

What is EITC Due Diligence?

By Shirley Callahan, EA

The Basic Mechanics

All Workers Claiming the EITC Must:

- Have a valid Social Security Number,
- Not file as “married filing separate,”
- Not file Form 2555 or Form 2555-EZ (related to Foreign Earned Income),
- Meet the investment income limitation (\$3,300 or less for tax year 2013),
- Have earned income,
- Not be the qualifying child of another person,
- Generally, be a U.S. citizen or resident alien for the entire year.

To Claim EITC with a Qualifying Child, the Child Must Pass All of the Following Tests:

Relationship

- A son or daughter (including an adopted child or child placed for adoption)
- Stepchild
- Foster child placed by an authorized placement agency or court
- Brother, sister, half brother, half sister, stepbrother, stepsister or a descendant of any of them

Age, at the end of the filing year, the child was:

- Younger than the worker (or worker’s spouse if married filing jointly) and
 - Younger than 19,
 - Or younger than 24 and a full-time student
- Any age if permanently and totally disabled

Residency

- Child must live with the worker, or the worker’s spouse if filing a joint return, in the United States for more than half of the year.

Joint Return

- The child cannot have filed a joint return, unless the child and the child’s spouse did not have a filing requirement and filed only to claim a refund.

Preparers must understand who is a Qualifying Child. For EITC, the Qualifying Child does not need to meet the support test under the Uniform Definition of a Child.

Only one person can claim the same qualifying child for EITC and other tax benefits. If more than one person claims the child, the IRS applies the tiebreaker rules.

Tax Managers and company owners should create a yearly tradition in your office for to review the EITC Due Diligence Training Module provided at <http://www.eitc.irs.gov/Tax-Preparer-Toolkit/ddmodule> . It's not as easy as you might think. The training is very educational, and you can earn Continuing Education credit and print a Certificate of Completion when you successfully pass the test.

Tie-Breaker Rules

If a child **is claimed** as a qualifying child by two or more taxpayers in a given year, the child will be the qualifying child of:

- the parent;
- if more than one taxpayer is the child's parent,
 - ✓ whoever the child lived with the longest, or
 - ✓ if the time was equal, the parent with the highest AGI;
 - ✓ Please note on 2013 Pub 596, Pg 13, Example 11, if the parents are not married, they can choose who can claim for EIC purposes regardless of earnings.
- if no taxpayer is the child's parent, the taxpayer with the highest AGI.
- anyone who can claim the qualifying child who has a higher AGI than the parent.

Top 10 Minimum Qualifiers

How can a preparer open a dialogue to QUICKLY determine qualifications? I mean, do you really want to know their entire life history? No, sometimes the details can be a little sordid, can't they? It's more than you wanted to know about anybody. So what are the MINIMUM QUESTIONS we can ask to QUICKLY qualify an EITC claim and get on to our next client?

We have designed for you a set of minimal questions that will help you to quickly ascertain that an EITC claim:

1 Who else did you live with?
2 Who else did the child live with?
3 Where did you and the child live?
4 What is your relationship to these children?
5 When did the other parent move in? Move out?
6 Where are the mother / father?
7 Were you ever married to the mother / father?
8 How do you support yourself and your children?
9 Proof of Identity (first year)
a. Taxpayer(s)
b. Child(ren)
10 Dependent's Proof of Residency (every year)
a. Medical
b. School
c. Social Security Adm
d. Public Assistant Programs

See the last 3 pages of this document for client handout you can use.

Penalties Preparers Face

No, we are not the auditors; however, penalties and sanctions can be severe.

- A \$500 penalty for each EITC due diligence offense. Section 6695(g).
- A penalty of at least \$1,000 for each disallowed EITC claim if a pattern exists. Section 6694(a).
- A penalty of at least \$5,000 for each disallowed EITC claim if the preparer is willfully and intentionally negligent. Section 6694(b)

We cannot become complacent. The fines are too expensive to risk! Additional assessments of return-related penalties against a tax preparer may result in:

- 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

The penalties are assessed against the employee!

The employer of the penalized employee will be asked to show that they are properly training, supervising, and reviewing their employees' tax returns, AND have written procedures in place. The employers face separate sanctions from the employee.

Schedule C Challenges

We can reasonably expect IRS to **disallow single entry Schedule C with EITC claims** since IRS is not inclined to believe there really was a legitimate business.

IRS is looking for phantom income designed to hit the "sweet spot" where maximum EITC refunds can be obtained. 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 consistent, complete, and correct.

As a preparer, you need to ask for proof of income, expenses, mileage records, and licensing. As a preparer, we cannot allow our Schedule C / EITC clients to cherry pick their deductions to maximize their EITC claim. However, we can allow our clients to cherry pick Section 179 or bonus depreciation to maximize EITC.

All expenses have to be deducted although you don't need to be aggressive about it. If the client cannot prove mileage or exclusive use of a home office; those deductions, of course, can be denied.

IRS is suggesting that we suggest logical expenses to our clients using the Cohan rule.

A perfect example is a manicurist or a plumber. They cannot operate without supplies and a license. A manicurist may have booth rent, and a plumber may have a storage unit to hold his equipment. A caterer must have a clearance from the Health Department. Now it has become our job to remind our clients of business purchases their competitors have; i.e. mileage, computers, office supplies, the list is endless.

The following quote is from a preparer recently hit with EITC due diligence penalties. “You MUST have notes *in addition to the 8867* or they will nail you. We expanded our office procedures to insure that each EITC return contains beefy relevant notes.”

Audit Triggers ~ High Risk Returns

1. False business income
2. Income in the EITC Sweet Spot
3. Schedule C returns with:
 - a. No expenses
 - b. Overstated expenses
 - c. Excessive use of Code 99999999
 - d. Little or no records for income and expenses
 - e. Income in the EITC sweet spot
 - f. No 1099 statements
 - g. Cash-based businesses
4. Rounded Income and Expenses
5. Disabled children
6. Male Head of Household
7. Low income with dependents
8. Claiming children other than your own
9. No child care

Audit Notice by Phone

The EITC audit can begin with a phone call, not a letter. No, it’s not a prank call. They will call and tell you when the audit will be. You will not be able to request a delay. They will present you with a list of 25 returns they want to inspect. If they find problems on 5 returns, they can then request 25 more up to a total of 125 returns. Five problem EITC returns would cost \$2500, and 125 returns would cost \$62,500. We have heard of numerous preparer penalties in the \$50-60,000 range being assessed. With the new PTIN registration, IRS is now using data mining techniques to more easily track trends preparer by preparer.

EITC Due Diligence ~ Are We Charging Enough?

Having fewer errors protects the clients, builds their trust, and gets us more referrals, so it's good for business, and it keeps us out of trouble. Who needs IRS penalties that with a little extra diligence could have been avoided? Tax Attorney Robert Grossman tells us that tax professionals are not charging enough for the risks they're taking. It is important to know that E&O Insurance does not cover violations stemming from due diligence errors made on Form 8867.

The full-length EITC Qualifier consists of the next two pages so you can copy and use in your office. It is advisable to have the client answer the questions in his or her own handwriting. Every client should answer the first two sections 1) Living Arrangements, and 2) Relationship to Child(ren). Based on the Top 10 Qualifiers above, you will be able to determine how many other sections the client should document.

The client will only have to answer those sections you deem are necessary after getting (and documenting) the answers for the top 10 qualifiers above.

Disclaimer: This presentation is designed to provide general information – not a specific determination for your situation. This presentation in no way is meant to substitute for research that may be necessary from tax law, tax publications, and reference manuals. As a collector of information, I am sharing this information with you as a means to stimulate discussion. I am by no means an expert, and this list is by no means all inclusive. Please do not use this information to make important tax decisions for your clients without further investigation into the tax code. If you believe that I am wrong or if a link is out of date, please contact me so I may correct future issues.

EITC QUALIFIER ~ THE TOP 10 ~ QUICK VERSION

1 Who else did you live with?
2 Who else did the child live with?
3 Where did you and the child live?
4 What is your relationship to these children?
5 When did the other parent move in? Move out?
6 Where are the mother / father?
7 Were you ever married to the mother / father?
8 How do you support yourself and your children?
9 Proof of Identity (first year)
c. Taxpayer(s)
d. Child(ren)
10 Dependent's Proof of Residency (every year)
e. Medical
f. School
g. Social Security Adm
h. Public Assistant Programs

If the long version of the EITC Qualifier is necessary, have the taxpayer fill it out and sign it for you. Retain all these notes in your files along with a signed Form 8867.

EITC QUALIFIER ~ LONG VERSION

The Earned Income Tax Credit (EITC) is a very valuable tax credit available for families and low income households. IRS is targeting these tax returns for examination, and this work is necessary so that we can insure IRS that due diligence requirements are being followed.

Not only do tax preparers face a \$500 penalty *per return*, but IRS can also penalize us up to \$5,000 for negligence or intentional disregard of the rules and regulations when preparing EITC returns in accordance with Internal Revenue Code § 6694. Additionally, sanctions may be imposed on tax professionals including:

- 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

Please Forgive Us if We Seem Nosey

As much as we value our relationship with you, we value our relationship with the authorities who may take from us our right to be in the business of preparing tax returns.

***Questions on Living Arrangements

1 Who else did you live with?
2 Who else did the child live with?
3 Where did you and the child live?
4 Did the mother / father of the children live with you last year?
5 Do other residents in the home earn more income than you?
6 What months did you and the Qualifying Child live together?

***Relationship to Child(ren)

1 What is your relationship to these children?
2 Were you ever married to the mother / father?
3 Why is the child's name different from yours?
4 When did the other parent move in? Move out?
5 If you are not the parent, do you have custody?
6 If you are not the biological parent, where are they?
7 How long did the children live with you?
8 Do you have daycare expenses?
9 Who takes care of the child while you work?
10 What school does the child attend?
11 Does the school list your address as the child's address?
12 Do you have the child's birth certificate / SSA card?
13 Are you old enough to be the parent of the children?
14 Age of taxpayer _____. Age of Qualifying Children _____
15 Does child provide > half his own support?
16 Are you under age 18? Yes / No Are you under age 24 and still in school? Yes / No
17 Unless disabled, the child should be younger than taxpayer Age difference _____
18 If claiming an adult who is disabled:
a Please describe the disability:
b How long is the disability expected to last?
c Has a doctor documented the disability? Do you have or can you obtain that documentation?
d What is the disabled person's income?
e Is Qualifying Child receiving SSI / in process / or denied?

Marital Status Inquiry for the Divorced and Separated

1 Are you still married?
2 When did you separate from your spouse?
3 When was the divorce / separation final? Please provide Year / Month
4 Did you move to separate homes. If so, when?
5 What months during the year did your child live with you?
6 Do you pay more than half of the rent, utilities, food, etc. for the household where you and your Qualifying Child live? (a) All (b) Rent (c) Utilities (d) Food (e) Car
7 Review Form 886-H-HOH which outlines documentation required to prove HH filing status.

Qualifying Child is Different This Year

1 Have you recently divorced?
2 Where did the child live last year?
3 What is your relationship with the prior caretaker of the children?

Insufficient Income ~ How Do You Support Your Children?

1 Who else contributes to the household expenses?
2 Other sources that may have been used to pay household expenses: a Credit cards used for support. Names of credit cards used: b Family members provide support. Names of family members: c Child support. Records that can prove child support: d Insurance settlement. Type of settlement:

Self-Employment Inquiries

1 Briefly describe your business:
2 Does your work require a license? Describe:
3 How much do you charge for your services?
4 What records support your income? _____ Receipts _____ Deposits _____ Invoices _____ Log _____ Ledger Att?
5 How many customers do you have OR children that you babysit? What are their names?
6 Who provides the supplies used in your work?
7 What tools are necessary for your work?
8 Did you receive any 1099s from your customers?
9 Do you have City / County / State business licenses?
10 Do you file sales tax returns?
11 Without receipts and record, a logical recreation will be necessary. Att?
12 By law you are required to keep adequate records. What records will prove your income and expenses?
13 Circle One: QuickBooks Excel Bank records Ledgers Log Invoices Receipts Att?
14 Do you drive to multiple work locations in a day?
15 Do you have a mileage log to prove your business miles?

Date _____

Income / Expense Documents Preparer Relied Upon: _____

Info Obtained from _____

Preparer Signature _____

Identity Documents: _____

Residency Documents: _____
