequate reasonable steps taken are sufficient to satisfy legal requirements. A reasonable person (in this case a reasonable and well-informed tax return preparer knowledgeable in the law) would presumably not take unlimited and unending steps as part of a due diligence process. Some stopping point must exist, but unfortunately at this time proposed Treas. Reg. § 1.6695-2(b)(3) provides little guidance as to where to stop, placing undue burden and unnecessary uncertainty on tax return preparers. This is particularly important in the context of a tax return preparer's ability to rely upon a taxpayer's statements when the tax return preparer has no reason to believe the information furnished to the tax return preparer is incorrect.

By way of example, if a tax return preparer, in determining head of household status eligibility, asks a taxpayer whether he paid for more than half of the household expenses during the taxable year, and the taxpayer responds with "yes," and no other information furnished to or known by the tax return preparer contradicts or otherwise undermines the taxpayer's "yes" statement, is the tax return preparer unable to accept the taxpayer's "yes" statement without further inquiry? Must the tax return preparer request supporting taxpayer financial statements, or an income and expense declaration from the taxpayer along with proof of payment? Should any requested financial statements be audited? Presumably, absent being furnished or having knowledge of inconsistent or undermining information that would give a reasonable and well-informed tax return preparer reason to doubt the taxpayer's "yes" statement, a tax return preparer would be able to rely on the taxpayer's "yes" statement and cease further inquiry.

However, in application it has been observed that the IRS expects tax return preparers not only to make the inquires, but also track down and verify the underlying accuracy of the responses thereto. We believe this is inconsistent with the law, wherein IRC § 6695(g)

merely requires preparers to make the requisite inquiries but does not require them to verify their accuracy. [1] If an incorrect position was taken on the return, IRC § 6694 would be the basis for penalizing the preparer, not IRC § 6695(g). Thus, additional guidance is needed.

E. Form 8867

As stated, IRC § 6695(g) merely requires tax return preparers "… to comply with due diligence requirements imposed by the Secretary by regulations …" It does not require tax return preparers to complete IRS Form 8867. The Treasury's broad latitude with respect to carrying out IRC § 6695(g) due diligence requirements by regulation, has, for the time being "written in" a requirement for tax return preparers to complete and submit a Form 8867 ("… or such other form and such other information as may be prescribed by the Internal Revenue Service… ") (Treas. Reg. § 1.6695-2T(b)(1)).

We believe requiring Form 8867 to be completed and submitted with the applicable tax return places a disproportionate and undue burden on the tax return preparer and results in unnecessary confusion. We respectfully submit that the Form 8867 should either be eliminated or, in the alternative, made optional under the regulations.

Currently, IRS Form 8867 instructions (Dec. 05, 2017) provide that Form 8867 must be filed with the return or amended return claiming the applicable IRC § 6695(g) covered credit. The instructions to Form 8867 also provide a list of four numbered steps that it suggests, if followed, means the tax return preparer has "… complied with the due diligence requirements set forth in Treasury Regulations…" This is a potentially misleading statement in that logically a tax return preparer complies with the due diligence requirements set forth in the regulations by actually complying with them. Accordingly, unless the IRS wishes to duplicate the applicable regulations in the Form 8867 instructions verbatim, the IRS may wish to consider omitting any implication that following the Form 8867 and its instructions constitutes deemed compliance with Treas. Reg. § 1.6695-2. The concern is that tax return preparers are lulled into a false sense of security with respect to Form 8867 itself, whereby a tax return preparer may believe that he or she has satisfied the IRC § 6695(g) due diligence requirements simply by completing and submitting a Form 8867 and following the Form 8867 instructions.

It is theoretically feasible for a tax return preparer to perform and contemporaneously document due diligence steps and inquiries taken with respect to IRC § 6695(g) covered credits without completing and submitting a Form 8867. It has been our collective experience that in practice tax return preparers fall on both sides of the spectrum in that some diligently complete and submit Forms 8867 with the incorrect belief that doing so insulates them from IRC § 6695(g) penalty liability, and some tax return preparers are not even aware of the existence of Form 8867, but make reasonable inquiries and contemporaneously document

[1] Generally, a return preparer "may rely in good faith without verification upon information furnished by the taxpayer" per Treas. Reg. 1.6694-2 and Rev. Rul. 80-40, 1980-2 C.B. 774, as well as Circular 230, § 10.34(d).

steps taken and inquiries made with respect to taxpayer eligibility for IRC § 6695(g) covered credits.

While Form 8867 may serve as a useful guide for tax return preparers to follow, IRC § 6695(g) itself does not require completion and submission of Form 8867, and if Form 8867 is retained, the Form 8867 along with corresponding instructions should make it eminently clear that tax return preparers must follow and comply with the IRC § 6695(g) regulations to avoid the imposition of potentially financially crippling penalties. Many taxpayers eligible for IRC § 6695(g) covered status and/or credits are low income and unable to afford expensive tax return preparation. It is entirely conceivable that in many instances a single penalty will exceed the amount of compensation received by the tax return preparer to prepare the tax return at issue. This lack of proportionality and potential to financially harm a tax return preparer makes it incumbent on the IRS to ensure that the IRC § 6695(g) regulations are drafted and implemented in such a way as to minimize and avoid inadvertent failures to the greatest extent feasible, which may require elimination of Form 8867 or, if retained, make completing and submitting Form 8867 optional and clarify that following and complying with the IRC § 6695(g) regulations is the sole means by which a tax return preparer may avoid imposition of the penalty.

Date: August 24, 2018