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Dave DuVal • Feb. 26, 2019

For most tax professionals, conducting due diligence is second nature, an automatic reflex much like breathing. When a function becomes this automatic, some practitioners may be lulled into a routine of "checking the boxes" and relying on information and knowledge gleaned from taxpayers in the past to prepare current year tax returns.

Circular 230, found in Title 31 of the United States Code, contains the minimum

incomplete and/or inaccurate. This additional inquiry is where some practitioners may be falling short. Circular 230 contains the ***minimum ethical requirements*** we are required to follow. For some areas of practice, this minimum is not enough and following it may cause dire consequences. This is especially true when preparing income tax returns that claim the Head of Household filing status and certain credits.

Through IRC §6695(g), the IRS has placed special, more stringent due diligence requirements on certain credits; among them are the *Earned Income Tax Credit* (EIC), *Child Tax Credit* (CTC), *Additional Child Tax Credit* (ACTC), and the *American Opportunity Tax Credit* (AOTC). The refundable component to these credits makes them susceptible to a high incidence of fraud. IRC §6695(g) requires tax practitioners to meet additional due diligence requirements when preparing tax returns that contain these credits.

To facilitate these due diligence requirements, the IRS created Form 8867 *Paid Preparer's Due Diligence Checklist*. This form requires tax practitioners to certify, to the best of their knowledge, that the answers to the form questions are true, correct, and complete. Practitioners are required to submit this completed form with any tax return they prepare that contains one of these credits. Failure to comply with these requirements may result in a $500 per violation or incident, which has been indexed for inflation. For the tax year 2018, the penalty is $520 per incidence.

In other words, if a tax practitioner prepares a return that contains the Child Tax Credit, Earned Income Tax Credit and American Opportunity Tax Credit, the tax practitioner could be fined for three $520 penalties if the IRS determines there was insufficient due diligence in determining if the taxpayer qualified for these credits. For tax returns filed in 2019, the penalty is $530 per incident.

The Tax Cuts and Jobs Act of 2017 expanded the IRC §6695(g) due diligence requirements to include the new *Family Credit* or *Other Dependent Credit* (ODC) and the Head of Household filing status. Form 8867 has also been updated to incorporate

Checklist, and this form must be completed "based on information provided by the taxpayer to the tax return preparer, or otherwise be reasonably obtained or known by the tax return preparer."

- The preparer must compute the credit(s) by either completing the worksheets included with the form instructions for Form 1040 and/or Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)* based on information obtained by the taxpayer or otherwise record how the credit was computed.
- The preparer must have knowledge. The tax return preparer must not know or have reason to know that any information used to determine the taxpayer's eligibility for one of the credits or the Head of Household (HOH) status is incorrect.
- The preparer must retain the records involved in the determination of the credits or Head of Household status, including a copy of the Form 8867, any worksheets or calculations used to determine the amounts, and a record of how and when the information used to complete Form 8867 was obtained. This includes the name of the person(s) who provided the information and copies of any documents provided by the taxpayer. These documents must be maintained for a minimum of three years after either the return or claim for refund is filed, or the due date of the return without regard to extensions, if that is later.

Treasury Reg. §1.6695-2(b) provides extensive guidance on the knowledge condition in the form of eight examples of what the IRS considers "knowledge." Examples One, Three, and Five illustrate that simply relying on the taxpayer's answers to standard questionnaires or tax organizers, with no other backing data, is insufficient to establish due diligence. In the absence of additional information or supporting documents from the taxpayer, the practitioner must make additional "reasonable inquiries" to determine if the taxpayer is eligible for the credits or Head of Household status.

In Example Six, the practitioner knows the taxpayer from prior social interactions.

made sufficient inquiries to verify a taxpayer is eligible in one year, they do not need to verify this again in a subsequent year. How long a practitioner can rely on previously provided information is unclear. However, it is assumed that documents that do not change do not have to be collected again. An example of this would be a birth certificate. Information that can change needs to be verified each year.

The regulation does not address what types of documentation the IRS will expect practitioners to provide in the event of an audit beyond generalities regarding worksheets and copies of the taxpayer-provided information. The tax practitioner still needs to make a judgment call on what and how much information they need to obtain; however, in the event of an audit, this still may not be sufficient to prevent the imposition of a penalty. In an audit situation, the IRS has the benefit of 20/20 hindsight and may have access to information that the practitioner did not have during the time the return was prepared. A good documentation guideline might be to refer to the documents the IRS requests on Form 886-H-DEP, *Supporting Documents for Dependency Exemptions*, Form 886-H-AOC, *Supporting Documents to Prove American Opportunity Credit*, Form 886-H-HOH, *Supporting Documents to Prove Head of Household Filing Status*, and Form 886-H-EIC, *Documents You Need to Provide So You Can Claim the Earned Income Credit on the Basis of a Qualifying Child or Children*. Copies of these Forms are available on the IRS website, www.irs.gov.

It is clear the IRS is looking for complete and detailed information as to how a practitioner determined that a taxpayer qualified for the EIC, CTC, ACTC, AOTC, ODC, and Head of Household filing status. To arm themselves, practitioners should keep detailed and contemporaneous notes on the questions and answers they ask their clients. Based on the examples in the final regulations, merely documenting a taxpayer response or stating awareness of the taxpayer's circumstances based on prior interactions, may not be enough to escape the Due Diligence Penalty.

For a minimum of three years, practitioners need to maintain detailed records such

and any associated worksheets.
- A record of any additional questions asked (other than the questions listed on Form 8867) along with any of the answers that are given.

In the frantic rush of tax season, it may be expedient to rely on tax software to automatically answer all the questions on Form 8867, but this may end up being a costly mistake. The IRS does conduct Due Diligence audits, and tax professionals have been fined thousands of dollars for violations. In addition to due diligence audits, the IRS is sending out Letter 5025 to practitioners who may have filed returns that claimed credits without meeting the due diligence requirements. This is considered a "soft notice" as the IRS does not require a response. However, the notice does make it clear that the practitioner is on the IRS's "radar" and will be monitoring future returns submitted by the practitioner.

For many practitioners, the due diligence requirements may seem excessive and intrusive. However, until the rules and regulations are changed, practitioners are being held to these requirements. Failure to perform the proper due diligence not only may drain your bank account, but it may also cause a loss of reputation. The IRS may audit all your client returns that contain any one of these credits or that claimed the Head of Household filing status. If they conclude the taxpayer does not qualify for either the credit(s) claimed or Head of Household filing status, the taxpayer will owe additional tax, interest and possibly penalties. Furthermore, your clients may be prevented from claiming these credits in the future. Before the filing season becomes too hectic, it may be worthwhile to review a copy of Letter 5025, which is available on the IRS website. Additionally, the IRS has an online toolkit for tax practitioners that contain a "Due Diligence Training Module." As the saying goes, "An ounce of prevention is worth a pound of cure."