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Earned Income Tax Credit

Due Diligence and You

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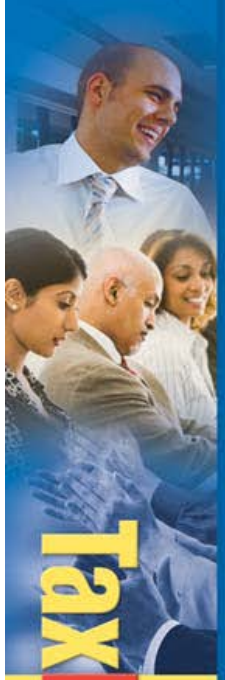
What's New for EITC Tax Year 2009

- Changes to Uniform Definition of a Child
- Addition of third child
- Increased income threshold for married couples



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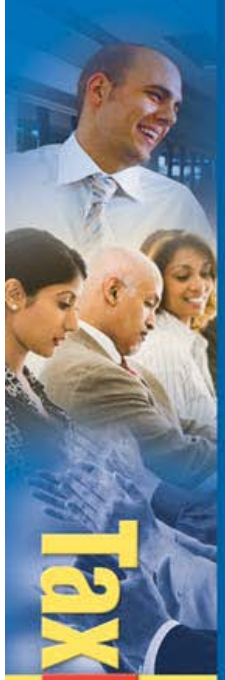
What is EITC Due Diligence

- EITC error rate is 23-28%
- More than 70% of EITC returns are prepared by paid preparers
- Congress enacted in response to EITC error rate
- Requires paid preparers to take extra steps to ensure correct EITC claims



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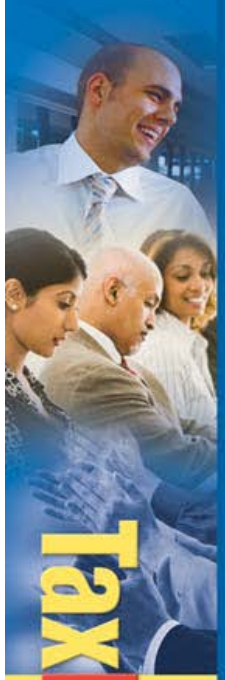
EITC Due Diligence

- Internal Revenue Code §6695(g)
- Due Diligence has 4 requirements
  - **Completion of Eligibility Checklist**
  - **Computation of the Credit**
  - **Records Retention**

AND….



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EITC Due Diligence

Knowledge Requirement

- 90% of penalties assessed for failure to comply with this area

- Know the law
- Ask the right questions
- Get all the facts
- Document as you go

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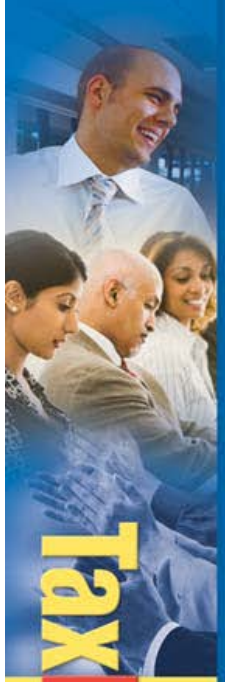
Due Diligence Common Errors

Pay particular attention to the following issues that account for more than 60% of all EITC errors

1. Claiming a child who does not meet the age, relationship or residency requirement
2. Filing as single or head of household when married
3. Under or over- reporting income



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Best Practices

- Conduct a thorough interview
- Get the right information
- Don't rely on software alone
- Protect your client's personal information

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Best Practices to Resolve or Avoid Qualifying Child Issues

- Conduct a thorough interview
- Ask enough questions to accurately determine if the child meets the residency test
- Phrase questions in terms your clients understand
- Follow up on any questionable issues about the relationship

Due Diligence - Know the law. Ask the right questions. Get all the facts.

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Best Practices to Resolve or Avoid Filing Status Issues

Ask enough questions to be able to accurately determine your client's filing status

Phrase questions in terms your clients understand

Consider using the IRS Form 886-H-HOH to illustrate head of household requirements

Due Diligence - Know the law. Ask the right questions. Get all the facts.

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Best Practices to Resolve or Avoid Income Reporting Issues

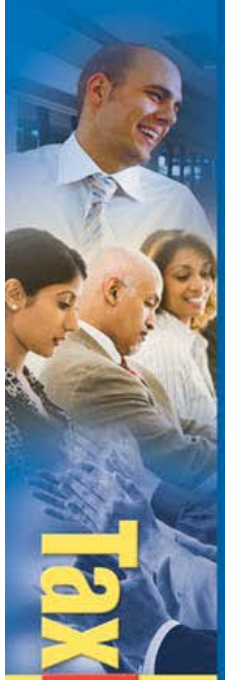
Ensure clients are not under or over-reporting income or expenses

Be on the lookout for questionable Schedule C's that either qualify the taxpayer for EITC or maximize the EITC

Guide clients without records through a reconstruction of income and expenses

Ensure all required items are included on the return

Due Diligence - Know the law. Ask the right questions. Get all the facts.



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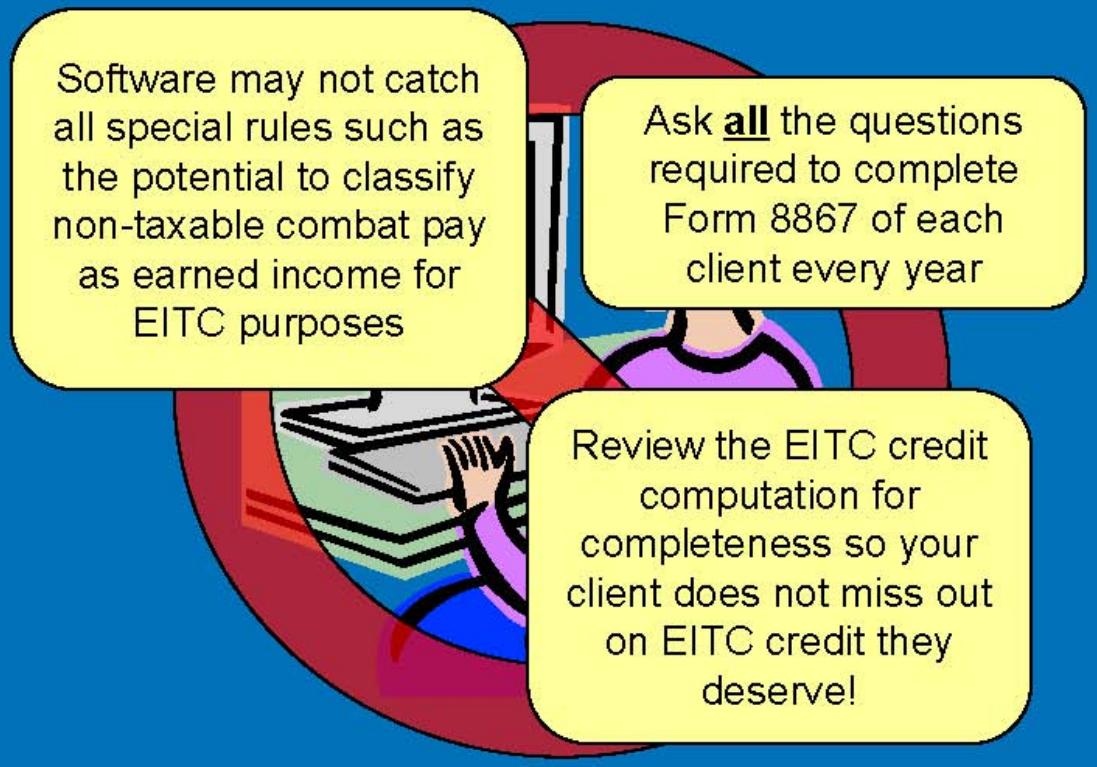
Don't Rely on Software Alone

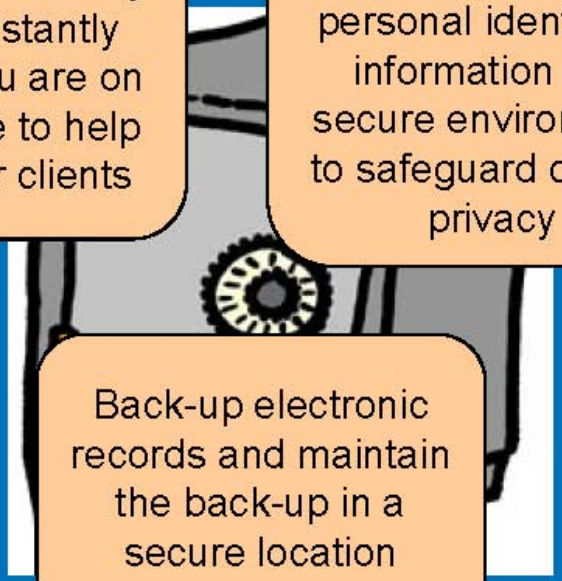


Due Diligence - Know the law. Ask the right questions. Get all the facts.

Protect Your Client's Personal Information

The threat of identity theft is constantly growing. You are on the front line to help protect your clients

Maintain all clients' records containing personal identifying information in a secure environment to safeguard clients' privacy

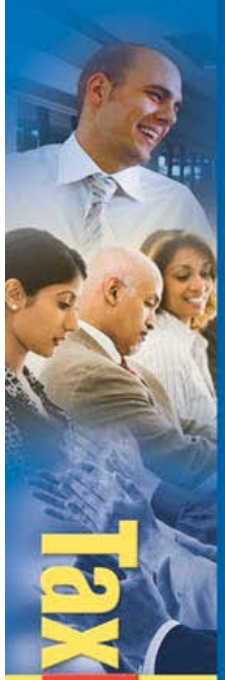


Back-up electronic records and maintain the back-up in a secure location

Due Diligence - Know the law. Ask the right questions. Get all the facts.

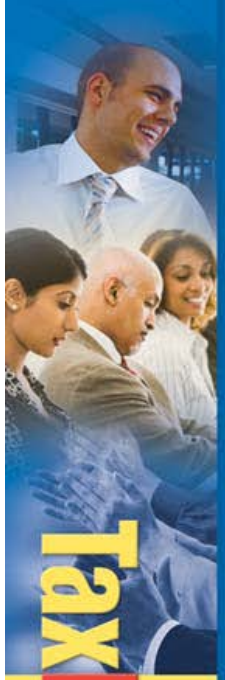
Applying EITC Due Diligence in your tax practice

Due Diligence - Know the law. Ask the right questions. Get all the facts.



Scenario 1

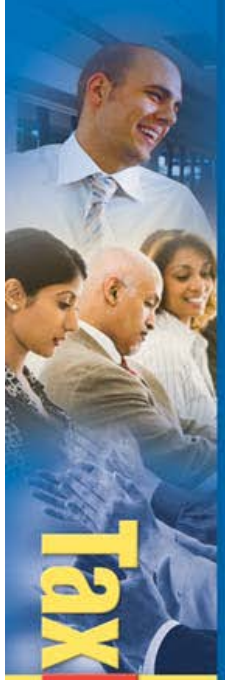
- Mike wishes to have his taxes prepared. He informs you:
  - He is single
  - He is 18 years old
  - He has W-2 wages of $12,750
  - His sister lives with him, and he wants to claim EITC



Scene 1 – Take 1

You ask…	He says…
• Did anyone else live in the house with you and your sister?	• Our mother lived with us
• How many months did your sister live with you?	• The three of us lived together all year
• How old is your sister?	• My sister is 21
• Is she a full-time student?	• She is a full time college student
• Is your sister disabled?	• My sister is not disabled
• How much did your sister's parents earn last year?	• My mother earned $27,000 last year. I don't know about my father…

Due Diligence - Know the law. Ask the right questions. Get all the facts.



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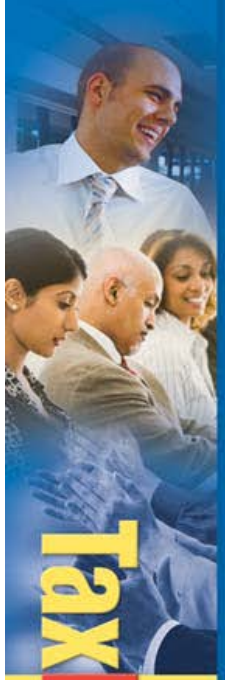
Does Mike qualify for EITC?

- No, Mike and his sister are both qualifying children of their mother.
- Since Mike is a qualifying child of another individual, he cannot claim EITC.



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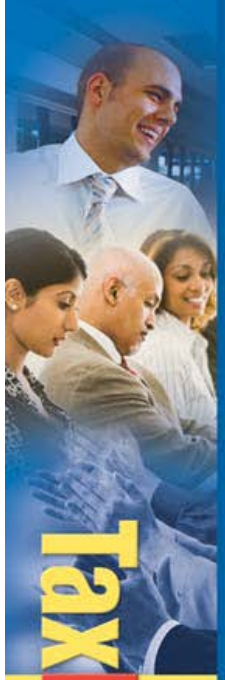
Scene 1 – Take 2

You ask…

- Did anyone else live in the house with you and your sister?
- How many months did your sister live with you?
- How old is your sister?
- Is your sister a full time student?
- Is your sister disabled?

He says…

- No
- My sister and I lived together all year
- My sister is 21
- My sister is a full time student
- My sister is not disabled



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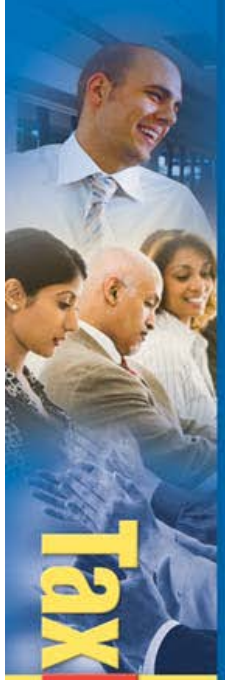
Does Mike qualify for EITC?

- No, although his sister meets the relationship and residency requirements, the 2009 changes to the Uniform Definition of a Child require that the taxpayer claiming the child be older than the child being claimed unless the child is permanently disabled.



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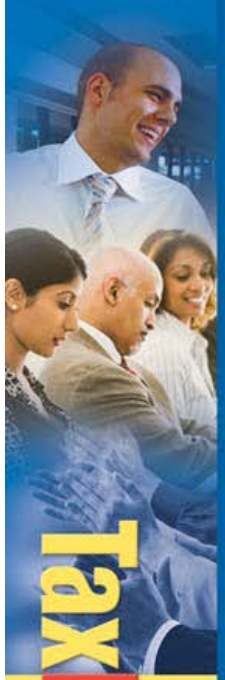
Scene 1 – Take 3

You ask…	He says…
• Did anyone else live in the house with you and your sister?	• No
• How many months did your sister live with you?	• My sister and I lived together all year
• How old is your sister?	• My sister is 21
• Is your sister a full time student?	• No
• Is your sister disabled?	• Yes, she has Cerebral Palsy
• How long has she had this disability?	• Since birth
• Can she hold a job?	• No
• How much money did your sister's parents earn last year?	• Our parents are deceased

Due Diligence - Know the law. Ask the right questions. Get all the facts.



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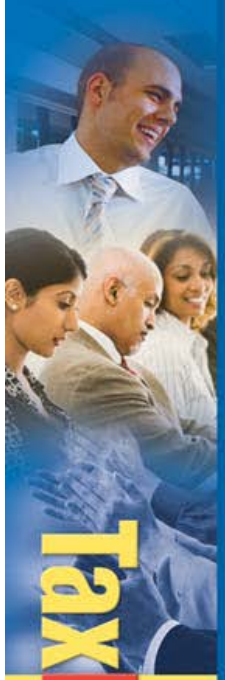
Does Mike qualify for EITC?

- Yes, Mike's sister meets the relationship, age and residency requirements, therefore Mike should be able to claim her.



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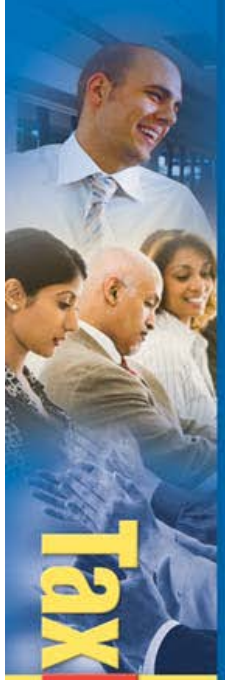
Scenario 2

- Roberta comes to you to have her taxes prepared. She informs you:
  - She is 24 years old and single
  - She lives in Kansas City, MO
  - She has 2 foster children
  - She has W-2 earnings of $20,000
  - She wants to claim EITC



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Scene 2 – Take 1

You ask….	She answers…
• Did anyone else live with you last year?	• My boyfriend lived with me all year
• How long did the foster children live with you last year?	• The children lived with me all of last year
• How old are the children?	• The children are 3 and 5
• Were the children placed with you by a court or other social services agency?	• No, the children are my boyfriend's children. I just call them my foster children

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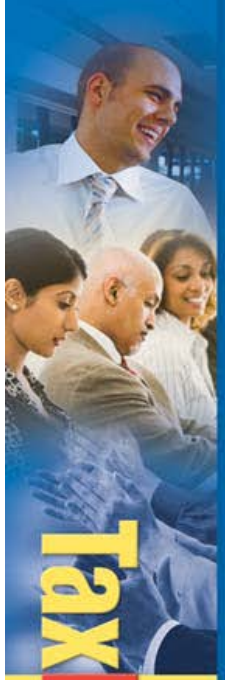
Are the children Roberta's qualifying children?

- No, the children do not meet the relationship requirement. They do not qualify as foster children under the law.



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Scene 2 – Take 2

You ask….	She answers…
• Did anyone else live with you last year?	• My boyfriend lived with me all year and my sister lived with me until May
• How long did your foster children live with you last year?	• The children lived with me all of last year
• How old are the children?	• The children are 3 and 5
• Were the children placed with you by the courts or another social services agency?	• Yes, by the court. The children are my sister's children. My sister went to jail in May. I am keeping her children

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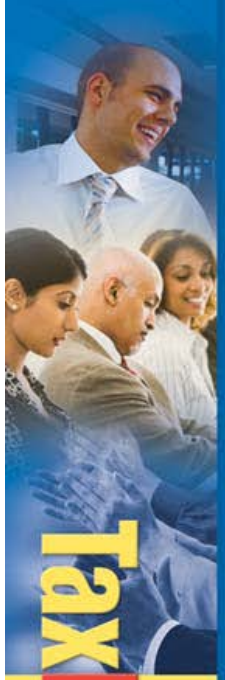
Would you prepare Roberta's return claiming EITC?

- Not yet.
  - Although you now know that the children are legitimate foster children and Roberta's niece and nephew so the children meet the age, relationship and residency requirements, you still have to explore the issue of Roberta's income versus the income of the children's parents.

- You need to ask 1 more question.



Scene 2 – Take 2 (continued)

You ask….

- What was the income of the children's parents during the tax year?

She answers…

- My sister didn't work much during the year. She has a bunch of W-2's that don't add up to more than $2,000
- The children's birth certificates state the father is unknown

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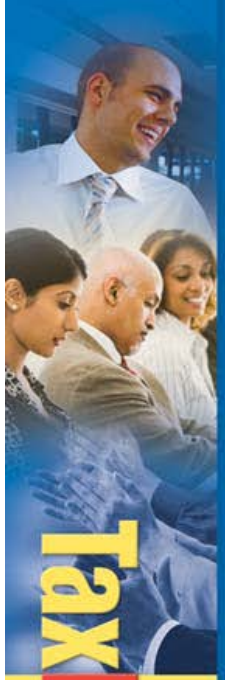
Would you prepare Roberta's return claiming EITC?

- Yes, you now know that the children are legitimate foster children and Roberta's niece and nephew so the children meet the age, relationship and residency requirements.
- You have adequately explored the issue of Roberta's income versus the income of the children's parents.



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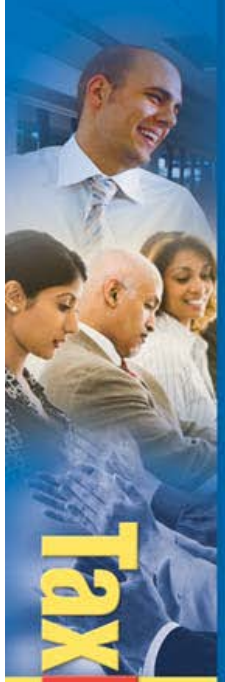
Scenario 3

- A client, John, tells you:
  - He is head of household and has two children ages 7 and 9
  - He was self-employed cutting lawns, earned $12,000 and had no expenses

Scene 3 – Take 1

You ask….	He answers…
• Are you or were you ever married?	• My wife died 4 years ago
• Did you live with anyone else besides your children?	• No
• When did you start your lawn mowing business?	• I started the business this year
• Do you have records of the amount of money you received from mowing lawns?	• No, but I know what I earned
• How much money did you charge to mow a lawn?	• 35 dollars per lawn
• How many lawns did you cut?	• I don't know, it wasn't always the same lawns
• Who provided the lawn mower, gas, etc?	• I used my own mower and bought my own gas
• Do you have receipts for your expenses?	• No

Due Diligence - Know the law. Ask the right questions. Get all the facts.



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Would You Prepare His Tax Return?

- Probably not
  - You need to tell him that IRS requires a written record of earnings and expenses—copies of receipts, invoices, etc.
- Unless
  - You explain to him how to reasonably reconstruct his income and expenses

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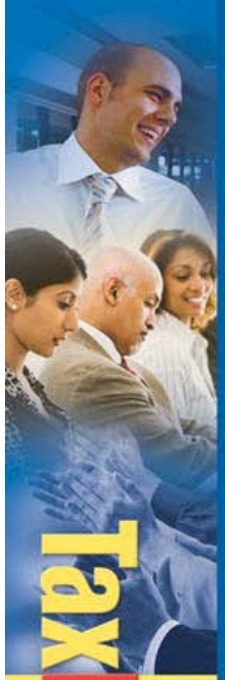
How Would John Reconstruct His Income and Expenses?

- Using a calendar, determine how many weeks he worked mowing lawns and how many lawns he mowed each week
  - Multiply the number of lawns by the $35 he said he earned for each to determine income
- Calculate the following expenses:
  - How much gas was used mowing these lawns, and what the price of gas was at the time
  - The mileage he was traveling between job sites
  - The value of any equipment purchased for his job (can use third party sources if invoice is not available)
  - The value of any incidentals needed for the job (trash bags, brooms, etc.)
- Document the income and expenses he has calculated



John returns….

…and he has brought reconstructed records of his income and expenses with him.

Would You Prepare His Tax Return?

- Probably yes
  - He has reconstructed his records
- But
  - You need to look at the reasonableness of his income and expenses

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EITC Due Diligence Compliance Programs

- Due Diligence Visits
- Streamlined Injunctions

Due Diligence - Know the law. Ask the right questions. Get all the facts.

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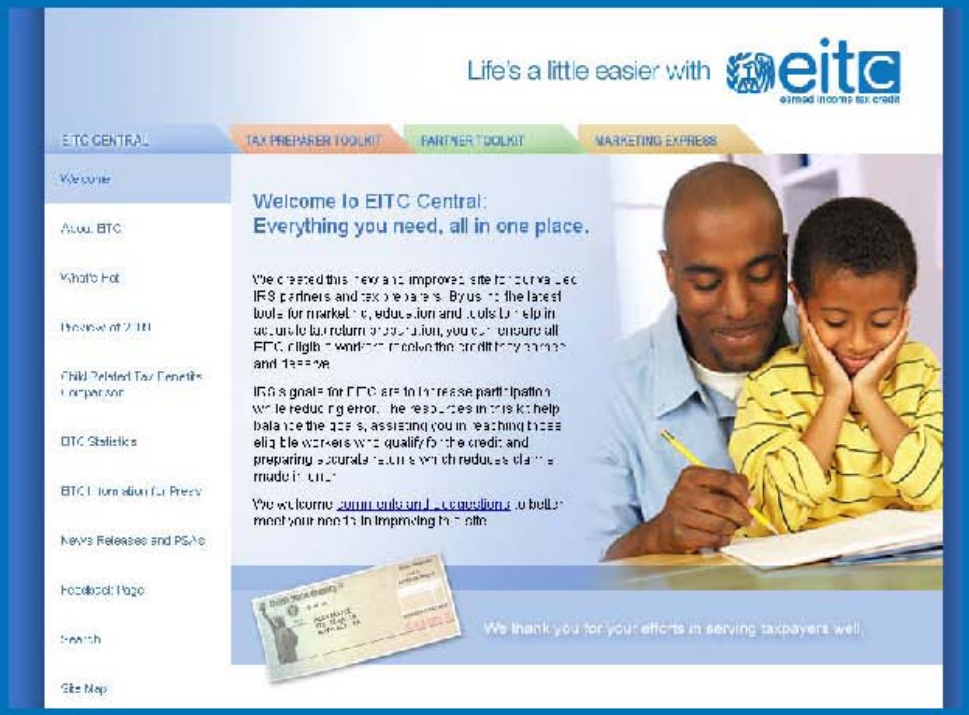
EITC Central

Your home for all things EITC:



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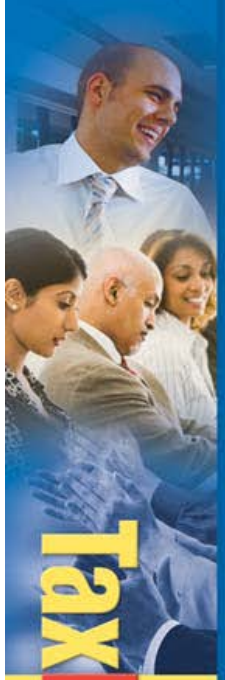

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EITC Due Diligence Means…

Know the law

Ask the right questions

Get all the facts