



Due Diligence Training Manual

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Due Diligence and the EITC

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Introduction

According to statistics supplied by the Internal Revenue Service (IRS), nationwide during 2018, 25 million eligible workers and families received about \$63 billion in earned income tax credit (EITC). However, other figures provided by the IRS¹ estimate that about 27% of all EITC claims are paid in error, which could result in refunds being delayed or denied and a ban on the taxpayer from claiming the credit for two to ten years. Some of these errors were caused by misinterpreting the law; some occurred because the preparer accepted client-provided information at face value; and others were due to deliberately fraudulent claims. In an attempt to minimize incorrect claims for EITC and to reduce the revenue shortfall caused by such claims, the IRS has instituted a preparer compliance campaign to educate the paid tax preparers who are responsible for around two-thirds of the EITC claims filed each year.

Course Objectives

The purpose of this course is to provide a thorough review of the eligibility requirements for the EITC for the 2019 tax year and to present and discuss the EITC due diligence program implemented by the IRS to prevent the filing of incorrect or fraudulent claims. The four requirements of due diligence will be outlined, and case studies will be used to highlight the practical application of due diligence by tax preparers. The penalties that the IRS may assess against tax preparers who fail to meet their due diligence obligations are also presented.

Upon conclusion of this course, you will be able to:

- ✓ correctly apply the 14 different rules that apply to taxpayers' eligibility to claim the EITC
- ✓ identify the three most common errors in filing claims for EITC detected by the IRS and recognize the due diligence measures that tax preparers can take to avoid these errors
- ✓ identify the four types of due diligence that tax preparers must exercise when preparing an EITC claim
- ✓ identify the purpose of IRS Form 8867 and the type of information it contains
- ✓ given basic personal details of a taxpayer wishing to claim EITC, recognize the types of questions a tax preparer should ask to determine eligibility for EITC
- ✓ identify the types of penalties and other consequences that may apply to taxpayers, tax preparers, and tax preparation firms in cases where an incorrect claim for EITC has been filed

Chapter 1

Review of EITC Eligibility

Given that the earned income tax credit (EITC) is intended for the benefit of lower income taxpayers, there are a number of rules that apply to determining eligibility for the credit. These rules are intended to ensure that the EITC is only received by those taxpayers for whom the credit was designed. A taxpayer's filing status, age, income from other sources, and the number of dependent children are all factors that influence whether or not the taxpayer can claim the EITC and how much he or she is eligible to receive.

In this chapter, we will examine these rules in turn.

Chapter Objectives

Upon conclusion of this chapter, you will be able to:

- ✓ given a list of the 14 rules that apply to eligibility to claim the EITC, correctly apply those rules for taxpayers with or without qualifying children
- ✓ identify criteria that disqualify all taxpayers from eligibility regardless of the number of qualifying children
- ✓ identify the acceptable forms of taxpayer identification that may be used instead of a regular Social Security number for the purpose of claiming the EITC

Rules for All Taxpayers

There are a total of seven rules that apply to all taxpayers with regard to determining EITC eligibility. These are discussed in turn.

Rule 1: Taxpayer Must Have Earned Income

The taxpayer must have earned income in order to qualify for the EITC. A couple filing a joint return meets this rule if at least one spouse works and has earned income.

Earned income includes:

- ✓ wages, salaries, tips, and other taxable employee pay
- ✓ net earnings from self-employment
- ✓ gross income received as a statutory employee
- ✓ for a taxpayer retired on disability, taxable benefits received under his or her employer's disability retirement plan until he or she reaches minimum retirement age

Earned income does **NOT** include:

- ✓ interest and dividends
- ✓ pensions and annuities
- ✓ Social Security and Railroad Retirement benefits (including disability benefits)
- ✓ alimony and child support

- ✓ welfare benefits
- ✓ workers compensation benefits
- ✓ unemployment compensation (insurance)
- ✓ nontaxable foster care payments
- ✓ veterans' benefits, including VA rehabilitation payments
- ✓ payments received from a disability insurance policy for which the taxpayer paid the premiums, regardless of the taxpayer's age

Rule 2: Taxpayer AGI Limit

The taxpayer's AGI must be below a set amount, depending on his or her filing status and the number of qualifying children. The AGI limits are adjusted every year, and the maximum allowable AGI figures for the 2019 tax year are found in the following table.

If filing . . .	Qualifying Children Claimed			
	Zero	One	Two	Three or More
Single, Head of Household or Widowed	\$15,570	\$41,094	\$46,703	\$50,162
Married Filing Jointly	\$21,370	\$46,884	\$52,493	\$55,952
https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year (July 2019)				

Rule 3: Valid Social Security Number(s)

The taxpayer (and his or her spouse if filing a joint return) must have a valid Social Security number (SSN) issued by the Social Security Administration. Any qualifying child listed on Schedule EIC must also have a valid SSN unless the child was born and died in 2019. In such a case, the taxpayer must attach to his or her return a copy of the child's birth certificate, death certificate, or hospital records showing a live birth. The credit cannot be claimed if the taxpayer or child obtains an ID number after the tax filing deadline, even if an extension is filed.

The following is considered a valid SSN for the purpose of this rule:

- ✓ a taxpayer with a Social Security card with the legend "Valid for work only with INS authorization" or "Valid for work only with DHS authorization"

The following examples are **NOT** considered valid SSNs for the purpose of this rule:

- ✓ a taxpayer with a Social Security card with the legend "Not valid for employment"
- ✓ a taxpayer with an individual taxpayer identification number (ITIN) instead of an SSN
- ✓ a taxpayer with an adoption taxpayer identification number (ATIN) instead of an SSN

Rule 4: Filing Status Cannot Be "Married Filing Separately"

A taxpayer with filing status "married filing separately" cannot claim the EITC.

Rule 5: U.S. Citizen or Resident Alien All Year

A taxpayer who was a nonresident alien for any part of the year cannot claim the earned income credit unless his or her filing status is married filing jointly, and:

- ✓ The other spouse is a U.S. citizen or resident alien.
- ✓ The couple chooses to treat the nonresident spouse as a U.S. resident.

If they make this choice, then both spouses are taxed on their worldwide income.

Rule 6: Cannot File Form 2555 or Form 2555-EZ

Taxpayers who file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion, cannot claim the EITC.

Rule 7: Investment Income Must Be \$3,450 or Less

Taxpayers with investment income greater than \$3,450 cannot claim the EITC.

A taxpayer must meet the tests associated with all seven of the above rules in order to proceed to the next step of evaluating eligibility to claim the EITC. The next sets of rules are related to the number of qualifying children, if any.

Rules for Taxpayers Without Children

A taxpayer with no qualifying children must meet the test associated with the following four rules.

Rule 1: Taxpayer Aged Between 25 and 65

A taxpayer wishing to claim the EITC must be at least age 25 but under age 65 at the end of 2019. For married taxpayers filing a joint return, at least one spouse must be at least age 25 but under age 65 at the end of 2019. If one spouse died during the year, his or her age at death is used for the purpose of this rule.

Rule 2: Cannot Be the Dependent of Another Person

A taxpayer who can be claimed as the dependent of another person—even if that person does not actually claim him or her—cannot claim the EITC.

Rule 3: Cannot Be the Qualifying Child of Another Person

A taxpayer who can be claimed as the qualifying child of another person—even if that person does not actually claim him or her—cannot claim the EITC.

Rule 4: Must Have Lived in the U.S. More than Half of the Year

A taxpayer (and spouse if filing jointly) cannot claim the EITC unless he or she has lived in the U.S. for more than half of the year. For this rule, the U.S. is defined as the 50 states and the District of Columbia. It does *not* include Puerto Rico or U.S. possessions such as Guam.

U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period for purposes of the EITC.

Rules for Taxpayers with Children

A taxpayer with children must meet the tests associated with the following three rules to see whether their children qualify for the purposes of claiming the EITC.

Rule 1: Child Must Meet Relationship, Age, Residency, and Joint Return Tests

A taxpayer's child is a qualifying child if he or she meets the following four tests:

- ✓ relationship
- ✓ age
- ✓ residency
- ✓ joint return

Relationship Test



The child must be the taxpayer's:

- ✓ son, daughter, stepchild, adopted child, foster child, or a descendant of any of them
- ✓ brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them

Note

An adopted child is always treated as the taxpayer's own child. The term "adopted child" includes a child who was lawfully placed with the taxpayer for legal adoption.

For purposes of the EITC, a person is the taxpayer's foster child if he or she is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Age Test

To satisfy this test, a taxpayer's child must be:

- ✓ under age 19 at the end of 2019 and younger than the taxpayer (or spouse, if filing jointly)
- ✓ under age 24 at the end of 2019, a student, and younger than the taxpayer (or spouse, if filing jointly)
- ✓ permanently and totally disabled at any time during 2019, regardless of age

Note

To qualify as a student, the taxpayer's child must be, during some part of each of any five calendar (not necessarily consecutive) months during the calendar year:

- ✓ a full-time student at a school that has a regular teaching staff, course of study, and regular student body at the school
- ✓ a student taking a full-time, on-farm training course given by a school described above or a state, county, or local government

A full-time student is a student who is enrolled for the number of hours or courses the school considers to be full-time attendance.

A school can be an elementary school, junior or senior high school, college, university, or technical, trade, or mechanical school. However, on-the-job training courses, correspondence schools, and schools offering courses only through the Internet do not count as schools for the EITC.

Residency Test

The child must have lived with the taxpayer in the United States for more than half of 2019, where the United States is defined as the 50 states and the District of Columbia. This definition does not include Puerto Rico or U.S. possessions such as Guam.

Taxpayers can regard any time that the child is away from home on a temporary absence due to a special circumstance as time the child lived with them. Examples of a special circumstance include illness, school attendance, business, vacation, military service, and detention in a juvenile facility.

A child who was born or died in 2019 is treated as having lived with the taxpayer for more than half of 2019 if the taxpayer's home was the child's home for more than half the time he or she was alive during the year.

Joint Return Test

To meet this test, the taxpayer's child cannot file a joint return for the year. The only exception to this rule is if the child and his or her spouse file a joint return only as a claim for refund and no tax was owed.

Even if the taxpayer's child does not file a joint return, if he or she was married at the end of 2019, he or she cannot be a qualifying child unless:

- ✓ The taxpayer can claim an exemption for the child.
- ✓ The reason the taxpayer cannot claim an exemption for the child is that there is an agreement in place to let the child's other parent claim the exemption under special rules for divorced or separated parents (or parents who live apart). More information on these rules can be found in IRS Publication 596, Earned Income Credit (EIC).

Rule 2: Qualifying Child Cannot Be Used by More than One Person for EITC

In general, only one taxpayer may claim all of the following tax benefits related to a child, assuming they qualify:

- ✓ the exemption for the child
- ✓ the child tax credit
- ✓ head of household (HOH) filing status
- ✓ the credit for child and dependent care expenses
- ✓ the exclusion for dependent care benefits
- ✓ the EITC

In other words, taxpayers cannot agree to divide the tax benefits related to a given child. Some exceptions apply for divorced or separated parents or parents who live apart. In case of dispute, a series of tiebreaker rules are used to determine which person can treat the child as a qualifying child to claim the six tax benefits listed above. More information on these rules can be found in IRS Publication 596, Earned Income Credit (EIC).

Rule 3: Cannot Be a Qualifying Child of Another Taxpayer

A taxpayer who can be claimed as the qualifying child of another person—even if that person does not actually claim him or her—cannot claim the EITC. The taxpayer would be the qualifying child of another person if he or she met the relationship, age, residency, and joint return tests described earlier for Rule 1.

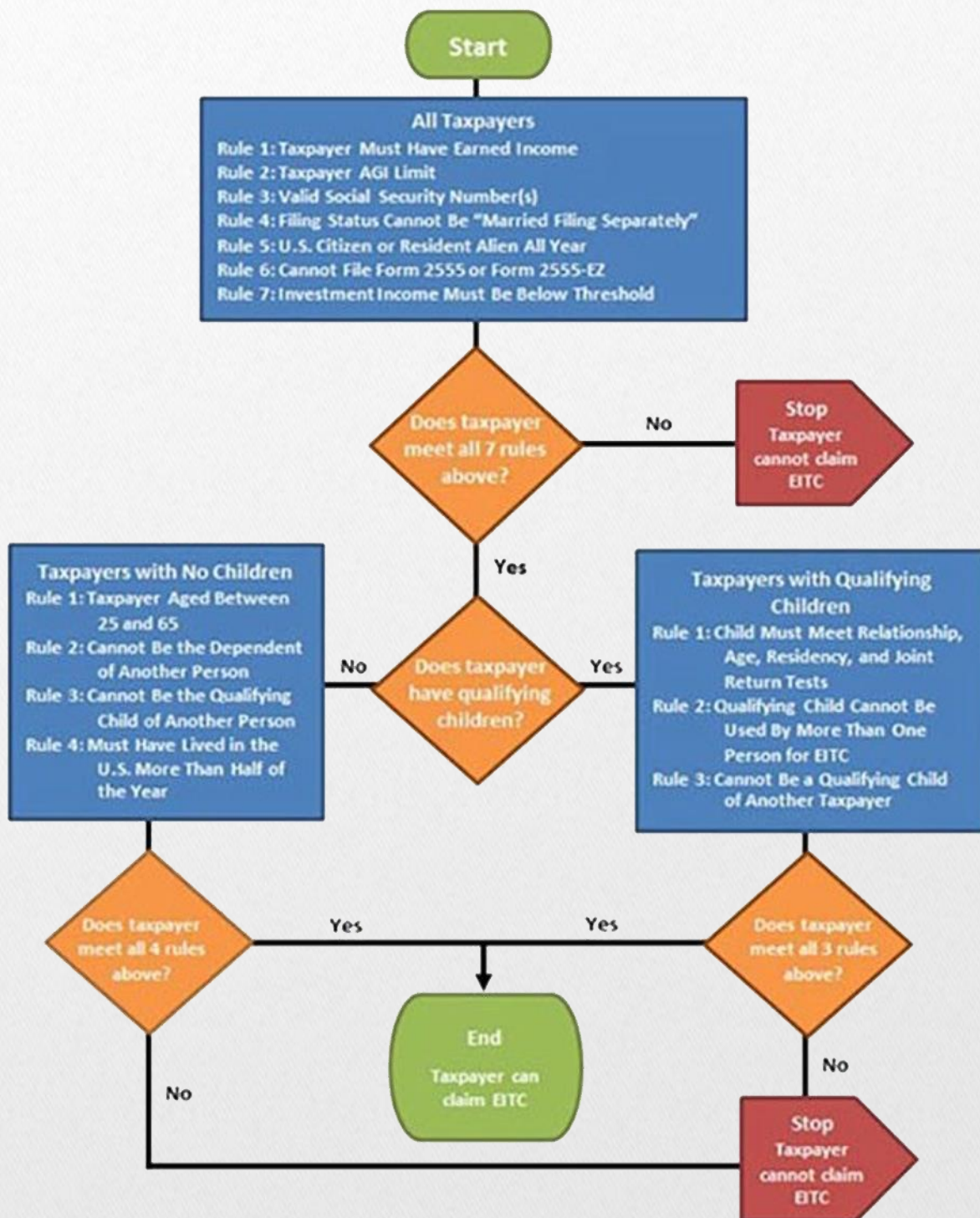
Summary

As we have seen, there are many factors that must be taken into account when determining a taxpayer's eligibility to claim the earned income tax credit. In order to try to create some kind of logical flow to the process of determining eligibility in each case, the different variables have been grouped into three different sets of rules, namely:

- ✓ rules that apply to all taxpayers
- ✓ rules that apply to taxpayers with qualifying children
- ✓ rules that apply to taxpayers without qualifying children

The following diagram represents the order in which the rules should be applied.

Summary of EITC Eligibility Rules



Chapter 1 Review Questions

1. Roger was 24 at the end of the last tax year and is filing as a single taxpayer. His AGI last year was \$13,000, and he has no dependents. Is he eligible to claim the earned income tax credit for last year?
 - A. Yes, provided he meets the other tests such as citizenship, residency, and so on.
 - B. Yes, but only if he is a full-time student.
 - C. No; Roger is disqualified by his age.
 - D. No; Roger's AGI is too high to allow him to claim EITC.
2. Of the following list of taxpayers, who is clearly ineligible to claim the EITC?
 - A. Sophie, two children, filing separately from her husband
 - B. Mario, one child, filing jointly with his wife, reporting foreign earned income on Form 2555
 - C. Andrew and Beth, no children, filing jointly, lived in England until August when they returned to the U.S.
 - D. all of the above
3. Debbie is a resident alien who lived all of last year in the United States. She wishes to claim the EITC as part of her tax return. Which one of the following pieces of identification would be acceptable to demonstrate her potential eligibility?
 - A. a valid ITIN card showing her full name
 - B. a Social Security card with the legend "Valid for work only with INS authorization"
 - C. a valid driver's license from her U.S. state of residency showing her correct address a
 - D. valid British passport with her resident alien visa inside
4. Which of the following statements is correct when it comes to applying the rules for eligibility for the EITC?
 - A. Some rules apply to all taxpayers, some rules apply to taxpayers with children, and other rules apply to taxpayers with no children.
 - B. There are no rules that apply to all taxpayers, but the rules that apply to taxpayers with children are different from the rules that apply to taxpayers with no children.
 - C. Some rules apply to all taxpayers, and the rules that apply to taxpayers with children are the same as the rules that apply to taxpayers with no children.
 - D. All of the rules are the same for all taxpayers, regardless of whether they have children.

Answers to Chapter 1 Review Questions

1.

- A. This answer is incorrect. Roger's AGI is below the threshold for single taxpayers with no children; however, taxpayers without children must be aged between 25 and 65 to claim the EITC. Since Roger is 24, he is ineligible.
- B. This answer is incorrect. Whether or not a taxpayer is a student has no bearing on eligibility for EITC. However, age and AGI are both factors.
- C. That's correct! Roger's AGI is below the threshold for single taxpayers with no children; however, he fails the age test because taxpayers without children must be aged between 25 and 65 to claim the EITC.
- D. This answer is incorrect. Although Roger's AGI is below the threshold for single taxpayers with no children, his age is also a factor in determining eligibility.

2.

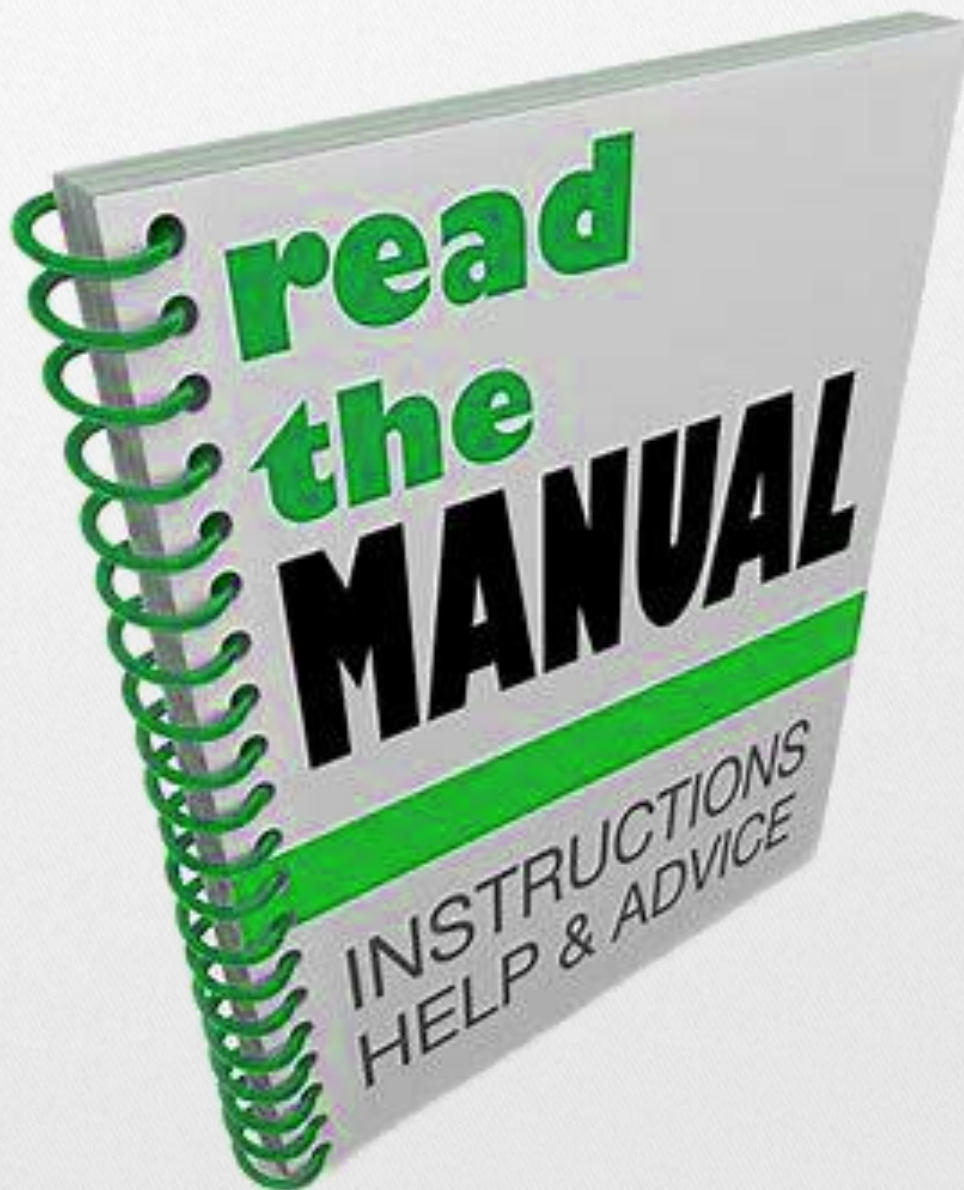
- A. This answer is incorrect. Sophie cannot claim EITC because taxpayers with status married filing separately are not eligible.
- B. This answer is incorrect. Because Mario is using Form 2555 to exclude foreign income, he cannot claim the EITC.
- C. This answer is incorrect. Taxpayers without children who lived in the U.S. for less than half the year are not eligible to claim EITC. Andrew and Beth are ineligible for EITC because they lived in England for the first eight months of the year.
- D. That's correct! Among the conditions that disqualify taxpayers from being able to claim the EITC are: married filing separately status; use of Form 2555 or 2555-EZ to exclude foreign income; and taxpayers without children who lived in the U.S. for less than half the year. As a result, all of the taxpayers listed in this question are ineligible to claim the EITC.

3.

- A. This answer is incorrect. Taxpayers must have a valid Social Security number that allows them to work in the U.S. An ITIN card cannot be substituted for an SSN for the purpose of the EITC.
- B. That's correct! Debbie must have a valid Social Security number (SSN) issued by the Social Security Administration to be eligible for the EITC. This SSN card is still acceptable if it is endorsed with the legend "Valid for work only with INS authorization" or "Valid for work only with DHS authorization." However, if it is endorsed "Not valid for employment," she is disqualified from the EITC. An ITIN cannot be substituted for a valid SSN, nor can a driver's license or passport.
- C. This answer is incorrect. For the purpose of EITC eligibility, a driver's license cannot be substituted for a valid Social Security card that shows that the taxpayer is authorized to work in the U.S.
- D. This answer is incorrect. A valid passport may be used for identification in a number of areas, but in relation to claiming the EITC, a passport cannot be substituted for a valid SSN that shows that the holder is authorized to work in the U.S.

4.

- A. That's correct! There are seven rules that apply to all taxpayers, a set of three rules that apply to taxpayers with children, and a different set of four rules that apply to taxpayers with no children.
- B. This answer is incorrect. There are seven rules that apply to all taxpayers and different sets of rules that apply to taxpayers based on whether or not they have children.
- C. This answer is incorrect. The rules that apply to taxpayers with children are different from the rules that apply to taxpayers with no children.
- D. This answer is incorrect. There are some rules that apply to all taxpayers, but there are also further sets of rules that apply differently to taxpayers based on whether or not they have children.



Chapter 2

Most Common EITC Errors

As we saw in the last chapter, there are a number of rules that must be used in determining a taxpayer's eligibility to claim the earned income tax credit (EITC). The flow chart at the end of Chapter 1 was intended to provide a pictorial representation of the logical flow that must be used in applying the various rules, but even in the simple case of a taxpayer with no qualifying children, it can be seen that 11 different rules must be applied. In a complex system such as the EITC, it is not surprising that mistakes are sometimes made in determining eligibility. In this chapter, we will review the three most commonly made errors that together account for some 60 percent of all incorrect EITC claims according to information gathered by the IRS. We will also discuss due diligence practices that help tax preparers avoid these problem areas.

Chapter Objectives

Upon conclusion of this chapter, you will be able to:

- ✓ identify the three areas in which the IRS has found mistakes are most commonly made in claims for EITC
- ✓ recognize examples of mistakes that preparers commonly make in the above three areas
- ✓ identify the due diligence actions that preparers should take in each of the three areas to avoid mistakes

Claiming a Child Who Is Not a Qualifying Child

This is the most common EITC error, according to the IRS. As we saw in the last chapter, for a child to be considered a qualifying child, he or she must meet *all* of the following tests:

- ✓ relationship
- ✓ age
- ✓ residency
- ✓ joint return

Many taxpayers meet several of these requirements, but they must meet all of them to be eligible to claim the EITC. If two people who file separate tax returns claim the same child, tiebreaker rules must be used to determine which person has the valid claim. These rules can be summarized as follows:

- ✓ If only one of the persons is the child's parent, the child is treated as the qualifying child of the parent.
- ✓ If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year. If the child lived with each parent for the same amount of time, the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income (AGI) for the year.

- ✓ If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year.
- ✓ If a parent can claim the child as a qualifying child but no parent does claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who can claim the child. If the child's parents file a joint return with each other, this rule can be applied by treating the parents' total AGI as divided evenly between them.

Due Diligence by the Tax Preparer

Under the provisions of Circular 230, tax preparers have a "knowledge" requirement that means they must apply a reasonableness standard to the information they receive from their clients. If the information provided by the client appears to be incorrect, incomplete, or inconsistent, the preparer must make additional inquiries of the client until satisfied that the correct and complete information needed to prepare the return has been obtained.

The preparer must ask adequate and sometimes probing questions of their clients to determine whether they meet the requirements for claiming the EITC. To help with this process, the IRS has created Form 886-H-EIC, Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child or Children. This form (which is also available in Spanish) gives details of the evidence the taxpayer should be able to provide if requested in order to substantiate a claim for EITC. It thus provides some helpful guidance to the tax preparer in formulating questions to ask the client when preparing the tax return and to demonstrate due diligence on the part of the preparer. The form is signed under penalty of perjury by the taxpayer (and spouse for joint returns).

Even in relatively straightforward cases, this form can be very helpful to show to clients during the course of the tax interview to help them understand the details of the requirements for a qualifying child or children. A copy of the two-page form is shown next.

**Documents You Need to Send to Claim the Earned Income Credit
on the Basis of a Qualifying Child or Children for Tax Year 2019**

Taxpayer name	Taxpayer Identification Number	Tax year
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To get Earned Income Credit (EIC), the child must have lived with you, be related to you and be a certain age.

Para recibir el Crédito por Ingreso del Trabajo (EIC, por sus siglas en inglés), el niño tiene que haber convivido con usted, ser su pariente, y tener una edad específica. Visite [IRS.gov/espanol](https://www.irs.gov/espanol) para buscar la versión en español del Formulario 886-H-EIC (SP) (Rev. 10-2019) o llame al 1-800-829-3676.

Visit [IRS.gov/eic](https://www.irs.gov/eic) to find out more about who qualifies for EIC.

1. Each child that you claim must have lived with you for more than half of 2019* in the United States. The United States includes the 50 states and the District of Columbia. It doesn't include Puerto Rico or U.S. possessions such as Guam.

*Count time that you or the child is temporarily away from home due to special circumstances as time the child lived with you. Examples include illness, college, business, vacation, military service or detention in a juvenile facility.

To prove the child lived with you in the United States, the document(s) must have: - your U.S. address, your name, and the child's name. (If you use a P.O. Box as your mailing address, you must send a completed Form 1093, P.O. Box Application stamped by the Post Office) - the dates in 2019 the child lived at the same address as you must cover more than half of 2019 - if the document has the child's name and your address but not your name, you need to send in another document with your name showing the same address	You can send one or more of the following documents to prove the child lived with you for more than half of 2019: - school records (you may need to send one or more school records) - Medical records from doctors, hospital or medical clinic (immunization records may not include all the necessary information) - adoption or child placement documents - court records	Or, send dated statements on letterhead from: - the child's school - the child's childcare provider (not a relative) - the child's health care provider, doctor, nurse or clinic - a social service agency - a placement agency official - your employer - an Indian tribal official - your landlord or property manager - a place of worship - shelters
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2. Each child that you claim must be related to you in one of the ways listed below. If the child is:	Then, send in copies of:
Your son or daughter (including an adopted child):	Nothing at this time, go to Section 3. If your name is not on the child's birth certificate, send us other records or documents proving you are the parent such as adoption records, court decree or paternity test results. If the child was not born in the United States, we need a copy of the birth certificate or immigration papers in English or a copy of the legal translation.
Your grandchild or great grandchild:	One or more birth certificates or other legal documents proving how you are related. For example, if you are claiming your: - Grandchild, send your child's and grandchild's birth certificates - Great grandchild, send your child's, your grandchild's and your great grandchild's birth certificates If the names aren't on the birth certificates, you need to send another type of document such as a court decree or paternity test results.

Table continued...

2. Each child that you claim must be related to you in one of the ways listed below. If the child is	Then, send in copies of:
<i>Your niece or nephew</i>	One or more birth certificates or other legal documents proving how you are related. For example, the child's birth certificate, showing your brother as the father, your brother's birth certificate showing your mother's name and your birth certificate showing your mother's name. If the names aren't on the birth certificates, you need another type of document such as a court decree or paternity test.
<i>Your brother, sister, half brother, or half sister</i>	One or more birth certificates or other legal documents proving how you are related. For example, if you are claiming your half-brother, you need your brother's birth certificate with the name of your mother or father and your birth certificate with the name of the same mother or father. Both birth certificates must have the name of the parent in common. If not, you need another type of document, such as a court decree or paternity test results.
<i>Your stepson, stepdaughter, step-brother, step-sister, step-grandchild, or step-great grandchild</i>	One or more birth certificates or other legal documents, such as court papers or marriage licenses, proving how you are related. If the birth certificate doesn't have the name of the parent to prove how you are related, you need another type of document, such as court decree or DNA test results.
<i>A child pending adoption</i>	If the adoption is not final, you need a statement on letterhead from an authorized adoption agency.
<i>Your foster child placed with you by an authorized placement agency</i>	A statement on the letterhead of the authorized placement agency or the court document placing the child with you during 2019.
3. Age of each child that you claim is:	Then, send in copies of:
<i>Under age 19 at the end of 2019 and younger than you (or your spouse if filing a joint return)</i>	Nothing at this time.
• <i>age 19 but under age 24 at the end of 2019, and</i> • <i>a full-time student for any part of 5 calendar months during 2019, and</i> • <i>younger than you (or your spouse if filing a joint return)</i>	• School records showing the child was considered a full-time student for any part of five months of the tax year. It can be any five months of the year. The months do not have to be consecutive. • The school records must show the child's name and the dates the child attended school during 2019.
<i>Any age and permanently and totally disabled at any time during 2019</i>	A letter from a doctor, other health care provider, a social service program or government agency verifying the person is: permanently and totally disabled. To be permanently and totally disabled for EIC purposes, the condition must last or be expected to last continuously for at least a year or is expected to result in death, and the person can't work or perform other substantial gainful activities.
We must have proof for all three: you are related to the child, the child lived with you and the child's age. If you don't have or can't get the legal documents that we ask for, you can't claim EITC with that child. But, you may still be eligible for EIC without a qualifying child.	
Important things to check before sending copies of your documents to us:	
☐ Your records and documents prove all three, the child lived with you, is related to you and is a certain age. If not, we cannot allow your claim for EIC. ☐ Your documents are for 2019 not the current year. ☐ If your documents are not in English, you are sending a legally translated document. ☐ We cannot accept documents signed by someone related to you for example, your sister takes care of the child while you work. You can't send a statement signed by your sister as the childcare provider to prove the child lived with you. ☐ You are using the same record or document to prove different things. For example, you use a school record to show the child attended school from January to May and then another record showing the same child attended from September to December during 2019. If the records show your address and list you as the parent, you can use the records to prove the child lived with you for more than half the year in 2019 and that the child is related to you. If the child is age 19 but under age 24, the records also prove the child is the right age.	
Catalog Number 35113Q	www.irs.gov
	Form 886-H-EIC (Rev. 10-2019)

Married Taxpayers Incorrectly Filing as Single or HOH

This is the second most common EITC error, according to the IRS. While some of this incorrect choice of filing status may be due to misunderstanding on the part of the taxpayer, it seems that there are some married taxpayers who intentionally claim single or head of household (HOH) filing status in order to circumvent the AGI limits for eligibility and thus claim a larger amount of EITC.

Not completing the appropriate due diligence can lead to fines. IRS Section 6695(g)(1) indicates that such failure to complete due diligence in determining actual eligibility and the appropriate amount for this HOH benefit (on a return or refund claim) can result in a \$500 taxpayer penalty per failure.

Under IRC Section 6695(g)(1), tax preparers who are not diligent in determining eligibility could result in a fine of \$500 for each failure. This diligence requirement applies in determining an EITC or HOH filing status.

Due Diligence by the Tax Preparer

Once again, the "knowledge" requirement states that tax preparers must apply a reasonableness standard to the information they receive from their clients. If the information provided by the client appears to be incorrect, incomplete, or inconsistent, the preparer must make additional inquiries of the client until satisfied that the correct and complete information needed to prepare the return has been obtained.

Tax preparers with clients claiming HOH filing status must ask adequate questions of their clients to determine that they meet the requirements, which can sometimes be confusing—especially when determining whether a married taxpayer can be considered unmarried for tax purposes. This will often require the preparer to ask probing questions of the client.

Form 886-H-HOH, Supporting Documents to Prove Head of Household Filing Status, can be very helpful to the tax preparer when asking questions of the client and explaining the types of supporting documentation that may be required. Similarly, Form 886-H-DEP, Supporting Documents for Dependency Exemptions, can also be very useful as part of the discussion.

Copies of these forms are included next. Both of these forms are also available in Spanish.

Form 886-H-HOH (October 2019)		Department of the Treasury-Internal Revenue Service	
Supporting Documents To Prove Head of Household Filing Status			
You may qualify for Head of Household filing status if you meet the following three tests: Marriage Test, Qualifying Person Test, and Cost of Keeping up a Home Test.			
Name of Taxpayer		Taxpayer Identification Number	Tax Period Ending
Marriage Test	If You Are:	Then send photocopies of the following documents for tax year 2019	
	Single	Go to the Qualifying Person Test and Cost of Keeping up a Home Test.	
	Divorced or legally separated	Entire divorce decree, separate maintenance decree, or separation agreement.	
	Married, but your spouse did not live with you during the last 6 months of tax year 2019	Documents verifying your spouse did not live with you during the last 6 months of the year, such as a lease agreement, utility bills, a letter from a clergy member, or a letter from social services.	
Qualifying Person Test <i>(If your relationship with the child is not in this listing, please see Publication 501, Exemptions, Standard Deduction, and Filing Information for more information).</i>	If the Person Is:	And	Then send photocopies of the following documents for tax year 2019
	Your child (including an adopted child, or a pending adoption). Your brother or sister, stepbrother or stepfather, or any of their descendants (for example, grandchild, niece, or nephew). Your eligible foster child (a child placed in your home by an authorized placement agency or by a court order).	You can claim a dependency exemption for the child. The child lived in your home for more than half of 2019 (temporary absences away from home, such as time spent at school, count as time lived at home). Note—A married child must be your dependent.	Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child). To show both you and your child lived together for more than half of 2019, send: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter.) Send as many documents as necessary to show that the child lived with you for more than half of the year.
Cost of Keeping up a Home Test	If:	And	Then send photocopies of the following documents for tax year 2019
	You pass both the marriage test and the qualifying person test.	You paid more than half the cost of keeping up your home for 2019.	Rent receipts, utility bills, grocery receipts, property tax bills, mortgage interest statement, upkeep and repair bills, property insurance statement, and other household bills.

Catalog Number 35108X www.irs.gov Form **886-H-HOH** (Rev. 10-2019)

Supporting Documents for Dependency Exemptions

Taxpayer name		Taxpayer Identification Number	Tax Year
If You Are:	And:	Then please send photocopies of the following documents:	
Divorced, legally separated, or living apart from the other parent of the child claimed on your return.	Both parents (together) provided more than half of the child's total support for the tax year. and One or both parents have custody.	Entire divorce decree, separation agreement, decree of separate maintenance. If you are living apart from the child's other parent, but you are not divorced or legally separated, send proof that you did not live with the child's other parent for the last six months of the year. Current custody order, completed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents or a similar statement as applicable for 2019. You may need to send more than one document.	
If the Person Is:	And:	Then please send photocopies of the following documents:	
Your qualifying child	The child is: your son, daughter, adopted child, a child lawfully placed with you for legal adoption, stepson, stepdaughter, brother, sister, stepbrother, stepsister, foster child placed with you by an authorized placement agency or by court order, or a descendant of any such person (for example, a grandchild, a niece, or a nephew). and The child lived with you for more than half of 2019; (temporary absences away from home, such as the child going away to school, count as time lived at home). and The child did not provide half of his or her own support for 2019. and At the end of 2019, the child is under age 19, or a full-time student under the age of 24, or permanently and totally disabled regardless of age.	Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child). To show both you and your child lived together at the same address or addresses for more than half of 2019, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.) You may need to send more than one document to show that the child lived with you for more than half of the year.	
If the Person Is:	And:	Then please send photocopies of the following documents:	
Your qualifying relative	Your relative is any of the relatives listed in the box above or any of the following: father or mother and their ancestors, step-father or step-mother, aunt or uncle, brother-in-law or sister-in-law. and You provided over half of his or her support in 2019, (except for children of divorced or separated parents). and Can not be claimed as a qualifying child by any other person in 2019.	Birth and marriage certificates that verify your relationship to the qualifying relative. If you claim a non-blood related person as a qualifying relative, send proof the person has lived in your home for the entire 12 months of the year. To show both of you lived together at the same address or addresses for all of 2019, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.)	

*** Note - Send Us Copies of the Following Documents as Proof You Provided More Than Half of Your Dependent's Total Support: ***

- A statement of account from a child support agency.
- A statement from any government agency verifying the amount and type of benefits you and/or your dependent received for the year.
- Rental agreements or a statement showing the fair rental value of your residence (proof of lodging cost).
- Utility and repair bills (proof of household expenses) with canceled checks or receipts.
- Daycare, school, medical records or bills (proof of child's support) with canceled checks or receipts.
- Clothing bills (proof of child's support) with canceled checks or receipts.

Catalog Number 35111U

www.irs.gov

Form **886-H-DEP** (Rev. 10-2019)

Income-Reporting Errors

The IRS has noted that taxpayers sometimes over-report or under-report income to qualify for or maximize the amount of EITC.

The most common of these cases involve Schedule Cs with:

- ✓ large losses to bring income down to qualify for EITC
- ✓ bogus or inflated Schedule C income to maximize the amount of EITC
- ✓ Schedule Cs without expenses

All of these practices are in violation of the Internal Revenue Code, which holds that self-employed taxpayers filing a Schedule C Profit or Loss from Business must report the correct gross income and all related deductions on their return.

Due Diligence by the Tax Preparer

Once again, the “knowledge” requirement comes into play for the tax preparer, who must apply a reasonableness standard to the information provided by the client and must make additional inquiries of the client until satisfied that the correct and complete information needed to prepare the return has been obtained.

The preparer may need to ask probing questions to determine the correct facts. For example, further questions must be asked in cases where a self-employed client claims income without an associated Form 1099. The client should be asked what types of records are available to support the income figure he or she provided to the tax preparer. This in turn leads to questions about expenses related to the business and the availability of supporting documentation.

While it is impossible for the preparer to establish conclusively within a short period of time whether a genuine business existed as claimed by the client, he or she must apply judgment and experience to discern whether the statements being made by the client are reasonable. If the information provided by the client appears to be incorrect, incomplete, or inconsistent, then additional inquiries must be made.

Summary

The IRS has noted that many errors are made every year in claiming the EITC—of which some are due to inadvertent misunderstanding or misapplication of the EITC eligibility rules and of which others are made due to a deliberate falsification of the facts surrounding the taxpayer.

In this chapter we have reviewed the three errors that are made most frequently, according to the IRS. In each case we have seen that the tax preparer has an obligation to exercise due diligence by asking questions of the client until satisfied that the claim is reasonable, and the tax preparer has no knowledge to lead him or her to think otherwise.

The goal for each preparer must be to ultimately feel confident that each return he or she prepares is correct and complete and that his or her EITC due diligence requirements have been complied with.

Chapter 2 Review Questions

1. Which of the following has *not* been identified by the IRS a type of error that is most commonly made when preparing EITC claims?
 - A. a self-employed taxpayer reporting income incorrectly
 - B. a taxpayer without a valid SSN attempting to claim EITC
 - C. a taxpayer claiming a child who is not a qualifying child
 - D. a married couple filing incorrectly as head of household
2. Joe is a self-employed roofer for whom Anne is preparing a Schedule C. Which one of the following characteristics of the Schedule C information reported by Joe should give Anne cause to suspect that Joe's claim for EITC might possibly be fraudulent?
 - A. Joe's business mileage has increased 50 percent over the previous year.
 - B. Joe's gross sales have increased 50 percent over the previous year.
 - C. Joe's expenses for materials have been reduced by 50 percent over the previous year.
 - D. Joe's sales have remained the same as last year, but expenses have been reduced by 90 percent over the previous year.
3. Which of the following is *not* the name of an IRS form that can be used by a tax preparer as an aid to determine the eligibility of taxpayers to claim the EITC?
 - A. Form 886-H-HOH
 - B. Form 886-H-DEP
 - C. Form 886-H-MFS
 - D. Form 886-H-EIC

Answers to Chapter 2 Review Questions

1.

- A. This answer is incorrect. Income reporting errors have been identified by the IRS as one of the three most prevalent problem areas in EITC claims. For example, self-employed taxpayers may sometimes maximize their receipts or minimize their expenses for the purpose of obtaining a larger amount of EITC.
- B. That's correct! While it is true that a taxpayer without a valid Social Security number cannot claim the EITC, this is not one of the top three errors identified by the IRS. The other answer alternatives listed in the question are each an example of one of the top three errors.
- C. This answer is incorrect. The IRS has identified that taxpayers claiming children who do not truly qualify for EITC purposes is one of the three most common errors made on EITC claims.
- D. This answer is incorrect. Married taxpayers who incorrectly use the head of household filing status is one of the three errors that appear most often on EITC claims, according to statistics kept by the IRS.

2.

- A. This answer is incorrect. On its own, the increase in mileage may be of no consequence. Joe's customer list may have changed during the past year, and thus he needed to travel further to meet with them.
- B. This answer is incorrect. Anne need not necessarily be concerned about an increase in sales receipts, since this could quite possibly be a normal part of Joe's business cycle.
- C. This answer is incorrect. It is entirely possible that Joe may have succeeded in finding a cheaper supplier for his materials, or he decided to stop doing those jobs that required the more expensive supplies. Thus, Anne should not necessarily be concerned by this change.
- D. That's correct! While all businesses go through ups and downs from year to year, it is highly unlikely that Joe would be able to reduce his expenses by 90 percent from one year to the next while maintaining the same amount of sales. The other alternatives listed could all be legitimate changes caused by market conditions and changing suppliers, but Anne should ask Joe for more information on how he can explain such a drastic decrease in expenses. It may be that he is trying to inflate his income so he can claim a higher amount of EITC.

3.

- A. This answer is incorrect. This form is used in determining eligibility as an aid in EITC claims in relation to a taxpayer who is claiming head of household filing status.
- B. This answer is incorrect. This form is used during the preparation of an EITC claim in order to determine the eligibility of one or more dependents to be included as part of the claim.
- C. That's correct! The Form 886-H-MFS does not exist; however, the other three forms listed can all be used for purposes such as to help determine a taxpayer's filing status for head of household and the eligibility of dependents to be regarded as qualifying children.
- D. This answer is incorrect. Form 886-H-EIC is used; it indicates which documents need to be sent to claim the EIC on the basis of a qualifying child or children.

Chapter 3

EITC Due Diligence Law and Regulation

In the last chapter, we looked at the most common errors that are made in claiming the earned income tax credit. We concluded by saying that tax preparers must make every effort to meet the due diligence requirements placed on them by tax code. In this chapter, we will review Internal Revenue Code § 6695 and other related regulations that describe in detail the due diligence requirements for EITC and the penalties for failing to meet those requirements.

Chapter Objectives

Upon conclusion of this chapter, you will be able to:

- ✓ identify the four general areas in which tax preparers are responsible for performing due diligence when preparing claims for EITC
- ✓ recognize examples of the activities that a tax preparer would engage in for the purpose of meeting due diligence requirements in each of the four areas above
- ✓ identify the forms that must be used when completing a claim for EITC and state which of them must be filed with the tax return
- ✓ identify the types of records that must be created when determining eligibility for EITC and the minimum period of time for which these records must be kept on file

Internal Revenue Code § 6695(g)

Failure to Be Diligent in Determining Eligibility for Filing HOH or Claiming Earned Income Credit

This section of the code states:

Any person who is a tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining—(1) eligibility to file as a head of household (as defined in section 2(b)) on the return, or (2) eligibility for, or the amount of, the credit allowable by section 24, 25A(a)(1), or 32, shall pay a penalty of \$500 for each such failure.

The penalty had been set at \$100 up until late 2011 when it was increased in response to the IRS initiative to reduce the number of erroneous claims made each year for EITC. The penalty is adjusted for inflation each year and now stands at \$520 for tax year 2019.

Internal Revenue Code § 1.6695-2

Tax Return Preparer Due Diligence Requirements for Determining Earned Income Credit Eligibility

This section of the code provides details of the actions that tax preparers must take to meet their due diligence requirements. These actions fall into four general categories.

Complete and Submit Form 8867

Preparers must:

- ✓ complete the EIC portion of Form 8867, Paid Preparer's Due Diligence Checklist, to make sure they consider all EITC eligibility criteria for each return prepared
- ✓ complete the checklist based on information provided by the client(s)
- ✓ for returns or claims for refund filed electronically, submit Form 8867 to the IRS electronically along with the return
- ✓ for returns or claims for refund not filed electronically, attach the completed form to any paper return they prepare and file
- ✓ for returns or claims for refund that a tax practitioner prepares but does not submit directly to the IRS, provide the completed Form 8867 to the taxpayer to send with the filed tax return or claim for refund

Computing the Credit



To compute the credit, tax preparers should complete the EITC worksheet, which can be found in the Form 1040 instructions or in Publication 596, Earned Income Credit.

A similar document containing the same information can also be used, provided it clearly shows what is included in the computation, i.e., self-employment income, total earned income, investment income, and adjusted gross income.

Most tax preparation software packages also contain the EITC worksheet or an equivalent document.

Knowledge

A key part of the due diligence obligations for tax preparers is based on the preparer's knowledge of both the tax law and each client's particular situation. Preparers must:

- ✓ know the law and use their knowledge of the law to ensure they are asking their clients the right questions to get all relevant facts
- ✓ take into account what the client says and what the preparer knows about the client
- ✓ not know or have reason to know that any information used to determine their client's eligibility for, or the amount of, EITC is incorrect, inconsistent, or incomplete

- ✓ make additional inquiries if a reasonable and well-informed tax return preparer would know that the information is incomplete, inconsistent, or incorrect. For example, if a 22-year-old taxpayer wants to claim two sons, ages 10 and 11, as qualifying children for purposes of the EITC, the preparer must make additional reasonable inquiries regarding the relationship between the taxpayer and the children, as the age of the taxpayer appears inconsistent with the ages of the children claimed as sons.
- ✓ document **at the time of the interview** any additional questions the preparer asks and the client's answer to those questions

Keeping Records

Tax preparers must not only create records of their interviews with taxpayers but must also store those records for future reference. To comply with their due diligence requirements, preparers must:

- ✓ keep a copy of Form 8867 and the EIC worksheet, as well as a record of any additional questions they asked their client and the client's answers to those questions
- ✓ keep copies of any documents provided by the client that the preparer uses to determine eligibility for, or the amount of, the EITC
- ✓ keep a record of who provided the information used to prepare Form 8867 and the related worksheets, how the information was provided, and when it was received by the preparer
- ✓ keep records in either paper or electronic format and ensure that these records can be retrieved if the IRS asks for them
- ✓ keep these records for three years from the latest date of the following that apply:
 - the original due date of the tax return (not including any extension of time for filing)
 - the date the tax return or claim for refund is filed if the return or claim for refund is filed electronically and is signed by the return preparer
 - the date the tax return or claim for refund is presented to the client for signature if the return or claim for refund is not filed electronically
 - for a preparer only prepares part of the return or claim for refund and another preparer completes and signs the return or claim for refund, keep the date that the part of the return he or she was responsible was submitted to the signing preparer

Summary

In this chapter, we reviewed the tax practitioner's due diligence requirements for EITC according to the Internal Revenue Code. We saw that these requirements could be divided into four parts and that the tax preparer must not only ask the taxpayer questions designed to discover the truth about the taxpayer's situation, but he or she must also create written records to document the EITC interview. The checklist Form 8867 is at the center of the recording process, along with the EITC worksheet that is used to calculate the amount of credit that the taxpayer may claim. In addition, we saw that the tax preparer is required to keep copies of his or her records and make them available to the IRS if requested.

Chapter 3 Review Questions

1. Which of the following is *not* an area in which tax preparers must exercise due diligence when preparing EITC claims?
 - A. keeping records
 - B. calculating the amount of the credit
 - C. completion of Form 2441
 - D. completion of Form 8867
2. How long must a tax preparer keep records relating to an interview with a taxpayer for whom an EITC claim was lodged?
 - A. for at least three years from the original due date of the return
 - B. for at least two years from the original due date of the return
 - C. for at least three years from the later of the original due date of the return or the extended due date
 - D. for at least two years from the later of the original due date of the return or the extended due date
3. Which of the following forms and documents created during an interview to determine EITC eligibility must be filed together with the client's tax return?
 - A. EIC worksheet
 - B. Form 8867
 - C. additional interview questions and answers
 - D. all of the above

Answers to Chapter 3 Review Questions

1.

- A. This answer is incorrect. The creation and keeping of records is an area in which tax preparers must practice due diligence, and records must be kept for a prescribed minimum period.
- B. This answer is incorrect. Tax preparers are required to exercise due diligence when calculating the amount of the EITC for which a taxpayer is eligible, making sure the amount claimed is correct.
- C. That's correct! Form 2441 is used to calculate the Child and Dependent Care credit and is thus not directly related to preparing a claim for EITC. Tax preparers must use due diligence in completing Form 8867, calculating the amount of the credit, keeping records, and applying their knowledge of tax law and the individual client's situation.
- D. This answer is incorrect. Because Form 8867 is used to document the process the tax preparer used when gathering EITC information from the client, it is important that due diligence is used in completing the form.

2.

- A. That's correct! All records and supporting documents relating to the client's claim for EITC must be kept on file for a minimum of three years from the due date of the return, not including extensions.
- B. This answer is incorrect. The minimum period for recordkeeping related to the EITC is three years, not two.
- C. This answer is incorrect. EITC recordkeeping requirements do not take into account any filing extensions on the taxpayer's return.
- D. This answer is incorrect. Corresponding to the normal period during which the IRS may audit a tax return, records relating to a claim for EITC must be kept on file for a minimum of three years.

3.

- A. This answer is incorrect. The EIC worksheet is an important part of the process of preparing a claim for EITC, but it is not required to be filed together with the return. Instead, it is kept on record by the tax preparer.
- B. That's correct! The only form required to be filed with the client's tax return is Form 8867. The other documents that are used to determine eligibility are kept on record by the tax preparer so that they can be shown to the IRS later if requested.
- C. This answer is incorrect. Additional interview questions and answers help in establishing the facts supporting an EITC claim; however, the IRS does not need to receive these documents. They should instead be kept on file by the tax preparer.
- D. This answer is incorrect. Only Form 8867 is sent to the IRS with the tax return. The other documents are kept on file by the tax preparer.

Chapter 4

Form 8867 Paid Preparer's Due Diligence Checklist

In the last chapter, we discussed the steps a Circular 230 tax preparer must take to meet due diligence requirements relating to the earned income tax credit. We saw that the creation of accurate and comprehensive records is a key part of those due diligence requirements and that Form 8867 is at the center of the information-gathering process critical to creating accurate and complete records. In this chapter, we will look at the portions of Form 8867 that deal with the Earned Income Credit.

Chapter Objectives

Upon the conclusion of this lesson, you will be able to:

- ✓ identify the purpose of Form 8867
- ✓ recognize examples of the way in which questions to the taxpayer should be phrased when completing Form 8867

Overview

As we saw earlier in the course, there are a number of tests that have to be satisfied before a taxpayer is eligible to claim the EITC. Form 8867 was originally designed as a checklist to help tax preparers make sure they asked all of the right questions for determining eligibility during the tax interview with regard to the EITC, while meeting the related due diligence requirements. However, beginning with the 2016 tax year, the form was changed in focus and expanded in scope to include new due diligence requirements for the Child Tax Credit (CTC), the Additional Child Tax Credit (ACTC), and the American Opportunity Credit (AOTC) along with the EITC.

Regardless of which credit is involved, Form 8867 is intended to ensure that the tax preparer proceeds through the information-gathering process in an orderly fashion and satisfies the due diligence requirements along the way. The form's title, "Paid Preparer's Due Diligence Checklist," clearly describes its function.

Form 8867 is comprised of a total of 12 mostly multi-part questions, of which the first eight apply to all four credits, and question nine applies specifically to the EITC.

Form 8867 and the EITC

As discussed above, the revised Form 8867 focuses on the tax preparer meeting his or her due diligence requirements while interviewing the client. As such, it focuses as much on the “how” of the interview as it does on the “what.”

For example, question 4 asks the preparer to answer yes or no to the following:

4. Did any information provided by the taxpayer, a third party, or reasonably known to you in connection with preparing the return appear to be incorrect, incomplete, or inconsistent? (If “Yes,” answer questions 4a and 4b. If “No,” go to question 5.)
 - a. Did you make reasonable inquiries to determine the correct or complete information?
.....
 - b. Did you document your inquiries? (Documentation should include the questions you asked, whom you asked, when you asked, the information that was provided, and the impact the information had on your preparation of the return.)

In order to make the client interview as effective and efficient as possible, the questions a preparer asks of the client should not only be asked in a language that the client is able to understand but also in a way that leads that taxpayer to provide detailed information. A good technique is to ask open-ended questions rather than simple questions with a “yes” or “no” answer. For example, the question “Was the taxpayer’s investment income more than \$3,450?” could be asked as “How much was the taxpayer’s investment income?” Phrasing the question in this way is more likely to produce a truthful answer from the client.

Form **8867**Department of the Treasury
Internal Revenue Service**Paid Preparer's Due Diligence Checklist**

Earned Income Credit (EIC), American Opportunity Tax Credit (AOTC), Child Tax Credit (CTC) (including the Additional Child Tax Credit (ACTC)) and Credit for Other Dependents (ODC), and Head of Household (HOH) Filing Status

▶ To be completed by preparer and filed with Form 1040, 1040-SR, 1040-NR, 1040-PR, or 1040-SS.
▶ Go to www.irs.gov/Form8867 for instructions and the latest information.

OMB No. 1545-0074

2019Attachment
Sequence No. **70**

Taxpayer name(s) shown on return

Taxpayer identification number

Enter preparer's name and PTIN

Part I Due Diligence Requirements

Please check the appropriate box for the credit(s) and/or HOH filing status claimed on the return and complete the related Parts I-V for the benefit(s) claimed (check all that apply).

☐ EIC ☐ CTC/ACTC/ODC ☐ AOTC ☐ HOH

	Yes	No	N/A
1 Did you complete the return based on information for tax year 2019 provided by the taxpayer or reasonably obtained by you?	☐	☐	☐
2 If credits are claimed on the return, did you complete the applicable EIC and/or CTC/ACTC/ODC worksheets found in the Form 1040, 1040-SR, 1040-NR, 1040-PR, or 1040-SS instructions, and/or the AOTC worksheet found in the Form 8863 instructions, or your own worksheet(s) that provides the same information, and all related forms and schedules for each credit claimed?	☐	☐	☐
3 Did you satisfy the knowledge requirement? To meet the knowledge requirement, you must do both of the following: • Interview the taxpayer, ask questions, and contemporaneously document the taxpayer's responses to determine that the taxpayer is eligible to claim the credit(s) and/or HOH filing status. • Review information to determine that the taxpayer is eligible to claim the credit(s) and/or HOH filing status and to compute the amount(s) of any credit(s).	☐	☐	☐
4 Did any information provided by the taxpayer or a third party for use in preparing the return, or information reasonably known to you, appear to be incorrect, incomplete, or inconsistent? (If "Yes," answer questions 4a and 4b. If "No," go to question 5.)	☐	☐	☐
a Did you make reasonable inquiries to determine the correct, complete, and consistent information?	☐	☐	☐
b Did you contemporaneously document your inquiries? (Documentation should include the questions you asked, whom you asked, when you asked, the information that was provided, and the impact the information had on your preparation of the return.)	☐	☐	☐
5 Did you satisfy the record retention requirement? To meet the record retention requirement, you must keep a copy of your documentation referenced in 4b, a copy of this Form 8867, a copy of any applicable worksheet(s), a record of how, when, and from whom the information used to prepare Form 8867 and any applicable worksheet(s) was obtained, and a copy of any document(s) provided by the taxpayer that you relied on to determine eligibility for the credit(s) and/or HOH filing status or to compute the amount(s) of the credit(s). List those documents, if any, that you relied on.	☐	☐	☐
6 Did you ask the taxpayer whether he/she could provide documentation to substantiate eligibility for the credit(s) and/or HOH filing status and the amount(s) of any credit(s) claimed on the return if his/her return is selected for audit?	☐	☐	☐
7 Did you ask the taxpayer if any of these credits were disallowed or reduced in a previous year? (If credits were disallowed or reduced, go to question 7a; if not, go to question 8.)	☐	☐	☐
a Did you complete the required recertification Form 8862?	☐	☐	☐
8 If the taxpayer is reporting self-employment income, did you ask questions to prepare a complete and correct Schedule C (Form 1040 or 1040-SR)?	☐	☐	☐

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 26142H

Form **8867** (2019)

Part II Due Diligence Questions for Returns Claiming EIC (If the return does not claim EIC, go to Part III.)

	Yes	No	N/A
9a Have you determined that the taxpayer is, in fact, eligible to claim the EIC for the number of qualifying children claimed, or is eligible to claim the EIC without a qualifying child? (Skip 9b and 9c if the taxpayer is claiming the EIC and does not have a qualifying child.)	☐	☐	☐
b Did you ask the taxpayer if the child lived with the taxpayer for over half of the year, even if the taxpayer has supported the child the entire year?	☐	☐	☐
c Did you explain to the taxpayer the rules about claiming the EIC when a child is the qualifying child of more than one person (tiebreaker rules)?	☐	☐	☐

Part III Due Diligence Questions for Returns Claiming CTC/ACTC/ODC (If the return does not claim CTC, ACTC, or ODC, go to Part IV.)

	Yes	No	N/A
10 Have you determined that each qualifying person for the CTC/ACTC/ODC is the taxpayer's dependent who is a citizen, national, or resident of the United States?	☐	☐	☐
11 Did you explain to the taxpayer that he/she may not claim the CTC/ACTC if the taxpayer has not lived with the child for over half of the year, even if the taxpayer has supported the child, unless the child's custodial parent has released a claim to exemption for the child?	☐	☐	☐
12 Did you explain to the taxpayer the rules about claiming the CTC/ACTC/ODC for a child of divorced or separated parents (or parents who live apart), including any requirement to attach a Form 8332 or similar statement to the return?	☐	☐	☐

Part IV Due Diligence Questions for Returns Claiming AOTC (If the return does not claim AOTC, go to Part V.)

	Yes	No
13 Did the taxpayer provide substantiation for the credit, such as a Form 1098-T and/or receipts for the qualified tuition and related expenses for the claimed AOTC?	☐	☐

Part V Due Diligence Questions for Claiming HOH (If the return does not claim HOH filing status, go to Part VI.)

	Yes	No
14 Have you determined that the taxpayer was unmarried or considered unmarried on the last day of the tax year and provided more than half of the cost of keeping up a home for the year for a qualifying person?	☐	☐

Part VI Eligibility Certification

► You will have complied with all due diligence requirements for claiming the applicable credit(s) and/or HOH filing status on the return of the taxpayer identified above if you:

- Interview the taxpayer, ask adequate questions, contemporaneously document the taxpayer's responses on the return or in your notes, review adequate information to determine if the taxpayer is eligible to claim the credit(s) and/or HOH filing status and to compute the amount(s) of the credit(s);
- Complete this Form 8867 truthfully and accurately and complete the actions described in this checklist for any applicable credit(s) claimed and HOH filing status, if claimed;
- Submit Form 8867 in the manner required; and
- Keep all five of the following records for 3 years from the latest of the dates specified in the Form 8867 instructions under *Document Retention*.
 - A copy of this Form 8867;
 - The applicable worksheet(s) or your own worksheet(s) for any credit(s) claimed;
 - Copies of any documents provided by the taxpayer on which you relied to determine the taxpayer's eligibility for the credit(s) and/or HOH filing status and to compute the amount(s) of the credit(s);
 - A record of how, when, and from whom the information used to prepare this form and the applicable worksheet(s) was obtained; and
 - A record of any additional information you relied upon, including questions you asked and the taxpayer's responses, to determine the taxpayer's eligibility for the credit(s) and/or, HOH filing status and to compute the amount(s) of the credit(s).

► If you have not complied with all due diligence requirements, you may have to pay a \$530 penalty for each failure to comply related to a claim of an applicable credit or HOH filing status.

	Yes	No
15 Do you certify that all of the answers on this Form 8867 are, to the best of your knowledge, true, correct, and complete?	☐	☐

Form **8867** (2019)**Question 9**

This three-part question applies specifically to the EITC and is designed to make preparers review whether they have correctly applied the rules relating to any qualifying children. In this question, preparers are asked to answer yes or no to the following:

- Have you determined that this taxpayer is, in fact, eligible to claim the EIC for the number of children for whom the EIC is claimed, or to claim EIC if the taxpayer has no qualifying child? (Skip 9b and 9c if the taxpayer is claiming EIC and does not have a qualifying child.)

- b. Did you explain to the taxpayer that he/she may not claim the EIC if the taxpayer has not lived with the child for over half the year, even if the taxpayer has supported the child?
- c. Did you explain to the taxpayer the rules about claiming the EIC when a child is the qualifying child of more than one person (tie-breaker rules)?

In the case of taxpayers who are eligible to claim the EITC but do not have a qualifying child, the instructions for Form 8867 advise preparers to simply answer “yes” for question 9a and skip questions 9b and 9c. But, in cases where a child is the qualifying child for more than one person, the tiebreaker rules may need to be applied.

Tiebreaker Rules

More complete information can be found in IRS Publication 596, Earned Income Credit, but the main principles are as follows:

- ✓ If only one of the persons is the child’s parent, the child is treated as the qualifying child of the parent.
- ✓ If the parents file a joint return together and can claim the child as a qualifying child, the child is treated as the qualifying child of both of the parents.
- ✓ If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year. If the child lived with each parent for the same amount of time, the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income (AGI) for the year.
- ✓ If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year.
- ✓ If a parent can claim the child as a qualifying child but no parent does so, the child is treated as the qualifying child of the person who had the highest AGI for the year but only if that person's AGI is higher than the highest AGI of any of the child’s parents who can claim the child.

Question 12—Credit Eligibility Certification

As discussed earlier, the penalty for failing to meet EITC due diligence requirements is \$520, but this penalty now also applies to the new due diligence requirements for the CTC and AOTC. This means that a practitioner who prepares a tax return that claims the EITC, CTC, and AOTC and files HOH could be subject to a penalty of \$2,080 if he or she fails to meet the due diligence requirements for each of those credits. Question 12 is designed as a confirmation by the preparer that he or she has met the due diligence standards required for **all** credits claimed on the Form 8867.

That is, in order to claim any or multiple of these credits—ETIC, CTC, AOTC—while filing HOH, all requirements for the credits must be met. Lines 10 and 11 do not negate this requirement.

The preamble to question 12 sets out the preparer’s due diligence requirements and serves as a reminder of the steps the preparer is required to take in interviewing the client with regard to each of the Form 8867 credits that are claimed on behalf of the taxpayer. The question itself calls for a simple yes/no response from the preparer that he or she certifies that all of the answers on the form are, to the best of the preparer’s knowledge, “true, correct, and complete.” It is, of course, impossible for a preparer to guarantee with full and complete certainty that every answer provided by the taxpayer relating to Form 8867 is true, correct, and complete unless he or she visits that taxpayer’s home, interviews schoolteachers and caregivers, and performs a forensic audit of bank accounts and other records relating to the taxpayer’s income and expenses. Expecting taxpayers and their preparers to adhere to such an intrusive and time-consuming standard of proof would be not only unreasonable but also impractical.

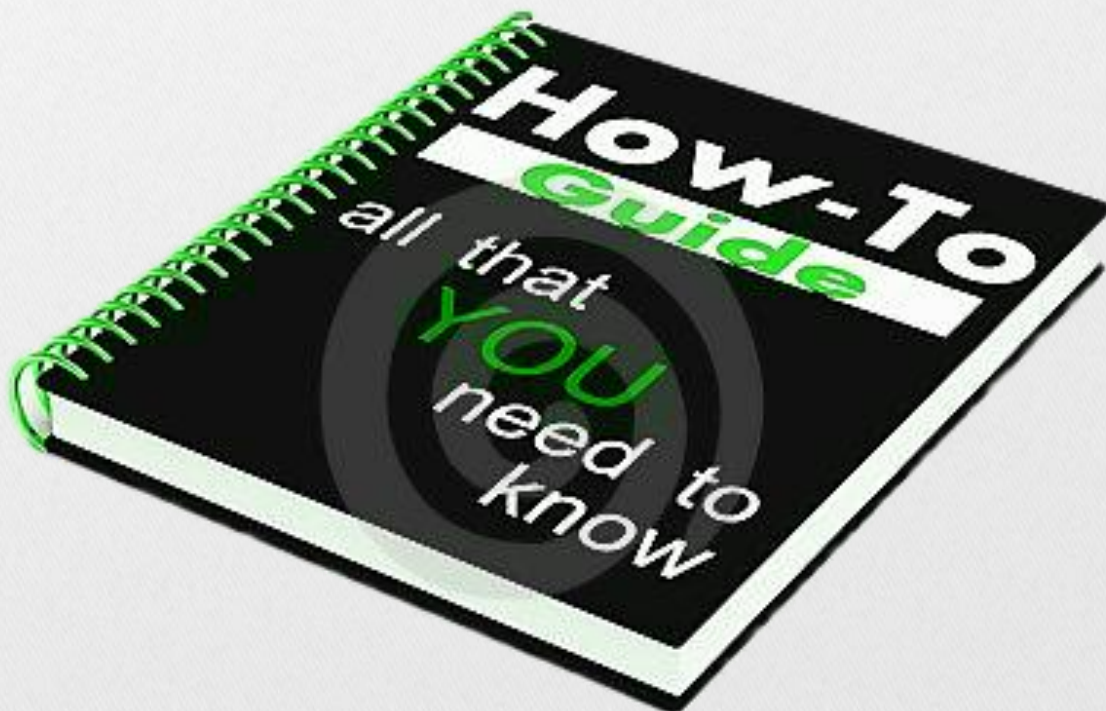
For that reason, the standard represented by question 12 of Form 8867 requires preparers to make inquiries of the taxpayer that are reasonable in nature. Nevertheless, preparers must extend those inquiries and ask for more details if the initial responses received seem inconsistent or evasive or if the preparer has reason to doubt the truthfulness of the responses he or she has received.

Despite the best efforts of tax preparers to obtain “true, correct, and complete” information at all times, taxpayers who are determined to misrepresent themselves can sometimes talk their way through an interview and trick a preparer into filing a false or fraudulent claim for the EITC or other credit. In such cases, preparers who have performed all of the required due diligence procedures can point to their completed Form 8867 and its supporting documentation to show that they followed all of the steps required by the IRS but were simply outfoxed on this occasion by a determined fraudster.

In this way, Form 8867 not only serves as a workflow aid for tax professionals but also as a safety net in case they are ever questioned by the IRS.

Summary

As we have seen, Form 8867 is designed to make sure that the tax preparer has done a thorough job of obtaining information for the eligibility tests that must be met prior to making a claim for EITC. The form provides a framework for the tax preparer to address his or her due diligence responsibilities in logical order by asking questions of the taxpayer and recording his or her responses. Different commercial tax preparation software programs will have different types of screens for inputting the answers to the questions relating to Form 8867, but the end result will be to produce a completed form for filing with the tax return as well as a copy of the EIC Worksheet (or equivalent) for recordkeeping along with an extra copy of Form 8867.



Chapter 4 Review Questions

1. Which of the following best describes the purpose of Form 8867 in relation to the EITC?
 - A. It provides the tax preparer with an orderly structure for meeting EITC due diligence requirements.
 - B. It provides details of the documentation provided by the taxpayer to support the EITC claim.
 - C. It provides the IRS with a comprehensive view of how the preparer determined the taxpayer's eligibility.
 - D. all of the above
2. Marion is doubtful that her client is answering her questions entirely truthfully. What is the best way for her to phrase a question about the residency of her client's qualifying children?
 - A. Did the children both live with you last year?
 - B. In what places did each child live last year?
 - C. Did the children both live in the U.S. for more than half of last year?
 - D. Were the children both living in the U.S. at the end of the year?
3. Roger is completing Form 8867 for his client Margie in relation to her claim for the EITC. How should he answer questions 9a, 9b, and 9c given that Margie has no qualifying children??
 - A. He can skip this question entirely.
 - B. He should answer "yes" to part a and skip parts b and c.
 - C. He should answer "no" to all three parts.
 - D. He can ignore question 9 because it does not apply to the EITC.

Answers to Chapter 4 Review Questions

1.

- A. This answer is incorrect. Form 8867 indeed provides an orderly structure for meeting EITC due diligence requirements, but it also has further benefits.
- B. This answer is incorrect. The preparer should list on Form 8867 the taxpayer documents that he or she used to determine EITC eligibility; however, the form also has other purposes.
- C. This answer is incorrect. The answers to the questions on Form 8867 together create a comprehensive summary of how the preparer was able to determine the taxpayer's eligibility, but that is not the sole purpose of the form.
- D. That's correct! A fully-completed Form 8867 creates a detailed summary of the sources of information used by the tax preparer as well as providing evidence that the tax preparer exercised due diligence in gathering and recording the information used to prepare the claim for the EITC.

2.

- A. This answer is incorrect. This question invites a simple yes/no answer and provides a hint to the client on what the most favorable answer would be. There are better ways to ask for this information.
- B. That's correct! Qualifying children must live in the U.S. for more than half of the year. The taxpayer is likely unaware of this requirement, and because Marion already has her doubts, she should avoid asking about residency in a way that allows the client to guess what the most favorable answer would be. Rather than asking a question that allows a simple yes/no answer, Marion should ask a question that is open-ended and requires the taxpayer to provide the specific details of the children's residency.
- C. This answer is incorrect. Asking this question provides an indication to the client that she should probably answer yes, but Marion has no way of ascertaining how truthful such an answer may be. Her goal should be to ask questions in such a way that it makes the client do the talking.
- D. This answer is incorrect. Apart from inviting a simple yes/no response, this question also invites the client to provide an answer that may or may not be truthful. Marion should phrase her questions in a way that prompts the client to explain the children's situation in detail.

3.

- A. This answer is incorrect. Roger should not skip this question but instead should answer it in the way recommended by the instructions for the form.
- B. That's correct! Roger should answer "yes" to part a and skip parts b and c in accordance with the instructions for Form 8867.
- C. This answer is incorrect. The instructions for Form 8867 provide specific guidance for this situation.
- D. This answer is incorrect. Question 9 does indeed apply to the EITC and the instructions for the form offer specific guidance on how to handle Margie's situation.

Chapter 5

Case Studies and Scenarios

Now that we have reviewed the eligibility requirements for claiming the earned income tax credit and discussed the due diligence that tax preparers must exercise in preparing such claims, including the forms and checklists that are used, the next step is to examine some examples of different cases where taxpayers are seeking to claim the EITC. In each case, a general scenario will be presented, and we will consider several different actions for the tax preparer to take depending on the answers given by the client.

Chapter Objectives

Upon the conclusion of this chapter, you will be able to:

- ✓ given the basic personal details of a taxpayer wishing to claim the EITC, identify suitable questions designed to correctly establish eligibility
- ✓ when reviewing answers provided by taxpayers in response to EITC eligibility questions, recognize how techniques of critical thinking are used to eliminate possible ambiguity and doubt when asking follow-up questions

Case 1—Separated Spouse



A client informs her tax preparer that she is separated from her husband and has her eight-year-old son living with her. As part of the process of preparing a full and accurate tax return, the preparer will check whether the client is eligible to claim the EITC.

As we have seen already, there are a number of questions that need to be asked to clarify the client's situation. For this client, the most pertinent questions relate to:

- ✓ her marital status
- ✓ her filing status
- ✓ the residency of her son

The preparer now needs to ask a series of questions in these subject areas to determine whether the client meets the criteria for eligibility.

Marital Status

Asking questions to determine the client's marital status is important because the results will also affect her filing status.

Scenario 1

Question

Preparer: Are you still married?

Client: Yes; we're not divorced, but we *are* separated.

Analysis of Answer

Because the client is married, she will have to file either MFJ or MFS. If she files MFS, she will not be able to claim the EITC; however, she may qualify as head of household if she can be "considered unmarried" for tax purposes. The conditions for the client to be considered unmarried at the end of the tax year are:

- ✓ She must file a separate return.
- ✓ She must have paid more than half the cost of keeping up the home for the tax year.
- ✓ Her husband did not live in the home during the last six months of the year.
- ✓ Her home was the main home for more than half the year for her son.
- ✓ Her son must qualify as a dependent.

More information about the above is needed before a determination can be made regarding EITC.

Question

Preparer: When did you separate from your husband?

Client: Last February.

Analysis of Answer

A clearer understanding of the term "separated" is needed. Was she separated legally? Was she living separately from her husband?

Question

Preparer: Where does your husband live?

Client: He moved into an apartment in February when we separated.

Analysis of Answer

The requirement of not living together for the last six months of the year is met, but there remain a few other questions before the client can be considered unmarried.

Question

Preparer: How long during the year did your son live with you?

Client: The whole year except for one week during the summer and every other weekend when he was visiting his father.

Analysis of Answer

The son lived with her for well over half of the year, so this requirement is met.

Question

Preparer: Who paid the bills for maintaining your home during the year?

Client: I did. I even got a part-time job to help out.

Analysis of Answer

The client obviously meets the test for providing more than half the cost of maintaining the home for the year. She can thus be considered unmarried and can file as head of household. The preparer should now go on and ask further questions according to the checklist on Form 8867 to determine whether the client is eligible to claim EITC.

If the client responds to the preparer's questions in a different way, the outcome may also be quite different, as we will see in Scenario 2.

Scenario 2

Question

Preparer: Are you still married?

Client: Yes, we're still married, but we don't live together.

Analysis of Answer

Similar to the previous scenario, the client can file MFJ, MFS, or possibly HOH if she meets the requirements to be considered unmarried for tax purposes. Further questions are needed.

Question

Preparer: When did you separate from your husband?

Client: In September last year.

Analysis of Answer

The client cannot be considered unmarried because she did not live apart from her husband for the last six months of the year. Thus, she cannot file as HOH and must choose between MFJ and MFS.

Question

Preparer: Do you and your husband plan to file a joint return?

Client: No, I don't want to have anything to do with him financially. I want my own refund.

Analysis of Answer

According to this answer, the client wants to file married filing separately. The preparer must then inform her that she is unable to claim the EITC with this filing status.

Case 2—Self-Employed Pool Man



A client informs his tax preparer that he is head of household with two children aged 10 and 12. He goes on to say that his only earned income is \$16,000 from his own swimming pool care business. As part of the process of preparing a full and accurate tax return, the preparer will check whether the client is eligible to claim the EITC.

As we have seen already, there are a number of questions that need to be asked to clarify the client's situation. For this client, the most pertinent questions relate to:

- ✓ his marital status
- ✓ his filing status
- ✓ the residency of the children
- ✓ the net income from the business

The preparer now needs to ask a series of questions in these subject areas to determine whether the client meets the criteria for eligibility. Similar questions to those we saw in Scenario 1 would first be asked to determine the taxpayer's eligible filing status and whether the children qualify to be included when calculating the available EITC amount.

Net Business Income

If the client's answers to the above questions indicate that he may be eligible to claim the EITC, then the next step will be to ask about the nature of his Schedule C business.

Scenario 1

Question

Preparer: How much did you earn last year in your business?

Client: \$16,000.

Preparer: \$16,000 exactly?

Client: Yes.

Analysis of Answer

While it is certainly possible for the sales of the business to be exactly \$16,000, the roundness of this number may lead the preparer to ask further questions.

Question

Preparer: What kind of records do you have that you used to calculate your total sales for the year?

Client: Actually, I don't have any written records—I just know what jobs I did and what it all added up to.

Analysis of Answer

Once again, it's entirely possible that the client is telling the truth, but more questions should be asked to probe further.

Question

Preparer: How do you decide how much to charge your customers?

Client: Well, each one is different, but I usually charge around \$100 per month for an average-size pool.

Preparer: Is it the same price each month for the whole year?

Client: No, in the summer I charge a bit more because I have to visit more often, and then in the winter I charge a bit less.

Analysis of Answer

It would seem very difficult for someone with no written records to keep track of a very flexible pricing scheme such as the taxpayer has just described. Further questions regarding the legitimacy of the business should be asked.

Question

Preparer: How did you keep track of your expenses for equipment and chemicals?

Client: I didn't have any expenses because I just used the customers' tools and supplies.

Preparer: How did the customers know what chemicals to buy?

Client: I would tell them in advance.

Analysis of Answer

It is quite possible for a very well-organized and experienced pool maintenance person to warn his customers in advance of the chemicals that are needed for maintaining their swimming pools, but it seems unrealistic that a business would operate in this way. Common sense would tell the preparer that customers who pay for a pool service do so because they do not want to bother with buying chemicals, and they expect that this should be taken care of within their monthly service fee.

Given the doubt surrounding the taxpayer's answers to all of the above questions, it sounds likely that the taxpayer is attempting to file a claim for EITC based on a self-employed business that does not exist. If the client responds to the preparer's questions in a different way, the outcome may also be quite different, as we will see in Scenario 2.

Scenario 2

Question

Preparer: What kind of records do you have that you used to calculate your total sales for the year?

Client: Actually, I don't have any written records. But, I put every payment from my customers into my business bank account, and it all added up to \$16,000.

Analysis of Answer

This explanation sounds plausible, but more questions should be asked to probe further.

Question

Preparer: How do you decide how much to charge your customers?

Client: Just to make it easy on myself to keep track of, I charge \$100 per month for each pool no matter what size.

Preparer: Is it the same price each month for the whole year?

Client: No, from May to August I charge \$125 because I have to visit more often and then from December to February I charge \$75. The other months are all \$100.

Analysis of Answer

This pricing scheme sounds quite simple to follow and would fit with the preparer's common knowledge of the local environment. Further questions regarding expenses should be asked to make sure that the taxpayer is not trying to inflate his income for the purposes of claiming the EITC.

Question

Preparer: How did you keep track of your expenses for equipment and chemicals?

Client: I bought all my tools and supplies using my business credit card, so I have all of those statements.

Preparer: Did you record your mileage driving to your customers' homes?

Client: No, I meant to buy a log book for that, but I never did.

Analysis of Answer

The taxpayer's answers seem much more in line with the operation of a legitimate business than was the case in Scenario 1. Although he does not have the usual written records and receipts that are normally used to construct Schedule C, in this scenario his bank statements could be used to create a reasonable reconstruction of his income and expenses for the year. The taxpayer could also use Google Maps or a similar program to create a reasonable approximation of his business mileage for the year, given that he made regular visits to the homes of his customers several times each month.

Under these circumstances, the preparer would have met due diligence requirements prior to preparing a claim for EITC. However, in practice, the preparer should also advise the taxpayer of the types of records that should be kept on an ongoing basis instead of being reconstructed at the end of the year. These records would include vehicle logbooks, sales receipt records, receipts for purchases of equipment and supplies, customer invoices, and so on.

Summary

During this chapter, we saw how important it is for tax practitioners to ask their clients questions that probe beyond the basic level. It is easy for a busy tax preparer who asks the simple questions needed to establish eligibility for EITC to overlook the subtleties that may lie within the client's answers. In the first case, we saw the importance of clarifying the term "separated" to ensure that both the client and the tax preparer had the same understanding of the client's marital situation. In the second case, we saw the importance of asking follow-up questions to a taxpayer who regards himself as self-employed. Given that this is one area identified by the IRS for potential fraudulent claims, tax preparers should make sure to satisfy themselves as to whether a legitimate business truly exists prior to taking the net income into account when calculating EITC.

In the next chapter, we will review the consequences of the incorrect filing of claims for EITC.



Chapter 5 Review Questions

1. Jane is about to prepare Don's Schedule C for his paper-hanging business. What is the best way for her to phrase her question regarding the amount of his business mileage so that she can get the most truthful and accurate answer possible?
 - A. Did you drive about the same number of miles as last year?
 - B. About how many miles do you think you drove last year?
 - C. How did you record the number of business miles you drove last year?
 - D. What was your average business mileage each month last year?
2. In which of the following cases relating to an EITC claim would a follow-up question be needed when a taxpayer has answered the question "What is your marital status?" as listed below?
 - A. I'm separated.
 - B. I'm married, and we're filing jointly.
 - C. I'm single and have never been married.
 - D. I've been divorced for two years.
3. What should be the nature and purpose of questions a tax preparer asks a client when trying to establish eligibility to claim the earned income tax credit?
 - A. The questions should be designed to lead the taxpayer to provide answers that indicate eligibility to claim the EITC in most circumstances.
 - B. There is no need to ask any questions if the taxpayer successfully claimed the EITC on his or her prior year tax return.
 - C. The questions should be open-ended, and they should be worded such that they encourage the taxpayer to provide full and truthful answers.
 - D. The questions should be designed such that the taxpayer can provide short answers and make the EITC interview as short as possible.

Answers to Chapter 5 Review Questions

1.

- A. This answer is incorrect. Asking the question in this way invites Don to simply answer yes regardless of how many miles he actually drove.
- B. This answer is incorrect. Don may or may not have kept a mileage log, but asking him to simply estimate his mileage is highly unlikely to result in a truthful and accurate answer.
- C. That's correct! This question calls on Don to discuss the evidence of business mileage. If he has documented his miles in some way, this question will lead him to not only describe his mileage records but also state his total mileage. On the other hand, the other three answer alternatives to the question invite Don to provide an estimate that may be completely inaccurate or even fraudulent.
- D. This answer is incorrect. It is extremely unlikely that Don would know his average monthly mileage, and thus his answer to this question would be at best a guess. Multiplying that guess by 12 to produce a mileage figure for the year only further compounds the error inherent in the original estimate.

2.

- A. That's correct! The term "separated" requires clarification by the tax preparer so that the correct filing status of the taxpayer can be established. For example, is the taxpayer legally separated? Planning to file married filing separate? Living apart from the spouse? For how long? In contrast, the other answer alternatives to the question are quite clear-cut and need no further elaboration.
- B. This answer is incorrect. This answer makes the taxpayer's filing status very clear, and no further questions are needed.
- C. This answer is incorrect. A taxpayer who answers in this way makes it clear that his or her filing status will not cause a disqualification from claiming EITC.
- D. This answer is incorrect. From this response, the tax preparer knows that the taxpayer will not file married filing separately and thus is not automatically disqualified from claiming the EITC.

3.

- A. This answer is incorrect. The questions should not lead the taxpayer or provide any indication of what the most favorable answers should be.
- B. This answer is incorrect. The fact that the taxpayer claimed EITC in a prior year has no bearing when preparing the current year return. The tax preparer must make appropriate inquiries, because the prior year claim may have been made in error, or the taxpayer's circumstances may have changed.
- C. That's correct! The questions should be designed to uncover the full and complete details of the taxpayer's eligibility for the EITC, and experience has shown that open-ended questions are the most effective way to encourage the taxpayer to provide comprehensive and factual information.
- D. This answer is incorrect. The emphasis when asking questions of the taxpayer should not be on the brevity of the interview but rather on establishing the true facts and circumstances of the taxpayer's claim—no matter how long this may take.

Chapter 6

Consequences of Filing EITC Claims Incorrectly

Tax return preparers are expected and trusted by their clients to know the laws regarding the earned income tax credit and to apply that law correctly. Similarly, the IRS expects tax preparers to meet due diligence requirements in preparing claims for the EITC as part of their duty to create an accurate and complete tax return for every client. EITC claims that are prepared incorrectly affect both the taxpayer and the tax preparer because the IRS has a number of actions at its disposal to respond to erroneous claims. In this chapter we will review the actions that the IRS may take against the taxpayer and tax preparer, depending on the circumstances of each case.

Chapter Objectives

Upon conclusion of this chapter, you will be able to:

- ✓ identify the actions that may follow in relation to the taxpayer when a claim for EITC has been disallowed by the IRS
- ✓ identify the penalties that may be imposed on a tax preparer in relation to not correctly following due diligence requirements, taking an unreasonable position, or disregarding IRS rules or regulations with regard to a claim for EITC
- ✓ recognize circumstances under which an employer or employing firm may also be penalized if an employee fails to comply with the EITC due diligence requirements

Taxpayer's Claim Disallowed by IRS

If the IRS audits a tax return and disallows all or part of a claim for EITC, a number of different actions may result. The taxpayer:

- ✓ must repay the amount in error, with interest
- ✓ may need to file the Form 8862, Information to Claim Earned Income Credit after Disallowance (see further details below)
- ✓ cannot claim EITC for the next two years if the IRS finds the error is because of reckless or intentional disregard of the rules
- ✓ cannot claim EITC for the next ten years if the IRS finds the error is because of fraud

Form 8862

If the EITC claim was denied or reduced in a given year for any reason other than a math or clerical error, the taxpayer must generally attach a completed Form 8862 to his or her next tax return if he or she wishes to claim the EITC. However, there are some exceptions to this requirement, as follows.

Exception 1

Form 8862 does not need to be filed if either (1) or (2) below is true.

1. After the EITC was reduced or disallowed in the earlier year:
 - a. The taxpayer filed Form 8862 in a later year, and the EITC for that later year was allowed.
 - b. The taxpayer's EITC has not been reduced or disallowed again for any reason other than a math or clerical error.
2. The taxpayer is claiming the EITC without a qualifying child for the current year, and the only reason the EITC was reduced or disallowed in the earlier year was because the IRS determined that a child listed on Schedule EITC was not the taxpayer's qualifying child.

Exception 2

The taxpayer should neither file Form 8862 nor take the EITC for a period of:

- ✓ two years after there was a final determination by the IRS that the erroneous EITC claim was due to reckless or intentional disregard of the EIC rules
- ✓ ten years after there was a final determination that the erroneous EITC claim was due to fraud

Preparer's Due Diligence Failure

If the IRS audits a tax return and finds that the preparer did not meet all four due diligence requirements in preparing to file as HOH and/or claim for EITC, CTC, and/or AOTC, the following penalties may be applied:

- ✓ a \$520⁴ preparer penalty for each failure to comply with EITC due diligence requirements for returns required to be filed after December 31, 2011 (for reference see IRC Section 6695(g))
- ✓ a minimum preparer penalty of \$1,000 if the IRS finds that any part of the amount of taxes owed is due to an unreasonable position taken by the preparer (for reference see IRC Section 6694(a))
- ✓ a minimum preparer penalty of \$5,000 if the IRS finds that any part of the amount of taxes owed is due to the preparer's reckless or intentional disregard of rules or regulations (for reference see IRC 6694(b))

An employer or employing firm may also be penalized if an employee fails to comply with the EITC due diligence requirements. The firm would risk penalty if any of the following situations apply:

- ✓ Management participated in or, prior to the time the return was filed, knew of the failure to comply with the due diligence requirements.
- ✓ The firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements.
- ✓ The firm established appropriate compliance procedures but disregarded those procedures through willfulness, recklessness, or gross indifference, including ignoring facts that would lead a person of reasonable prudence and competence to investigate or figure out the employee was not complying.

Other Preparer-Related Consequences

In addition to the above penalties related to a preparer's failure to exercise due diligence in preparing a claim for EITC, the following actions may also apply:

- ✓ disciplinary action by the IRS Office of Professional Responsibility
- ✓ suspension or expulsion of the preparer and/or firm from IRS e-file
- ✓ injunctions barring the preparer from preparing tax returns or imposing conditions on the tax returns he or she may prepare

Summary

As we have seen, the IRS takes the matter of incorrect EITC claims very seriously. Both the taxpayer and preparer can be affected by the consequences of filing a claim in a manner that is not supported by the facts and circumstances of each case. The taxpayer's ability to claim the EITC in future years may be affected when a claim is rejected entirely or in part. In addition, monetary penalties can be applied against the preparer, his or her employer, or both for a failure to exercise due diligence.

Tax preparers can avoid the risk of such consequences by ensuring that the correct due diligence procedures that we have reviewed throughout this course are applied in every case where a claim is made for the earned income tax credit.



Chapter 6 Review Questions

1. Terry is a taxpayer whose claim for EITC on last year's tax return was partly disallowed by the IRS because of a math error. What are the possible consequences that may result from this event?
 - A. Terry will have to file Form 8862 with his tax return for the next two years.
 - B. Terry will not be allowed to claim the EITC for a period of two years.
 - C. Terry will not be allowed to claim the EITC for a period of ten years.
 - D. None. Terry will simply receive the correct amount of EITC based on his circumstances.
2. The IRS has found that Dave failed to meet his due diligence requirements when preparing an EITC claim for a certain client of his on a 2017 tax return. What is the monetary amount of the preparer penalty that he may face as a result?
 - A. \$1,000
 - B. \$510
 - C. \$100
 - D. \$5,000
3. Who is potentially liable to suffer the consequences for a fraudulent claim for EITC filed by a tax preparer, depending on the circumstances of the case?
 - A. the taxpayer
 - B. the tax preparer
 - C. the tax preparer's employer
 - D. all of the above

Answers to Chapter 6 Review Questions

1.

- A. This answer is incorrect. The IRS detected a math error in Terry's claim for last year and corrected the EITC amount accordingly. There is no further consequence to this event except that it may make Terry double-check his arithmetic on next year's return.
- B. This answer is incorrect. Terry may have been barred from filing for EITC for two years if the IRS view had been that he intentionally disregarded the rules, but this was not the case. Instead, it was a simple math error that caused the discrepancy.
- C. This answer is incorrect. If he had attempted to claim EITC fraudulently, Terry may have been barred from filing for EITC for ten years, but in this case, the discrepancy in the amount claimed was caused by a simple math error.
- D. That's correct! Because the EITC was reduced due to a math error, there is no further consequence. The IRS will calculate the correct amount of EITC and adjust Terry's return accordingly. If the disallowance had been due to a disregard of IRS rules or fraud, Terry would face more serious consequences, including possibly being disqualified from filing an EITC claim for a period of years.

2.

- A. This answer is incorrect. If Dave had taken an unreasonable position in filing for EITC, he may have faced a fine of \$1,000, but his offence in this instance did not rise to that level of severity.
- B. That's correct! Circular 230 preparers face a \$510 preparer penalty for each failure to comply with EITC due diligence requirements for returns required to be filed after December 31, 2011. (For reference, see IRC Section 6695(g)). Higher penalties may be levied if a preparer takes an unreasonable position or recklessly disregards the EITC rules.
- C. This answer is incorrect. The monetary penalty for tax preparers failing to meet due diligence requirements has been set at a level higher than \$100.
- D. This answer is incorrect. A reckless or intentional disregard of rules or regulations relating to EITC would cause Dave to risk a fine of \$5,000; however, in this case his penalty is a lower amount.

3.

- A. This answer is incorrect. Taxpayers who file a fraudulent EITC claim indeed risk facing consequences from the IRS, but they are not alone in that risk.
- B. This answer is incorrect. Tax preparers who sign returns containing fraudulent EITC claims risk further consequences, including fines and suspension. However, there are other parties who may also share both the blame and the consequences.
- C. This answer is incorrect. Even though a tax preparer's employer may have had no active part in the filing of a fraudulent EITC claim, the IRS may take action against the employer if there were no safeguards in place to prevent such claims.
- D. That's correct! The tax preparer, taxpayer, and tax preparer's employer may all suffer some consequence of a fraudulent claim. The employer would be affected if the firm did not have adequate due diligence procedures in place or failed to enforce them.

Appendix

Further information for tax preparers on the IRS initiative for reducing the number of incorrect EITC claims can be found at the following location on the IRS Web site:

<http://www.eitc.irs.gov/rptoolkit/main/>.

Additionally, the IRS created a Due Diligence training video that demonstrates the application of the due diligence procedures and walks you through some examples, it is located at the following URL address:

<https://www.eitc.irs.gov/tax-preparer-toolkit/due-diligence-training-module/eitc-due-diligence-training-module>.

The simplest way to gain access to this information is to copy and paste the URL address into your Internet browser.



Glossary

adjusted gross income (AGI)—The taxpayer's total adjusted gross income (AGI) is the amount that is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses.

age test—The age test is one of the tests for identifying a qualifying child: Was the potential dependent under age 19 and younger than the taxpayer at the end of the year? Or, was the person under age 24 at the end of the year and a full-time student for some part of each of five months during the year? Or, was the person any age and permanently and totally disabled?

child and dependent care credit—The child and dependent care credit is a nonrefundable credit that allows taxpayers to claim a credit for paying someone to care for their qualifying dependents under the age of 13 or spouses or dependents who are unable to care for themselves. The credit ranges from 20% to 35% of the taxpayer's child and dependent care expenses.

child tax credit—a credit that may reduce federal income tax by as much as \$1,000 for each qualifying child

dependent—A dependent is someone who is supported by another taxpayer (for whom he or she is a dependent) and who meets all applicable dependency tests.

due diligence checklist (Form 8867)—a form to be completed by paid preparers and filed with Form 1040, 1040A, or 1040EZ to provide documentary evidence that the preparer has interviewed the taxpayer thoroughly on the subject of the claim for EITC and to list the type(s) of supporting documentation provided by the taxpayer to support the claim

earned income—Earned income includes wages, salaries, tips, and other employee compensation includible in gross income. It also includes net earnings from self-employment and other income received for personal services. It does not include interest and dividends, pensions and annuities, Social Security and railroad retirement benefits (including disability benefits), or alimony and child support.

earned income credit—The earned income credit is a refundable tax credit that can be paid to low-income workers even if no income tax was withheld from the worker's pay. To receive the credit, a taxpayer must file a tax return and meet applicable requirements.

EIC—Earned income credit, also referred to as earned income tax credit (EITC), is a refundable tax credit available to lower-income filers who meet various income and other requirements.

filing statuses—There are five taxpayer categories that determine the amount of tax and/or tax credits that apply to different taxpayers. The five filing statuses are (from lowest to highest tax): married filing jointly; qualifying widow(er) with dependent child; head of household; single; and married filing separately.

head of household filing status—filing status generally for unmarried taxpayers who paid more than half the cost of keeping up a home for a qualified dependent relative during the tax year

investment income—Investment income includes taxable interest and dividends, tax-exempt interest, capital gain net income, net income from rents and royalties not derived from a trade or business, and net income from passive activities.

joint return test—The joint return test is one of the tests for identifying a qualifying child or qualifying relative as a dependent. Generally, a married person cannot be claimed as a dependent if he or she files a joint return.

married filing jointly—Married filing jointly is a filing status for taxpayers who are married to each other or live together in a common law marriage and combine their income and deductions on the same tax return. The status also applies to taxpayers who are separated but not divorced at the end of the year and to taxpayers whose spouse died during the tax year and who has not remarried, as long as one tax return is used for both individuals.

married filing separately—Married filing separately is a filing status for taxpayers who are married to each other or live together in a common law marriage and report their own incomes and deductions on separate tax returns.

nonresident alien—a residency status of an individual who does not meet the green card test or the substantial presence test

qualifying child—Under IRS rules, a “qualifying child” is one who meets five tests. Those five tests are relationship, age, residency, joint return, and a special test for qualifying child of more than one person.

relationship test—The relationship test is one of the tests for identifying a qualifying child as a dependent: Was the person the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (i.e., the taxpayer's grandchild, niece, or nephew)?

residence test—The residence test is one of the tests for identifying a qualifying child as a dependent: Did the potential dependent live with the taxpayer as a member of the taxpayer's household for more than half of the year?

resident alien—An individual is considered to be a U.S. resident alien if he or she meets either the green card test or the substantial presence test.

self-employment income—Self-employment income is earned income from a trade, business, farming, or profession that is not paid by an employer. For example, seamstresses and lawn care workers who work for themselves (and not for someone else) are considered self-employed.

single filing status—Single filing status is the filing status that applies to a taxpayer who (1) has never married or (2) is legally separated or divorced.

United States—For the rules that relate to residency in the U.S., the United States is defined as the 50 states and the District of Columbia. It does **not** include Puerto Rico or U.S. possessions such as Guam.

End Notes

¹ <https://www.etc.irs.gov/tax-preparer-toolkit/tools-and-tips/handling-the-most-common-errors/handling-the-most-common-errors>

² <https://www.etc.irs.gov/etc/files/downloads/f886-h-etc.pdf>

³ Instructions: <https://www.irs.gov/pub/irs-pdf/i8867.pdf> Form: <https://www.irs.gov/pub/irs-pdf/f8867.pdf>

⁴ Adjusted for inflation thru 2019.





TAX PREPARER'S NOTES



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