

TAX TALK TODAY®

EITC DUE DILIGENCE... IT'S YOUR RESPONSIBILITY

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Brought to you by the IRS and produced by L&M Production Design Group, based in Alexandria, VA, "Tax Talk Today"® is a free, live, monthly interactive Webcast aimed at educating tax professionals on the most contemporary and complex tax issues. Now in its seventh year with over 500,000 viewings, the award-winning series airs monthly at www.TaxTalkToday.tv and programs are archived on the site for one year after each episode. For additional information or to inquire about sponsorship opportunities, please contact Paul Lamonía at (703) 642-6505 or Lamonía@LMpdg.com or visit www.TaxTalkToday.tv.

PHYLLIS GRIMES: This is “Tax Talk Today”, the tax show for the tax pro. Today’s program, “EITC Due Diligence: It’s Your Responsibility.” Hello, I’m Phyllis Grimes and welcome to “Tax Talk Today”, a series of programs brought to you by the Internal Revenue Service. The “Tax Talk Today” series provides you, the tax professional, with the opportunity to interact directly with representatives of the IRS and practicing professionals on current tax issues. In addition, viewing the “Tax Talk Today” series is an easy way to earn continuing education credits. You can purchase CE credits through the “Tax Talk Today” store and earn one credit for today’s program. You will need the course number, which is given at the end of the program. So don’t forget to jot it down.

Also, we want your questions throughout today’s program, so please e-mail your questions to questions@taxtalktoday.tv. If you have not already done so, visit the resource section of our website. We have posted an outline for today’s program, as well as additional, valuable information. Now, let’s get on to today’s program, “EITC Due Diligence: It’s Your Responsibility.” Paid tax-return preparers must meet four specific due diligence requirements when preparing returns claiming the Earned Income Tax Credit of face potential penalties.

Today, we will discuss what you must do to meet these requirements and get the latest information from the IRS executive and technical staff responsible for the \$43 billion program. Let’s join our first panel. Today’s moderator is Les Witmer. Les brings to “Tax Talk Today” 23 years of experience with the IRS and is currently a communications consultant in Atlanta. Joining Les is Debra Holland, Earned Income Tax Credit program director for the Wage and Investment Division of the IRS, and Bridget Tombul, special counsel to division counsel, for the Wage and Investment Division of the IRS. The complete files for our guests are on the “Tax Talk Today” website.

Les?

LES WITMER: Thanks, Phyllis. Everyone realizes that the Earned Income Tax Credit or EITC program is a federal poverty – anti-poverty program that’s designed to raise the income levels of American families above the poverty line. With that in mind, Debra, what is the goal or what is the purpose behind the IRS in administering the program?

DEBRA HOLLAND: Well, first, it’s a very large program. About 23 million taxpayers receive the Earned Income Tax Credit each year in the amount of about \$43 billion. So it’s a very large program. We face two main challenges. The first is participation rate. What that’s about is we want to make sure that all individuals who are entitled to EITC claim it and actually get the credit. We estimate participation rate is

about 75 to 80 percent, which is rather high for a social benefit program. The other side of the challenge involves the compliance point of view and in that vein, about 23 to 28 percent is the error rate that we estimate that is associated with EITC returns.

MR. WITMER: Okay. Well, we certainly want to focus on that and the – especially the due diligence requirements for EITC. But before we do that, maybe it'd be good to give our viewers some of the basic background on the Earned Income Tax Credit program. What are some of the general rules that apply?

MS. HOLLAND: Okay. To claim the Earned Income Tax Credit, first of all, you must have, of course, earned income. You must have a valid Social Security number. You must have a filing status that is other than “married, filing separately.” You can't claim the credit with a “married, filing separate” status. You generally must be a U.S. citizen or a resident alien for the entire year. You cannot be filing Form 2555 or 2555EZ, which both have to do with foreign earned income. And your investment income can be limited; the amount for 2007 was \$2,950. And then, finally, you cannot be the qualifying child of another person. Now, all individuals who claim EITC must meet all of those rules.

MR. WITMER: Okay. Maybe we need to clarify and get a definition of what is the IRS definition for a qualifying child?

MS. HOLLAND: To be a qualifying child for purposes of EITC, there are three rules. The first is called the relationship rule. And that basically says that the person that you're claiming as a qualifying child must be related to you with a certain relationship as defined by law. For example, those relationships include son, daughter, including an adopted child that's been placed with you for adoption, a stepchild, foster child. It could include brothers, sisters, stepbrothers, stepsisters, or a descendent of any of those relationships so, for example, a grandchild would qualify.

The second rule has to do with residency. That one says, basically, you must have lived with that qualifying child for at least half of the year in the United States. And then, lastly, there's an age requirement. That one says that the individual who's a qualifying child must be under 19 or under 24 and a full-time student or any age if the individual is permanently and totally disabled at any time during the year. So all three requirements must be met to be a qualifying child for purposes of EITC.

MR. WITMER: Okay. Bridget, each year we go through a series, probably, of changes with the Earned Income Tax Credit. For 2008, are there changes that our practitioners should be aware of?

BRIDGET TOMBUL: Yeah, the Earned Income Tax Credit is indexed every year for different income amounts because the amount of Earned Income Tax Credit that you qualify for depends on the amount of earned income that you have, your filing status, and also the number of qualifying children you have. So, for example, if you're a married couple with two qualifying children earning about \$17,000 for the year, your

maximum credit could be as much as \$4,800. And that would be the peak of the credit. And then the credit phases out as the income goes out. So the credit will be completely phased out once that married couple with two children has earned \$41,000, about.

Unmarried taxpayers can also qualify for the credit, but you can't file, as Debra had mentioned "married, filing separately." So it would be only those taxpayers filing with a single filing status or a head-of-household filing status and then the "married, filing joint." And, again, the income levels vary and determine how much you qualify for. And childless taxpayers can also qualify. Their credit is much lower than everyone else's, but, generally, a childless worker with income of about \$12,000 would qualify for the credit, but the maximum credit for childless workers is \$438 for 2008.

MR. WITMER: Okay, good. That information and much of the information we talked about is on the "Tax Talk Today" resource page, along with other information. Just a reminder; please check it out. Before we go on and talk about the EITC due diligence, our Phyllis Grimes had the opportunity to interview Cheryl Sherwood, IRS director of campus compliance services. Let's hear what she had to say about EITC, and in particular, EITC compliance.

MS. GRIMES: I'm here with Cheryl Sherwood, IRS Director of campus-compliant services. Cheryl, the Earned Income Tax Credit, or EITC, has been around since 1975. What advice can you offer to tax professionals so they can best serve their clients who may be under audit for EITC issues?

CHERYL SHERWOOD: Well, practitioners know that the IRS has made many administrative changes to the EITC since it was implemented first 33 years ago. With this in mind, let me offer three suggestions as to how practitioners can best serve their clients. Number one: know the law. It's critical for practitioners to reexamine the tax law's governing EITC each year and advise their clients accordingly. The most up-to-date information can be found at irs.gov. The EITC assistant is a great tool that will help practitioners determine eligibility.

Number two: due diligence – be aware of the due diligence requirements that publish four different subjects. One, completion of the completion eligibility checklist; two, correct competition of the credit; three, knowledge of correct and accurate client information; and last, retaining client records. Again, the irs.gov website offers a whole host of tools and information on due diligence and other EITC subjects.

And my third suggestion is double-check all EITC claims. It's worth mentioning here that the numbers of EITC cases being referred for review are on the rise.

MS. GRIMES: Why has there been this increase?

MS. SHERWOOD: Well, within the past year, the IRS has stepped up specialized training for all employees who process EITC returns. A direct result of this has been an increase in the number of cases being referred for a second look and

eventually investigated for fraud. Now, cases found to have elements of fraud present will likely have a penalty imposed.

MS. GRIMES: And what kind of penalty?

MS. SHERWOOD: Taxpayers making fraudulent EITC claims can be banned for 10 years from applying for the credit. The penalty is imposed if the primary purpose of the fraudulent act was to take illegal advantage of this credit. And if a case involves a tax preparer, the IRS will take action against the preparer for the promoter of the fraud.

MS. GRIMES: Now, if a case is found to be fraudulent, how would a taxpayer be notified?

MS. SHERWOOD: Once we identify fraud and our counsel agrees, a 30-day letter and then a 90-day statutory notice of deficiency letter is sent to the taxpayer informing them of our findings and of the penalty. Now, of course, taxpayers have appeal rights in both the 30-day letter and the statutory notice letter explaining these rights and their options.

MS. GRIMES: So let's say I receive one of these notices. Now what?

MS. SHERWOOD: One word: timeliness. It's crucial for practitioners to apply by the deadline that is provided on the notice. If not, if they can't provide all the information, at least call the phone number and discuss the case. If our timeframe is not met, the IRS will disallow the items in question and interest will continue to accrue on any balance due. This is the last chance to resolve the dispute informally.

MS. GRIMES: Thank you for these suggestions, Cheryl.

MR. WITMER: Cheryl Sherwood mentioned several different EITC compliance issues. We want to focus, Debra, on of course EITC due diligence. Maybe we need some clarification between due diligence – EITC due diligence – and the regular audit of an EITC return. What's the difference?

MS. HOLLAND: Well, the big difference is that due diligence regulations and rules apply to practitioners. And so when we – the IRS – goes out and does a due diligence compliance check, we go to a practitioner's office and ask that practitioner to allow us to look at a sample of tax returns and then we make a decision about whether or not the practitioner has met those four due diligence requirements.

Now, if those requirements are met, of course that's a good thing; and if not, the practitioner could be subject to a \$100-per-return penalty. Now, when you contrast that to individual audits, individual audits involve one tax return, one tax preparer – excuse me, one individual taxpayer – and of course then we may assess additional tax and penalties based upon that individual audit.

LES WITMER: Okay, Sherrill headlined four different areas of the due diligence program. Can you tell us a little bit more about each one of those areas? What makes up the due diligence program?

MS. HOLLAND: Due diligence law first came into being in 1997 with a part of the code, the tax code, and then the IRS issued regulations that described those four requirements. And the first one has to do with what we call the EITC checklist or check-sheet. It's form 8867, that asks a number of questions about EITC eligibility and, of course, the return preparer is required to complete that sheet based upon the information provided by the taxpayer.

The second involves use of a computation checklist or form. The EITC calculation form can be used for that. And I might mention that for both of those requirements, the 8867 and the use of the EITC computation or calculation check-sheet, both of those often are met by the use of software. As you know, many practitioners use software.

The third requirement that was mentioned is the record-retention requirement that generally says that you must keep those documents for at least three years. And then the last one, the fourth one, is the knowledge requirement. That's the one that's the most often problematic. That particular requirement says that the return preparer must ask additional questions or make additional inquiries if the information that's furnished by the taxpayer about EITC is incomplete, incorrect, or inconsistent. So due diligence is all about conducting a thorough interview and making sure you have all of the facts to make an assessment as to whether or not EITC is – the individual is qualified for it.

MR. WITMER: Bridget, we placed on "Tax Talk Today" resource page proposed regs on this that came out not too long ago. And I'm sure the due diligence and the knowledge area was an area of concern. Can you tell us a little bit more about what those proposed regs actually had to say?

MS. TOMBUL: Sure. The proposed regs were published June 17th of this year. An important point that I would like to make is that the proposed regs are not in effect until they are finalized. And we don't expect – and we expect them to be applicable to returns filed and claims made after they are finalized. But, in any event, we don't expect that to be before December 31st of this year.

The due diligence aspect of the – for EITC, due diligence aspect of these regs actually focuses in on the knowledge requirements. And the background is that the knowledge requirement is that a practitioner must have no reason to know that something is incorrect, inconsistent, or incomplete. And so we wanted to flesh out a little more of what that meant, "reason to know." So the regulations talk about that. A practitioner has to make reasonable inquiries if a reasonable and well-informed tax-return preparer knowledgeable in the law would conclude that the information on the tax return was incorrect, inconsistent, and incomplete.

So the important thing to point out is that it doesn't matter what this particular tax-return preparer knows about the law; they're held to the standard of a reasonable preparer who does know the law. And then the other aspect of the proposed regulations is that the preparer has to make a contemporaneous documentation of additional questions asked and answered if there is something that appears to be incorrect, inconsistent, or incomplete.

MR. WITMER: Okay. Now, there was a response period for these regs. Is that over?

MS. TOMBUL: Yes, the response period is over so –

MR. WITMER: So the next step is to analyze that?

MS. TOMBUL: Yeah, that's ongoing. I think they've actually maybe even completed the step of analyzing – (chuckles) – the comments, but when regulations go through to be published, they have to be approved at all levels of IRS and also through the Treasury tax policy office. So when we have proposed regs, we get comments back in from the public and all of those comments are considered and they'll determine, are they going to address the comments? Are they going to change the proposed regs based on those comments? Or are they not going to? And usually the comments are addressed in what's called the preamble of the final regulations where we get into depth of, we received this comment; we either adopted it, we did not, and this is the reasons why.

MR. WITMER: Okay. I'm sure that will be a news item for us in the future. Okay. Thank you on that interesting overview of EITC due diligence. Now back to Phyllis for the headline news.

MS. GRIMES: Here are the top stories from the IRS. National phone forum on the audit process – the IRS is sponsoring a phone forum entitled “The Field Audit Process: Working Together Toward a Mutual Commitment Date” on Wednesday, September 17, 2008, from 10:00 a.m. to 11:00 a.m. Learn how the IRS selects returns for field examinations, the different phases of a field examination, what is the definition of a mutual commitment date, and much more. You also may earn one CPE credit. Click on the National Phone Forum link on the resource page for more information.

Changes are coming in 2009 for correcting errors on employment taxes. Form 941c, supporting statement to correct information, will soon be replaced by a new set of dual-purpose forms for adjustments and refunds, which will reduce burden for correcting errors on employment taxes starting in January 2009. The new forms are user friendly and make changes easy and accurate. Each standalone form will correspond to and relate line-by-line with the employment tax return it is correcting. A total of five forms matching the original employment tax returns include forms 941x, 943x, 944x, 945x, and CT-1x. Look for more information on the new adjustment process and forms on IRS.gov. A copy of the final regulations can be found in the Federal Register, volume 73, number 127, issue July 1st, 2008.

IRS processing power gets a punch. The time it takes for IRS to process your client's e-filed return is getting shorter. Thanks to the CADE system, or Customer Account Data Engine, almost a quarter of all taxpayer accounts were updated this past tax season in a day instead of a week, which is the normal time it takes with the agency's older systems. This past tax season, CADE posted more than 30.5 million tax returns. That's more than 21 percent of all returns handled by IRS this tax year and nearly three times the number posted last year.

CADE processed taxpayer refunds on average five days faster than the aged legacy systems. With each new release, IRS will improve the efficiency of CADE. The January 2008 release of the system helped to quickly process certain 1040, 1040a, and 1040EZ forms along with Schedule C, E, and F for Form 1040 and other schedules such as the Earned Income Tax Credit, or EITC. CADE also processed returns with simple math errors and generated notices to taxpayers.

Eventually, CADE will handle the more than 140 million tax returns processed by the IRS. Now let's continue our conversation on EITC due diligence. Joining our panelists are Sherrill Gregory, an enrolled agent from Orange County, California, and Sue Gaston, CPA and director of industry operations for H&R Block. Les?

MS. WITMER: Welcome to both of you. What we'd like to do is maybe hear from you on your reactions to the first segment, particularly how you or your practitioner colleagues might feel there are issues to the due diligence requirements and the proposed regs. So I guess that's a good place to start. Sherrill, what are some of the reactions or what do you see as some of the issues?

SHERRILL L. GREGORY: Well, as we all know, the EITC rules are extremely complicated. So it's difficult for taxpayers to know what it is that they have to do to qualify or not qualify, but it's equally difficult for tax professionals to know how to elicit the right information in a question to a taxpayer as to whether they do or don't qualify.

SUE GASTON: So I think in addition to what Sherrill said, I would say that there's also the case where the taxpayer comes in and provides – purposely maybe – provides misinformation about the qualification of EITC. So in order for a tax professional to find out if the information is reasonable, obviously they need to ask a lot of questions, as we talked about earlier, when Bridget referenced the new proposed regs. We need to ask questions when things appear to be inconsistent, incomplete, or incorrect.

Another challenge that I think we're going to face is that we will be adding some time to the interview for every client that's affected by this. And obviously we'll have to take the time to document the questions and the answers.

MR. WITMER: Debra, I know that IRS just had a series of tax forums, that this was a topic at many of them as well as your outreach to practitioners. Are these the type of comments you've been hearing about the due diligence and the proposed regs?

MS. HOLLAND: Yeah, we hear the types of concerns that are being suggested quite frequently when we're out in the community talking to tax-return preparers. I would agree that the tax law around EITC can be complex. We see the arena of being able to address EITC error requires a number of things. One is that taxpayers and – excuse me, tax preparers – are knowledgeable. And I think that's the point Sue was making is, know the law to the highest degree possible. And then a good, solid interview that helps uncover all of the facts about the individual's circumstances will help a practitioner determine whether or not someone qualifies.

I have to tell you that one of the reasons that we issued the due diligence proposed regulations was in response to questions from the preparer community about due diligence law. And the whole intent was to clarify when do the due diligence requirements kick whenever a knowledgeable preparer, knowledgeable in the law, would deem that we need additional information to make that determination and then to provide some examples of situations where we see incorrect, incomplete, or inconsistent information often given. So we certainly are in partnership with the preparer community to try to get EITC returns right.

MR. WITMER: You mentioned documentation. Is there something in particular that the IRS is looking for as far as the documentation or is that left to the practitioner?

MS. HOLLAND: Well, the due diligence requirements call for additional inquiries to be conducted when the information is incorrect, incomplete, or inconsistent. And the proposed reg adds the word "contemporaneous." Bridget, do you want to talk about that?

MS. TOMBUL: Yeah, sure. When we talk about a contemporaneous documentation requirement, we're talking about doing it either while you're interviewing the taxpayer or very close in time to when you interviewed the taxpayer to show that you actually did delve into the issue when something appeared off. So we just want to make sure that that's documented as opposed to I think what we had seen in the past was people glossing over this knowledge requirement – (chuckles) – and just going through the checklist, you know, check, check, check; can you wind your way through the maze of the checklist and get to the end and get EITC. We want people to get a more rounded interview, a more complete look at, does this really make sense and then document it to make sure that it does.

And the documentation actually will protect the practitioner because it will build a file for you if the IRS comes to you later and says, there's errors here in the EITC, what's going on? You can pull out your documentation and say, well, I asked this question and that question and here's the answers. So I think it helps on both sides to make sure that the EITC is accurate and also protects the practitioners.

MS. GREGORY: It's my pattern when I'm interviewing a taxpayer to write down the date, the time, whom I'm interviewing, and general answers to your questions. Is that going to be sufficient or should I be doing something else?

MS. TOMBUL: No, I think that's fine. I think what you have to document and when you have to document is really going to be based on the facts and circumstances that you're seeing case by case. So we can't give a standard answer: write this down, write that down, then you're done. (Chuckles.)

MS. GREGORY: But if it feels wrong to me –

MS. TOMBUL: You have to use your judgment. Right. Use your smell-test.

(Laughter.)

MS. GREGORY: I've developed that highly over the last 16 years, but –

MS. TOMBUL: That's what we want. We want you to use your judgment as opposed to just ticking off questions and making sure that they can – because, like you said, some people are very well-versed in EITC and they know what answers to give. (Chuckles.) And so we want to make sure that the practitioners and the preparers are really using their own common sense and judgment if something appears off.

MR. WITMER: Okay. Let's take a couple of examples of this and maybe that will show it. In reading the proposed regs, there were examples in the proposed regs that might bring this out. Could you tell us a couple of those and maybe we can have the discussion as to how you would handle that and what the IRS is looking for in that?

MS. TOMBUL: Sure. Okay, let's say that during your interview process, your client says that she's separated from her spouse and a child lives with her and she wants to claim the EITC as a head of household. And if you look at her records and everything, it's apparent that she earns very minimal income that would not ordinarily be sufficient to support a household like the rent or the mortgage, electric, water, food, expenses for the children.

In that situation, you have to, as the preparer, delve into questions as to whether she has the correct filing status and if other things appear off or inconsistent or incomplete, go into those. So as practitioners, how would you approach that situation?

MS. GREGORY: I'd be looking for other sources of income that may not be taxable because it may be that they are genuinely able to handle that household, but maybe there are loans, credit cards, or loans from family, or perhaps child support, or something that doesn't show up as taxable. So it may not be just as it appears.

MS. GASTON: And I think I would be asking about other income in terms of, you know, additional W-2s that maybe the client doesn't have with them on the visit,

other income in terms of Schedule C income. Maybe they have a business and they haven't decided that they're going to tell us about that yet. I think there are some things that we could do, and then, obviously, to apply the filing status roles to make sure that they actually qualify for the status that we're going to take on the return.

MS. HOLLAND: One thing that I've seen occasionally is a situation where the income will be a very minimal amount, does not appear it's enough to support the household, but we find that the individual maybe only worked a couple of months during the year and then other months of the year had some type of benefits or other assistance. So it's possible for that circumstance to happen, as we all know, but I think the example that you gave is one of those where the fact that that income is so low is one of those red flags that does require additional inquiries. It's incomplete information based solely on what we heard in order to make a decision as to whether or not EITC is due.

Another thing that you mentioned in that example was that the person came in and said that he or she was head of household. And do you see situations where people come in and tell you they're head of household and their interpretation of what that means might be different than yours?

(Laughter.)

MS. GREGORY: Entirely likely.

But somewhere along the line, they've heard that that's a magic phrase and so they're ready.

(Laughter.)

MS. HOLLAND: Another example of where our position is, that you'd need to probe to make that decision, asking the questions that would help you determine if that's the appropriate filing status based on the law, the tax law.

MR. WITMER: Another example?

MS. TOMBUL: Okay. Let's say, again, you have a client who says she's head of household, has two children ages 13 and 14, and she says she's earned \$12,000 as a self-employed babysitter, but has no expenses. So it would be unusual to have no expenses and be self-employed. So you'd want to delve into that as well as head of household to make sure you have a complete picture. (Inaudible) – anything come to mind?

MS. GREGORY: Well, I wouldn't necessarily assume it's a bad claim or that there's any bad purpose behind it because sometimes small-business owners think, well, I didn't keep track of it, or it's a very small amount. And so they don't want to give you an expense amount. And you have to start asking more questions. You're babysitting; are you taking care of the children in your home, in which case, there might be an office in the home for childcare. Or do you drive them anywhere? Perhaps there's some auto

expenses. Are you providing food as part of the childcare, in which case there's a per diem for that. So I think we need to start asking the taxpayers specific questions about that business. And it may be their expenses; they just didn't think it mattered.

MS. GASTON: I think I would also ask questions around the income because the client brings in the amount and says, I earned \$12,000. Well, first of all, that's an even amount and, second of all, how did that client actually document that that was the income from the self-employment. So I think I would ask questions about how they documented that, maybe – did they keep the notes on a calendar? Do they have receipts to show that that's what they charged for each particular income item, et cetera?

MS. HOLLAND: You know, this is a circumstance that the IRS only sees when we're talking about Earned Income Tax Credit. Let me tell you what I mean by that. Often, when we audit returns, what we see is income underreported in order to reduce the tax liability. But when you talk about Earned Income Tax Credit, sometimes we see people who will claim they made – had income that they actually did not have in order to generate an Earned Income Tax Credit amount. And so probing for the income and the expenses is what we believe is part of due diligence around that whole type of question.

MS. TOMBUL: And, of course, anytime that would come up, you'd want to do a contemporaneous documentation.

MR. WITMER: Documentation, okay. We've got some questions that have come in from our viewers. Here's one that's probably on the mind of several viewers: "What defense does a paid preparer have against an outright lie told them by the taxpayer when the preparer has no knowledge or suspicion that they are lying?"

MS. HOLLAND: That's a question that we often get from the EITC office as well. The first thing I would say is to the question – what defense does a preparer have? The answer to that is asking the right questions and documenting those answers and to bring us a form. So that's your protection, so to speak, as a preparer.

What I would say though is I would not expect a preparer to be trying to ever insinuate or suggest that a taxpayer is being untruthful. We in the IRS don't do that either. Obviously, we're all professionals. But what we're talking about when we talk about due diligence is these mental bails. If a preparer receives answers to questions during the normal course of the interview that are inconsistent, then it is incumbent on that preparer to ask more questions to flesh out the facts and make that determination as to whether or not someone qualifies and to document those answers. That's really what due diligence is about.

MS. GREGORY: And it's partly our responsibility as whether we're going to sign that tax return, which means if somebody comes in, it's not just your due diligence. But I have something on the line there also as a paid preparer in this Circular 230. And I had clients come in one year who had previously filed two returns – head of household –

splitting the children. They were married at the same address. But the previous preparer allowed them to do two head of household, the returns, and claim earned-income credit.

And clearly, for me, that's a problem when the return comes in. But there are other times when somebody just knows the answers to give me and there isn't any way on the surface for me to know that those answers are incorrect.

MS. HOLLAND: Both of those examples, we think, are situations where the due diligence rules do apply. You had circumstances in the first example that because of your knowledge of the prior-year return, you know that there is a potential or a possibility that that is an incorrect return, if you claimed EITC for that taxpayer. And so you'd want to ask all the questions to make the determination if they do or don't qualify for that status. Document the answers. And obviously, if the person qualifies, do the return and claim the EITC. If not, then advise your client that they do not qualify.

MS. GASTON: Debra, when we talk about documentation, do we mean that we have to document the questions and answers, the actual conversation? Or can we just document a summary of the information?

MS. HOLLAND: Well, you know, you mentioned earlier, Sue, that one of the barriers maybe for paid preparers will be the time that's involved to document the answers. So we're not looking for you to write a book. What we're looking for is when we walk in, if we're doing a due diligence audit on a preparer, we're going to look at your case files. We're going to look at the return itself, any supporting documentation that the preparer has maintained – intake sheets, software, whatever was used. And if the information is documented that clearly shows that someone is entitled to EITC, that's a good thing. But if there is no documentation around some of these issues that the questions were asked and how they were answered, then obviously due diligence has not been met. And in that case, that preparer could be subject to a \$100-per-return penalty.

MS. TOMBUL: Yeah, and I think it's important to take it on a case-by-case, facts and circumstances basis, because depending on what issue comes up, you're going to want to use more documentation versus less documentation, because really it does come from you in whether cases of whether the penalties would apply.

MR. WITMER: Okay, Debra, you mentioned the penalty. What are the consequences, if due diligence is not followed?

MS. HOLLAND: This might be the time to describe a little bit about what a due diligence audit looks like. The Internal Revenue Service would send the paid preparer a letter asking to come into your office and look at the tax returns. We usually try to schedule that first meeting within 15 days of receipt of the letter. Then we have a revenue agent from the IRS who goes out to the preparer's place of business, looks at a sample of tax returns – about 25, as I mentioned earlier. We would look at all the case documentation, software being used, sometimes training material, those types of documents. And then, that revenue agent will make a decision, return by return, as to

whether or not those four requirements of due diligence are met. If they're met again, that's a good thing. And if they're not met, then the auditor could assess up to \$100 per return.

The auditor does have the ability to pull additional returns based upon what they find in the first 25. And then after the audit, the auditor will issue a letter – a findings letter – and then the individual has many of the same rights that they have in an individual audit. You can choose within 30 days – we call it a 30-day letter – you can choose to either agree and pay the amount or disagree and then, of course, appeal rights apply pretty much the same way as with individual audits.

MR. WITMER: We've gotten some other questions. And here's one that basically follows up to the question we had before. "If a preparer is aware that the taxpayer is not willing to file an active return and leaves the preparer who refused to submit the remedies form, what steps should the preparer take to notify the IRS of the likelihood of fraud and abuse? And how would they do it if they wanted to do that?"

MS. HOLLAND: Well, first of all, we do want preparers to let us know if they are aware of other preparers who are less scrupulous or may be deliberately preparing incorrect EITC returns. And the way that they go about doing that is if you go out to the Internal Revenue Service website – that's irs.gov – we do have a way that you can submit that information to us anonymously if you choose.

What we do with that is our criminal investigation division looks at all of those leads and makes decisions about how they can potentially develop criminal cases. They do investigations and the more that we have information from the public like this, the more likely it is that we can address those bad behaviors.

MR. WITMER: Now, one of the things that has been seen in the earned income tax area you mentioned – fraudulent returns in a criminal investigation is outright abuse in this area. Where is that at? I know that's not your area – criminal investigations – but I think that would be interesting to our viewers. What's happening in that area?

MS. HOLLAND: Well, clearly there are times when there is EITC returns that are done by preparers may be incorrect because the preparer just simply didn't know, doesn't have the appropriate knowledge – made a mistake, so to speak. And of course, that's not fraud. But when we do run across what we've – what is out and out fraud, which is criminal behavior – I'll give you a few examples of a few things that we have seen through our criminal investigation division.

We've heard about and seen situations where we had a preparer, for example, who was engaged in using Social Security numbers of some individuals on other people's returns. People call it selling Social Security numbers sometimes, in order to generate EITC claims, keeping large parts of that tax return for the preparer and providing small amounts to the individuals that are also involved. Those types of things are prosecuted. And we develop criminal cases.

When we do actually get a conviction – and we often do have jail-time convictions – those then become a matter of public record. So some of you may have seen in the news situations where the individuals have been prosecuted and have received jail time.

MR. WITMER: Okay, you mentioned errors. And that also has been an area, in my experience and involvement over the years, that take place. Numerous types of errors that you see recurring. What are some of the most frequent errors? And what can be done about it?

MS. HOLLAND: The biggest error that we see most often is in the area of qualifying children. We went over those rules earlier. And the individuals being able to use a qualifying child to generate an EITC claim in meeting all of those rules. And particularly troubling can be the residency test. You know, the child must have lived with the person who is claiming EITC for more than half a year. And we sometimes see that rule not being met.

Then, we also see filing status errors where an individual – here's an example. Maybe we have a married couple who is still living in the same home together. And they would legitimately qualify only for married filing jointly or married filing separate statuses. But if they instead file with head of household or single statuses, they can in effect double the amount of their earned-income tax credit or get a credit when they might have not qualified with joint income. So we sometimes see filing status errors for that reason.

Income is a third area where people are generating claims for EITC, claiming they have income that they don't have, similar to the example that you used. And then, we often see errors around Social Security numbers – individuals who claim credits without Social Security numbers or use the wrong numbers.

MR. WITMER: What are some of the things our viewers certainly enjoy hearing from practitioners, if you can give them any tips on things that you do or your office does that works well. What are some of the things that you do to help prevent the errors and not have errors on the EITC returns?

MS. GREGORY: EITC returns can be a little scary to do as a preparer. So I not only take a great deal of CPE to make sure that I know the rules and that I stay up on that but as I already mentioned, any time I'm talking with the taxpayer, I've got a pad of paper. And whether it's by phone or in person, I've got a pen and a pad of paper and the date and the time and what we're talking about, because it helps me reference on something – maybe I'm doing the return a week later. It helps me come back to where we were at the time of the interview.

MS. GASTON: I think another way to do this is through the software. And I think we've developed a working relationship with the IRS and software development

community to actually take a look at what we can do more in the software to help preparers meet the due diligence requirements.

One of the things that we've been able to share with each other as the IRS has learned a lot from software developers in terms of what are the tax professional issues and challenges that they face, as well as we've learned a lot from the IRS on some of the challenges that they face as well. About 80 percent of all EITC returns that are done by preparers that are filed electronically are represented by this taskforce, this group of software developers working with the IRS.

And I think what we have come to find out is that we actually have common goals. We want to get EITC right. We want to give it to the people who deserve it and qualify for it and deter the others that don't.

I think some of the things that have actually come out of this software development panel have actually been things that we can do as best practices in this software. So we have made suggestions around things like make sure you have preparer notes. That's going to be really important now that the proposed regs have come out and said you need to document. So I think that's number one.

Along the same lines, I think, providing information to tax professionals as to what to look at in the return. So in other words, having pop-ups or help screens or education guides – those kinds of things that can tell people, hey, this looks like one of these situations where you might want to spend a little bit more time. Some other things that software developers – that we've suggested to them – are making sure that we have things in there like links to the IRS EITC training materials and education materials. I think that will be extremely important.

And then, lastly, I'd just like to say that I think telling the tax professionals that use the software that software is only a tool for you, not a substitution for that knowledge requirement. And what we'd like to see is tax professionals letting their software companies know if there are things that they feel that are missing from the software that maybe we could do better to enhance that EITC experience.

MS. GREGORY: And I'll tell you that diagnostic tools are incredibly important to a practitioner, especially as we get deeper and deeper into filing season and our time is getting more limited to get the returns out the door. Sometimes that's what reminds me that we've got an issue. And it's nothing I saw immediately because I don't remember every year exactly what that income threshold is. So I'm glad to see that.

MR. WITMER: And I'm sure we have a wide variety of preparers who are involved with the EITC from the large preparer groups that probably see a lot of that to maybe some of the others who maybe do this only as pro bono work or do just a few of these returns. So I think that sounds like it's a very good, useful tool for across the board to better news preparing.

MS. HOLLAND: Yeah, I would just like to add – the joint software IRS group that we formed that Sue was referencing has been a particularly good experience. I think it's a good example of the IRS working with the paid preparer community to try to address some of these compliance issues. So anyone who was involved with that, I want to thank for their participation on that group. About 70 percent of all EITC returns are prepared using software – excuse me, by paid preparers and then a very high percentage of those returns, over 80 percent, use software. And so you can see why we thought that software and enhancements to the software as a tool to help with due diligence was something that would be beneficial.

I think the preparers that are listening to the show today may see some changes or some improvements in software, including some of the things that Sue mentioned for the upcoming filing season.

MR. WITMER: Very good. We've gotten a good many questions and let me try to work some of these in. Some of them deal with due diligence but as we might expect, some of them are still involved in basics of EITC, so maybe let's handle a few of both. Here's one, a mother is audited for EITC. She is a divorced parent of a pre-school-aged child who lives with her. During the audit, she is asked to prove her child meets the age, relationship, and residency requirements. If the child's father is required to pay medical bills, so doctor bills will not suffice and the mother's mother provides daycare for free, what else can the mother provide to show residency? Now, this would – this would just be the straight EITC audit.

MS. HOLLAND: Yes, but it's a common question and it's a common dilemma that I think some of these claimants face. What we're looking for, in an audit, first of all, the individual can prove age and relationship with something like a birth certificate, which is not an uncommon document for a benefits program to request. In terms of residency, that's a little more complicated, but some of the types of documents that the IRS will accept are medical records, school records, daycare records. We will accept from a member of the clergy on a church letterhead, for example, a letter that states that the individual lived with this particular person for more than half the year. And there are a number of other documents that could be presumably accepted by us, that obviously, it is a benefit, it is a tax credit that is being claimed, and the Internal Revenue Service would need documentation to show that residency.

MS. GREGORY: It can be difficult for taxpayers, for the average taxpayer, to understand what it is that the IRS is looking for and to be able to write it in a timely manner. And I've had clients who have lost their 30-day, lost their 90-day, and we have to go in through taxpayer advocate or some other way to reopen the case on it. And not that they didn't have it; they didn't quite understand how to get it to you.

MS. GASTON: I think another good tool for tax professionals is the Form 886 EIC and associated forms. I think that's a great way to educate the client, up front, as to what they might need if they need to provide documentation for an EITC claim.

MS. HOLLAND: Yeah, let me just say that I certainly respect the job that you do and I understand and we empathize with the fact that sometimes, getting that documentation can be somewhat burdensome. So we appreciate the efforts that you make in that area.

MR. WITMER: Okay, let's get on to some of the other questions. How does a preparer know when the knowledge requirement comes into play? Sue?

MS. GASTON: So I think it's back to the discussion around making reasonable inquiries when things don't sound – when things sound incorrect, incomplete, or inconsistent. And so I think that's like Bridget's saying, kind of an individual call for the tax professional to kind of understand when they're getting the information from the taxpayer that maybe things don't sound quite right and you made need to dig a little deeper.

(Cross talk, laughter.)

MS. HOLLAND: Yeah, I'd like to say that the bottom line is this. If an independent auditor walks into your office and pulls that case file, are we able to see from the documentation and from the questions that you asked, clearly that the individual qualifies for EITC? If the case does not have documentation, for example, that these issues that we've talked about today, like head of household and other issues, then clearly, you know, it doesn't hold up to the standards of the audit. So there's really not a one thing that would trigger you needing to ask additional questions. Sometimes it's a series of answers that don't stay consistent. Do you encounter that?

MS. GREGORY: Yes.

MS. HOLLAND: So there's really not a simple answer to that. It's a matter of collecting all the information to determine whether or not someone qualifies.

MR. WITMER: Okay, here's another one. A taxpayer wants to file head of household and claim his niece and nephew as qualifying children for EITC. What additional inquiries need to be made?

MS. GREGORY: I think it is an automatic that those children would not qualify but I'd want to know where the parents are and if there's a reason why the parents are not claiming the children. Niece and nephew is part of the line that works on an EITC claim.

MS. GASTON: Yeah, I think delving into the relationship aspect and finding out why, exactly, this person is going to claim this niece and nephew, not just where are the parents, but kind of, why are you thinking that you're entitled to this claim? And a lot of times, it may be because the parents have passed away and maybe, you know, both killed at the same time and so that gives an opportunity for somebody else to take – take parenting control for these children.

MR. WITMER: Okay.

MS. HOLLAND: Yeah, in that example, I think there are really two issues. One is the head of household status and we talked about that. The other is, in order to qualify, those three rules need to be met. So that's what you do; you file back, you ask the questions about residency, age, and relationship. In this example, a niece would meet relationship but the other questions, document the answers and if the person qualifies, you file the claim.

MR. WITMER: A taxpayer claimed one qualifying child on the return last year and wants to claim a different qualifying child this year. What needs to be documented?

MS. GREGORY: Back to wanting to know why the difference? What was different about last year and this year? Do you have a divorced situation where maybe you've got custody that changed during the year? Or was there some set of circumstances that changed that? Was there a birth, perhaps, or an adoption?

MS. HOLLAND: That's an excellent example, by the way, of a situation that the IRS sees as requiring additional inquiries. And the question is, the key question is, what's changed? You know, that's possibly, clearly, you know, that a child that you claimed last year for EITC purposes – they no longer qualify this year and they you may have had another child that does. So it's possible, but clearly, you ask the questions and document the answers. And I think it's a lot different depending whether you were the preparer last year because if you were, obviously, you noticed that there's switch. But maybe if you weren't the preparer, you may not have that information.

MR. WITMER: Okay. Do EITC due diligence audits ever trigger audits of the preparer's clients? Or vice versa? Debra, you kind of talked it down to being two separate things, here. But do they ever trigger back into the other direction?

MS. HOLLAND: Yeah, I would never say never about anything. But here's the normal process; the normal process is that we have separate processes that we use to identify individuals to audit and separate processes to we use to do a due diligence audit. What happens in due diligence audits is we have, obviously, data about returns and we are able to determine that in some cases, that certain preparers or preparer firms appear to be filing a large number or an inordinate number of EITC claims that, according to our systems, may not be good claims. And that would trigger, potentially, a due diligence audit of that preparer firm. So they really are handling these two separate processes.

MR. WITMER: As former spokesman, a key word I used to use was pung, P-U-N-G, probably, usually, normally, generally. (Laughter.) Get you off the hook.

MS. HOLLAND: Okay.

(Laughter.)

MR. WITMER: Let's go into some of the – some of the ones here that we've gotten in that get away from due diligence but really go into the EITC – the rules that you talked about earlier. Is it possible that a person who has head of household status with a dependent, obviously, both with no Social Security, but with an ITIN number, can get earned income credit?

MS. HOLLAND: Ah, I think the key here, if I understand that question correctly, is that the claimants don't have Social Security numbers, they have I-10s and in that case, the claimants do not qualify. One of those basic requirements that we talked about earlier is that to claim EITC, the claimants must have a valid Social Security number as well as the qualifying children, if that's part of the claim.

MR. WITMER: Okay. A 40-year-old, totally disabled man lived with his sister and brother-in-law. The disabled brother receives Social Security. The sister and brother-in-law cannot prove support. Am I correct that the disabled brother qualifies as a qualifying child?

MS. HOLLAND: I think this question points that there is a difference in the rules for when someone qualifies as a dependent, versus when someone qualifies as a qualifying child. And with the facts that you just read, I believe it's possible that this person is a qualifying person for EITC. I understood that the age requirement would be met because we said that any age, with someone who's permanently and totally disabled, a brother-in-law is a relationship that meets the relationship test, and the last test would be do the individuals live in the same home for at least half the year. And if those three things are met, then yes, that person could be a qualifying child for the purposes of EITC and might not be a dependent. That is possible.

MS. GASTON: I think one other thing we want to look at in that situation is to make sure that the client really understands what permanently and totally disabled means because I think sometimes, they have a little bit different impression than we do what that term means.

MS. HOLLAND: Good point. You know, I think that's a good point a lot – about a lot of the different things when we start talking about substantiating a claim. I think one thing a preparer can do to help their clients is explain what type of documentation IRS would want. If you filed that claim, we would be looking for some type of documentation of permanent and total disability, either doctor's statements that say that or Social Security records that say that. So I think that's a real good point, you know, helping explain what it is the IRS would consider to make that claim valid is something you can do for your clients.

MR. WITMER: Okay. We've gotten a flurry of questions here at the end. We're trying to get through as many as possible but like always, if we don't get to your question, we'll post it under the "Tax Talk Today" resource page, both the question and the answer.

Here's one, "I'd like an opinion on the validity of returns where the preparer has chosen to omit some deductions in order to increase earned income and thus increase the amount of EITC claimed by the taxpayer."

MS. HOLLAND: Okay. Again, if I understand that question correctly, a preparer is choosing to not claim some deductions for the client that are allowable by law and reductions are what we call allowed, or allowable, meaning that the expectation is that you take them. And if we got into an audit where we have that circumstance, it's likely we would reduce that EITC claim.

MS. GASTON: I think we're also back to the discussion around expenses, in terms, you know, letting the taxpayer know, if they're in a certain profession, what kinds of things may be eligible for expenses because – I think as you said earlier, there's doubtful that there's really a Schedule C self-employment case out there with absolutely no expenses.

MS. GREGORY: But when you have a client that, along the way, says, well, gee, if I didn't deduct this, what would happen to my return and we've all had that happen, then it sets a different level of what we have to do in that.

MR. WITMER: Okay, we've got about a minute left so let's see if we can get through this last one. "If a client is audited about EIC or head of household filing status and the client cannot produce the documents necessary to satisfy the IRS, is the preparer subject to penalties?"

MS. HOLLAND: That sounds like an individual audit, an individual audit of the taxpayer return, and normally, we don't assess preparer penalties. We do have, you know, I say again, it's hard to say never, we do have some types of compliance tools where we'll look at a group of individual returns and audit all of those returns and assess preparer penalties. But generally, the answer to that question is no.

MR. WITMER: Okay, all right. Last word from the practitioners, what would you pass on as things that viewers should really be aware of in EITC or what's the main thing, maybe, that they should be aware of from our program today?

MS. TOMBUL: I think today's word is documentation. I think it's a requirement that's new and it's something some people may not be accustomed to doing.

MR. WITMER: Okay, Sue?

MS. GASTON: I think also, the knowledge requirement, making sure that tax professionals really understand the EITC requirements and make sure that they can explain that to their clients.

MR. WITMER: Okay, good, good information. Thanks for a really interesting discussion on earned income tax credit. But before we close out, let's go back to Phyllis.

MS. GRIMES: That brings us to the end of today's program. But mark your calendars for Tuesday, November 4th, 2008, which is Election Day, for our next program, "Preparing for the New Form 990."

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Finally, tell your colleagues to watch "Tax Talk Today." I'm Phyllis Grimes. We'll see you in November. Thanks for watching.

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