

**2011**

**IRS/EITC Software Developers Working Group**

**SDWG FY 2011 ANNUAL REPORT**

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## 1 Introduction

The IRS/EITC Software Developers Working Group is a partnership between the IRS Earned Income Tax Credit (EITC) Office and various software industry representatives from within the membership of the National Association of Computerized Tax Processors (NACTP) and the Council of Electronic Revenue Communication Advancement (CERCA). Since this Working Group was formed in February 2008, working sessions have been held to identify issues, potential short-term and long-term best practices, and software enhancements that could improve the quality of EITC returns, increase EITC participation for eligible taxpayers and help preparers meet their due diligence requirements.

Building upon their work in the previous years, the Working Group continued to address EITC issues and also broadened their focus to issues surrounding the Schedule C, *Profit or Loss from Business*; the EITC Due Diligence Audit Process; Service-wide Preparer Registration Initiative; other refundable credits including First-Time Home Buyer Credit (FTHBC), the Adoption Credit, the American Opportunity Tax Credit (AOTC), and the Child Tax Credit (CTC) / Additional Child Tax Credit (ACTC), and self-preparation software.

Recognizing 9 out of 10 taxpayers use a return preparer or tax preparation software, the Working Group plays a key role in improving the process and accuracy of the tax filing experience.

### 1.1 Purpose of Report

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The purpose of this document is to acknowledge and document the recent efforts of the Working Group as well as to address the future initiatives identified by the Working Group during 2011 meetings. The Working Group develops recommendations for the tax software industry, the return preparer community, as well as the Internal Revenue Service. This report documents the current recommendations developed during the FY 2011 working sessions.

### 1.2 Key Stakeholders

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Although the primary audience of the Working Group recommendations is the tax software industry, this annual report will be shared with return preparers and the IRS community. Members of the Working Group are expected to socialize the information from the Working Group meetings to others within their companies and industry and provide feedback to the group. In order to obtain more information or provide feedback, contact Peter Maser (Peter.E.Maser@irs.gov) or a member of the Working Group.

### 1.3 Voluntary Implementation of Recommendations

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The recommendations of the Working Group will be communicated to the software developer industry with the expectation that software companies will implement some or all of the recommendations. The implementation of these recommendations is voluntary and should not be

interpreted as regulatory. In addition, the contents of this report do not constitute official IRS guidance.

## 2 EITC Recommendations

The Working Group continues to address issues related to the EITC. In FY 2010, they tackled return preparer due diligence issues associated with the preparation of Schedule C. In FY 2011, the Working Group continued to develop a better understanding of the Due Diligence Audit process and what is required to satisfy the Knowledge Requirement. Also, one of the Working Group’s earliest recommendations to require submission of the Form 8867 has been realized.

### 2.1 Due Diligence and Schedule C Income Reporting

Paid tax return preparers generally can rely on the taxpayer’s representations, but EITC due diligence requires the paid preparer to take additional steps to determine that the net self-employment income used to calculate the amount of or eligibility for EITC is correct and complete.

Income reporting errors are among the three most common EITC errors and were highlighted during the 2010 Tax Forums through the Tax Tales due diligence videos. The videos are now available on EITC Central, <http://www.eitc.irs.gov/rptoolkit/ddvideos/>.

In 2009 meetings, the Working Group identified due diligence issues associated with the preparation of Schedule Cs. The FY 2010 proposed recommendations focused on additional training and guidance for tax preparers preparing a Schedule C.

The group developed this training module that introduces the due diligence responsibilities involved with preparing returns with a Schedule C where EITC is claimed. The module also includes recordkeeping guidelines, recommendations on reconstructing records, and examples of how to comply with EITC due diligence in common Schedule C situations a preparer may encounter.

After approval by Counsel, the Schedule C and Records Reconstruction training module was posted to the EITC Central Toolkit on March 5, 2011. The training module was advertised at the 2011 Tax Forums as well as on the EITC Central website and through other external communications. The interest has been very positive with over 7,500 accesses of the web page as of December 2011.

| # | Proposed EITC Recommendation   |
|---|--|
| 1 | The Working Group suggested the completed training module be expanded into a qualifying Continuing Professional Education (CPE) module |

## 2.2 EITC Due Diligence Audit Case Studies

In a continued effort to understand return preparers’ responsibilities specifically related to the Knowledge Requirement, Working Group members performed case studies on the prior year Due Diligence Audits performed on their software users. The real life cases selected included both penalty and non-penalty results.

The group analyzed the documentation reviewed by the examiner as well as the examiner’s conclusions to better understand when and what additional questioning would be required to meet a preparer’s due diligence. Attention was given to cases where answers to the additional questions were simply, “yes,” “no,” or “I don’t know.” The group’s review identified some inconsistencies. The Working Group developed the following recommendations to address the inconsistencies:

| # | Proposed EITC Recommendation  |
|---|---|
| 2 | IRS should address the examiner inconsistencies of penalty assertion  |
| 3 | IRS should improve the due diligence penalty explanation with the use of more consistent language                             |
| 4 | IRS should develop a more comprehensive list of scenarios that require additional inquiries to meet the knowledge requirement |

The first two recommendations are being implemented for FY 2012. The third recommendation may be developed in conjunction with the Working Group during the FY 2012 working sessions.

The training for the Due Diligence Audits is being provided by a single source to ensure the message is consistent to all examiners. The training has been recorded and is available for review to any examiner.

A template has been developed for the Due Diligence Audit Explanation including details surrounding the penalty if assessed. The Due Diligence Audit Explanation will provide valuable insight into understanding the examiners’ determination. The Working Group felt this information would be helpful to understand what additional questions should be asked to meet due diligence.

## 2.3 Submission of Form 8867, *Paid Preparer’s Earned Income Credit Checklist*

The IRS created Form 8867, *Paid Preparer’s Earned Income Credit Checklist*, to help preparers meet their due diligence requirements by obtaining eligibility information from their clients. As completion of Form 8867 is an integral step in the EITC due diligence process, the Working Group discussed a recommendation to submit the form during return transmittal during the June 2009 working session.

Aligning with the Working Group recommendation, the IRS issued proposed regulations that would require paid tax return preparers, beginning in 2012, to submit a Form 8867 with any federal return claiming EITC. Current regulations require tax return preparers to complete the Form 8867 or its equivalent; using an equivalent will no longer be an option.

| # | Proposed EITC Recommendation   |
|---|--|
| 5 | The Working Group recommended modifications to the Form 8867 to provide additional guidance on documentation to substantiate eligibility |

The Working Group reviewed Form 8867 to identify opportunities to provide additional guidance to return preparers. The group prepared two versions of Form 8867 for consideration by the IRS for TY 2012.

### 3 FY 2010 Refundable Credit Recommendations

In FY 2010, the Working Group expanded their scope beyond EITC to serve the tax preparer community in response to new refundable credits including the First-Time Home Buyer Credit and the Adoption Credit.

#### 3.1 First-Time Home Buyer Credit Recommendations

Last year the IRS issued over 5 million reminder notices to educate taxpayers on FTHBC repayment obligations and potential recapture obligations as applicable. In FY 2010, the Working Group proposed the development of an IRS.gov lookup tool for the credit claimed and repayment required by taxpayers to support preparers' and taxpayers' efforts to calculate and properly report recapture of the credit.

As recommended by the Working Group, the IRS is developing a FTHBC Web Look-up Tool that will replace the need to issue reminder notices. This tool is scheduled to be available January 2012.

The web application will provide critical account information that will assist taxpayers to accurately self report FTHBC repayment obligations on their tax returns. The tool will provide information for all FTHBC recipients; however, it primarily impacts taxpayers that have a 15 year FTHBC repayment requirement or an accelerated repayment based on the change to the home. The web tool is not authorized for third party users; it is specific for the individual taxpayers. However, it does allow the user to print the account screen, therefore allowing him to share this information with his preparer.

#### 3.2 Adoption Credit Recommendations

Since the Adoption Credit was expanded by the Affordable Care Act enacted in March 2010, the Working Group members provided suggestions on material the IRS could develop to assist

taxpayers and preparers to properly compute the Adoption Credit. Early in the 2011 filing season, the Service recognized high percentages of taxpayers were not attaching adequate documentation to the paper return to support their claim of the adoption credit.

With input from the Working Group and based on the 2010 suggestions, the Service executed a significant communications effort including a Tax Tip, email blasts to adoption organizations, e-News to Tax Professionals, a YouTube video, and an updated FAQ's on Adoption Credit for documentation requirements for special need adoptions. The Service also revised Form 886-H-Adopt, which is used during the audit process to request supporting documentation for the adoption credit claims.

In addition to the communications and documentation efforts, the Service was able to leverage its relationship with some of the Working Group members to request immediate software changes to support Adoption Credit documentation requirements. These software updates resulted in improved processing of returns claiming the Adoption Credit.

## **4 FY 2011 Refundable Credit Recommendations**

In FY 2011, the Working Group continued to expand their scope to address issues of more refundable credits affected by the American Recovery and Reinvestment Act (ARRA) of 2009. The American Opportunity Tax Credit (AOTC) and the Additional Child Tax Credit (ACTC) have unique challenges when addressing compliance for both preparers and taxpayers. In addition to addressing the specific challenges of each credit, the Working Group was interested in the intersection of the population that claimed one of these credits and EITC.

### **4.1 AOTC Recommendations**

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Following the creation of the AOTC by the ARRA, the credit was extended to Tax Years 2011 and 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. In addition to the extension, the maximum credit amount was increased from \$1,800 to \$2,500, and the originally non-refundable credit was changed to a refundable credit. 40% of the credit may be refundable (up to \$1,000).

With the increase in the credit amount and the change to refundable credit, there has been an increase in the number of fraudulent claims. Several factors serve as barriers to reducing improper payments for the AOTC. The lack of sufficient Math Error Authority and lack of accurate third party data (1098-T) to determine AOTC eligibility for students are two major challenges for AOTC. Currently the only way to address AOTC math errors are through exam audits. Another major challenge is that educational institutions may be filing inaccurate 1098-Ts and/or may not be issuing them at all.

In an effort to address these challenges, the Service plans to implement several initiatives:

- Redesign the TY2012 Form 8863
- Perform a soft notice campaign for the student/preparer addressing either lack of a 1098-T or box 8 not indicated as at least half-time
- Mail soft notices to the top 20 educational institutions that have not issued 1098-Ts

The Working Group has suggested the following recommendations to assist during the transition with these Service initiatives:

| # | Proposed AOTC Recommendation  |
|---|---|
| 1 | Establish an AOTC landing page on IRS.gov that provides preparers with information about who is eligible to claim the credit and what expenses are eligible for reimbursement   |
| 2 | Create a decision tree for AOTC to help the preparer easily navigate to a determination on whether or not the credit is allowable   |
| 3 | Provide links to the Department of Education’s accredited institutions enabling the preparer to quickly establish whether or not the educational institution is a valid institution with regard to the taxpayer claiming AOTC |
| 4 | Research the subset of returns where both EITC and AOTC were claimed to identify any fraud trends   |

#### 4.2 ACTC Recommendations

Under ARRA, the ACTC amount is higher, making it more attractive and subject to fraud and abuse. Based on the lower earned income threshold, more taxpayers will qualify and receive an increase in this refundable credit. The Service has identified two main risk areas with ACTC:

- 1) Children not meeting the Residency Test
- 2) False or unverifiable earned income

As part of its ACTC strategy, the Service will educate the taxpayers and preparers on the CTC/ACTC eligibility requirements in forms, publications and software and improve both written instructions and software features/prompts regarding specific eligibility for the CTC/ACTC.

In an effort to assist the Service with its ACTC Strategy, the Working Group proposed the following recommendations:

| # | Proposed ACTC Recommendation  |
|---|---|
| 1 | Research the subset of returns where both EITC and ACTC were claimed to identify any fraud trends |

| # | Proposed ACTC Recommendation   |
|---|--|
| 2 | Train paid preparers preparing a return with a disabled dependent to ask the taxpayer if the dependent is receiving SSI benefits |

The Working Group plans to continue its work to address ACTC issues including the challenges surrounding ACTC claims and ITINs.

## 5 Future Working Group Initiatives

Since its creation in 2008, several Working Group recommendations have been implemented by the Service, as well as, by software companies. These recommendations, along with established best practices for the tax software industry and return preparer community, have proven significant in support of the Service's objective for improved compliance. Considering the changing economic conditions and frequent legislative responses, the IRS/EITC Software Developers Working Group will continue its valuable work with future initiatives:

- The Working Group will discuss the impacts of the new regulations and the increased penalty amount
- Due to the decline in the volume of returns prepared by paid return preparers, greater attention has been drawn toward the accuracy of self-prepared returns. The Working Group will continue to discuss improvements to Off-the-Shelf software to address the accuracy of self-prepared returns.
- The Working Group will consider recommending revisions of forms to capture compliance information on the face of the form making the compliance requirements explicit for both taxpayers and paid preparers.
- The Working Group expressed an interest in expanding their current scope to address issues of noncompliance and opportunities to provide education and guidance to preparers for other refundable and non-refundable credits including the Healthcare Credit.
- The Working Group will explore the usability of required documentation submitted as MeF attachments on electronically filed returns, reducing the need for paper-filed returns.
- Additionally, the Working Group expressed an interest in expanding their current scope to address issues of noncompliance and opportunities to provide education and guidance to preparers for Household Help.

## Appendix – IRS/EITC Software Developers Working Group Members

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