THE CALIFORNIA LAWYERS ASSOCIATION
TAXATION SECTION
TAX PROCEDURE AND LITIGATION COMMITTEE

PROPOSED CHANGES TO IRS EARNED INCOME TAX CREDIT ("EITC") (OR MORE BROADLY NOW, REFUNDABLE TAX CREDITS AND HEAD OF HOUSEHOLD FILING STATUS) DUE DILIGENCE STANDARDS UNDER IRC § 6695(g) (TREAS. REG. §§ 1.6695-2, 1.6695-2T)

Kevan P. McLaughlin is a member of the State Bar of California and the Taxation Section of the California Lawyers Association.[1, 2] The author wishes to thank the various members of the State Bar of California, California Lawyers Association, and the Los Angeles County Bar whose exceptional efforts allow for this opportunity.

Contact Persons: Kevan P. McLaughlin, JD, LL.M
McLaughlin Legal, APC
5151 Shoreham Place
Suite 265
San Diego, CA 92122
(858) 678-0061
kevan@mclaughlinlegal.com

---

[1] The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California, California Lawyers Association, or of the Los Angeles County Bar Association.

[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this paper.

EXECUTIVE SUMMARY [3]

Originally enacted as part of the Taxpayer Relief Act of 1997, IRC § 6695(g) imposes a penalty on tax return preparers who fail to comply with certain due diligence requirements when preparing return(s) that claim, now among other things, Earned Income Tax Credits ("EITC") under IRC § 32. Since 1998, the requisite due diligence requirements have been imposed via regulations and include, notwithstanding recent revisions: (1) completion of an eligibility checklist; (2) correct computation of credit(s); (3) not knowing, or having a reason to know, that any information used in determining eligibility is incorrect, incomplete, or inconsistent; and (4) retention of certain records. Although a powerful tool in combatting unscrupulous tax return preparers, the IRC § 6695(g) penalty has transformed into something which causes significant concerns for others in the tax preparing community, and addition, suffers from structural problems.

This concern is in part because of the current amount of the penalty, which in 2011 increased from $100 to $500 per return and is now further indexed to inflationary increases as a result of the Tax Increase Prevention Act of 2014. Moreover, the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") further extended the applicability of the IRC § 6695(g) penalty and due diligence requirements to other tax return items, including: (1) the child tax credit ("CTC") under IRC § 24; (2) education credits under IRC § 25A(a)(1); and (3) head of household filing status.

This paper comments on the structural issues of IRC § 6695(g) and the regulations found at Treas. Reg. §§ 1.6695-2, 1.6695-2T, which were released on December 5, 2016. First, the paper addresses the lack of guidance regarding imputed or preexisting knowledge. Where Treas. Reg. § 1.6695-2T(b)(3), Examples 2 and 4 provide some guidance, their scope is quite narrow in application. Additional consideration of a tax return preparer's personal knowledge, and further the contemporaneous documentation thereof, is needed.

[3] The views expressed herein are those of the authors and do not necessarily reflect the views of anyone else. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or an opinion provided by the authors to the reader. The reader is also cautioned that this material may not be applicable to, or suitable for, the reader's specific circumstances or needs, and may require consideration of non-tax and other factors if any action is to be contemplated. The reader should contact his or her tax advisor prior to taking any action based upon this information. The authors assume no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.

Second, the paper addresses the inequities created for tax return preparers given IRC § 6695(g)'s strict liability nature. The paper addresses these concerns by suggesting the extension of refund litigation relief found for other tax return preparer penalties and also suggests a safe-harbor remedy if the underlying credit or filing status is sustained.

Third, the paper addresses the concern that Form 8867 is overly burdensome to tax return preparers and may have little current value. Fourth, the paper requests and suggests further guidance regarding the "inadvertent and isolated" exception to the IRC § 6695(g) penalty, in part analogizing well-established reasonable cause standards. Finally, the paper comments on the *ad hoc* nature of IRC § 6696(g) enforcement and proposes a unified set of standards for Revenue Agents.

DISCUSSION

I. BACKGROUND

First enacted in 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.[4]

On December 22, 1997, the IRS published Notice 97-65.[5] Therein the IRS first set out four specific due diligence requirements a preparer must satisfy. Largely unchanged even today, the four original requirements to avoid the imposition of the IRC § 6695(g) penalty were:

(1) Complete the Earned Income Credit Checklist as attached to Notice 97-65, or in the alternative, record the information necessary to complete the checklist elsewhere in the preparer's files.
(2) Complete the Earned Income Credit Worksheet as contained in the applicable Form 1040 instructions, or in the alternative record the computation and information necessary to complete the Computation Worksheet.
(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.
(4) Retain for three years the Eligibility Checklist and Computation Worksheet (or alternative records), and a record of how and when the information used to determine eligibility for, and the amount of, the EIC was obtained by the preparer.

On December 21, 1998, temporary regulations relating to the due diligence requirements were published,[6] which became final on October 17, 2000,[7] and generally mirrored Notice 97-65's four requirements. Since October 17, 2000, the four due diligence requirements imposed on preparers are:

---

[4] Taxpayer Relief Act of 1997, PL 105–34, August 5, 1997, 111 Stat 788 ("(2) DUE DILIGENCE REQUIREMENT ON INCOME TAX RETURN PREPARERS. Section 6695 is amended by adding at the end the following new subsection: (g) FAILURE TO BE DILIGENT IN DETERMINING ELIGIBILITY FOR EARNED INCOME CREDIT.—Any person who is an income tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of $100 for each such failure.").

[5] 1997-51 I.R.B. 14, 1997-2 C.B. 326

[6] 63 C.F.R. § 70339-01 (1999)

[7] 65 C.F.R. § 61268-01 (2000)

(1) *Form 8867*. A preparer must complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist*.
(2) *Worksheet*. A preparer must 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) *Knowledge*. The preparer must 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.
(4) *Document Retention*. The preparer must 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.

Another key development in the guidance for return preparers occurred on December 22, 2008.[8] Prior to that date, the applicable guidance lacked any standard by which a return preparer must approach information that appeared incomplete or inconsistent. When Teas. Reg. § 1.6695-2(b)(3) was adopted, it not only gave a general definition of the knowledge requirement and applicable standard, but also for the first time gave several examples.[9] Importantly, the regulation provided that:

> *A tax return preparer 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.*

Furthermore, the prior Treas. Reg. § 1.6695-2(b)(4)(i)(C) was reinforced by providing that "tax return preparer must also *contemporaneously* document in the files the reasonable inquiries made and the responses to these inquiries."[10]

[8] 73 C.F.R. § 78430-01 (2008)
[9] *Id*.
[10] *Id*. (emphasis added).

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, which increased the penalty to $500 per return.[11] The penalty later became indexed to inflationary increases as a result of the Tax Increase Prevention Act of 2014 and IRC § 6695(h).[12]

Most recently, the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") now extends the application of the IRC § 6695(g) penalty and due diligence requirements to other refundable tax credits, including the child tax credit ("CTC") under IRC § 24(b), education credits under IRC § 25A(a)(1), and head of household filing status as defined under IRC § 2(b).[13]

II. POTENTIAL PROBLEMS

Few, if any, tax professionals would argue that due diligence requirements do not serve an important function in curbing problem-preparers and decreasing the risk of improper refunds to ineligible taxpayers. This is particularly true in the area of refundable credits because, unlike other credits that are limited to the amount of an individual's income tax liability, refundable credits may result in a payment to a taxpayer beyond their tax liability. As the Treasury Inspector General for Tax Administration ("TIGTA") has noted, this characteristic poses "a significant risk as an avenue for those seeking to defraud the Government."[14] Recent examples of these problem preparers abusing the EITC system are aplenty.[15]

In response IRC § 6695(g) has become one of, if not the, most important tool in combatting such unscrupulous return preparers. However, in addition to a 400% increase to the face of the penalty, before inflationary adjustments, IRC § 6695(g)

[11] PL 112-41, October 21, 2011, 125 Stat 428, § 501(a).

[12] PL 113-295, December 19, 2014, 128 Stat 4010, § 208(c)

[13] PL 115-97, 2017 HR 1, PL 115-97, December 22, 2017, 131 Stat 2054, § 11001(b)

[14] TIGTA Report, *Improvements Are Needed to Better Document the Return Preparer Refundable Credit Compliance Treatment Identification and Selection Process*, Ref. No. 2018-40-001 (October 19, 2017).

[15] *See e.g.*, *U.S. v. Verbal*, 1:16CV441 (M.D.N.C. Mar. 19, 2018)

seems ripe for even greater expansion into new tax areas.[16] Left unchanged with its increasing amount, scope, and applicability, the important goals of IRC § 6695(g) may soon be outweighed by the significant burden it can place on preparers and the tax system as a whole.

The author's comments regarding the IRC § 6695(g) penalty can be categorized into five groups: (A) needed guidance for imputed or existing personal knowledge; (B) suggested relief for the strict liability application of IRC § 6695(g); (C) concerns regarding Form 8867; (D) suggested alternatives for the "inadvertent and isolated" standard; and (E) the need for a uniformed standard of application.

A. Imputed or Existing Personal Knowledge

The knowledge requirement of IRC § 6695(g) is arguably the most important protection against unscrupulous tax practitioners. Under that requirement, currently found at Treas. Reg. § 1.6695-2(b)(3),[17] a tax return preparer cannot know, or have reason to know, the information they use to determine credit eligibility is incorrect. Moreover, a preparer cannot ignore incorrect, inconsistent, or incomplete information, and must make reasonable inquiries if a reasonable third-person preparer would conclude the information was also incorrect, inconsistent, or incomplete. And further still, under Treas. Reg. §§ 1.6695-2(b)(3) and (b)(4)(i)(C), the preparer must contemporaneously document how and when they learned of the information used the prepare the return. The concern raised by many preparers, however, is what to do with their preexisting knowledge?

In practice the issue arises in one of 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

[16] *See e.g.*, H.R. 3430 114th Cong. (2015) (proposing to expand IRC § 6695(g) to cover credits claimed under IRC §§ 24, 25A, or 32); H.R. 2973, 114th Cong. (2015) (proposal to require preparers to also verify if a student with respect to whom qualified tuition and related expenses were paid was also lawfully present in the U.S.); H.R. 1298, 114th Cong. (2015) (proposing to require return preparers, in addition to the already existing four due diligence requirements, to receive information from the taxpayer regarding the issuance of their social security numbers, and if not issued, if they are a lawful permanent resident); S. 3451, 114th Cong. (2016); H.R. 4693, 114th Cong. (2016) (suggested amending IRC § 6695(g) to cover EITC and a new "Young Child Tax Credit"); S. 2024, 115th Cong. (2017) (proposal to extend the penalty to cover a foster care tax credit under a new IRC § 25E).

[17] 81 C.F.R. § 87446 (2016)

and may not think to make, or document, any additional inquiries about the qualifying child, *i.e.*, where are the child's parents?

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. When the child's aunt later asks the preparer to help file her taxes, the preparer would already have the preexisting professional knowledge and may not think to make any further inquiries.

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, Treas. Reg. § 1.6695-2T(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 would conclude that the aunt claiming a qualifying child was inconsistent 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, suggest 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 continue by providing a situation where the preparer gains the requisite knowledge from preparing the taxpayer's return in a prior year. Similarly, Example 4 suggests 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.

Examples 2 and 4, however, do not provide as strong of guidance as is needed upon further review, because both use imputed knowledge from preparing tax preparation practices. In theory, in either Examples 2 or 4 there should be sufficient contemporaneous information to meet the (b)(3) knowledge requirement in a client's prior year file, or another client's file. Nevertheless, preparers remain concerned regarding personal or professional knowledge that is acquired outside the tax return preparation context. Additional guidance is needed.

One possible solution could be a small change to Treas. Reg. § 1.6695-2(b)(3)(i). As currently drafted, the third-party standard appears to exist even if the preparer had undisputed knowledge that no information was incorrect, incomplete, or inconsistent. It is important to maintain this "reasonable and well-informed tax return preparer" standard, but when the standard, as drafted, is triggered has become an area of confusion. The IRS should consider adjusting the Treas. Reg. § 1.6695-2(b)(3)(i) knowledge requirement by further considering language used in applicable provisions of Circular 230.[18]

Thus, a proposed change to the knowledge requirement could be:

> *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, incomplete, or inconsistent. The tax return preparer may not ignore the implications of information furnished to, or known by, the tax return preparer, and must make additional reasonable inquiry of his or her client if the information is incomplete, inconsistent, or incorrect. The tax return preparer must also contemporaneously document in the files any inquiries made and the responses to those inquiries. In evaluating whether a tax return preparer complied with this requirement, a reasonable and well-informed tax return preparer knowledgeable in the law standard shall apply.*

Without this, or similar solution, 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. Relief for Strict Liability Application

Section § 6695(g) applies much like a strict liability penalty, in that a tax return preparer can be assessed the entire penalty, even if the underlying taxpayer was fully entitled to the credits and/or filing status. This liability without harm

[18] *E.g.*, Cir. 230 § 10.37(c).

presents a considerable challenge to return preparer, particularly when considering the limitations on challenging an IRS determination and the potentially disproportionate amount of the penalty when compared to the price charged for the underlying tax return.

1. *Extended Refund Litigation Relief*

To better understand the unequitable burden a preparer may face as a result of an IRC § 6695(g) penalty, it becomes necessary to consider the procedures, in general, for return preparer penalties.

Audits of return preparer due diligence compliance typically begin with a scheduled audit appointment in advance of the current tax year's filing season. Little, if any, advanced notice of the due diligence audit is given to the preparer. During the audit an IRS Revenue Agent typically interviews the preparer about their business practices and begins to review at least twenty-five returns. If the Revenue Agent identifies violations of the IRC § 6695(g) due diligence requirements, they expand the audit to more returns. This process is unique to other return preparer penalty investigations, which do not typically begin with the preparer. Instead they are generally the extension of an audit to the underlying taxpayer's return, which suggests a violation on the part of the preparer.

A return preparer due diligence investigation may thereafter result in a determination that the preparer fell short of any of the four specifically required standards. If so, an IRC § 6695(g) penalty will be proposed and a Letter 1125 and Form 5816, *Report of Tax Return Preparer Penalty Case*, is usually generated by the Revenue Agent and send to the preparer. Included in that correspondence will be instructions that the preparer can appeal the decision within 30-days by filing an administrative protest. At this point the IRC § 6695(g) penalty process is similar to other preparer penalties including IRC § 6694, because the preparer has the ability challenge the proposed penalty, before assessment, in front of the IRS Office of Appeals. However, the potential inequities involved with this issue become apparent if an IRC § 6695(g) pre-assessment appeal is unsuccessful in two ways.

First, IRC § 6695(g) is an aggregating penalty without any upper limits. Under Treas. Reg. § 1.6695-2T(a), "[a] separate penalty applies with respect to each credit claimed on a return or claim for refund for which the due diligence requirements … are not satisfied." Therefore, a preparer can face a $2,000 penalty, per return, with adjustments for inflation. Moreover, under Treas. Reg. § 1.6695-

2(c), a firm may now itself be subject to the full penalties, raising the total potential cost related to a single tax return to $4,000, adjusted for inflation.

In this way the IRC § 6695(g) penalty stands in stark contrast to many other preparer related penalties. First, it has no upper limits. For example, IRC §§ 6695(a), 6695(b), 6695(c), 6695(d), 6695(e), and 6704(b)(2) all establish limits on the maximum penalty a preparer can face per calendar year. However, IRC § 6695(g) has no such restrictions. Second, the IRC § 6695(g) penalty has no proportionality to the preparer's direct benefit, *i.e.*, the fees derived for preparing the return. Unlike IRC §§ 6694(a) and (b), which can, in part, establish the amount of the penalty by reference to the income derived (or to be derived) by the preparer, IRC § 6695(g) makes not such connection.

These two unique features of IRC § 6695(g) can manifest into substantial prejudices, particularly for less affluent tax preparers. It is not uncommon, given the eligibility criteria for the EITC, that the underlying taxpayers are from a lower social-economic status. A natural extension of their status is a limit on the price they can afford to pay for tax return preparation services. Therefore, a return preparer who services such a lower social-economic client base could find the IRS assessing them an IRC § 6695(g) penalty well in excess of the fees charged to prepare the returns. For example, a $2,000 penalty, per return, adjusted for inflation, easily eclipses the price of a $100 tax return, and may not take long for the aggregation of all per return penalties to even the exceed the preparer's entire gross income.

Acknowledging the deterrent effect, which should not be abandoned, Congress and the IRS should nevertheless consider some additional relief provisions to protect preparers from what could otherwise become extreme injustices from expanding IRC § 6695(g) penalties.

Returning to the administrative process of assessing and appealing an IRC § 6695(g) penalty, assume that the IRS's conclusion in a pre-assessment appeal erroneously sustained the penalty. So, while both IRC §§ 6695(g) and 6694 penalties will have pre-assessment appeal rights, the appeal process ends thereafter for the former. The ability to protest the IRC § 6695(g) preparer's innocence next lies in judicial review, which is in most cases becomes cost-prohibitive. The U.S. Tax Court, a pre-payment forum of strict limited jurisdiction, has not been given the authority to adjudicate IRC § 6695(g) penalties. Thus preparers are left with a District Court as the only judicial venue to dispute their assessment. However, a general rule of federal tax procedure exists in that a taxpayer (or preparer in these circumstances) can maintain a tax refund action in District Court only after paying the assessment in full.[19] Therefore a preparer may be precluded from further relief until they pay the, arguably disproportionate and limitless, penalty in full.

Nevertheless, what has become known as the *Flora* Rule's "pay-to-play" regime is not without exception. Over time the "divisibility" exception was created, whereby if a tax or penalty can be divided into separate portions or transactions, a taxpayer can pay only one such divisible portion to serve as a test upon which the entire aggregate assessment can be decided.[20] The divisibility exception to the full prepayment *Flora* Rule has been recognized by the IRS and other courts with respect to penalties imposed by IRC §§ 6695(d),[21] 6672,[22] 6700,[23] 6701,[24] , 6708,[25] 6721,[26] and 6722.[27] This ability to pay only a portion of the entire penalty before litigating in District Court provides access to an otherwise unattainable and cost-prohibitive remedy. It could, and has been, argued that IRC § 6695(g) meets the test as a divisible penalty. Thus, if a preparer pays the full amount of one separate portion, *i.e.*, $500, they may have the ability to maintain a refund suit over the remaining parts of the entire IRC § 6695(g) assessment.

In fact, this ability to avail oneself of alternative U.S. Tax Court pre-payment jurisdiction has been relied on as a key factor in support of the full prepayment *Flora* Rule exception.[28] For example, in 2006 the IRS acknowledged the unfairness a limitless penalty, like Section 6695(g), could have if not held divisible. In IRS CCA 200646016, it was observed that:

> *As shown by both of the failure to file examples cited above, each possesses a maximum penalty that can be assessed against*

---

[19] 28 U.S.C. § 1346; *Flora v. United States*, 362 U.S. 145 (1960).

[20] *See e.g., Steele v. U.S.*, 280 F.2d 89, 90 (8th Cir. 1960); *Korobkin v. United States*, 988 F.2d 975, 976 (9th Cir. 1993) ("taxes or penalties that are seen as merely the sum of several independent assessments triggered by separate transactions … In such a case, the taxpayer may pay the full amount on one transaction, sue for a refund for that transaction, and have the outcome of this suit determine his liability for all the other, similar transactions.").

[21] *Nordbrock v. United States*, 173 F.Supp. 2d 959 (D. Ariz. 2000), *aff'd* 248 F.3d 1172 (9th Cir. 2001)

[22] S*ee e.g.*, *Davis v. United States*, 961 F.2d 867 (9th Cir. 1992)

[23] *Hankin v. United States*, 891 F.2d 480 (3rd Cir. 1989); *accord*, *Nielsen v. United States,* 976 F.2d 951 (5th Cir. 1992)

[24] *Id.*; *accord, Gates v. United States*, 874 F.2d 584, 587, FN 3 (8th Cir. 1989)

[25] IRS CCA 200646016 (Nov. 17, 2006)

[26] IRS CCA 201315017 (Apr. 12, 2013)

[27] *Id.*; *but see contra*, IRS CCA 201150029 (Dec. 16, 2011) (finding IRC § 6677 was not a "dividable tax" for purposes of the full prepayment *Flora* Rule).

[28] *See Flora*, 362 U.S. at 158; *accord, Boynton v. U.S.*, 566 F.2d 50, 53 (9th Cir. 1977).

the taxpayer. Thus, the taxpayer has a calculable ceiling to which he or she can be subjected. This is true of practically every other penalty contained in the Internal Revenue Code. ... Because Congress enacted a penalty that has the potential for extremely high, unlimited and continuously accruing penalties, it is reasonable to interpret the statute in a manner that provides a reasonable means of obtaining potential relief by an affected material advisor. If the penalty was not considered divisible, difficulty in implementing the full pay rule would result because it would be hard for the material advisor to ascertain and pay the full amount due.

Notwithstanding its similarities, both in structure and application to other preparer penalties, IRC § 6695(g) has been found not to be a divisible assessment.[29] As a result, a preparer must pay the entire amount of the IRC § 6695(g) penalty before seeking judicial review. Reasonable means of mitigating this inequity are needed.

For that solution, Congress and the IRS should look to IRC §§ 6694(c) and 6703 for guidance. Under these two provisions, if a tax return preparer is assessed the applicable penalty, they have 30-days to pay 15% of the penalty and use that partial-payment to satisfy the prepayment *Flora* Rule. This exception is also made clear to preparers in the instructions to Form 6118, *Claim for Refund of Tax Return Preparer and Promoter Penalties*, which states that: "If you were assessed a penalty under section 6700, 6701, or 6694, you may file a claim for refund upon paying 15% of the penalty if you do so within 30 days from the date of notice and demand."[30]

By extending to IRC § 6695(g) the same kind of refund litigation relief, like that found in IRC § 6694(c), Congress and the IRS could help alleviate possible inequities that currently exist. Accordingly, a preparer who would otherwise be priced out of judicial review could still maintain a process to ultimately vindicate themselves. Furthermore, the deterrent effect of the penalty would not be compromised as the whole assessment could later be made, and the 15% is not so *de minimis* as to reduce all barriers to judicial challenge. Nonetheless, offering the ability to pay only 15% of an otherwise limitless penalty strikes a balance between affording tax preparers the opportunity to further dispute IRS conclusions and the overall objectives of IRC § 6695(g).

---

[29] *Nguyen v. U.S.*, 16CV00391 JAH-DHB, at 2 (S.D. Cal. Jan. 18, 2018).

[30] Form 6118 (Rev. April 2017), Cat. No. 24415J.

2. *Safe-Harbor Relief*

As discussed above, IRC § 6695(g) penalties apply regardless of whether the underlying taxpayer was fully entitled to the credit and/or filing status. Many tax return preparers struggle with this penalty-without-harm approach, and frequently cite their client's full legal entitlement to the credit as justification for relief. Unfortunately, as IRC § 6695(g) currently exists, no such relief is available. For example, a preparer could face a $2,000 penalty, adjusted for inflation, if they fail to complete a Form 8867 in violation of Treas. Reg. § 1.6695-2T(b)'s requirement. This is true even if the underlying taxpayer was fully eligible to file a head of household and receive the applicable credits. Thus, the IRS should consider adopting a safe-harbor relief remedy to further curb the possible inequities of the penalty.

To do so, Congress and the IRS should look to IRC § 6694(d). Under IRC § 6694(d), a return preparer can seek to abate an IRC §§ 6694(a) or (b) penalty if there is a final administrative or judicial determination that there was no understatement of liability.[31] A similar remedy should be considered for IRC § 6695(g).

In isolation, or in conjunction with some relief from the full prepayment *Flora* Rule, a safe-harbor exception to the penalty would further alleviate the burden on preparers created by IRC § 6695(g)'s strict liability nature. This becomes especially important for the innocent preparer who, despite a possible administrative error or omission, otherwise correctly and accurately reported their client's true and correct tax credits and/or filing status.

C. Form 8867

Treas. Reg. § 1.6695-2T(b)(1) mandates that a preparer completes a Form 8867, *Paid Preparer's Earned Income Credit Checklist*, as one of the four due diligence requirements. However, the effectiveness of this requirement as a tool to

[31] I.R.C. § 6694(d) ("If at any time there is a final administrative determination or a final judicial decision that there was no understatement of liability in the case of any return or claim for refund with respect to which a penalty under subsection (a) or (b) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the person who made such payment as an overpayment of tax without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.")

combat unscrupulous preparers may be questionable. For example, a series of TIGTA reports have identified a surprising number of EITC claims that were filed without the required Form 8867.[32] That number of tax returns claiming the EITC with a missing or incomplete Form 8867 may be on the decline,[33] but that decline may have as much to do with the IRS's extensive educational outreach endeavors about the need for a Form 8867. Meanwhile, Form 8867 disproportionally burdens preparers. In fact, the IRS estimates that it will take a preparer nearly two-hours to complete and file a Form 8867.[34] This can be contrasted with the zero hours a taxpayer would expend to prepare their own return, nevertheless claiming the exact same credits and/or filing status, because Form 8867 is applicable *only* to paid tax return preparers.

The combination of its potential ineffectiveness and outbalanced obligation should prompt a discussion about Treas. Reg. § 1.6695-2T(b)(1) and the future need of Form 8867, if any. Moreover, the IRS likely has the tools to already monitor and link returns to preparers claiming head of household status or covered credits. The redundancy of those tools further questions the usefulness of Form 8867.

The concern raised here are the consequences the added costs (both in the time required to prepare the Form 8876 and increasing amount of the IRC § 6695(g) penalty) may have on the tax system as a whole. Asking preparers to spend greater time on preparing growing due diligence forms and checklists, in an area where they may already face pressures against passing those increased costs to clients, creates a risk that those taxpayers will go elsewhere. The system then could suffer a fate worse than a preparer who does not file a complete Form 8867: (1) unguided, self-preparing taxpayers who may be prone to greater mistakes than miscalculating an EITC; or (2) an increase in black market or ghost preparers.

Ultimately the objectives of IRC § 6695(g) can still be served without the need to prepare and file a Form 8867. Instead the IRS should rely on preexisting tools to identify applicable returns, and devote greater resources into the educational outreach programs that are undoubtedly of greater return in curbing unscrupulous preparers.

---

[32] *See e.g.,* TIGTA Report, *Processes Do Not Maximize and Use Third-Party Income Documents to Identify Potentially Improper Refundable Credit Claims*, Ref. No. 2017-40-042 (July 17, 2017).

[33] *See e.g.*, TIGTA Report, *Key Tax Provisions Were Implemented Correctly for the 2014 Filing Season*, Ref. No. 2014-40-077 (September 19, 2015).

[34] 2017 Instructions for Form 8867, Cat. No. 59407V

D. Inadvertent and Isolated 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."[35]

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? Without further guidance these questions plague preparers and may invite costly, and potentially disparate, answers.[36]

A solution may already exist in well-familiar precedent. At their core "isolated" and "inadvertent" address concerns over frequency and *mens rea*. 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,"[37] and 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)[38] list and detail six factors for consideration to determine whether a tax preparer is entitled to the "reasonable cause" or "good faith"

---

[35] 1997-51 I.R.B. 14, 1997-2 C.B. 326

[36] *See e.g.*, *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) (unpublished) (seeking to define a Florida statute's affirmative defense and the terms "isolated and inadvertent."); *Heritage Residential Care, Inc. v. Div. of Lab. Standards Enf't*, 120 Cal. Rptr. 3d 363, 370 (Cal. App. 6th Dist. 2011) (analyzing the definition of the word "inadvertent," as used in Cal. Lab. Code Ann. § 226.3, to mean "unintentional," "accidental," or "not deliberate.").

[37] IRC § 6694(a)(3).

[38] Treas. Reg. § 1.6694-2(e)

defense: (1) the nature of the error;[39] (2) the frequency of the errors;[40] (3) the materiality of the errors;[41] (4) the preparer's normal office practice;[42] (5) reliance on

[39] Treas. Reg. § 1.6694-2(e)(1) ("The error resulted from a provision that was complex, uncommon, or highly technical, and a competent tax return preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. The reasonable cause and good faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund by the tax return preparer.").

[40] Treas. Reg. § 1.6694-2(e)(2) ("The understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund. Furthermore, the reasonable cause and good faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good faith exception.").

[41] Treas. Reg. § 1.6694-2(e)(3) ("The understatement was not material in relation to the correct tax liability. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the reasonable cause and good faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.").

[42] Treas. Reg. § 1.6694-2(e)(4) ("The tax return preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the tax return preparer, indicates that the error in question would occur rarely and the normal office practice was followed in preparing the return or claim for refund in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.").

the advice of another preparer,[43] and (6) reliance on administrative or industry practices.[44]

Adopting a "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 and would further enhance preparers in knowing their rights and responsibilities.

E. Uniformed Application

It has been the experience of many tax preparers that at the culmination of an EITC Due Diligence audit, the Revenue Agent presents a list of the files reviewed and those that failed an applicable requirement(s). Frustratingly, what accompanies such a list is usually a legend that attempts to give a reason for the penalty; however, the penalty reason legends have in practice been far from uniform.

While a "penalty reason code" for standardized application does appear to exist, it has not been widely disseminated – to IRS Revenue Agents or preparers. Moreover, one "reason" referenced in the supposed standardized workpaper allows Revenue Agents to cite other issues and insert their own explanation. Disparities have arisen in the use and depth of this "reason," making it increasingly difficult for

[43] Treas. Reg. § 1.6694-2(e)(5) ("For purposes of demonstrating reasonable cause and good faith, a tax return preparer may rely without verification upon advice and information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer or other party, as provided in § 1.6694–1(e). The tax return preparer may rely in good faith on the advice of, or schedules or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), who the tax return preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if— (i) The advice or information is unreasonable on its face; (ii) The tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or (iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.").

[44] Treas. Reg. § 1.6694-2(e)(6) ("The tax return preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.").

the preparer to provide a defense as to the specifically applicable due diligence requirement(s).

The need and benefit for a uniformed set of applicable "reasons" is almost self-evident. In so doing, especially if adequately disseminated, the IRS will further promote diligent preparer conduct but also create consistent results in enforcement. This uniformed standard also has independent utility by allowing for the ability to accurately track and report the specific due diligence requirements that plague the system.

III. CONCLUSION

Section 6695(g) currently serves a vital function on combatting unscrupulous return preparer. However, it appears poised to apply to more and more credits and/or filing statuses. With that expanding scope, in addition to its increasing amount, IRC § 6695(g)'s unique application may create significant problems for return preparers and jeopardize its otherwise critical objective.