GET READY FOR FORM 8867

And Related Due Diligence Required By the PATH Act and the TCJA

By Aaron P. Borden, JD, CPA

Form 8867, and the related due diligence required under Treas. Reg. § 1.6695-2, has historically been associated with the Earned Income Tax Credit and was rarely required in most CPAs' practices. However, Form 8867, and the related due diligence, will have a much more prominent role in most return preparers' practices beginning in the 2019 filing season. In fact, return preparers will likely find that Treas. Reg. § 1.6695-2 due diligence is required for almost every Form 1040 return impacted by dependents.[1] This increase in required due diligence is a result of several recent legislative changes.

The first factor expanding the required due diligence arises from the combined impact of the Protect Americans from Tax Hikes Act (PATH Act) and the Tax Cuts and Jobs Act (TCJA). The PATH Act extended the Treas. Reg. § 1.6695-2 due diligence requirements to tax returns claiming the Child Tax Credit. While this change increased the frequency of the required due diligence beginning in 2016, the impact of this change will be compounded for the 2018 through 2025 tax years as a result of the TCJA's significant expansion of the Child Tax Credit.

For 2018 through 2025 tax years, the Child Tax Credit, in essence, replaces the dependency exemption for most taxpayers. Almost all individual taxpayers will be able to claim the Child Tax Credit, because the phase out does not begin until the taxpayer's modified AGI reaches $400,000 for joint filers and $200,000 for all other filers (compared with the pre-TCJA phase out that began at $110,000 for joint filers, $55,000 for married filing separate and $75,000 for head of household).

In addition, the TCJA expands the categories of dependents who qualify for the Child Tax Credit by creating a $500 credit for qualifying relatives. Prior to the TCJA, children under the age of 17 were qualifying children for Child Tax Credit purposes. Under the TCJA, the taxpayer's children ages 17 through 23, lineal ancestors, stepparents, aunts, uncles, nieces, nephews, certain in-laws and certain other dependents who live with the taxpayer are qualifying relatives who may give rise to the Child Tax Credit.

The second factor expanding the due diligence requirements is in connection with certain other tax positions. In 2016, the PATH Act also expanded the Treas. Reg. § 1.6695-2 due diligence requirements to tax returns claiming the American Opportunity Credit and the Additional Child Tax Credit, and in 2018, the TCJA expanded the associated due diligence requirements to the head of household filing status.

[1] While the dependency exemption is temporarily removed by the TCJA, the determination of dependents remains relevant. For instance, head of household filing status and the Child Tax Credit require a consideration of taxpayers' dependents.

UNDER FINAL REGULATIONS ADOPTED NOV. 5, 2018, COMPLETING FORM 8867 IS AN ESSENTIAL PART OF THE DUE DILIGENCE PROCESS.

As a result, for the 2018 and subsequent tax years, return preparers are required to complete Form 8867 and the related due diligence in connection with any return claiming the Child Tax Credit, the Additional Child Credit, the American Opportunity Credit or the head of household filing status.

Due Diligence Required

The return preparer due diligence requirements are found in Treas. Reg. § 1.6695-2. Under final regulations adopted Nov. 5, 2018, completing Form 8867 (based on information provided by the taxpayer) is an essential part of the due diligence process. However, there are additional due diligence requirements that return preparers often overlook, including: (1) completing the applicable worksheets prescribed by the IRS or recording in one or more documents the method and information used to make the computations,[2] (2) meeting the knowledge requirements concerning the basis for the benefits claimed on the return and contemporaneously documenting inquiries and responses related to meeting the knowledge requirements,[3] and (3) retaining the documents used in preparing the return for three years.[4] A return preparer who completes and files Form 8867, but fails to comply with the additional requirements, has not satisfied the due diligence requirements of Treas. Reg. § 1.6695-2 and may be subject to penalties.

Penalties for failure to be diligent are usually associated with the return preparers' failure to meet the knowledge requirements in Treas. Reg. § 1.6695-2(b)(3). This provision states that a return preparer: (1) must not know that any information used to determine the taxpayer's eligibility is incorrect, (2) must not have reason to know that any information used to determine the taxpayer's eligibility is incorrect, (3) may not ignore the implications of information furnished to, or known by, the return preparer, (4) must make reasonable inquiries if the information appears to be incorrect, inconsistent or incomplete, and, arguably most important, (5) must contemporaneously document in his/her file any inquiries made and the responses to those inquiries.

As detailed below, the examples in the regulations focus on when information should appear incorrect, inconsistent or incomplete to the return preparer and when a return preparer can rely on existing knowledge to satisfy the knowledge requirement.

> Incorrect Information Requiring Additional Inquiries

The regulations provide the following example of a situation where additional inquiries are required, because the information provided by the taxpayer should appear incorrect to the return preparer.

[2] Treas. Reg. § 1.6695-2(b)(2).
[3] Treas. Reg. § 1.6695-2(b)(3).
[4] Treas. Reg. § 1.6695-2(b)(4).

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 Earned Income Tax Credit. To meet the knowledge requirement, Preparer F must make reasonable inquiries to determine whether W is eligible for the Earned Income Tax Credit, 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.[5]

ALSO SEE THE REGULATIONS FOR AN EXAMPLE THAT INDICATES ADDITIONAL DUE DILIGENCE IS REQUIRED WHEN A 32-YEAR-OLD TAXPAYER SEEMINGLY QUALIFIES FOR THE AMERICAN OPPORTUNITY TAX CREDIT.

The regulations do not explain why additional due diligence is required in this fact pattern. However, the fact pattern suggests that return preparers should suspect that this information is incorrect when a self-employed individual indicates that he/she did not incur any business expenses. In this example, the facts are particularly suspect, because the taxpayer reports self-employment income in an amount that would maximize the taxpayer's Earned Income Tax Credit. Therefore, the return preparer must make additional inquiries to confirm that the taxpayer has not omitted business expenses to maximize her Earned Income Tax Credit.

> Inconsistent Information Requiring Additional Inquiries

The regulations provide the following example of situations where the information provided by the taxpayer appears to be inconsistent.

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 Earned Income Tax Credit and the Child Tax Credit. 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, Preparer C must make reasonable inquiries to determine whether each boy is a qualifying child of Q's for purposes of the Earned Income Tax Credit and the Child Tax Credit, including reasonable inquiries to verify Q's relationship to the boys. Preparer C must also contemporaneously document these inquiries and the responses.[6]

In this example, the inconsistent information is clearly the taxpayer's age in relationship to her children's ages and the return preparer must conduct additional due diligence to confirm the relationship.

The regulations also provide an example that indicates additional due diligence is required when a 32-year-old taxpayer seemingly qualifies for the American Opportunity Tax Credit.[7]

> Incomplete Information Requiring Additional Inquiries

The regulations provide the following examples of situations where additional inquiries are necessary, because the taxpayer did not provide complete information.

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 Earned Income Tax Credit and the Child Tax Credit.

To meet the knowledge requirement, Preparer D must make reasonable inquiries to determine whether R is

[5] Treas. Reg. § 1.6695-2(b)(3)(ii)(G).

[6] Treas. Reg. § 1.6695-2(b)(3)(ii)(A).

[7] Treas. Reg. § 1.6695-2(b)(3)(ii)(H).

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 Earned Income Tax Credit) or a dependent of her parents (which would make R ineligible to claim the Child Tax Credit). Preparer D must contemporaneously document these inquiries and the responses.[8]

In 2019, S engages Preparer E to prepare his 2018 federal income tax return. During Preparer E's standard intake interview, S states that he has never been married and that his niece and nephew lived with him for part of the 2018 taxable year. Preparer E believes S may be eligible to file as head of household and claim each of these children as a qualifying child for purposes of the Earned Income Tax Credit and the Child Tax Credit, but the information furnished to Preparer E is incomplete.

To meet the knowledge requirement, Preparer E must make reasonable inquiries to determine whether S is eligible to file as head of household and whether each child is a qualifying child for purposes of the Earned Income Tax Credit and the Child Tax Credit, including reasonable inquiries about the children's residency, S's relationship to the children, the children's income, the sources of support for the children and S's contribution to the payment of costs related to operating the household. Preparer E must contemporaneously document these inquiries and the responses.[9]

The second example above was modified in the final regulations to clarify that the IRS believes additional due diligence is required in that fact pattern, because the information is incomplete. This modification, combined with the first example, suggests that the IRS believes additional due diligence is required anytime the facts indicate that the qualifying child or other qualifying relative might be a dependent of someone other than the taxpayer.

> Reliance on Existing Knowledge

In certain circumstances, a return preparer may satisfy the knowledge requirement based on existing knowledge without having to make additional inquiries. The following examples in the regulations illustrate situations in which the return preparer may be able to satisfy the knowledge requirement based on existing knowledge.

Returning to taxpayer Q above (a 22-year-old taxpayer who has never been married and has two sons, ages 10 and 11), 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. 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.[10]

Returning to taxpayer R above (an 18 year-old taxpayer who has never been married, has one child, an infant, and lived with her parents during part of the 2017 tax year), 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 Earned Income Tax Credit or Child Tax Credit on R's parents' return. Therefore, Preparer D is not required to make additional inquiries to determine that R is not her parents' qualifying child or dependent.[11]

However, the knowledge requirement must be satisfied with pre-existing knowledge that was acquired in the context of the preparer's tax return preparation practice and the preparer may not rely on pre-existing knowledge acquired from outside social interactions. The following example from the regulations illustrates this distinction.

Returning to taxpayer S above (never married and his niece and nephew lived with him for part of the 2018 taxable year), Preparer E knows from prior social interactions with S that the children resided with S for more than one-half of the 2018 tax year and that the children did not provide over one-half of their own support for the 2018 tax year.

To meet the knowledge requirement, Preparer E must make the same reasonable inquiries to determine whether S is eligible to file as head of household and whether each child is a qualifying child for purposes of the Earned Income Tax Credit and the Child Tax Credit. This includes reasonable inquiries about the

[8] Treas. Reg. § 1.6695-2(b)(3)(ii)(C).
[9] Treas. Reg. § 1.6695-2(b)(3)(ii)(E).
[10] Treas. Reg. § 1.6695-2(b)(3)(ii)(B).
[11] Treas. Reg. § 1.6695-2(b)(3)(ii)(D).

children's residency, S's relationship to the children, the children's income, the sources of support for the children and S's contribution to the payment of costs related to operating the household. Preparer E must contemporaneously document these inquiries and the responses.[12]

The above examples reinforce the requirement to contemporaneously document the inquiries made and the responses to those inquiries to satisfy the knowledge requirement of due diligence. During the comment period for the regulations, one commenter recommended that the IRS permit return preparers to demonstrate satisfaction of this requirement through other forms of evidence, such as testimony. The IRS rejected this suggestion and reiterated that contemporaneous documentation is an important requirement for improving compliance and reducing the error rate in tax returns.

Due Diligence Penalty

Section 6695(g) imposes a $500 penalty[13] on return preparers for each failure to be diligent. Prior to recent changes, each failure to be diligent was a per-return penalty. However, after section 6695(g) was expanded by the PATH Act and the TCJA, the regulations provide for a separate penalty for each credit or head of household claimed on a return; thus, the IRS may impose multiple penalties on a return preparer in connection with a single return. The IRS' position is illustrated by the following example from the regulations.

Penalty Relief Under Treas. Reg. 1.6695-2(d)

The regulations provide an exception to penalty at the IRS' discretion. Under Treas. Reg. § 1.6695-2(d), the penalty will not be assessed if the return preparer can demonstrate to the satisfaction of the IRS that, considering all the facts and circumstances, the 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 a tax return was isolated and inadvertent.

Additional Inquiries

Form 8867, and the related due diligence required under Treas. Reg. § 1.6695-2, will likely be required on a significant number of individual tax returns for the 2018 and subsequent tax years. In light of this fact, return preparers must be alert to situations that require additional due diligence, because the information provided by the taxpayer is incorrect, inconsistent or incomplete. In these situations, the return preparer must make additional inquiries and contemporaneously document the inquiries and responses to avoid the $500 penalty imposed under section 6695(g) for each failure to be diligent.

THE REGULATIONS PROVIDE AN EXCEPTION TO PENALTY AT THE IRS' DISCRETION.

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[12] Treas. Reg. § 1.6695-2(b)(3)(ii)(F).
[13] The penalty is subject to an annual inflation adjustment and is currently $520 per failure to be diligent.