



Earned Income Tax Credit Preparer Due Diligence

Phone Forum for Practitioners

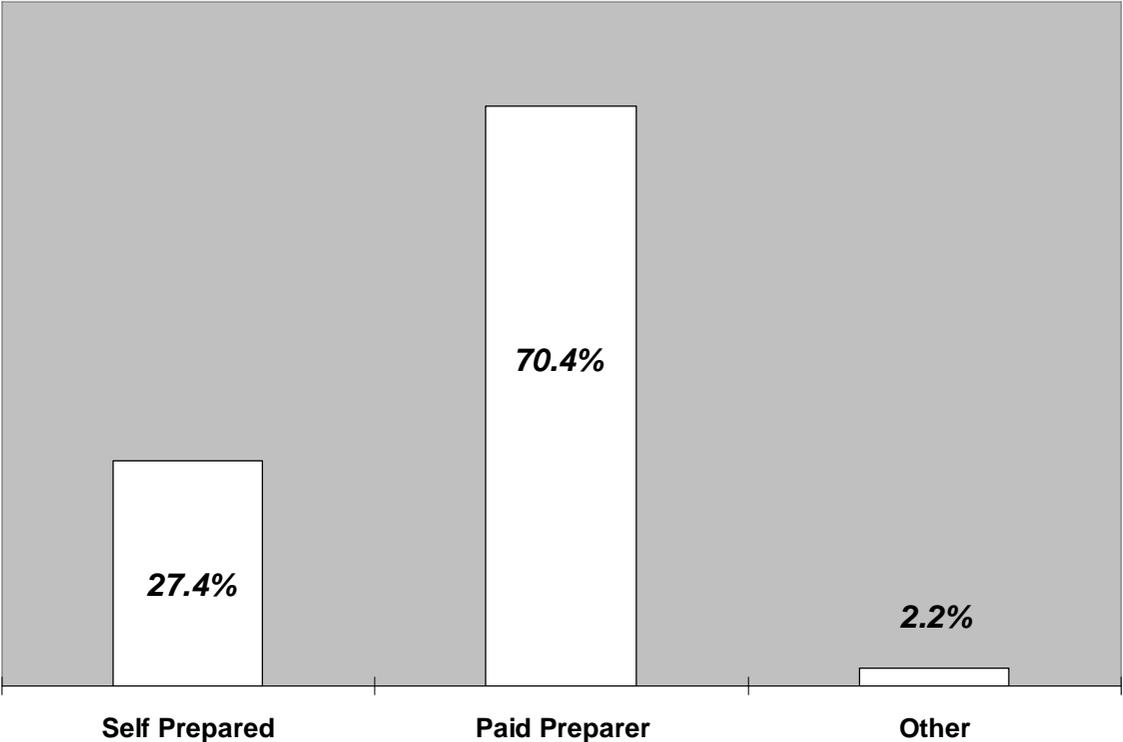
**Lynne Morrison
Senior Program Analyst
EITC Office
January 16, 2008**

EITC Facts

- For TY 2006 22.4M returns were credited with \$43.7B in EITC
- Although the number of individuals claiming EITC is high, erroneous payments are also high
 - Participation is estimated at 75% to 80%
 - 23% - 28% error rate according to current estimates
 - Estimated \$10B to \$12B in improper payments
- Three issues accounted for more than 60 percent of the erroneous claims according to last comprehensive study for TY 1999
 - Qualifying Children
 - Filing Status
 - Income Misreporting

Over 70% of EITC Claimants Use Paid Tax Preparers

EITC Return Preparation Methods



Recent Events Highlight the Need to Address Preparer EITC Due Diligence

- **Government Accountability Office (GAO) Audit – TY 2005 Filing Season**
 - Shopped 10 returns with EITC scenario
 - 8 out of 10 did not report all income
 - 5 out of 10 did not ask where child lived or ignored GAO's answer
 - 5 out of 10 incorrectly claimed an additional child
 - Refunds reported were correct in 2 cases, overstated in 8
 - Only 1 preparer asked all due diligence questions
- **The preparer community has expressed concern regarding preparer due diligence at IRS Tax Forums**
- **Publicity on Criminal Cases and Civil Injunctions filed against preparers who filed EITC returns**

Internal Revenue Code § 6695(g)

- **Enacted in 1997 in an effort to address EITC error and preparer due diligence**
- **Any income tax preparer who prepares a return or claim for refund who fails to comply with the due diligence requirements, imposed by the Secretary by regulations, concerning eligibility for and amount of EITC shall pay a penalty of \$100 for each failure**
- **Treasury Regulations enumerate 4 requirements**
- **Paid preparers must comply with all four requirements**

Treasury Reg. § 1.6695-2 sets out the four due diligence requirements

Requirement	Description
1 - Completion of Eligibility Checklist	<ul style="list-style-type: none"> ▶ Preparer must either complete Form 8867, Paid Preparer's EIC Checklist, or its equivalent ▶ Completion must be based on information provided by the taxpayer to the preparer
2 - Computation of the Credit	<ul style="list-style-type: none"> ▶ Preparer must keep the EIC worksheet or an equivalent that demonstrates how the EITC was computed
3 - Knowledge	<p>Preparer</p> <ul style="list-style-type: none"> ▶ Must not know or have reason to know that any information used by the preparer in determining the taxpayer's eligibility for, or the amount of, the EITC is incorrect ▶ May not ignore the implications of information furnished to, or known by, the preparer ▶ Must make reasonable inquiries if information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete
4 - Record Retention	<p>Preparer</p> <ul style="list-style-type: none"> ▶ Must retain Form 8867 and EIC worksheet or equivalents, and ▶ Must maintain record of how and when the information used to complete these forms was obtained ▶ Must verify the identity of the person furnishing the information ▶ Must retain records for 3 years after the June 30th following the date the return or claim was presented for signature

Two requirements are fairly straightforward

- **Requirement #2 - EITC Worksheet**
- **Requirement #4 - Recordkeeping**

Two requirements are fairly straightforward

Requirement #2 - EITC Worksheet

- Computational in nature
- Programmed into most tax preparation software
- Reflects computation of self-employment income, total earned income, investment income and adjusted gross income
- Rarely a compliance issue unless preparer doesn't use software or fails to keep records

Two requirements are fairly straightforward

Requirement #4 - Recordkeeping

- Must keep Form 8867, EIC worksheet and record of how and when information was furnished and who furnished information used to prepare EITC claim
- The *when* aspect is documented by the tax return
- The *who* and *how* aspects are generally documented by either the interview software or a paper intake sheet completed by client
- May be kept in paper or electronic format
- Recordkeeping is a common noncompliance issue

Two requirements are more challenging

- **Requirement #1 - Form 8867, Paid Preparer's Earned Income Credit Checklist**
- **Requirement #3 – Knowledge Requirement**

Two requirements are more challenging

Requirement #1 - Form 8867, Paid Preparer's Earned Income Credit Checklist

- Form 8867 was designed to ensure paid preparers considered all EITC requirements when preparing an EITC return
- Form 8867 contains 19 questions covering EITC qualifications
- The paid preparer is expected to ask questions of the client and explain the questions when needed
- The last 4 questions on Form 8867 address the preparer's due diligence responsibilities (added in December 2006)

Form 8867, Part I, addresses EITC requirements for all taxpayers

- Filing status
- Valid Social Security number - Ideally Social Security cards should be reviewed by preparer
- Foreign Earned Income exclusion
- Non-resident Alien status
- Investment Income
- Whether taxpayer is a qualifying child of another

Form 8867, Part II , addresses EITC requirements for taxpayers with a qualifying child

- Relationship of child
- Marital status of child
- Residency of child
- Age of child
- Valid Social Security Number for child
- Whether child is a qualifying child of another taxpayer
- Tie-breaker rule application
- Overall income limits for EITC

Form 8867, Part III, addresses EITC requirements for taxpayers without a qualifying child

- Residency of taxpayer
- Age of taxpayer
- Whether taxpayer can be claimed as a dependant on another return
- Overall Income limitation for EITC

Form 8867, Part IV, addresses the paid preparer's due diligence requirements

- Was Form 8867 prepared based on info provided by the taxpayer or reasonably obtained by the preparer?
- Was EIC worksheet completed?
- Did the practitioner comply with the knowledge requirement of IRC § 6695(g)?
- Did the preparer keep the records required by IRC § 6695(g)?

But EITC Due Diligence Means More than a Checkmark on a Form

Two requirements are more challenging

Requirement #3 - Knowledge Requirement

- Requires that tax preparer evaluate the information received from the client
- Requires tax preparer to apply a **consistency** and **reasonableness** standard to the client's information
- Software programs generally do not address these issues and should not be relied on solely to meet the knowledge requirement
- A preparer, knowledgeable in the tax law, is expected to make additional inquiries when the information furnished by the client warrants it
- In 2007, 90% of due diligence penalties were assessed due to failure to comply with the knowledge requirement

Examples of situations where knowledge requirement would be applicable

- During the interview process, the client informs the preparer that she is separated from her spouse. Their child lives with her and she wants to claim EITC. The preparer should ask the appropriate questions to determine the correct filing status for the client and to determine how long the child lived with each parent in order to meet the knowledge requirement.
- During the interview process, the client, who is 18 years old, mentions that she and her infant daughter live with her parents. She has earnings of \$3,000 from a part time job. She wants to claim EITC. In order to meet the knowledge requirement the preparer should ask the appropriate questions to determine if this client is a qualifying child of her parents and therefore, ineligible to claim EIC.

Examples - continued

- Client comes in to have his return prepared. He is 22 years old and is claiming that he has two sons, ages 10 and 11, that he wants to claim for EITC. In order to meet the knowledge requirement, the preparer should ask additional questions since the ages of the children appear inconsistent with the client's age.
- Client comes in to have her return prepared. She states that she is head of her household and has 2 children ages 13 and 14. She states that she was self-employed as a babysitter, earned \$12,000, and had no expenses. The information appears incomplete since it is unlikely that someone who is self-employed had no business expenses. The preparer should make additional reasonable inquiries to ensure the income is legitimate.

Examples - continued

- A client claiming head of household is also claiming his niece and nephew as qualifying children for EITC. Reasonable inquiries should be made to determine whether EITC qualifications are met, which would include questions concerning status/location of children's parents.
- A returning client has different qualifying children, with different relationships to her, from last year. Inquiries should be made to determine the facts regarding why this is so and that the children meet all EITC requirements.
- A returning client who filed married filing joint last year tells you she wants to file as head of household. Inquiries should be made to determine whether the client was divorced or legally separated or can be "considered unmarried" for filing status purposes.

According to practitioner feedback at the IRS Tax Forums, many preparers rely on software to satisfy their due diligence requirements

- Software cannot satisfy all due diligence requirements
- Due diligence requires professional knowledge of EITC requirements and the application of sound judgment and common sense to the information provided by clients
- Software issues to consider:
 - If Form 8867 fills automatically based on interview questions, does the interview in your software include all the required items?
 - Do you ask all the interview questions? Some software allows the preparer to skip over questions and the software enters a default.
 - Do you conduct a complete interview for returning clients or do you use prior year information?
 - Some software allows the user to override the Forms 8867 and EIC worksheets

IRC §6695(g) Penalty Exceptions

- The preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with due diligence requirements
- The failure to meet the requirements on a given return was isolated and inadvertent
- Key Points to the Exception:
 - ▶ Whether preparers are trained in EITC Due Diligence requirements?
 - ▶ Whether there are written instructions to employees on how to comply?
 - ▶ Whether there is a quality control process?

EITC Due Diligence Visits Background

- The first EITC due diligence audits were conducted in 1999
- IRS examiners have conducted nationwide due diligence audits annually
- The number of preparers visited has ranged as high as 10,000
- Preparers are selected for due diligence visits based on the high likelihood that the returns they prepare have EITC error
- That likelihood is based on standard criteria applied to all EITC returns
- The FY 2008 visits started October 30, 2007 and will continue through filing season

Key Facts about EITC Due Diligence Visit Program

- The EITC Due Diligence visit is an **examination** to determine whether a paid preparer is in compliance with all 4 requirements of IRC §6695(g)
- General examination guidelines apply to these visits
- You should be prepared to schedule an appointment within 15 days of examiner notification
- If you are an employee preparer (i.e. you work for a tax preparation firm), your employer will also be contacted and interviewed
- Penalties are \$100 for each return for which due diligence requirements are not met

What you can expect if you are selected for an EITC Due Diligence visit

Preparer Contacted to Set Appointment



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- ▶ Appointment set by phone or letters
- ▶ Will contact both employee and employer in applicable situations

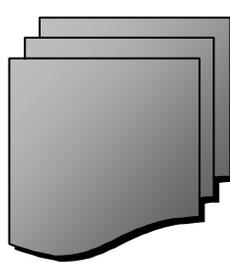
Preparer Interviews conducted



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- ▶ Examiner interviews preparer and employer

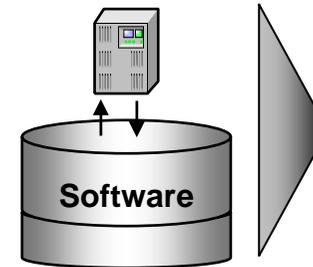
Examiner Reviews Returns



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- ▶ Examiner reviews 25 returns
- ▶ Sample expanded if non-compliance with due diligence requirements is noted

Examiner Reviews Software



4

- ▶ Data intake questionnaire reviewed
- ▶ Form 8867 questionnaire reviewed
- ▶ EIC Computation Worksheet reviewed
- ▶ Review for presets and overrides

Examiner Makes Penalty Determination



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- ▶ Examiner determines if preparer has complied with IRC 6695(g)
- ▶ If penalties are warranted, examiner determines whether to assess penalties against the employer or employee preparer

Other Key Facts about EITC Due Diligence Visit Program

- If penalties are proposed you may
 - Agree and pay the penalties
 - Request an informal managerial hearing to discuss the issues
 - Choose to disagree with the penalties
 - File a timely protest to request an Appeals hearing before penalties are assessed

- You may file Form 6118, Claim for Refund of Income Tax Return Preparer Penalties, after penalties are assessed and within 3 years from the date you pay the penalties

Status of additional guidance for IRC §6695(g)

- ▶ Additional guidance is on IRS Chief Counsel's Business Plan for year ending 6/30/2008
- ▶ When guidance is issued provide your feedback to IRS contact listed

Summary

- **EITC Due Diligence means more than a checkmark on a form**
- **A preparer cannot rely on software alone**
- **Know the EITC tax law**
- **Apply sound judgment and common sense to information provided by clients and ask questions when needed**

EITC Resources

- On-Line Tools at [irs.gov](https://www.irs.gov)
 - EITC Website: www.irs.gov/eitc
 - Tax Practitioner Toolkit: www.eitcfortaxpreparers.com
 - EITC Assistant
 - Publications, Forms and Worksheets, including
 - Publication 596, Earned Income Credit
 - Form 8867, Paid Preparer's Earned Income Credit Checklist
- Questions from Phone Forum? E-mail Nationalphoneforum@irs.gov