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Representing the Taxpayers Without
Records, Record Keeping and Due
Diligence Requirements

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Learning Objectives

At the end of this course, you will be able to:

- Recognize various IRS reconstruction methods
- Describe the authority for estimating income and expenses
- Identify tax professional due diligence requirements
- Consequences of not adhering to due diligence requirements



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Overview

Overview

- Approximately 21 million Schedule C forms are filed each year.
- IRS estimates that between 21 percent to 26 percent of EITC claims are paid in error. Some of the errors are unintentional caused by the complexity of the law, but some of the claims are intentional disregard of the law.



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Income Reconstruction

Income Reconstruction

A self-employed individual is required to report all income and deduct all expenses.

- Authority for deduction of expenses is Revenue Ruling 56-407, 2 C.B. 564.
- Revenue Ruling addressed the issue of whether taxpayers may disregard allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Under § 1402(a), every taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Because the net earnings from self-employment included in earned income for EIC purposes are defined by cross-reference to the definition of net earnings from self-employment under I.R.C. §1402(a), this ruling applies equally to the EIC.
- See Chief Counsel Advice CCA 20022051.

Conduct a thorough and in-depth interview

- Ask clients to describe daily and weekly activities of the business.
- Casual conversations about business practices may prove insightful.
- Review supporting documentation.
- Educate clients on recordkeeping.

Record Reconstruction

- Determine exactly what records have been lost
- Prioritize importance of lost items
- Consider the time and expense locating lost items
- Determine sources to obtain lost items (transcripts, FOIA, state and local agencies, financial institutions)

IRS Reconstruction Methods

- Bank Deposits and Cash Expenditures Method
 - compares the total deposits plus cash expenses minus nontaxable sources of income to the total receipts shown on the return.
- Markup Method
 - uses a common denominator within the business records to identify unreported income.
- Net Worth Method
 - $\text{Assets, less Liabilities} = \text{Net Worth}$

IRS Reconstruction Methods

- Source and Application of Funds
 - uses changes in assets and liabilities, along with expenditures for nontaxable income and nondeductible receipts.
- Unit and Volume Method
 - gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer .

Form **4822**
 (Rev. 6-83)

Department of the Treasury - Internal Revenue Service
STATEMENT OF ANNUAL ESTIMATED PERSONAL AND FAMILY EXPENSES

TAXPAYER'S NAME AND ADDRESS _____ TAX YEAR ENDED _____

ITEM	BY CASH	BY CHECK	TOTAL	REMARKS
1. PERSONAL EXPENSES				
Groceries and outside meals				
Clothing				
Laundry and dry cleaning				
Barber, beauty shop, and cosmetics				
Education (tuition, room, board, books, etc.)				
Recreation, entertainment, vacations				
Dues (clubs, lodge, etc.)				
Gifts and allowances				
Life and accident insurance				
Federal taxes (income, FICA, etc.)				
2. HOUSEHOLD EXPENSES				
Rent				
Mortgage payments (including interest)				
Utilities (electricity, gas, telephone, water, etc.)				
Domestic help				
Home insurance				
Repairs and improvements				
Child care				
3. AUTO EXPENSES				
Gasoline, oil, grease, wash				
Tires, batteries, repairs, tags				
Insurance				
Auto payments (including interest)				
Lease of auto				
4. DEDUCTIBLE ITEMS				
Contributions				
Medical Expenses				
Insurance				
Drugs				
Doctors, hospitals, etc.				
Taxes				
Real estate (not included in 2. above)				
Personal property income (State and local)				
Interest (not included in 2. and 3. above)				
Alimony				
Union dues				
Miscellaneous				
5. PERSONAL ASSETS, ETC.				
Stocks and bonds				
Furniture, appliances, jewelry				
Loans to others				
Boat				
TOTALS ▶				

Cat. No. 23460C U.S. Government Printing Office: 1996 - 405-500/33728 Form 4822 (Rev. 6-83)



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COHAN RULE

Deductions in General

“Deductions are a matter of legislative grace; taxpayers bear the burden of substantiating their claimed deductions by keeping and producing records sufficient to enable the Commissioner to determine the correct tax liability.” INDOPCO, Inc. v. Comm’r, 503 U.S. 79, 84 (1992)

Authority for Estimates - Cohan Rule

- When the TP establishes that the TP paid or incurred deductible expenses but does not establish the amount of the deduction to which TP is entitled, TP may be entitled to estimate the amount allowable. Cohan v. Comm'r, 39 F.2d 540 (2d. Cir. 1930)

Application of Cohan Rule

- “[T]o qualify for the estimation treatment under Cohan, the taxpayer must establish that he is entitled to some deduction.”
- “[A] court should allow the taxpayer some deductions if the taxpayer proves he is entitled to the deduction but cannot establish the full amount claimed”
- “bearing heavily ... upon the taxpayer whose inexactitude is of his own making”

Application of Cohan Rule

- Burden of Proof:
 - Generally the taxpayer has the burden of proof
 - §IRC 7491(a) shifts burden of proof to IRS when the taxpayer:
 - Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
 - Complies with the requirements to substantiate deductions;
 - Maintains all records required under the Code; and
 - Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.



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Due Diligence

Due Diligence

- When you should ask additional questions:
 - A client wants to claim head of household filing status and claim his niece and nephew for the EITC and the CTC
 - A client has two qualifying children and wants to claim the EITC. She tells you she had a Schedule C business and earned \$10,000 in income and had no expenses
 - This information appears incomplete because it is unusual that someone who is self-employed has no business expenses

Due Diligence

- When you should ask additional questions:
 - A 32-year-old client indicates he's been going to college for many years and would like to claim the AOTC.
 - A client wants to claim the ODC for his three children. Your client is a resident alien. The children all have ITINs and lived part of the year outside the U.S.

Due Diligence

- Preparers must meet due diligence requirements when preparing returns reporting:
 - EITC, CTC, ACTC, ODC
 - AOTC and HOH filing status

Due Diligence

- Compute the credits and determine eligibility for HOH based on the Facts.
 - Know the laws thoroughly
 - Ask additional questions if you have doubt or question the correctness, consistency, or completeness of any information
 - Document your files at the time of the interview

Due Diligence

- Complete Form 8867 *Paid Preparer's Due Diligence Checklist*.
 - Answer each question based on information from your client you know to be true
 - Personally, complete Part VI, Eligibility Certification
 - Keep copies of the following either electronically or on paper for your records (for 3 years)

Due Diligence

- Keep copies of the following either electronically or on paper:
 - Form 8867
 - Applicable worksheet for credits claimed
 - Any documents you relied on to determine eligibility
 - A record of how, when, and whom you obtained the information

Due Diligence

- Keep documents for three years from the latest of:
 - The due date of the tax return
 - The date the tax return was electronically filed
 - For a paper return, the date the return or claim for refund was presented to your client for signature
 - If you are a non-signing tax return preparer, the date you submitted to the signing tax return preparer the part of the return for which you were responsible

Due Diligence

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

Due Diligence

- IRC §6695(g) requires paid tax return preparers to make additional inquiries of taxpayers.
- Additional inquiries made to comply with due diligence and the client's responses must be documented.



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Due Diligence Consequences

Due Diligence Consequences

- Due diligence promotes accurate claims of the EITC, CTC/ACTC/ODC, AOTC, and HOH filing status. Incorrect tax returns or claims for refund and failure to comply with the due diligence requirements can adversely affect you and your client.

Due Diligence Consequences

- Taxpayers may be subject to accuracy or fraud penalties.
- Banned from claiming EITC for a period of 2 or 10 years.

Due Diligence Consequences

- IRC 6695(g) - Paid preparers who fail to comply with due diligence requirements can be assessed a \$530 penalty for each failure for 2020.
- IRC 6694 - Preparer negligence or intentional disregard penalties range from \$1,000 to \$5,000.

Assessment of Preparer Related Penalties

- Suspension of the preparer from participation in IRS e-File and preparer registration.
- Injunctions barring the preparer from preparing tax returns.
- Referral for criminal investigation.
- Disciplinary action by the IRS Office of Professional Responsibility.