Earned Income Tax Credit
Preparer Due Diligence
A Balanced Approach

• Increase program participation
• Reduce erroneous payments
EITC Facts

• For Tax Year 2006, over $22M returns were credited with over $43B in EITC

• The number of individuals claiming EITC is high, and erroneous payments are also high
  – Participation is estimated at 75 to 80%
  – 23 to 28% error rate according to current estimates
For 2008, the Maximum EITC is $4,824

- Credit phases out as income increases
- Claiming children raises the limit on income eligibility and increases the value of the credit
- If married, income eligibility increases up to $3,000
70% of EITC Taxpayers Use Paid Preparers

Over 80% of EITC Returns Filed Electronically

Qualifying Children, Filing Status & Income Reporting Errors = Main Areas of Noncompliance

$10 – 12B in Erroneous Payments

EITC Environment
Why Talk About Due Diligence?

• Preparer community’s feedback regarding due diligence guidance

• GAO and external audit results

• Recent criminal cases and injunctions
A Balanced Approach to Addressing Due Diligence

Outreach and Education:

• Partnership with software developers to make enhancements
• Developing EITC training modules
• New IRS due diligence regulations
A Balanced Approach to Addressing Due Diligence

Compliance:

• Due Diligence Visits (DDV) / Audit Program
• E-file Sanctions
• Injunction Actions Barring Preparers from Return Preparation
• Criminal Prosecutions
EITC Due Diligence Is NOT Just A Checkmark On A Form!
Internal Revenue Code § 6695(g) – Due Diligence Requirements

Checklist Completion

Credit Computation

Knowledge of Correct Taxpayer Information

Record Retention
Requirement #1-Form 8867, Paid Preparer’s Earned Income Credit Checklist (or its equivalent)
Requirement #2 – Credit Computation
Requirement #3-Knowledge Requirement

Requires tax return preparer to:

• Evaluate the information received from the client
• Apply a consistency and reasonableness standard to the information
• Ask additional questions when applicable
• Make reasonable inquiries if the information appears to be incorrect, inconsistent, or incomplete
• Document additional inquiries and the client’s response
Requirement #4 - Recordkeeping

**Tax Return Preparers Must Keep:**

- Form 8867 or its equivalent
- EIC worksheet or its equivalent
- Record of how information was furnished and who furnished the information used to prepare EITC claim
The Knowledge Requirement is Addressed in New Proposed Regs. 1.6695-2

- A tax return preparer must make reasonable inquiries if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete.

- The tax return preparer must also contemporaneously document what additional inquiries were made and the client responses to these inquiries.
Not as Easy as it Looks

1. Must have earned income
2. Must have a valid Social Security number
3. Cannot file as married filing separately
4. Generally cannot be a nonresident alien
5. Cannot be a qualifying child of another person
6. Cannot be filing Form 2555 or Form 2555-EZ
7. Investment income amount is limited
<table>
<thead>
<tr>
<th>RELATIONSHIP</th>
<th>AGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is a son or daughter (including an adopted child or child placed for adoption), brother, sister, stepbrother, stepsister or a descendant of any of them</td>
<td>Younger than 19, or younger than 24 and a full-time student, or any age if permanently and totally disabled at any time during the year</td>
</tr>
<tr>
<td>At the end of the filing year was:</td>
<td>Lived with the claimant in the United States for more than half of the year</td>
</tr>
</tbody>
</table>
Example Scene 1

- A client wishing to have her taxes prepared informs you:
  - She is separated from her spouse
  - Her child, who is 7 years old, lives with her and she wants to claim EITC
Does This Scenario Prompt You to Ask More Questions?

**You ask...**

- Are you still married?
- When did you separate from your husband?
- Did you move to separate homes, and if so, when?
- How long during the year did your child live with you?
- Did you live with anyone else?

**She says...**

- Yes, I’m still married but separated
- January of last year
- Yes, in January of last year
- My child lived with me every day except every other weekend and two weeks in the summer
- No, I didn’t live with anyone
You Say…

• It looks like you may qualify for EITC. I’ll go through the rest of the questions and do the computations to make sure.
Scene 1--Take 2

You ask...

• Are you still married?

• When did you separate from your husband?

• When did you stop living in the same home?

• Are you going to file a tax return with your husband?

She says...

• Yes, I’m still married but separated

• November of last year

• I moved out when we separated in November

• No, I want my own refund
Does She Qualify for EITC?

- No
- Her filing status is:
  - Married Filing Separate
Example Scene 2

- A client walks into your office to have her taxes prepared and informs you:
  - She is 18 years old and never been married
  - She has a 2 year old daughter and lives with her parents
  - She has earnings of $3,000 from a part-time job
  - She wants to claim EITC
Scene 2 -- Take 1

You ask...
• When did you move in with your parents?
• Did your daughter live with you all year?

She says...
• November last year
• No, she lived with my parents
Does She Qualify for EITC?

- No
- Why?
  - The child had to live with her for more than half the year, so she doesn’t meet the Residency requirement
You ask...

- When did you move in with your parents?

She says...

- I have always lived with my parents
You Say…

• You don’t qualify for EITC because you are the qualifying child of your parents
Scene 2 -- Take 3

<table>
<thead>
<tr>
<th>You ask...</th>
<th>She says...</th>
</tr>
</thead>
<tbody>
<tr>
<td>• When did you move in with your parents?</td>
<td>• I moved home in November last year. It was too hard raising my daughter on my own</td>
</tr>
<tr>
<td>• Did your child live with you from January to November?</td>
<td>• Yes</td>
</tr>
</tbody>
</table>
You Say…

- It looks like you may qualify for EITC. I’ll go through the rest of the questions and do the computations to make sure.
Example Scene 3

- The next client informs you:
  - He is 22 years old
  - He has two sons, ages 10 and 11
  - He wants to claim EITC
Scene 3 -- Take 1

You ask…
- What is your relationship to these children?
- Were you ever married to the mother?
- Were the children placed in your home for adoption or as foster children by a court or authorized agency?

He says…
- They’re my girlfriend’s sons but I paid all the bills
- No
- No
You Say...

• Sorry, you don’t qualify for EITC because your girlfriend’s sons do not meet one of the defined EITC relationships.
## Scene 3 -- Take 2

### You ask...
- What is your relationship to these children?
- Were you ever married to the mother?
- Did the mother live with you last year?
- When did she move in?
- How long did the children live with you?
- The IRS may ask for documentation, do you have any proof the children lived with you, such as school or doctor records?

### He says...
- They’re my girlfriend’s sons but I paid all the bills
- Yes, but we divorced two years ago
- Yes, we got back together
- Late summer, August
- All year
- Yeah, both the doctor and school have my address, I pay all the bills
You Say...

• You may qualify for EITC, I need to ask you some additional questions
Example Scene 4

• A client tells you:
  – She is head of household and has 2 children ages 13 and 14
  – She was self-employed cleaning houses, earned $12,000, and had no expenses
Scene 4 -- Take 1

**You ask...**

- Are you or were you ever married?
- Did you live with anyone else besides your children?
- Do you have records of the amount of money you received from house cleaning?
- How much did you charge to clean a house?
- How many houses did you clean?
- Who provided the cleaning supplies?

**She says...**

- No
- No
- No, but I know what I earned
- 60 dollars per house
- I don’t know. It wasn’t always the same houses
- The home owner provided everything
Would You Prepare Her Tax Return?

- Probably not
  - You need to tell her that IRS requires a written record of amounts earnings and expenses—copies of receipts, invoices, etc.
- Unless,
  - She is able to reasonably reconstruct her income and expenses
### Scene 4 -- Take 2

**You ask...**

- Are you or were you ever married?
- Did you live with anyone else besides your children?
- Do you have records of the amount of money you received from house cleaning?
- Did you need to buy any supplies?
- Do you have receipts for the expenses?

**She says...**

- No
- No
- Yeah, I make entries on my calendar each week and I have copies of the receipts I gave out
- Yes, I purchased cleaning products, sponges, dust cloths and a vacuum
- Yes
Would You Prepare Her Tax Return?

• Probably yes
  – She has invoices and receipts
  – But, you need to look at the reasonableness of her income and expenses
Example Scene 5

• You completed a client’s tax return last year:
  – Last year, she filed single and claimed her child for the EITC
  – This year, she asks to claim 2 children for the EITC
Scene 5

You ask...

• Last year you claimed one child, what changed?
• Is the child related to you?
• Did the child live with you?

She says...

• My friend has 3 children and only needs 2 for the EITC, so she said I could use her child
• No
• No
You Say...

• Your second child does not qualify because the child does not meet the:
  – Relationship test
  – Residency test

• Now, I have to ask you additional questions to verify your first child still qualifies you for EITC
How Does the IRS Ensure Due Diligence Compliance?

Due Diligence Visits
EITC Due Diligence Visits

• Due diligence audits conducted annually
• Selection based on standard criteria applied to all EITC returns
• Due diligence visits are conducted between October and March
Key Facts About EITC Due Diligence Visit Program

• **Examination** to check paid preparer compliance with all 4 requirements of IRC §6695(g)
• General examination guidelines apply
• IRS requests appointments scheduled within 15 days of contact
• IRS will interview both the employee and employer
• Penalties are $100 for each return where due diligence requirements are not met
What You Can Expect if You are Selected for an EITC Due Diligence Visit

1. **Preparer Contacted to Set Appointment**
   - Appointment set by phone or letters
   - Both employee and employer (if applicable) are contacted

2. **Preparer Interviews conducted**
   - Examiner interviews preparer and employer

3. **Examiner Reviews Returns**
   - Examiner reviews 25 returns
   - Sample expanded if non-compliance with due diligence requirements is noted

4. **Examiner Reviews Software**
   - Data intake questionnaire reviewed
   - Form 8867 questionnaire reviewed
   - EIC Computation Worksheet reviewed
   - Presets and overrides reviewed

5. **Examiner Makes Penalty Determination**
   - 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 and receive 30-day letter
  – File a timely protest to request an Appeals hearing before penalties are assessed

• 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
IRC §6695(g) Penalty Exceptions

- Preparer’s normal office procedures are reasonably designed and routinely followed to ensure compliance
- Failure to meet the requirements on a return is isolated and inadvertent
- Key questions to determine whether exception may apply
  - Are preparers trained in EITC Due Diligence requirements?
  - Are there written instructions to employees on how to comply?
  - Is there a quality control process?
In 2007, 90% of Due Diligence Penalties Were Assessed Due to Failure to Comply With the Knowledge Requirement

Most problems occur when:

- Filing status may be unclear (e.g. separation)
- Qualifying child eligibility issues are apparent
- Information appears inconsistent or unlikely
Summary

• EITC Due Diligence is not just a checkmark on a form
• Don’t rely on software alone
• Know the EITC tax law
• Apply sound judgment and common sense to information provided
• Ask questions as needed and document the answers
EITC Resources

• On-Line Tools at 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