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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9799]

RIN 1545-BN61

Tax Return Preparer Due Diligence Penalty under Section 6695(g)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that modify existing regulations related to the penalty under section 6695(g) of the Internal Revenue Code (Code) relating to tax return preparer due diligence. These temporary regulations implement recent law changes that expand the tax return preparer due diligence penalty under section 6695(g) so that it applies to the child tax credit (CTC), additional child tax credit (ACTC), and the American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). The temporary regulations affect tax return preparers. The substance of the temporary regulations is included in the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

Applicability Date: For dates of applicability, see §1.6695-2T(e).

FOR FURTHER INFORMATION CONTACT: Rachel L. Gregory, 202-317-6845 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in these temporary and final regulations is in §§1.6695-2(b) and 1.6695-2T(b) and is reported on Form 8867, "Paid Preparer's Due Diligence Checklist." Responses to this collection of information are mandatory. The collection of information in current §1.6695-2 was previously reviewed and approved under control number 1545-1570. Control number 1545-1570 was discontinued in 2014, as the burden for the collection of information contained in §1.6695-2 is reflected in the burden on Form 8867 under control number 1545-1629.

**Background**

This document contains amendments to 26 CFR parts 1 and 602 under section 6695(g) of the Code, imposing a penalty on tax return preparers who fail to comply with the due diligence requirements imposed by the Secretary by regulations with respect to determining the eligibility for, or the amount of, the EIC. Section 6695(g) was added to the Code because Congress believed more thorough efforts by tax return preparers are important to improving EIC compliance. H.R. Rep. No. 105-148, 105<sup>th</sup> Cong. 1<sup>st</sup> Sess., p. 512 (June 24, 1997).

Enacted by section 1085(a)(2) of the Taxpayer Relief Act of 1997, Pub. L. 105-34 (11 Stat. 788, 955 (1997)), and effective for taxable years beginning after December 31, 1996, section 6695(g) originally imposed a \$100 penalty on an income tax return preparer who failed to meet the EIC due diligence requirements set forth in regulations

prescribed by the Secretary. Section 8246 of the Small Business and Work Opportunity Tax Act of 2007, Pub. L. 110-28 (121 Stat. 112, 200 (2007)) amended the penalty to apply to all tax return preparers. Section 501(a) of the United States-Korea Free Trade Agreement Implementation Act, Pub. L. 112-41 (125 Stat. 428, 459 (2011)), amended section 6695(g) to increase the amount of the penalty to \$500, effective for returns required to be filed after December 31, 2011. Section 208(c), Div. B of the Tax Increase Prevention Act of 2014, Pub. L. 113-295 (128 Stat. 4010, 4073 (2014)) (2014 Act), added section 6695(h), which indexes the penalty amount for inflation, effective for returns or claims for refund filed after December 31, 2014.

Section 1.6695-2 implements section 6695(g) by imposing due diligence requirements on persons who are tax return preparers under section 7701(a)(36) with respect to determining eligibility for, or the amount of, the EIC. The due diligence requirements set forth in §1.6695-2(b) are that the preparer must: (1) complete and submit Form 8867, "Paid Preparer's Earned Income Credit Checklist;" (2) complete the Earned Income Credit Worksheet (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) 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 (knowledge requirement); and (4) 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.

To comply with the knowledge requirement under §1.6695-2(b)(3), 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 the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete. Examples in §1.6695-2(b)(3)(ii) illustrate this requirement. This knowledge requirement is consistent with the verification requirement imposed on all tax return preparers with respect to preparation of any tax return or claim for refund under the accuracy-related standards set forth in §1.6694-1(e).

A tax return preparer is required to submit the Form 8867 to the IRS when the preparer electronically files the tax return. If a tax return preparer required to complete the Form 8867 is not electronically filing the taxpayer's return with the IRS, §1.6695-2(b)(1) provides rules for submission of the form. If the tax return preparer required to complete the Form 8867 is not the signing tax return preparer, the preparer satisfies the submission requirement by providing a copy of the completed Form 8867 to the signing tax return preparer. If the tax return preparer required to complete the Form 8867 is the signing tax return preparer but the taxpayer is not electronically filing the return, the preparer must provide a copy of the completed Form 8867 to the taxpayer to be attached to the return being filed with the IRS.

Section 1.6695-2(c) provides that a firm that employs a tax return preparer subject to a penalty under section 6695(g) is also subject to a penalty if certain conditions apply. Under this rule, a firm will be subject to a penalty if and only if one or

more members of principal management (or principal officers) of the firm or branch participated in, or prior to the time the return was filed, knew of the failure to comply with the due diligence requirements; the firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements; or, through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) the firm disregarded its own reasonable and appropriate compliance procedures. A firm subject to a section 6695(g) penalty under this section is not eligible for the exception to the penalty in §1.6695-2(d). Under this exception, the penalty will not be applied if the tax return preparer can demonstrate to the satisfaction of the IRS that, considering all of the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements, and the failure to meet the due diligence requirements with respect to the particular tax return or claim for refund was isolated and inadvertent.

Section 207, Div. Q of the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113 (129 Stat. 2242, 3082 (2015)) (PATH Act) amended section 6695(g) by expanding the scope of the due diligence requirements to also include claims of the CTC/ACTC under section 24 and the AOTC under section 25A(a)(1), effective for taxable years beginning after December 31, 2015.

These temporary regulations reflect the changes made to section 6695(g) by the PATH Act by expanding the due diligence requirements to the CTC/ACTC and the AOTC. These temporary regulations also conform the regulation to the 2014 Act, reflecting that the penalty is to be adjusted for inflation.

## **Explanation of Provisions**

The temporary regulations amend §1.6695-2 to implement the changes made by the PATH Act that extend the preparer due diligence requirements to returns or claims for refund including claims of the CTC/ACTC and/or AOTC in addition to the EIC. As a result of these changes, one return or claim for refund may contain claims for more than one credit subject to the due diligence requirements. Pursuant to the statute, each failure to comply with the due diligence requirements set forth in regulations prescribed by the Secretary results in a penalty. The section 6695(g) requirements apply to each credit claimed, meaning more than one penalty could apply to a single return or claim for refund. The temporary regulations provide examples to show how multiple penalties could apply when one return or claim for refund is filed.

The Form 8867 has been revised for the 2016 tax year and is a single checklist to be used for all applicable credits (EIC, CTC/ACTC, and/or AOTC) on the return or claim for refund subject to the section 6695(g) due diligence requirements. The Form 8867 was streamlined to eliminate unnecessary redundancy with other forms and schedules. These changes were intended to reduce burden while increasing the utility of the Form 8867 as a checklist for tax return preparers to more accurately determine taxpayer eligibility for credits, thereby reducing errors and increasing compliance by preparers and taxpayers. The temporary regulations clarify § 1.6695-2(b)(1)(ii) to illustrate that the completion of Form 8867 can be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained or previously known by the preparer.

The examples provided in § 1.6695-2(b)(3)(ii) have been updated to provide more insight into when a tax return preparer has satisfied the due diligence knowledge requirement, including for purposes of the CTC and AOTC. The updates to the examples in § 1.6695-2T(b)(3)(ii) illustrate that the knowledge requirement for purposes of due diligence can be satisfied in conjunction with a tax return preparer's information-gathering activities done for the purpose of accurately completing other aspects of a tax return or claim for refund. New examples, Example 2 and Example 4, have also been added to illustrate that in certain circumstances a tax return preparer may satisfy the knowledge requirement based on existing knowledge without having to make additional reasonable inquiries. Another new example, Example 7, provides an example of due diligence for purposes of the AOTC.

Section 1.6695-2(a) is amended by the temporary regulations to reflect the changes made by section 208(c) of the 2014 Act, requiring the IRS to index the penalty for inflation for returns or claims for refund filed after December 31, 2014. In addition, §1.6695-2T(c)(3) clarifies the parenthetical therein by removing the words "or ascertained."

### **Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Federal Register. Pursuant to section 7805(f) of

the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small businesses.

### **Drafting Information**

The principal author of this regulation is Rachel L. Gregory, Office of the Associate Chief Counsel (Procedure & Administration).

### **List of Subjects**

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 602

Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding a new entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.6695-2T is also issued under 26 U.S.C. 6695(g).

\* \* \* \* \*

Par. 2. Section 1.6695-2 is amended by revising the section heading and paragraphs (a), (b)(1)(i) introductory text, (b)(1)(ii), (b)(2), (b)(3)(i) and (ii), (b)(4)(i)(B) and (C), and (c)(3) to read as follows:

§ 1.6695-2 Tax return preparer due diligence requirements for certain credits.

(a) [Reserved]. For further guidance regarding the penalty for failure to meet due diligence requirements with respect to certain credits, see §1.6695-2T(a).

(b) \* \* \*

(1) \* \* \*

(i) [Reserved]. For further guidance regarding the completion of Form 8867, see §1.6695-2T(b)(1)(i).

\* \* \* \* \*

(ii) [Reserved]. For further guidance regarding the information used to complete the Form 8867, see 1.6695-2T(b)(1)(ii).

(2) [Reserved]. For further guidance regarding computation, see §1.6695-2T(b)(2).

(3) \* \* \*

(i) [Reserved]. For further guidance regarding the knowledge requirement, see §1.6695-2T(b)(3)(i).

(ii) [Reserved]. For current examples, see §1.6695-2T(b)(3)(ii).

(4) \* \* \*

(i) \* \* \*

(B) [Reserved]. For further guidance on the retention of records, see §1.6695-2T(b)(4)(i)(B).

(C) [Reserved]. For further guidance on the retention of records, see §1.6695-2T(b)(4)(i)(C).

\* \* \* \* \*

(c) \* \* \*

(3) [Reserved]. For further guidance on the special rule for firms, see §1.6695-2T(c)(3).

\* \* \* \* \*

Par. 3. Section 1.6695-2T is added to read as follows:

§ 1.6695-2T Tax return preparer due diligence requirements for certain credits  
(Temporary).

(a) Penalty for failure to meet due diligence requirements—(1) In general. A person who is a tax return preparer (as defined in section 7701(a)(36)) 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 child tax credit (CTC) and additional child tax credit (ACTC) under section 24, the American opportunity tax credit (AOTC) under section 25A(i), or 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 as prescribed in section 6695(g) (indexed for inflation under section 6695(h)) for each failure. A separate penalty applies with respect to each credit claimed on a return or claim for refund for which the due diligence requirements of this section are not satisfied and for which the exception to penalty provided by paragraph (d) of this section does not apply.

(2) Examples. The provisions of paragraph (a)(1) of this section are illustrated by the following examples:

Example 1. Preparer A prepares a federal income tax return for a taxpayer claiming the CTC and the AOTC. Preparer A did not meet the due diligence requirements under this section with respect to the CTC or the AOTC claimed on the taxpayer's return. Unless the exception to penalty provided by paragraph (d) of this section applies, Preparer A is subject to two penalties under section 6695(g): one for

failure to meet the due diligence requirements for the CTC and a second penalty for failure to meet the due diligence requirements for the AOTC.

Example 2. Preparer B prepares a federal income tax return for a taxpayer claiming the CTC and the AOTC. Preparer B did not meet the due diligence requirements under this section with respect to the CTC claimed on the taxpayer's return, but Preparer B did meet the due diligence requirements under this section with respect to the AOTC claimed on the taxpayer's return. Unless the exception to penalty provided by paragraph (d) of this section applies, Preparer B is subject to one penalty under section 6695(g) for the failure to meet the due diligence requirements for the CTC. Preparer B is not subject to a penalty under section 6695(g) for failure to meet the due diligence requirements for the AOTC.

(b) [Reserved]. For further guidance, see §1.6695-2(b).

(1) Completion and submission of Form 8867. (i) The tax return preparer must complete Form 8867, "Paid Preparer's Due Diligence Checklist," or such other form and such other information as may be prescribed by the Internal Revenue Service (IRS), and—

(A) through (C) [Reserved]. For further guidance, see §1.6695-2(b)(1)(i)(A) through (C).

(ii) The tax return preparer's completion of Form 8867 must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained or known by the tax return preparer.

(2) Computation of credit or credits. (i) When computing the amount of a credit described in paragraph (a) of this section to be claimed on a return or claim for refund, the tax return preparer must either—

(A) Complete the worksheet in the Form 1040, 1040A, 1040EZ, and/or Form 8863 instructions or such other form including such other information as may be prescribed by the IRS applicable to each credit described in paragraph (a) of this section claimed on the return or claim for refund; or

(B) Otherwise record in one or more documents in the tax return preparer's paper or electronic files the tax return preparer's computation of the credit or credits claimed on the return or claim for refund, including the method and information used to make the computations.

(ii) The tax return preparer's completion of an applicable worksheet described in paragraph (b)(2)(i)(A) of this section (or other record of the tax return preparer's computation of the credit or credits permitted under paragraph (b)(2)(i)(B) of this section) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained or known by the tax return preparer.

(3) Knowledge—(i) In general. 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 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 files any inquiries made and the responses to those inquiries.

(ii) Examples. The provisions of paragraph (b)(3)(i) of this section are illustrated by the following examples:

Example 1. In 2018, Q, a 22 year-old taxpayer, engages Preparer C to prepare Q's 2017 federal income tax return. Q completes Preparer C's standard intake questionnaire and states that she has never been married and has two sons, ages 10 and 11. Based on the intake sheet and other information that Q provides, including

information that shows that the boys lived with Q throughout 2017, Preparer C believes that Q may be eligible to claim each boy as a qualifying child for purposes of the EIC and the CTC. However, Q provides no information to Preparer C, and Preparer C does not have any information from other sources, to verify the relationship between Q and the boys. To meet the knowledge requirement in paragraph (b)(3) of this section, Preparer C must make reasonable inquiries to determine whether each boy is a qualifying child of Q for purposes of the EIC and the CTC, including reasonable inquiries to verify Q's relationship to the boys, and Preparer C must contemporaneously document these inquiries and the responses.

Example 2. Assume the same facts as in Example 1 of this paragraph (b)(3)(ii). In addition, as part of preparing Q's 2017 federal income tax return, Preparer C made sufficient reasonable inquiries to verify that the boys were Q's legally adopted children. In 2019, Q engages Preparer C to prepare her 2018 federal income tax return. When preparing Q's 2018 federal income tax return, Preparer C is not required to make additional inquiries to determine the boys relationship to Q for purposes of the knowledge requirement in paragraph (b)(3) of this section.

Example 3. In 2018, R, an 18 year-old taxpayer, engages Preparer D to prepare R's 2017 federal income tax return. R completes Preparer D's standard intake questionnaire and states that she has never been married, has one child, an infant, and that she and her infant lived with R's parents during part of the 2017 tax year. R also provides Preparer D with a Form W-2 showing that she earned \$10,000 during 2017. R provides no other documents or information showing that R earned any other income during the tax year. Based on the intake sheet and other information that R provides, Preparer D believes that R may be eligible to claim the infant as a qualifying child for the EIC and the CTC. To meet the knowledge requirement in paragraph (b)(3) of this section, Preparer D must make reasonable inquiries to determine whether R is eligible to claim these credits, including reasonable inquiries to verify that R is not a qualifying child of her parents (which would make R ineligible to claim the EIC) or a dependent of her parents (which would make R ineligible to claim the CTC), and Preparer D must contemporaneously document these inquiries and the responses.

Example 4. The facts are the same as the facts in Example 3 of this paragraph (b)(3)(ii). In addition, Preparer D previously prepared the 2017 joint federal income tax return for R's parents. Based on information provided by R's parents, Preparer D has determined that R is not eligible to be claimed as a dependent or as a qualifying child for purposes of the EIC or CTC on R's parents' return. Therefore, for purposes of the knowledge requirement in paragraph (b)(3) of this section, Preparer D is not required to make additional inquiries to determine that R is not her parents' qualifying child or dependent.

Example 5. In 2018, S engages Preparer E to prepare his 2017 federal income tax return. During Preparer E's standard intake interview, S states that he has never been married and his niece and nephew lived with him for part of the 2017 tax year. Preparer E believes S may be eligible to claim each of these children as a qualifying

child for purposes of the EIC and the CTC. To meet the knowledge requirement in paragraph (b)(3) of this section, Preparer E must make reasonable inquiries to determine whether each child is a qualifying child for purposes of the EIC and the CTC, including reasonable inquiries about the children's parents and the children's residency, and Preparer E must contemporaneously document these inquiries and the responses.

Example 6. W engages Preparer F to prepare her federal income tax return. During Preparer F's standard intake interview, W states that she is 50 years old, has never been married, and has no children. W further states to Preparer F that during the tax year she was self-employed, earned \$10,000 from her business, and had no business expenses or other income. Preparer F believes W may be eligible for the EIC. To meet the knowledge requirement in paragraph (b)(3) of this section, Preparer F must make reasonable inquiries to determine whether W is eligible for the EIC, including reasonable inquiries to determine whether W's business income and expenses are correct, and Preparer F must contemporaneously document these inquiries and the responses.

Example 7. Y, who is 32 years old, engages Preparer G to prepare his federal income tax return. Y completes Preparer G's standard intake questionnaire and states that he has never been married. As part of Preparer G's client intake process, Y provides Preparer G with a copy of the Form 1098-T Y received showing that University M billed \$4,000 of qualified tuition and related expenses for Y's enrollment or attendance at the university and that Y was at least a half-time undergraduate student. Preparer G believes that Y may be eligible for the AOTC. To meet the knowledge requirements in paragraph (b)(3) of this section, Preparer G must make reasonable inquiries to determine whether Y is eligible for the AOTC, as Form 1098-T does not contain all the information needed to determine eligibility for the AOTC or to calculate the amount of the credit if Y is eligible, and contemporaneously document these inquiries and the responses.

(4) Retention of records. (i) [Reserved]. For further guidance, see §1.6695-2(b)(4)(i).

(A) [Reserved]. For further guidance, see §1.6695-2(b)(4)(i)(A).

(B) A copy of each completed worksheet required under paragraph (b)(2)(i)(A) of this section (or other record of the tax return preparer's computation permitted under paragraph (b)(2)(i)(B) of this section); and

(C) A record of how and when the information used to complete Form 8867 and the applicable worksheets required under paragraph (b)(2)(i)(A) of this section (or other

record of the tax return preparer's computation permitted under paragraph (b)(2)(i)(B) of this section) was obtained by the tax return preparer, including the identity of any person furnishing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 and/or an applicable worksheet required under paragraph (b)(2)(i)(A) of this section (or other record of the tax return preparer's computation permitted under paragraph (b)(2)(i)(B) of this section).

(ii) through (iii) [Reserved]. For further guidance, see §1.6695-2(b)(4)(ii) through (iii).

(c) [Reserved]. For further guidance, see §1.6695-2(c).

(1) through (2) [Reserved]. For further guidance, see §1.6695-2(c)(1) through (2).

(3) The firm disregarded its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate) in the preparation of the tax return or claim for refund with respect to which the penalty is imposed.

(d) [Reserved]. For further guidance, see §1.6695-2(d).

(e) Applicability date. This section applies to tax returns and claims for refund prepared on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** with respect to tax years beginning after December 31, 2015. For returns and claims for refund prepared before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** with respect to tax years beginning before January 1, 2016, the

rules that apply are contained in §1.6695-2 in effect prior to **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. (See 26 CFR part 1 revised as of April 2016).

(f) Expiration date. This section will expire on **[INSERT DATE 3 YEARS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

**§ 602.101 [Amended]**

Par. 5. In § 602.101, paragraph (b) is amended by removing the entry for §1.6695-2 from the table.

John M Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: November 21, 2016.

Mark J Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2016-28993 Filed: 12/2/2016 8:45 am; Publication Date: 12/5/2016]