



Keeping Up With EICT Due Diligence Training Manual

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Introduction to the Course

The Earned Income Credit (EIC) is a refundable tax credit that has a significant impact on United States revenue. It is also the source of a disproportionately large number of errors in tax returns in which a claim for it is made. In a recent year, 148.7 million individual federal tax returns were filed, and more than 19% claimed the Earned Income Credit¹. Based on that percentage, it would not be unexpected that, in the years ahead, approximately one taxpayer in every five will claim the EIC. Approximately 70% of federal income returns claiming the earned income credit are prepared by professional tax return preparers.

This course briefly summarizes the earned income credit rules, examines the common errors committed when claiming the credit, discusses the EIC due diligence requirements imposed on professional tax return preparers, and identifies the sanctions to which preparers and their employers may be subject for a failure to meet expected due diligence requirements.

Learning Objectives

Upon completion of this course, you should be able to:

- ✓ Recognize the earned income credit eligibility rules;
- ✓ List the common errors committed in connection with claiming the earned income credit;
- ✓ Describe the consequences for the taxpayer of the IRS' disallowance of the earned income credit;
- ✓ Identify the tax return preparer's earned income credit due diligence requirements; and
- ✓ List the sanctions that may be applied on a tax return preparer and his or her employer for a failure to meet due diligence requirements.



Chapter 1

Earned Income Credit Rules

Introduction

“Due diligence,” is a term that entered the lexicon of common language in connection with the securities industry. Although it continues to be a common securities-related term, it is now employed in many other contexts. As it is used with respect to the earned income credit, it refers to an investigation designed to ensure the information provided to the Internal Revenue Service in support of a claim for the credit is correct and that the claiming taxpayer meets all the applicable rules.

To provide the background for a discussion of the due diligence requirements applicable to the earned income credit, this chapter will offer an overview of the earned income credit rules and a discussion of the common errors uncovered by the IRS in connection with claims for it.

Learning Objectives

When you have completed this chapter, you should be able to:

- ✓ Recognize the earned income credit eligibility rules that apply to all taxpayers, that apply to taxpayers who have a qualifying child, and apply to taxpayers without a qualifying child;
- ✓ List the most common earned income credit errors and their potential problem areas; and
- ✓ Identify the additional questions tax preparers need to ask if taxpayer-provided information appears incorrect, inconsistent or incomplete.

Nature of the Earned Income Credit

The earned income credit is a refundable tax credit available to low and moderate income taxpayers who meet specific requirements. Since the tax credit is refundable, a taxpayer may be eligible for the credit even though he or she has no income tax liability.

Central to the earned income credit requirements is that the taxpayer must have earned income, and that the taxpayer’s earned income must not exceed a specified annual amount. The annual income limitations vary depending upon whether or not the taxpayer has one or more qualifying children. In addition, the annual income limitations generally increase each year.

Earned Income Credit Eligibility

The earned income credit rules tend to be fairly complex, and that complexity can result in errors that may be expensive for both the taxpayer and the tax return preparer. The rules concerning a taxpayer’s eligibility for the earned income credit include:

- ✓ Rules that apply to everyone;
- ✓ Rules that apply if the taxpayer has a qualifying child; and
- ✓ Rules that apply if the taxpayer does not have a qualifying child.

The earned income credit eligibility applies multiple filters to the taxpayer. Thus, if the taxpayer meets all the earned income credit eligibility rules that apply to everyone, he or she is then subject to a second set of eligibility rules that vary depending upon whether or not the taxpayer has a qualifying child.

Eligibility Rules Applicable to Everyone

Seven earned income credit eligibility rules apply to every taxpayer with or without qualifying children. If the taxpayer fails to meet even one of the seven rules, he or she is ineligible for the credit. The seven rules of eligibility applicable to all taxpayers are as follows:

1. The taxpayer's adjusted gross income must not exceed specified amounts that vary depending upon the taxpayer's filing status and number of children—the maximum adjusted gross income at which the earned income credit continues to be available is generally higher for taxpayers whose filing status is married filing jointly and increases as the number of qualifying children increases up to three;
2. The taxpayer, spouse and qualifying children must all possess a valid Social Security number;
3. The taxpayer's filing status must not be married filing separately;
4. The taxpayer must be a U.S. citizen or resident alien for the entire year;
5. The taxpayer must not have any excluded foreign earned income;
6. The taxpayer's investment income must not exceed a specified amount; and
7. The taxpayer must have earned income.

Eligibility Rules Applicable to Taxpayers with a Qualifying Child

If a taxpayer meets all seven earned income credit eligibility rules that apply to everyone **and** has a qualifying child, the taxpayer must then meet the earned income credit eligibility rules that apply only to taxpayers with qualifying children. The earned income credit eligibility rules applicable to taxpayers with one or more qualifying children involve:

1. Tests that must be met including –
 - A relationship test that requires the child to be the taxpayer's
 - Son, daughter, stepchild, foster child, or a descendant of any of them, or
 - Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them;
 - An age test that requires the child to be
 - Younger than age 19 at the end of tax year and younger than the taxpayer (or the taxpayer's spouse, if filing jointly),
 - Younger than age 24 at the end of the tax year, a student, and younger than the taxpayer (or the taxpayer's spouse, if filing jointly), or
 - Permanently and totally disabled at any time during the tax year, regardless of the child's age;
 - A residency test requiring that the child, except for temporary absences, must have lived with the taxpayer in the United States (the 50 states and the District of Columbia only) for more than half the year; and
 - A joint return test requiring that the child must not have filed a joint tax return for the tax year, except when filing the return is only to claim a refund;

2. The qualifying child of more than one person rule that permits only one person to treat the child as a qualifying child for purposes of the earned income credit. If the taxpayer and another person both meet the qualifying child tests for purposes of the earned income credit, the tiebreaker rules are then used to determine which person is allowed to treat the child as a qualifying child; and
3. The qualifying child of another taxpayer rule that prohibits a taxpayer from claiming the earned income credit if he or she is a qualifying child of another taxpayer.

Eligibility Rules Applicable if Taxpayer Does Not Have a Qualifying Child

A taxpayer need not have a child in order to receive an earned income credit. Thus, if the taxpayer without a child meets all seven of the rules that apply to everyone, he or she needs only to meet the four eligibility rules that apply to a taxpayer without a qualifying child in order to receive the credit. Those four rules are:

1. The age rule that requires the taxpayer to be at least age 25 but less than 65 at the end of the tax year. (If a taxpayer is married and files a joint tax return, only one of the spouses must meet the age rule.);
2. The dependent of another person rule that prohibits a taxpayer eligible for the earned income credit from being the dependent of another person, even if the other person did not claim the taxpayer as a dependent;
3. The qualifying child of another taxpayer rule that makes the qualifying child of another taxpayer ineligible to receive an earned income credit; and
4. The main home rule that requires an eligible taxpayer to have lived in the United States more than half the year. (Residence in Puerto Rico or a U.S. possession does **not** qualify.)

Common Earned Income Credit Errors

Approximately one in five taxpayers—more than 28 million in a recent year—files a tax return in which the earned income credit is claimed. In light of the number and complexity of the rules that must be followed in order to support an earned income credit claim, it is not surprising that a substantial number of errors have occurred. The common errors encountered in connection with earned income credit returns leading to improper earned income credit payments have been identified by the Internal Revenue Service as:

- ✓ Complexity of the tax law;
- ✓ Structure of the earned income credit;
- ✓ Confusion among eligible claimants;
- ✓ High turnover of eligible claimants;
- ✓ Unscrupulous tax return preparers; and
- ✓ Fraud.

According to an Internal Revenue Service report, an improper earned income credit payment is deemed to occur if a taxpayer whose earned income credit claim is selected for review:

- ✓ Is unable to substantiate the claim to the satisfaction of the Internal Revenue Service;
- ✓ Is found to be ineligible for the earned income credit; or
- ✓ Is found to have received an earned income credit in excess of the amount to which he or she is entitled.

Although earned income credit errors may result from a wide range of factors, the IRS reports that more than 80% of all earned income credit errors involve only four issues. Those issues that cause a disproportionately large share of earned income credit errors are mistakes made by a taxpayer having to do with:

- ✓ Qualifying children;
- ✓ Filing status;
- ✓ Income reporting; and
- ✓ Social Security numbers.

In order to better identify a tax return preparer's due diligence requirements, let's briefly consider these issues. In so doing, we will examine the rules governing each of the issues and the questions a tax preparer should ask if the information provided by the client appears to be incorrect, inconsistent or incomplete.

Earned Income Credit Errors Involving Qualifying Children

The earned income credit error most commonly encountered is one involving a qualifying child. In the case of errors involving qualifying children, the child fails to meet all of the four eligibility tests, i.e. the tests related to the child's age, relationship, residency or joint return. While a taxpayer may fail to meet any one of the four tests, in most cases in which there is an error the child does not meet either:

- ✓ The relationship test, or
- ✓ The residency test.

Qualifying Child Requirements

The rule for claiming a child as a qualifying child for purposes of the earned income credit requires that:

- ✓ To be a qualifying child, the child must meet all relationship, age, residency and joint return requirements; and
- ✓ In the event two people filing separate tax returns claim the same child for purposes of the earned income credit, the tie-breaker rules are used to determine which taxpayer has the valid claim.

Thus, a child is a qualifying child for purposes of the earned income credit only if the child:

- ✓ Meets the relationship test by being related to the taxpayer as his or her –
 - Son or daughter,
 - Stepchild or foster child,
 - Brother or sister,
 - Half-brother, half-sister, stepbrother or stepsister, or
 - Any descendant of the above mentioned children;
- ✓ Meets the age test by being –
 - younger than age 19 (24 if a student) and younger than the taxpayer (or spouse if filing jointly), or
 - permanently and totally disabled at any time during the tax year, regardless of age (see **When a Child is Disabled** below);

- ✓ Meets the residency test by having lived with the taxpayer in the United States—i.e. one of the 50 states or the District of Columbia only—for more than half the year; and
- ✓ Meets the joint return test by not having filed a joint tax return for the tax year or (if the qualifying child and spouse have filed a joint tax return) they –
 - Do not have a filing requirement, and
 - Filed a joint return only to claim a refund (other than the earned income credit).

When a Child is Disabled

In order for a non-disabled child to be considered a qualifying child, he or she must normally meet the relationship, age and residency tests. For a child to meet the age test to be a qualifying child a non-disabled child must be under age 19 at the end of the year or a full-time student under the age of 24 at the end of the year. When a person meets the relationship, residency and joint return tests and is permanently and totally disabled, however, the age requirements applicable to being a qualifying child do not apply.

A person is considered “permanently and totally disabled” for purposes of the earned income credit if both of the following conditions apply:

- ✓ The person cannot engage in any substantial gainful activity due to a physical or mental condition; and
- ✓ A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

The term substantial gainful activity is defined and discussed in IRS Publication 524. As discussed on page 4 of Publication 524 “Credit for the Elderly or Disabled” substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit. Full-time work (or part-time work done at an employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that the individual is able to engage in substantial gainful activity.

Substantial gainful activity is not work done by the individual to take care of himself or herself or the person's home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that the individual is able to engage in substantial gainful activity.

The fact that the individual has not worked for some time is not, of itself, conclusive evidence that he or she cannot engage in substantial gainful activity.

When Two Taxpayers Claim a Qualifying Child

If two taxpayers who file separate tax returns claim the child, the child may only be claimed by one of the taxpayers. In such a case, special rules apply. The rules that apply when more than one person claims a child for purposes of the earned income credit are as follows:

- ✓ If the child is a qualifying child of more than one person and neither is a parent of the child –
 - They can agree with respect to which party can claim the child as a qualifying child, or
 - If they cannot agree as to who will claim the child as a qualifying child, the IRS applies the tie-breaker rules (see **Tie-Breaker Rules** below); and
- ✓ If the child is a qualifying child of more than one person and one or more of those persons is a parent of a child, a person other than a parent can claim the child *only* if his or her AGI is higher than the AGI of any parent of the child.

Tie-Breaker Rules

Only one taxpayer can claim the same qualifying child for purposes of the earned income credit. Thus, if two taxpayers filing separate tax returns claim the same qualifying child, the tie-breaker rules must be applied.

Under the tie-breaker rules, a child is treated as a qualifying child only by:

- ✓ The parents if they file a joint tax return;
- ✓ The parent if only one of the persons is the child's parent;
- ✓ The parent with whom the child lived the longest during the tax year if two of the persons are the child's parents and they do not file a joint return together;
- ✓ The parent with the highest adjusted gross income if the child lived with each parent for the same amount of time during the tax year, and the parents do not file a joint return together;
- ✓ The person with the highest adjusted gross income if no parent can claim the child as a qualifying child; or
- ✓ A person with the higher adjusted gross income than any parent who can also claim the child as a qualifying child but does not.

If another person uses the taxpayer's qualifying child to claim the earned income credit pursuant to the tiebreaker rules, the taxpayer can claim the earned income credit **only** if he or she has another qualifying child. The taxpayer cannot take the credit using the rules for those with no qualifying child.

Formerly, if a taxpayer had a qualifying child and did not claim the earned income credit using that qualifying child, the taxpayer could not take the earned income credit based on the rules applicable to those not having a qualifying child. The IRS changed its position in 2017 as to taxpayers who cannot claim a qualifying child as a result of application of the tiebreaker rules. Under the changed position, a taxpayer who is not permitted to claim an individual as a qualifying child after applying the tiebreaker rules may now claim the EIC without a qualifying child provided all other requirements are met.

Earned Income Credit Errors Involving a Client's Filing Status

A second common earned income credit error involves a client's filing status. Provided a client is otherwise qualified for the credit, the client may qualify for the earned income credit with a filing status of:

- ✓ Married Filing Joint;
- ✓ Qualified Widow(er) with Dependent Child;
- ✓ Single; or
- ✓ Head of Household.

The only filing status that would preclude a client's eligibility for the earned income credit is Married Filing Separate. However, the IRS notes that some married taxpayers falsely state they qualify for single or Head of Household filing status in order to avoid including a spouse's income in the calculations or for other reasons and to, thereby, fraudulently claim more earned income credit. So, to help ensure the credit is calculated correctly, assuming the client is eligible to claim it, it is important to ensure that the client's filing status is shown accurately.

To that end, let's briefly review the requirements for a client to file as Single or Head of Household.

Single Filing Status

Clients may claim a filing status of single only if unmarried. Thus, a client may file as single only if he or she:

- ✓ Had never been married;
- ✓ Was legally separated according to applicable state law under a divorce or separate maintenance decree at the end of the year (if a divorce was not final at the end of the year, the client is considered married); or
- ✓ Was widowed before the beginning of the tax year and did not remarry before the end of the year.

Head of Household Filing Status

More problematic from the perspective of filing status is the client who wishes to file as Head of Household. The ability to file as Head of Household is generally limited to unmarried individuals who provide a home for certain other persons and meet one of two tests related to the costs of maintaining a home during the year (see exception below for **Married Persons Living Apart**, however).

A client is considered unmarried for purposes of filing as Head of Household if any of the following applies:

- ✓ The client was legally separated according to applicable state law under a divorce or separate maintenance decree at the end of the year (if a divorce was not final at the end of the year, the client is considered married);
- ✓ The client was married but lived apart from his or her spouse for the last 6 months of the year and meets certain other rules applicable to married persons living apart; or
- ✓ The client is married to a nonresident alien at any time during the year and the client does not elect to treat the spouse as a resident alien.

In addition to being considered unmarried, the client must meet one of the following tests related to keeping up a home:

- ✓ The client paid more than half the cost of keeping up a home that was the main home for all of the year of the client's parent who is claimed as a dependent (the parent does not have to live with the client); or
- ✓ The client paid more than half the cost of keeping up a home in which the client lived and in which one of the following also lived for more than half the year –
 - A person the client can claim as a dependent, except for –
 - The client's child who is claimed as a dependent because of the rule for children of divorced or separated parents,
 - A person who is the client's dependent only because of living with the client for all the year, or
 - A person the client claimed as a dependent under a multiple support agreement,
 - The client's unmarried qualifying child who is not the client's dependent,
 - The client's married qualifying child who is not the client's dependent only because the client can be claimed as a dependent on another person's return for the year, or
 - The client's qualifying child who is not the client's dependent because of the rule for children of divorced or separated parents, even though the client is the custodial parent.

Married Persons Living Apart

An exception to the requirement that a taxpayer filing as head of household must be unmarried applies to certain married persons living apart. A client who is married may be considered unmarried and use a Head of Household filing status if all of the following apply:

- ✓ The client lived apart from his or her spouse for the last 6 months of the year (temporary absences are considered time living at home);
- ✓ The client files a separate return from the spouse;
- ✓ The client paid more than half the cost of keeping up his or her home during the year;
- ✓ The client's home was the main home of the client's child, stepchild or foster child for more than half the year; and
- ✓ The client can claim the child as his or her dependent or could claim the child except that the child's other parent can claim the child under the rule for children of divorced or separated parents.

Earned Income Credit Errors Involving Income Reporting

Since a taxpayer's income has a significant effect on earned income credit eligibility and amount, income reporting errors also contribute to a large number of earned income credit errors. In addition to a taxpayer's filing status and number of children, the earned income credit amount for which a taxpayer may be eligible is highly dependent on the amount of income received by the taxpayer during the year.

Earned Income Credit Errors Involving Social Security Numbers

The final common error noted in the Inspector General's report involved social security numbers. Every taxpayer, spouse and qualifying child is required to have a valid social security number in order to claim earned income credit. If a client's or spouse's social security number does not match the Social Security Administration records or if it is invalid or missing, the IRS may reject the return and disallow any claimed earned income credit.

Certain documents and identification numbers are **not** valid for purposes of the earned income credit. Such documents/numbers are:

- ✓ Individual Taxpayer Identification Numbers (ITINs);
- ✓ Adoption Taxpayer Identification Numbers (ATINs); and
- ✓ Social Security cards issued to individuals from foreign countries who are lawfully admitted to the United States without Department of Homeland Security work authorization and which bear the legend "NOT VALID FOR EMPLOYMENT."

Summary

Taxpayers must meet certain rules in order to claim the earned income credit. Those rules are:

- ✓ Rules that apply to everyone with or without a child,
- ✓ Rules that apply only if the taxpayer has a qualifying child, and
- ✓ Rules that apply only if the taxpayer does not have a qualifying child.

EIC rules that apply to everyone require that a) the taxpayer's AGI cannot exceed specified levels based on filing status, b) the taxpayer must have a valid social security number, c) the taxpayer cannot have a married filing separately filing status, d) if the taxpayer (or spouse, if married) was a nonresident alien for any part of the tax year, the taxpayer cannot claim the EIC unless the taxpayer's filing status is married filing jointly, e) a taxpayer excluding foreign earned income is ineligible to claim the EIC, f) the investment income of a taxpayer eligible to claim the EIC cannot exceed a specified amount, and g) a taxpayer otherwise eligible to claim the EIC must work and receive earned income.

If a taxpayer meets the rules that apply to all filers **and has a qualifying child**, a set of rules that apply only if a taxpayer has a qualifying must also be met. The rules that apply if the taxpayer has a qualifying child require that the child meet the relationship, age, residency and joint return tests.

Alternatively, if a taxpayer without a child meets all seven of the EIC rules that apply to all filers, he or she needs only meet four additional eligibility rules. Those rules are the age rule, the dependent of another person rule, the qualifying child of another taxpayer rule, and the main home rule.

The high level of EIC errors is believed to be attributable to several factors, including the complex nature of the tax law, the structure of the earned income credit, eligible claimant confusion, the high turnover of eligible claimants, unscrupulous tax return preparers, and fraud. More than 80% of all earned income credit errors result from errors involving qualifying children, filing status, income reporting and incorrect social security numbers.

The earned income credit error most commonly encountered is one involving a qualifying child in which the child fails to meet one or more of the four eligibility tests, i.e. the tests related to the child's age, relationship, residency or joint return. In most cases in which there is an error the child does not meet either the relationship or the residency test. Common EIC errors involve a client's filing status. In addition to simple mistakes, the IRS notes that some married taxpayers falsely state they qualify for single or Head of Household filing status in order to claim more EIC. The third most common EIC error involves income reporting. Since the EIC amount for which a taxpayer may be eligible is highly dependent on the amount of income received by the taxpayer during the year, taxpayers may have an interest in erroneously reporting income that is greater than or less than their actual income. The final common error is one involving social security numbers. Every taxpayer, spouse and qualifying child is required to have a valid social security number in order to claim EIC. If a client's or spouse's social security number does not match the Social Security Administration records or if it is invalid or missing, the IRS may reject the return and disallow any claimed EIC.



Chapter 1 Review Questions

1. Peter is considered permanently and totally disabled. He is a student at the local community college and lives with his brother and his brother's wife. What is the maximum age Peter may be and still meet the age test for purposes of the EIC?
 - A. Younger than age 19
 - B. Younger than age 21
 - C. Younger than age 24
 - D. No age limit applies in this case
2. What is the maximum age a taxpayer with no qualifying children may be at the end of the year and still qualify for the earned income credit?
 - A. Age 21
 - B. Age 25
 - C. Age 64
 - D. Age 70½
3. Which of the following is the most commonly encountered earned income credit error?
 - A. An error involving the taxpayer's filing status
 - B. An error involving the taxpayer's reported income
 - C. An error involving a qualifying child
 - D. An error involving an incorrect social security number
4. A taxpayer is ineligible for the earned income credit, even if otherwise eligible, if filing a federal income tax return as:
 - A. Single
 - B. Married Filing Separate
 - C. Head of Household
 - D. Married Filing Joint
5. What portion of the cost of keeping up a main home must be paid by a taxpayer filing as Head of Household?
 - A. All the cost of keeping up the house must be paid by the taxpayer
 - B. At least 25% of the cost of keeping up the house must be paid by the taxpayer
 - C. More than half the cost of keeping up the house must be paid by the taxpayer
 - D. No required home maintenance level is required to file as Head of Household

Answers to Chapter 1 Review Questions

1.

- A. This answer is incorrect. You correctly identified the maximum age a qualifying child may be who is not a student or disabled. However, in this case, Peter meets both of those conditions.
- B. This answer is incorrect. Age 21 is not a qualifying child's limiting age with respect to the age test for EIC eligibility.
- C. This answer is incorrect. Peter would normally need to be younger than age 24 at the end of the tax year and younger than the taxpayer (or the taxpayer's spouse if filing jointly) since he is a student. However, Peter's disability affects the usual age test.
- D. That's correct! A child meets the age test for purposes of the EIC, regardless of his or her age, if permanently and totally disabled at any time during the tax year.

2.

- A. This answer is incorrect. Age 21 is not a limiting age for purposes of the earned income credit. However, a taxpayer must be at least age 25 to claim EIC.
- B. This answer is incorrect. That is the *minimum* age at which a taxpayer must be in order to claim the earned income credit.
- C. That's correct! A taxpayer claiming the EIC must be at least age 25 but less than age 65 at the end of the tax year. If the taxpayer is married filing a joint return, either the taxpayer or spouse must be at least age 25 but under age 65 at the end of the year. Either spouse may meet the age test as long as one of the spouses does. If neither the taxpayer nor spouse is at least age 25 but under age 65, the taxpayer cannot claim the EIC. Thus the maximum age at which a taxpayer may claim the EIC is age 64.
- D. This answer is incorrect. Age 70½ is the age at which required minimum distributions must begin under certain IRAs and qualified plans. It has no relevance to the earned income credit.

3.

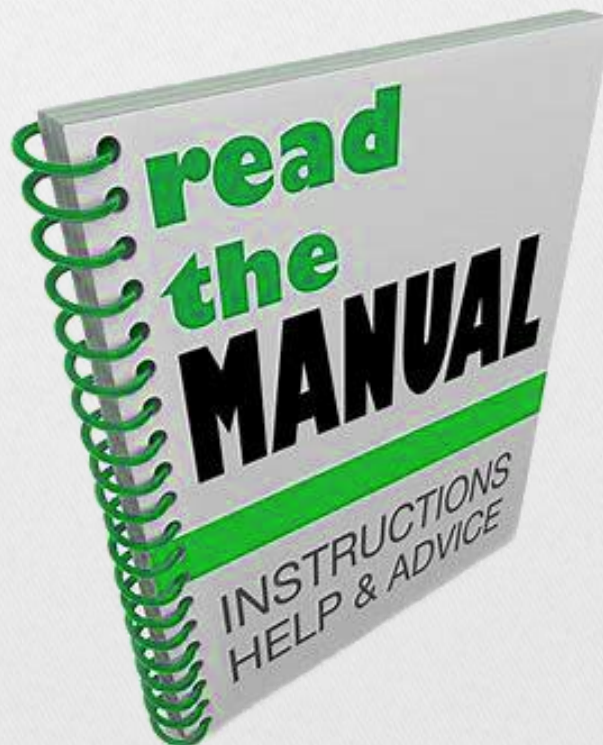
- A. This answer is incorrect. Although errors involving the taxpayer's claiming an incorrect filing status are among the four most common, it is not the most common.
- B. This answer is incorrect. Errors involving the reported income of a taxpayer claiming the earned income credit happen commonly. However, it is not the EIC error most commonly encountered.
- C. That's correct! The earned income credit error most commonly encountered is one involving a qualifying child. In the case of errors involving qualifying children, the child fails to meet all of the four eligibility tests, i.e. the tests related to the child's age, relationship, residency or joint return. In most cases in which there is an error the child does not meet either the relationship or the residency test.
- D. This answer is incorrect. EIC errors involving a taxpayer's, spouse's or qualifying child's social security number are fairly common but are not the error most frequently encountered. Furthermore, such social security number errors are automatically caught by the IRS.

4.

- A. This answer is incorrect. Taxpayers filing a federal income tax return as Single may qualify for the earned income credit.
- B. That's correct! A client may qualify for the EIC with a filing status of Married Filing Joint, Qualified Widow(er) with Dependent Child, Single or Head of Household provided he or she is otherwise qualified for the credit. The only filing status that would make a client ineligible for EIC is Married Filing Separate.
- C. This answer is incorrect. Although a taxpayer's status as Head of Household requires that he or she meet specific requirements, a Head of Household filer may be eligible for the earned income credit.
- D. This answer is incorrect. Married Filing Joint is an acceptable filing status for a taxpayer claiming the earned income credit.

5.

- A. This answer is incorrect. Although a taxpayer who paid all the cost of keeping up a house would be considered a head of household, provided he or she met the other requirements applicable to that status, paying the entire cost is not required.
- B. This answer is incorrect. A taxpayer who paid 25% of the cost of keeping up a main home would not meet the requirement to file as Head of Household.
- C. That's correct! In addition to being considered unmarried, a client wishing to file as Head of Household must pay more than half the cost of keeping up a main home and meet other requirements.
- D. This answer is incorrect. Filing as Head of Household requires a taxpayer to meet certain main home maintenance requirements.



Chapter 2

Due Diligence Requirements

Introduction

Taxpayers and tax return preparers generally find the earned income credit rules and requirements complicated with good reason. Due, in part, to the complicated nature of the rules, it is no surprise that 70% of tax returns claiming the earned income credit are prepared by commercial tax return preparers². Also, even though the credit is claimed by a minority of taxpayers—generally about one-fifth, depending upon the year—tax returns claiming the credit constitute a disproportionately large percentage (37%) of the audits performed by the IRS³.

Because of the large number of errors involving the earned income credit, tax return preparers must meet mandatory due diligence requirements. A failure to meet them can involve both reputational and financial cost for the preparer as well as possible criminal prosecution, and it may result in possible sanctions imposed on the preparer's employer. Additionally, if the earned income credit claim is found to be incorrect the taxpayer making the claim may be prohibited from claiming the earned income credit for up to ten years. This chapter considers the requirements of due diligence with respect to the earned income credit, the result of a failure to meet them and examines the results of earned income credit disallowance.

Learning Objectives

When you have completed this chapter, you should be able to:

- ✓ List the due diligence requirements a tax return preparer must meet when preparing a tax return claiming the earned income credit;
- ✓ Recognize the records a tax return preparer is required to keep to support a client's claim for the earned income credit;
- ✓ Identify the penalties that may be imposed on a tax return preparer for failing to comply with due diligence requirements when preparing a client's tax return claiming the earned income credit;
- ✓ Recognize the sanctions that may be imposed on an employer whose employee fails to comply with EIC due diligence requirements; and
- ✓ Identify the additional requirements imposed on taxpayers claiming the EIC following disallowance and the exceptions to those requirements;

The Statutory Requirement for Due Diligence – IRC §6695

Due diligence is a requirement imposed by statute on all tax return preparers completing tax returns in which the earned income credit is claimed. That statutory mandate is imposed by §6695(g) of the Internal Revenue Code. As noted in the inset below, §6695(g) imposes a financial penalty on any income tax return preparer failing to comply with the due diligence requirements related to determining a taxpayer's eligibility for the credit or its amount. The financial penalty was increased by subsequent legislation from \$100 to \$500 for returns filed after December 31, 2011. The 2019 penalty is \$530 per return for a failure to be diligent in determining eligibility for the earned income credit, with an unlimited maximum penalty for multiple failures to meet the due diligence requirements.

Sec. 6695. Other assessable penalties with respect to the preparation of income tax returns for other persons

(g) Failure to be diligent in determining eligibility for earned income credit

Any person who is an income 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 eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of \$100 for each such failure.

The term “due diligence” is one used in a wide range of applications. The requirements of due diligence, as the term is used with respect to a tax preparer’s federal income tax preparation, refers to the requirement that a tax preparer meet a particular standard of care that involves a) knowing the applicable law, b) asking the right questions, c) getting all the applicable facts, and d) maintaining appropriate documentation.

That standard of care is imposed by the Internal Revenue Code, and those specific requirements are provided by the Internal Revenue Service.

Specific Requirements Applicable to EIC Due Diligence

The due diligence requirements imposed on paid tax return preparers’ preparation of tax returns claiming the earned income credit mean the preparer must meet the following standards. Those standards require the preparer to:

1. Complete and submit a Paid Preparer’s Due Diligence Checklist;
2. Compute the applicable earned income credit using a worksheet;
3. Know the law relative to earned income credits;
4. Know the client; and
5. Maintain appropriate records related to preparation of the tax return.

Let’s consider these due diligence requirements in some detail.

Paid Preparer’s Due Diligence Checklist – IRS Form 8867

The Paid Preparer’s Due Diligence Checklist is provided by the IRS Form 8867. It is a form you must complete and submit to the IRS with a taxpayer’s tax return whenever an earned income credit is claimed.

The various questions posed on IRS Form 8867 act as memory-joggers and identify areas about which the tax preparer should obtain information from the taxpayer.

Treasury Regulations, Subchapter A, §1.6695-2(b)(1) prescribe the due diligence requirements a paid tax return preparer must meet with respect to completion and submission of IRS form 8867. According to the regulations, a paid tax return preparer is required to: (a) complete the form based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the preparer, and (b) provide the completed form for submission as follows:

- ✓ In the case of a ***signing tax return preparer who electronically files*** the tax return or claim for refund, the completed Form 8867 must be electronically filed with the tax return or refund claim;
- ✓ In the case of a ***signing tax return preparer who does not file the tax return or claim for refund electronically***, the completed Form 8867 must be provided to the taxpayer for inclusion when filing the tax return or claim for refund; and

- ✓ In the case of a ***non-signing tax return preparer***, the completed Form 8867 must be provided to the taxpayer in electronic or non-electronic format for inclusion when filing the tax return or claim for refund.

Due Diligence Questions to Ask to Avoid Qualifying Child Errors

The most common EIC error involves qualifying children. If a tax return preparer believes that the information provided by the client with respect to qualifying children is incorrect, inconsistent or incomplete, he or she should ask questions to resolve the inconsistency and/or obtain complete information.

If a client claims a qualifying child that is not the client's son or daughter, it is important to determine if the relationship test is met; in other words, whether the child is a stepchild or foster child, a brother or sister, or a half brother or half sister. Also, the tie-breaker rules can come into play under which the client may be ineligible to claim the credit on the basis of a qualifying child if it is also being claimed by the child's parents. Thus, the tax return preparer should ask –

- ✓ Where are the child's parents?
- ✓ Does the child's parent live in the client's household?
- ✓ Does any other relative of the child live in the household?
- ✓ Can anyone else claim the child for purposes of the earned income credit?

If the client's age is inconsistent with the age of the qualifying child, the tax return preparer should obtain additional information to ensure that the client doesn't fail to meet the age test applicable to a qualifying child. For example, a 22 year-old client may claim a 13 year-old qualifying son for purposes of the earned income credit. Since the age of the son and the client appear to be inconsistent—the client would have been age 9 when the qualifying child was born—the tax return preparer needs to verify the relationship between the client and the child. Accordingly, the tax return preparer should ask:

- ✓ Is the child your foster child or adopted child?
- ✓ Were you or are you married to the child's mother?
- ✓ How long has the child lived with you?
- ✓ Do you have any records to document that the child lived with you, such as school or doctor records?

Although the IRS does not routinely require a tax return preparer to review a child's birth certificate to verify age, if a preparer has reason to question a child's age or relationship the preparer may want to ask to see the child's birth certificate. In such a case, the preparer should keep a copy of the birth certificate for his or her records.

If the client is a single taxpayer with a young qualifying child and an earned income but no childcare expenses, the tax return preparer needs to ask questions to clarify the client's situation and determine if the client is a qualifying child of another taxpayer, such as of a father or mother with whom the client resides. So, the preparer should ask the following questions:

- ✓ What child care arrangements do you make?
- ✓ Does anyone else live in your household?

If the client claims an adult with a disability as a qualifying child, the tax return preparer should verify that the adult meets the tax law definition of permanently and totally disabled. To prove the client's child is permanent and totally disabled, the IRS asks for a letter from the child's doctor, other healthcare provider or any social service program or agency to verify the permanent and total disability. The preparer should keep a copy of the document and any other document used to determine eligibility for the earned income credit.

Avoiding Filing Status Errors

A tax return preparer working with a client claiming the earned income credit who wishes to file as Head of Household should ask additional questions if the preparer believes the client's filing status may be incorrect. In addition, the preparer should also ask the client to provide the required supporting documents to prove Head of Household filing status.

A client wishing to file as Head of Household must meet the marriage test, the qualifying person test and the cost of keeping up a home test. The supporting documents that must be furnished to the IRS with respect to those tests include the following:

- ✓ If the client is divorced or legally separated, the entire divorce decree, separate maintenance decree or separation agreement must be provided;
- ✓ If the client is married but claims the spouse did not live with him or her during the last 6 months of the tax year, documents verifying the spouse did not live with the client during the last 6 months of the year should be furnished, such as –
 - A lease agreement,
 - Utility bills,
 - A letter from a clergy member, or
 - A letter from social services;
- ✓ To meet the qualifying person test, the following documents should be furnished as appropriate –
 - Birth certificates or other official birth documents,
 - Marriage certificates,
 - A letter from an authorized adoption agency,
 - A letter from an authorized placement agency,
 - Court documents that verify the client's relationship to the child, and
 - Documents showing the child and the client lived together for more than half the year, including –
 - School, medical, daycare or social services records, and
 - 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; and

- ✓ To show the client paid more than half the cost of keeping up the home for the year, a tax preparer should ask the client to provide –
 - Rent receipts,
 - Utility bills,
 - Grocery receipts,
 - Property tax bills,
 - Mortgage interest statement,
 - Upkeep and repair bills,
 - Property insurance statement, and/or
 - Other household bills.

Avoiding Income Reporting Errors

In order to help avoid income reporting errors, tax return preparers must be aware of potential earned income credit income reporting problems and ensure they have sufficient income and expense information to enable them to prepare a complete and correct tax return. Some of the income reporting red flags that should cause a tax return preparer to seek additional information from a client are:

- ✓ W-2 forms and 1099 forms that appear altered or hand-prepared;
- ✓ W-2 forms that vary in appearance from others received from the same employer;
- ✓ W-2 forms with overstated withholding amounts;
- ✓ Schedule C or Schedule F income that appears questionable, particularly income not reported on a Form 1099;
- ✓ Client income that appears insufficient to support the client and his or her qualifying children;
- ✓ Schedule C or Schedule F income or losses unsupported by records;
- ✓ Schedule C or Schedule F losses that don't appear reasonable in light of the business, the client's income and previous tax returns; and
- ✓ Businesses reporting income on Schedule C or Schedule F that show unusually low or no expenses, particularly when other similar businesses normally incur such expenses.

Tax preparers should ask clients if they have provided all information with respect to their income. In addition, clients claiming income from self-employment that exceeds the aggregate amounts shown on their Forms 1099 should be asked to explain how they computed their income. Self-employed clients who claim to have expenses that are unsupported by appropriate records should also be asked to explain how they calculated their expenses.

Avoiding Social Security Number Earned Income Credit Errors

Generally social security number and math errors are caught automatically by the IRS. Thus, little is requested from the tax preparer with respect to a client's social security number. However, although the IRS does not require a tax preparer to review a client's social security cards, it is generally considered a good practice to do so and to keep a copy of the documents reviewed.

Paid Preparer's Due Diligence Checklist Best Practices

The following best practices are recommended to help preparers complete and submit a correct IRS Form 8867 in connection with a client's EIC claim:

- ✓ Ask all the applicable questions to complete Form 8867 for all EIC clients every year, even if the client has claimed the EIC in one or more prior years;
- ✓ Couch the questions in non-technical terms so that clients can more easily understand what is being asked;
- ✓ Ask enough questions to accurately determine the client's filing status and whether the client has a qualifying child; and
- ✓ Attach Form 8867 to every EIC claim and be sure to submit it with every electronic EIC claim prepared.

Figuring the Amount of the Earned Income Credit

NOTE: The following text makes reference to various *lines* on IRS Forms 1040 and 1040A. However, at the time this course was updated, the IRS had not yet released the final Forms 1040 or 1040A compliant with the Tax Cuts and Jobs Act of 2017. Accordingly, the references to specific lines on the forms should be disregarded.

If the taxpayer meets all of the rules applicable to his or her claiming EIC, the next step is figuring the amount of EIC. Determining the earned income credit is done on either EIC Worksheet A (Appendix A) or EIC Worksheet B (Appendix B).

- ✓ **EIC Worksheet A** is used if the taxpayer was not self-employed at any time during the tax year and was not a member of the clergy, a church employee who files Schedule SE, or a statutory employee filing schedule C or C-EZ.
- ✓ **EIC Worksheet B** is used if the taxpayer was self-employed at any time during the year or was a member of the clergy, a church employee who files schedule SE or a statutory employee filing schedule C or C-EZ.

The instructions for IRS Form 1040 "Lines 66a and 66b" walk you through the EIC rules—the rules for all filers, for filers with a qualifying child and for filers without a qualifying child—just discussed.

Calculating Earned Income for EIC Purposes

In Step 5 of those Form 1040 EIC instructions, the taxpayer's earned income for EIC purposes is calculated. That calculation begins with inserting the total of the taxpayer's wages, salaries, tips, etc. that appears on Form 1040, line 7. From that line 7 number, various amounts are then deducted to determine the taxpayer's earned income for purposes of the EIC. If the taxpayer received nontaxable combat pay, the taxpayer may elect to include that nontaxable combat pay in earned income for EIC purposes. However, electing to include the combat pay in earned income may increase or decrease the EIC.

The amount deducted from the total of the taxpayer's wages, salaries, tips, etc. that appears on Form 1040 line 7 is the total of the following **if included on line 7**:

- ✓ Taxable scholarships or fellowship grants not reported on Form W-2;
- ✓ Amounts received for work performed by the taxpayer while an inmate in a penal institution; and
- ✓ Amounts received as a pension or annuity from a nonqualified deferred compensation plan or nongovernmental section 457 plan.

The result of that calculation, plus the amount of nontaxable combat pay (if the taxpayer elects to include it), is the taxpayer's earned income for EIC purposes.

Taxpayers Not Self-Employed, Statutory Employees, Clergy or Church Employees

The earned income total just calculated may or may not be modified, depending on the taxpayer's employment status. If the taxpayer is not a) self-employed, b) a statutory employee filing Schedule C or C-EZ or c) a member of the clergy or person with church employee income filing Schedule SE, the earned income amount is not modified for purposes of the EIC. Instead, it should simply be entered on Worksheet A in Part 1, box 1.

Part 1 All Filers Using Worksheet A	1.	Enter your earned income from Step 5.	1	
	2.	Look up the amount on line 1 above in the EIC Table (right after Worksheet B) to find the credit. Be sure to use the correct column for your filing status and the number of children you have. Enter the credit here.	2	
		If line 2 is zero, STOP . You cannot take the credit. Enter "No" on the dotted line next to line 66a.		
	3.	Enter the amount from Form 1040, line 38.	3	
	4.	Are the amounts on lines 3 and 1 the same?		
		☐ Yes. Skip line 5; enter the amount from line 2 on line 6.		
		☐ No. Go to line 5.		

To determine the amount to be entered in box 2 of Worksheet A, check the Earned Income Credit (EIC) Table in the instructions to Form 1040 for the amount of the taxpayer's credit based on the taxpayer's earned income shown in box 1 for the taxpayer's filing status and number of children. The amount shown should be entered in box 2. An excerpt from a representative Earned Income Credit (EIC) Table is shown below:

		And your filing status is-							
If the amount you are looking up from the worksheet is-		Single, head of household, or qualifying widow(er) and the number of children you have is-				Married filing jointly and the number of children you have is-			
		0	1	2	3	0	1	2	3
At least	But less than	Your credit is-				Your credit is-			
19,000	19,050	0	3,239	5,396	6,093	107	3,373	5,572	6,269
19,050	19,100	0	3,231	5,386	6,082	104	3,373	5,572	6,269
19,100	19,150	0	3,223	5,375	6,072	100	3,373	5,572	6,269

For example, suppose the taxpayer's earned income shown in box 1 is \$19,067, the taxpayer files as single and has one qualifying child. The amount shown in box 2 should be \$3,231 (highlighted above). The amount entered in box 3 is the taxpayer's adjusted gross income shown on line 38 of the taxpayer's Form 1040. The amounts in boxes 1 and 3 are compared in Part 1, line 4; if they are the same, check "Yes" and enter the amount shown in box 2 in box 6. That is the amount of the taxpayer's earned income credit.

Part 2 Filers Who Answered "No" on Line 4	5. If you have: - No qualifying children, is the amount on line 3 less than \$8,650 (\$14,450 if married filing jointly)? 1 or more qualifying children, is the amount on line 3 less than \$19,030 (\$24,820 if married filing jointly)? ☐ Yes. Leave line 5 blank; enter the amount from line 2 on line 6. ☐ No. Look up the amount on line 3 of the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. Look at the amounts on lines 5 and 2. Then, enter the smaller amount on line 6.
Part 3 Your Earned Income Credit	6. This is your earned income credit. Reminder— ✓ If you have a qualifying child, complete and attach Schedule EIC.

If the amounts shown in boxes 1 and 3 are not the same—the amount in box 3 may be increased due to the taxpayer's receipt of various income items or reduced because of various above-the-line deductions, such as alimony paid—check "No" in Part 1, line 4 and go to Part 2, line 5 (shown above). If the amount in box 3 is less than the amount shown on line 5 for the taxpayer's filing status and number of children, enter the amount shown in box 2 in box 6.

However, if the amount in box 3 is not less than the amount shown on line 5 for the taxpayer's filing status and number of children—the amount in box 3 is the same or more than the amount on line 5, in other words—look up the amount on line 3 in the Earned Income Credit (EIC) Table for the taxpayer's filing status and number of children; then enter that amount in box 5. If an amount is entered in box 5, the amount that should be entered in box 6 is the **smaller** of the amount in box 5 or the amount in box 2.

When Worksheet A has been completed for the taxpayer, the amount entered in box 6, i.e. the taxpayer's earned income credit, should be entered on Form 1040.

If the taxpayer was a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from income. The taxpayer can elect to include this pay in earned income when figuring the EIC but is not required to do so. Making the election to include nontaxable combat pay may increase or decrease the taxpayer's EIC. So, it is important for the tax preparer to determine the applicable credit both with the nontaxable combat pay included and with it excluded. The amount of the nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If the taxpayer is filing a joint return and both the taxpayer and spouse received nontaxable combat pay, the taxpayer and spouse can each make their own election.

Self-Employed Taxpayers, Statutory Employees, Clergy and Church Employees

As noted earlier, the earned income total calculated in Step 5 of the Form 1040 EIC instructions may or may not be modified, depending on the taxpayer's employment status. If the taxpayer is a) self-employed, b) a statutory employee filing Schedule C or C-EZ, or c) a member of the clergy or person with church employee income filing Schedule SE, Worksheet B is used to determine the taxpayer's earned income credit.

Using Worksheet B to figure the EIC is required if the taxpayer answered “Yes” to Step 5, question 2. Answering “Yes” to question 2 indicates that the taxpayer was a) self-employed at any time during the year, b) filing Schedule SE as a member of the clergy or as someone who had church employee income, or c) filing Schedule C or C-EZ as a statutory employee. The tax preparer should complete Worksheet B, Part 1 if the taxpayer was required to file Schedule SE and:

- ✓ Was self-employed;
- ✓ Was a member of the clergy; or
- ✓ Received church employee income.

Part 1 Self-Employed, Members of the Clergy, and People With Church Employee Income Filing Schedule SE	1a.	Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies.		1a	
	b.	Enter any amount from Schedule SE, Section B, line 4b, and line 5a.	+	1b	
	c.	Combine lines 1a and 1b.	=	1c	
	d.	Enter the amount from Schedule SE, Section A, line 6, or Section B, line 13, whichever applies.	-	1d	
	e.	Subtract line 1d from 1c.	=	1e	

The amount to be entered in Part 1, box 1a is the combination of a) net farm profit or loss and farm partnerships, b) minus the amount of Conservation Reserve Program payments if the taxpayer received social security retirement or disability benefits (current law taxes such program payments otherwise), and c) the net profit or loss from self-employment (from Schedule C, C-EZ and K-1). The amount to be entered in Part 1, box 1b is the amount shown on Schedule SE, Section B, line 4b (for self-employed taxpayers electing an optional method to figure net earnings) and line 5a (church employee income from Form W-2). Enter the total of box 1a and box 1b in box 1c. Enter the amount shown on Schedule SE as a deduction for one-half of self-employment tax (Section A, line 6 or Section B, line 13) in box 1d. Subtract the amount in box 1d from the amount in box 1c, and enter the result in box 1e.

The amount to be entered in Part 2, box 2a is the net farm profit or loss from Schedule F, line 34 and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. The amount to be entered in box 2b is the net profit or loss from Schedule C, line 31, Schedule C-EZ, line 3, Schedule K-1 (Form 1065), box 14, code A (other than farming) and Schedule K-1 (Form 1065-B), box 9, code J1. Enter the sum of box 2a and box 2b in box 2c.

Part 2 Self-Employed NOT Required To File Schedule SE	2.	Do not include on these lines any statutory employee income, any net profit from services performed as a notary public, any amount exempt from self-employment tax as a result of the filing and approval of Form 4029 or Form 4361, or any other amounts exempt from self-employment tax.		
	a.	Enter any net farm profit or (loss) from Schedule F, line 34, and from farm partnerships, Schedule K-1 (Form 1065), box 14, code A*.		2a
	b.	Enter any net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1*.	+	2b
	c.	Combine lines 2a and 2b.	=	2c
<i>*If you have any Schedule K-1 amounts, complete the appropriate line(s) of Schedule SE, Section A. Reduce the Schedule K-1 amounts as described in the Partner's Instructions for Schedule K-1. Enter your name and social security number on Schedule SE and attach it to your return.</i>				

For statutory employees—those taxpayers who are considered independent contractors under common law rules and employees by statute for purposes of social security and Medicare contributions—tax preparers must use Part 3 of Worksheet B. In box 3 of the worksheet, simply enter the amount on Schedule C or Schedule C-EZ, line 1.

Part 3			
Statutory Employees Filing Schedule C or C-EZ	3. Enter the amount from Schedule C, line 1, or Schedule C-EZ, line 1, that you are filing as a statutory employee. <table border="1" style="float: right;"> <tr> <td style="width: 30px; text-align: center;">3</td> <td style="width: 100px;"></td> </tr> </table>	3	
3			

When Parts 1, 2 and 3 of Worksheet B have been completed, the amounts entered in boxes 1e, 2c and 3 need to be added to the taxpayer's earned income from Step 5. So, enter the taxpayer's earned income from Step 5 in Part 4, box 4a. Then add the amounts in Worksheet B boxes 1e, 2c, 3 and 4a and enter the total in box 4b. This amount should also be entered in Part 5, box 6.

Part 4			
All Filers Using Worksheet B	4a. Enter your earned income from Step 5. <table border="1" style="float: right;"> <tr> <td style="width: 30px; text-align: center;">4a</td> <td style="width: 100px;"></td> </tr> </table>	4a	
4a			
	b. Combine lines 1e, 2c, 3, and 4a. This is your total earned income. <table border="1" style="float: right;"> <tr> <td style="width: 30px; text-align: center;">4b</td> <td style="width: 100px;"></td> </tr> </table>	4b	
4b			
	If line 4b is zero or less, STOP. You cannot take the credit. Enter "No" on the dotted line on Form 1040.		
	5. If you have: • 3 or more qualifying children, is line 4b less than \$50,162 (\$55,952 if married filing jointly)? • 2 qualifying children, is line 4b less than \$46,703 (\$52,493 if married filing jointly)? • 1 qualifying child, is line 4b less than \$41,094 (\$46,488 if married filing jointly)? • No qualifying children, is line 4b less than \$15,570 (\$21,370 if married filing jointly)? ☐ Yes. If you want the IRS to figure your credit, see <i>Credit figured by the IRS</i>, earlier. If you want to figure the credit yourself, enter the amount from line 4b on line 6 of this worksheet. ☐ No. STOP. You cannot take the credit. Enter "No" on the dotted line on Form 1040.		

The total earned income calculated using Worksheet B is the income on which the EIC—the amount that should be entered in box 7—is based. Thus, to determine the amount to be entered in box 7 of Worksheet B, check the Earned Income Credit (EIC) Table in the instructions to Form 1040 and find the amount of the credit, if any, based on the taxpayer's total earned income shown in box 6 for the taxpayer's filing status and number of children. The amount shown should be entered in box 7.

An excerpt from the Earned Income Credit (EIC) Table is shown below:

		And your filing status is-							
If the amount you are looking up from the worksheet is-		Single, head of household, or qualifying widow(er) and the number of children you have is-				Married filing jointly and the number of children you have is-			
		0	1	2	3	0	1	2	3
At least	But less than	Your credit is-				Your credit is-			
23,400	23,450	0	2,536	4,470	5,166	0	3,373	5,572	6,269
23,450	23,500	0	2,528	4,459	5,155	0	3,373	5,572	6,269
23,500	23,550	0	2,520	4,448	5,145	0	3,373	5,572	6,269

For example, suppose the taxpayer's total earned income shown in box 6 is \$23,505, the taxpayer files as married filing jointly and has three qualifying children. The amount shown in box 7 should be \$6,269 (highlighted above).

The amount entered on Worksheet B, Part 5 in box 8 is the taxpayer's adjusted gross income shown on line 38 of the taxpayer's Form 1040. The amounts in boxes 6 and 8 are compared in Part 5, line 9; if they are the same, check "Yes" and enter the amount shown in box 7 in box 11. That is the amount of the taxpayer's earned income credit.

Part 5 All Filers Using Worksheet B	6. Enter your total earned income from Part 4, line 4b.	6	
	7. Look up the amount on line 6 above in the EIC Table to find the credit. Be sure to use the correct column for your filing status and the number of children you have. Enter the credit here. If line 7 is zero, STOP . You cannot take the credit. Enter "No" on the dotted line next to line 66a.	7	
	8. Enter the amount from Form 1040, line 38.	8	
	9. Are the amounts on lines 8 and 6 the same? ☐ Yes. Skip line 10; enter the amount from line 7 on line 11. ☐ No. Go to line 10.		

If the amounts in boxes 6 and 8 differ from each other, answer the questions in Part 6, line 10.

Part 6 Filers Who Answered "No" on Line 9	10. If you have: - No qualifying children, is the amount on line 8 less than \$8,650 (\$14,450 if married filing jointly)? 1 or more qualifying children, is the amount on line 8 less than \$19,030 (\$24,820 if married filing jointly)? ☐ Yes. Leave line 10 blank; enter the amount from line 7 on line 11. ☐ No. Look up the amount on line 8 of the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. Look at the amounts on lines 10 and 7. Then, enter the smaller amount on line 11.	10	
	Part 7 Your Earned Income Credit	11. This is your earned income credit. Reminder— ✓ If you have a qualifying child, complete and attach Schedule EIC. <i>If your EIC for a year after 1996 was reduced or disallowed, see Form 8862, who must file, earlier, to find out if you must file Form 8862 to take the credit for 20xx.</i>	11

If the answer to the questions on line 10 is "Yes," enter the amount previously entered in box 7 into box 11. However, if the answer to the questions posed in line 10 is "No," look up the earned income credit in the EIC Table for the taxpayer's filing status and number of children using the amount shown in box 8 and put the amount of credit shown in the Table in box 10. If the resulting amounts in boxes 7 and 10 differ from one another, enter the smaller amount in box 11. That is the amount of the taxpayer's earned income credit.

The amount of any applicable EIC is entered in the appropriate line of the taxpayer's return. (Line 66a on IRS Form 1040.)

Computation Best Practices

It is a computation best practice NOT to rely on computer software to ensure the earned income credit is correctly computed; computer software programs may miss one or more of the special rules that apply to the credit, such as the ability to classify nontaxable combat pay as earned income for EIC purposes. So, preparers should review the EIC computation for accuracy and completeness—whether or not computed by a software program—to help ensure clients don't fail to receive the credit for which they are eligible.

Know the Law and the Client

To meet the EIC due diligence requirements, a tax preparer must know the law and regulations relative to the earned income credit. However, equally important is that the tax return preparer know the client. Accordingly, tax preparers are required to ask appropriate questions and obtain all the relevant facts.

With respect to the knowledge component of the EIC due diligence requirements, tax preparers are required to:

- ✓ Know the law with respect to the EIC to ensure the tax preparer is asking the client the right questions in order to get all relevant facts;
- ✓ Take into account the information provided by the client and what the tax preparer knows about the client;
- ✓ Neither know nor have reason to know that any information used to determine the client's eligibility for, or amount of, the EIC is incorrect, inconsistent or incomplete;
- ✓ Make additional inquiries if a reasonable and well-informed preparer would know the information is incomplete, inconsistent or incorrect; and
- ✓ Document any additional questions asked of the client and the client's answer at the time of the interview.

Section 1.6695-2 of the regulations also speaks to the knowledge component of the EIC due diligence regulations. According to Treasury Regulations, Subchapter A, §1.6695-2(b)(3), the tax return preparer, in determining the taxpayer's eligibility for the EIC or its amount, must not base such determinations on information the preparer knows—or has reason to know—is incorrect. Furthermore, the preparer is expected to be proactive in ensuring the information used is correct.

Thus, preparers cannot ignore the implications of information furnished to or known by them and are required to make reasonable inquiries if the information provided appears to be incorrect, inconsistent or incomplete. The standard provided by the applicable regulations states that a tax return preparer must make reasonable inquiries if a reasonable and well informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent or incomplete.

When Should a Preparer Ask Additional Questions – Examples

The regulations also offer the following examples to guide preparers in dealing with situations in which information provided to them may be incorrect, inconsistent or incomplete.

In the first example provided, a 22 year-old taxpayer wants to claim two sons, ages 10 and 11, as qualifying children for purposes of the EIC. Since the age of the taxpayer appears inconsistent with the ages of the children claimed as sons, the preparer must make additional reasonable inquiries regarding the relationship between the taxpayer and the children.

In the second example, an 18 year-old female taxpayer with an infant has earned income of \$3,000 and states that she lives with her parents. She wants to claim the infant as a qualifying child for the EIC. Because of the taxpayer's age, income and her living with her parents, the information given to the

preparer appears to be incomplete and inconsistent. Accordingly, the preparer is required to make additional reasonable inquiries to determine if the taxpayer is the qualifying child of her parents. As a qualifying child of her parents, she would be ineligible to claim the EIC.

A third example offered by the explanatory material is one in which a taxpayer wants to claim his niece and nephew as qualifying children for the EIC. In such a case, the tax preparer should make reasonable inquiries to determine whether the children meet EIC qualifying child requirements and ensure that the possibility the children will be claimed by their parents or other relatives for purposes of the EIC is fully considered.

A final example is one in which a Schedule C taxpayer claims to have two qualifying children and wants to claim the EIC. She indicates that she has \$10,000 in business earnings and no expenses. Because it is very unlikely that a self-employed individual would have no business expenses, the information appears incomplete. Accordingly, the preparer must make additional reasonable inquiries regarding the taxpayer's business to determine whether the information regarding both her income and her expenses is correct.

Knowledge Requirement Best Practices

Several best practices apply to a preparer's need to meet the due diligence knowledge requirement when preparing EIC tax returns. The IRS urges preparers to:

- ✓ Apply common sense to the information supplied by the client and consistently ask oneself "Does the whole picture make sense to me?"
- ✓ Ask additional questions about any information received from the client that appears to be inconsistent or incomplete;
- ✓ Ask additional questions to ensure clients are not over-reporting or under-reporting income;
- ✓ Be sure Schedules C and F include all income and expenses;
- ✓ Guide self-employed clients without records so that a reconstruction of income and expenses, ensuring all required items are included on the return; and
- ✓ Document all additional questions asked to comply with the knowledge requirement and the client's responses to them.

Record Maintenance

In addition to completing and submitting a Paid Preparer's Due Diligence Checklist, computing the EIC using an appropriate worksheet, and asking the appropriate questions to obtain all the relevant facts, a tax preparer must also maintain appropriate records relative to each client's EIC, as prescribed in Treasury Regulations, Subchapter A, §1.6695-2(b)(4). Such records may be kept in either paper or electronic format; irrespective of how records are maintained, the tax preparer must be able to produce them if asked by the IRS.

The records that must be kept by the tax return preparer are the following:

- ✓ A copy of IRS Form 8867, Paid Preparer's Due Diligence Checklist;
- ✓ The EIC Worksheet (Worksheet A or B, as appropriate);
- ✓ A record of any additional questions asked of the client by the preparer to comply with EIC due diligence requirements and the client's answers to those questions; and
- ✓ Any documents provided by the client used by the preparer to determine eligibility for, or the amount of, the EIC.

The tax return preparer must keep the required documents for a period of three years from the **latest** of the following:

- ✓ The original due date of the tax return (not including any extension for filing);
- ✓ The date the tax return or claim for refund is electronically filed by a signing tax return preparer; or
- ✓ The date the tax return or claim for refund is presented to the client for signature by a signing tax return preparer.

If the tax return preparer prepares only part of the return or claim for refund, the preparer must keep the part of the return he or she was responsible for completing for three years from the date submitted to the signing tax return preparer.

Record Maintenance Best Practices

The following best practices are suggested to enable preparers to meet the record maintenance requirements of EIC due diligence:

- ✓ Make sure to keep copies of any client-provided documents relied upon to determine eligibility for or amount of EIC;
- ✓ Ensure that an accurate copy of any original document can be reproduced;
- ✓ Keep all client records containing personal identifiable information in a secure environment to safeguard client privacy;
- ✓ Make back-up copies of electronic records and keep them in a separate, secure location; and
- ✓ Be aware of the applicable record retention time frames.

Failure to Meet Due Diligence Requirements

Incorrect EIC returns may significantly affect a tax return preparer's client. In addition, however, a tax return preparer's failure to meet all four due diligence requirements—the requirements calling for a) completing and submitting a Paid Preparer's Due Diligence Checklist, b) computing the applicable earned income credit using a worksheet, c) obtaining sufficient knowledge of the law and the client relative to the EIC, and d) maintaining the required EIC-related records—can result in significant penalties imposed on the tax return preparer and his or her employer. Those penalties may be assessed for failure to meet the due diligence requirements **even if the EIC computation and filing is otherwise correct**.

Let's consider the tax preparer and employer penalties.

Consequences for the Tax Return Preparer

The failure of a tax return preparer to comply with the EIC due diligence requirements can be expensive with respect to both financial penalties and the adverse consequences for the tax preparer's career. If the IRS examines the EIC claims of a tax return preparer and finds that he or she did not meet all for due diligence requirements, the following penalties may be assessed:

- ✓ a \$500 penalty for each failure to comply with EIC due diligence requirements for returns required to be filed after December 31, 2011, increased to \$530 for 2019 (IRC §6695(g));
- ✓ a minimum penalty of \$1,000 if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to an unreasonable position (IRC §6694(a)); and
- ✓ a minimum penalty of \$5,000 if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to a reckless or an intentional disregard of rules or regulations (IRC §6694(b)).

In addition to these not-insignificant financial penalties, a tax return preparer who has failed to comply with EIC due diligence requirements may be:

- ✓ Suspended or expelled from IRS e-file;
- ✓ Subject to disciplinary action by the IRS Office of Professional Responsibility; and
- ✓ The subject of injunctions that bar the tax return preparer from preparing tax returns or which impose conditions on the tax returns that may be prepared.

To help assist in meeting the EIC due diligence requirements, tax return preparers should consider:

- ✓ Printing the questions asked by the preparer during the client interview and the client's answers, reviewing the questions and answers with the client and having the client sign the document; and
- ✓ Creating an interview sheet for clients to complete and sign before meeting with the preparer.

However, despite the client's signature on either or both of the suggested documents, the tax return preparer is not relieved of the requirement to perform appropriate EIC due diligence.

Consequences for the Preparer's Employer

In addition to the various penalties that may be imposed on the tax return preparer resulting from the failure to meet the EIC due diligence requirements, the IRS can also penalize an employer or employing firm if the employee preparer fails to comply with those requirements, provided certain other conditions apply. Those conditions, under which a penalty could be assessed on an employer for an employed tax return preparer's failure to meet due diligence requirements, are as follows:

- ✓ 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; or
- ✓ 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 to conclude that the employee was not complying.

Consequences for the Client of EIC Disallowance

When a client's claim for EIC has been disallowed by the IRS, certain consequences follow. Principal among those consequences are the following:

- ✓ Required repayment of any erroneously paid EIC plus possible penalties and interest;
- ✓ The need to file IRS Form 8862 in order to claim the EIC in a subsequent year; and
- ✓ Possible prohibition of subsequent EIC claims for a period of years.

The most significant consequences for a client in connection with a disallowed EIC claim are those prohibiting him or her from claiming the EIC again for a period of years. Those consequences are reserved for EIC claimants whose disallowance was due to reckless or intentional disregard of the EIC rules or to fraud.

Disallowance Due to Reckless or Intentional Disregard of EIC Rules

If a taxpayer's EIC claim has been denied due to an error deemed by the IRS to constitute reckless or intentional disregard of the EIC rules, the taxpayer is prohibited from claiming EIC again for a two-year period. The two-year period begins with the first tax year for which the taxpayer has not yet filed a tax return following the final determination. If the taxpayer has already filed his or her tax return for the current year by the end of the 90 days following receipt of the statutory notice of deficiency, the two-year period begins with the following year for which the taxpayer's return has not been filed.

For example, suppose the taxpayer claimed the EIC on his or her 2016 tax return. Further suppose that the taxpayer received a statutory notice of deficiency relative to that EIC claim from the IRS in September 2017 indicating an adjustment would be made and tax assessed unless the taxpayer filed a petition with the Tax Court within 90 days. If the taxpayer did not file a petition with the Tax Court within the time allotted, EIC would be denied in December 2017. If the IRS determined the EIC error was due to reckless or intentional disregard of EIC rules, the taxpayer would be prohibited from claiming the EIC for tax years 2017 and 2018. In order to claim the EIC for tax year 2019, the taxpayer must complete and attach IRS Form 8862.

However, if the taxpayer had received the statutory notice of deficiency in November 2017 and filed the 2017 tax return in January 2018, the 90-day period would not have expired before the 2017 return was filed. Thus, the taxpayer would be barred from claiming EIC for years 2018 and 2019.

Disallowance Due to Fraud

It should be no surprise that more significant consequences follow upon IRS determination that disallowance of an EIC claim was due to fraud. If the IRS disallows an EIC claim for error and the IRS determines that the error was the result of fraud, the taxpayer is prohibited from claiming the EIC for a period of 10 years after the most recent tax year for which there was a final determination.

For example, suppose that the facts are the same as in the previous example but the IRS had determined the error was due to fraud, the taxpayer would be prohibited from claiming the EIC for the 10-year period 2016 through 2025. In order to claim the EIC for tax year 2026, the taxpayer must complete and attach IRS Form 8862.

Claiming EIC after Disallowance

Taxpayers whose EIC claim for any year after 1996 was denied or reduced by the IRS may need to complete Form 8862, Information To Claim Earned Income Credit After Disallowance. IRS Form 8862, if required, must be attached to the current tax return of a taxpayer whose prior EIC claim was disallowed in order to claim the credit for a current year. Whether or not the form is required depends upon the reason for the denial or reduction and certain other factors.

IRS Form 8862 Timing

When the EIC is disallowed, the taxpayer receives a statutory notice of deficiency informing him or her that the EIC would be denied, an adjustment would be made and tax assessed unless the taxpayer files a petition with the Tax Court within 90 days. If the taxpayer does not act on the notice within the 90 days and the period ends before the taxpayer may file his or her tax return, a taxpayer claiming the EIC must file IRS Form 8862 along with the tax return for the current year.

For example, suppose a taxpayer received a statutory notice of deficiency in September 2017 in connection with the disallowance of the EIC and did not file a petition with the Tax Court by the end of the 90 day period that ends in December 2017. If the taxpayer claims the EIC for tax year 2017 (normally filed by April 15, 2018) an IRS Form 8862, if required, must be attached to the 2017 tax return. However,

if the taxpayer received the statutory notice of deficiency in February 2018, any IRS Form 8862 filing would not be required until the tax return for 2018 is filed (usually April 15, 2019).

Filing IRS Form 8862

If a taxpayer whose EIC claim has been disallowed in a prior year wishes to claim the EIC in a current year, IRS Form 8862 must be attached to the client's tax return unless:

- ✓ An exception applies; or
- ✓ The client is prohibited from claiming the EIC in the current year because of reckless/intentional disregard of EIC rules or fraud.

Let's consider the exceptions to the need to file IRS Form 8862 first.

Exceptions

Exceptions to a taxpayer's need to file IRS Form 8862 may apply to taxpayers claiming the EIC whose:

- ✓ Disallowance of a prior EIC claim was solely because of a math or clerical error;
- ✓ Prior IRS Form 8862 filing was accepted; or
- ✓ Prior EIC disallowance was for solely a qualifying child and no qualifying child is currently being claimed.

If a taxpayer's EIC claim was denied or reduced solely as the result of a math or clerical error—the arithmetic or Social Security number was incorrect, for example—IRS form 8862 should not be attached to the taxpayer's tax return; it is not required.

An IRS Form 8862 is not required to be attached to an EIC claimant's tax return if, after the EIC was reduced or disallowed in a prior year, both of the following apply:

- ✓ The taxpayer filed IRS Form 8862 in a later year and the EIC claim for that later year was allowed; and
- ✓ The taxpayer's EIC has not been reduced or disallowed again for any reason other than for a math or clerical error.

In addition, an IRS Form 8862 would not be required if the only reason for the disallowance of the taxpayer's EIC claim in the earlier year was due to an IRS determination that a child listed on Schedule EIC was not the taxpayer's qualifying child **and** the taxpayer is claiming EIC in the current year without a qualifying child.

Summary

The requirement that a paid tax return preparer perform appropriate due diligence with respect to preparing a return claiming the earned income credit is imposed by statute, and preparers failing to meet that requirement are subject to a financial penalty. The financial penalties range from \$500 to \$5,000 for each failure to comply with the due diligence requirements, depending on whether the failure was due to an unreasonable position or reckless and intentional disregard of the rules.

Under the due diligence requirements, a preparer must a) complete and submit a Paid Preparer's Due Diligence Checklist (IRS Form 8867), b) compute the applicable earned income credit using a worksheet, c) know the client and the law relative to earned income credits, and d) maintain appropriate records related to preparation of the tax return.

The Paid Preparer's Due Diligence Checklist (Form 8867) takes the preparer through the rules applicable to claiming the credit. If the taxpayer meets all the rules applicable to claiming the credit, the amount of EIC for which the taxpayer is eligible is determined using EIC Worksheet A—for taxpayers who were not

self-employed, not a member of the clergy, not a church employee who files Schedule SE, nor a statutory employee filing schedule C or C-EZ—or EIC Worksheet B for those taxpayers who can be included in one of those categories.

Tax preparers are expected to be proactive in ensuring the information used is correct. Accordingly, they must know the EIC rules to ensure they are asking clients the right questions in order to get all relevant facts. They must take into account the information provided by their clients as well as what the tax preparers know about the clients, and they are required to ask additional questions if a reasonable and well-informed preparer would know the information obtained by the preparer is incomplete, inconsistent or incorrect. The questions and the answers the preparers receive from their clients must be documented.

Tax preparers must also maintain appropriate records relative to each client's EIC, in paper or electronic format, and be able to produce them if asked by the IRS. The EIC-related records that must be kept by the tax preparer are a) a copy of IRS Form 8867, b) the EIC Worksheet used, c) a record of additional questions asked of the client and his or her answers to them, and d) client-provided documents used to determine eligibility for, or the amount of, the EIC.

The required documents must be maintained by the preparer for no less than three years from the latest of a) the original due date of the tax return, b) the date the tax return or claim for refund is electronically filed by a signing tax return preparer, c) the date the return or refund claim is given to the client for signature by a signing tax return preparer, or d) the date given to the signing tax return preparer if the (non-signing) tax preparer prepares only part of the return or claim for refund.

Tax return preparers failing to meet EIC due diligence requirements may be subject to a) suspension or expulsion from IRS e-file, b) disciplinary action by the IRS Office of Professional Responsibility, and c) an injunction barring them from preparing tax returns or the imposition of conditions on the tax returns that may be prepared. Those sanctions may apply even if the claim for the credit was otherwise correct.

Employers who employ tax return preparers may also be subject to penalties if an employee fails to comply with due diligence requirements. A penalty could be assessed on an employer for an employed tax return preparer's failure to meet due diligence requirements if a) management participated in or knew of the failure to comply with the due diligence requirements before the return was filed, b) the firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements, or c) the firm disregarded established procedures through willfulness, recklessness, or gross indifference.

Taxpayers claiming the EIC and who have had a prior EIC claim denied or reduced may be required to complete Form 8862, *Information To Claim Earned Income Credit After Disallowance* and attach it to any subsequent tax return claiming the EIC. Requirement for the form—and whether the taxpayer may claim EIC in the current year—depends upon the reason for the EIC denial or reduction. Accordingly, IRS Form 8862 needs to be attached to the client's subsequent tax return claiming the EIC unless an exception applies or the taxpayer cannot claim the EIC in the current year.

IRS Form 8862 is not required if a) disallowance of a prior EIC claim was due to a math or clerical error, b) an IRS Form 8862 was filed and accepted in a prior year, or c) the disallowance of the claimed EIC was for a qualifying child and no qualifying child is currently being claimed.

The disallowance of a client's EIC claim results in certain consequences for the taxpayer: repayment plus penalties and interest, required IRS Form 8862 filing to subsequent EIC claims, and the possible prohibition of EIC claims for several years in the case of errors resulting from fraud or the reckless or intentional disregard of EIC rules. Denial of a taxpayer's EIC claim because of an error resulting from a taxpayer's reckless or intentional disregard of the EIC rules will cause the taxpayer to be prohibited from claiming EIC again for a two-year period. If disallowance is due to an error resulting from fraud, the prohibition applies for a 10 year period.

Chapter 2 Review Questions

1. Celia is married to a nonresident alien who lives in Guatemala. Under what circumstances could she be eligible for the earned income credit?
 - A. Only if she files a federal tax return as married filing jointly
 - B. Only if the taxpayer was also a nonresident alien for part of the year
 - C. Only if the taxpayer's spouse agreed that her foreign income would be subject to U.S. taxation
 - D. Under no circumstances would the taxpayer be eligible for EIC
2. Harriet, a paid tax return preparer, failed to comply with the EIC due diligence requirements in completing her client's tax return for 2019. If the IRS determined that her failure was NOT due to reckless disregard for the EIC rules or maintaining an unreasonable position, what maximum financial penalty could be imposed?
 - A. \$100
 - B. \$530
 - C. \$1,000
 - D. \$5,000
3. Carol claimed the earned income credit last year, and it was disallowed by the IRS. If no exception applies, what additional IRS form must she attach to her current tax return in order to claim the EIC this year because of the disallowance?
 - A. IRS Form 8867
 - B. IRS Form 2555
 - C. IRS Form 8862
 - D. IRS Form 8853
4. Which of the following taxpayers whose EIC claim was previously disallowed would be required to file IRS Form 8862 in order to claim the earned income credit this year?
 - A. Phil, whose EIC was previously disallowed due to his arithmetic error
 - B. Peggy, whose EIC was previously disallowed for failing to include her self-employed expenses when calculating her income
 - C. Kim who has no qualifying children and whose EIC was previously disallowed because a child she claimed was determined not to be a qualifying child
 - D. Bill, whose EIC was disallowed four years ago but who filed IRS Form 8862 last year that was accepted

5. You are preparing a tax return for eighteen year-old Barbara whose income was \$4,000. She has a two year-old daughter, and both live with Barbara's mother. The initial questions to ask in order to determine if Barbara is eligible to claim the earned income credit should be focused on which of the following?
- A. Whether Barbara's daughter is a qualifying child
 - B. Whether Barbara has incurred any child care expenses
 - C. Whether Barbara can be claimed as a qualifying child for EIC purposes
 - D. Whether Barbara's daughter has a valid social security number



Answers to Chapter 2 Review Questions

1.

- A. That's correct! If the taxpayer (or spouse, if married) was a nonresident alien for any part of the tax year, the taxpayer cannot claim the EIC unless the taxpayer's filing status is married filing jointly.
- B. This answer is incorrect. If the taxpayer or spouse was a nonresident alien for any part of the year and the taxpayer's filing status is other than married filing jointly, the EIC is not available.
- C. This answer is incorrect. For Celia to be eligible for EIC, both her and her spouse's worldwide income would be subject to U.S. taxation. However, that is a *result* of Celia's choice that could make her eligible for EIC.
- D. This answer is incorrect. Celia may be eligible for EIC. However, the possible answer to Celia's ability to claim EIC lies in her federal income tax filing status.

2.

- A. This answer is incorrect. Although the financial penalty was \$100 for the failure to comply with EIC due diligence requirements, that penalty was increased for returns filed after December 31, 2011.
- B. That's correct! IRC section 6695(g) imposes a financial penalty on any income tax return preparer failing to comply with the due diligence requirements related to determining a taxpayer's eligibility for the credit or its amount. The financial penalty was increased by subsequent legislation from \$100 to \$500 for returns filed after December 31, 2011. In 2019 the penalty is \$530.
- C. This answer is incorrect. A minimum penalty of \$1,000 may be assessed if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to an unreasonable position. In this case that condition, i.e. maintaining an unreasonable position, was not found.
- D. This answer is incorrect. A minimum penalty of \$5,000 may be imposed if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to a reckless or an intentional disregard of rules or regulations.

3.

- A. This answer is incorrect. Although paid tax preparer are required to complete IRS Form 8867, the form is not required because of EIC disallowance nor required to be filed by a taxpayer.
- B. This answer is incorrect. If a taxpayer files IRS Form 2555, Foreign Earned Income Exclusion, the taxpayer is ineligible for EIC.
- C. That's correct! Taxpayers whose EIC claim for any year after 1996 was denied or reduced by the IRS may need to complete Form 8862, Information To Claim Earned Income Credit After Disallowance.
- D. This answer is incorrect. IRS Form 8853 is used in connection with Archer MSA and Qualified long-term care premium deductions and is not used with the earned income credit.

4.

- A. This answer is incorrect. The disallowance of a prior EIC claim because of a math or clerical error is an exception to the requirement for the taxpayer to file IRS Form 8862 in order to claim the EIC in a subsequent year.
- B. That's correct! Peggy must file IRS Form 8862 in order to claim the EIC. However, if her failure to include her expenses in calculating her self-employed income is deemed to be the result of fraud or the reckless or intentional disregard of EIC rules, she could be barred from the credit for several years.
- C. This answer is incorrect. When a prior EIC claim was disallowed solely because of a qualifying child and the taxpayer is claiming this year with no qualifying child, the taxpayer does not have to file IRS Form 8862.
- D. This answer is incorrect. If a claim for EIC was previously disallowed and the taxpayer subsequently filed an IRS Form 8862, no further filing of the form is required provided EIC is not subsequently disallowed for other than a math or clerical error.

5.

- A. This answer is incorrect. Although the status of Barbara's daughter as a qualifying child could affect the EIC for which she is eligible, the answer to a more central question related to whether Barbara herself is eligible should be asked.
- B. This answer is incorrect. While a taxpayer's expenses for child care could reduce Barbara's net income and may affect her EIC, they do not affect her eligibility to claim the credit.
- C. That's correct! A taxpayer who is the qualifying child of another taxpayer cannot claim the EIC whether or not the other taxpayer claims the EIC. Thus, it is important to ensure that Barbara is not the qualifying child of her mother based on the relationship, age, residency and joint return tests.
- D. This answer is incorrect. Whether or not Barbara's daughter has a valid social security number would affect Barbara's ability to claim her as a qualifying child. However, it would not affect her eligibility for the EIC.



Glossary

Age rule—The age rule requires that a taxpayer claiming the EIC must be at least age 25 but less than age 65 at the end of the tax year.

Dependent of another person rule—A taxpayer claiming the EIC cannot be the dependent of another person, regardless of whether or not the other person actually claimed the taxpayer as a dependent.

Disabled child (permanently and totally)—To be considered a permanently and totally disabled child for EIC purposes, the child must be unable to engage in any substantial gainful activity because of a physical or mental condition, and a doctor must determine the condition has lasted continuously for at least a year, can be expected to last continuously for at least a year, or can lead to death.

Document matching—Document matching is a process used by the IRS to reduce improper EIC payments in which income claimed on tax returns is matched to income reported by third parties.

Earned income—Earned income, for EIC purposes, includes a) wages, salaries, tips and other taxable employee pay, b) net earnings from self-employment, and c) gross income received by the taxpayer as a statutory employee.

Joint return test—One of the tests to determine whether a taxpayer's child is a qualifying child for purposes of the EIC. To meet the joint return test the child cannot file a joint return for the tax year, except when the child's filing a joint tax return is only to claim a refund.

Main home rule—Under the main home rule, a taxpayer claiming the EIC must have lived in the United States more than half the year.

Qualifying child—A taxpayer's child is a qualifying child for purposes of the EIC if the child meets the a) relationship test, b) age test, c) residency test, and d) joint return test.

Qualifying child of another taxpayer rule—A taxpayer claiming the EIC cannot be a qualifying child of another taxpayer.

Relationship test—One of the tests to determine whether a taxpayer's child is a qualifying child for purposes of the EIC. To meet the relationship test, a qualifying child must be a) the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them, or b) the taxpayer's brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.

Residency test—One of the tests to determine whether a taxpayer's child is a qualifying child for purposes of the EIC. To meet the residency test, a qualifying child must have lived with the taxpayer in the United States for more than half of the year. "United States" means the 50 states and the District of Columbia. However, the term does not include Puerto Rico or U.S. possessions.

School—A school, for purposes of the EIC, includes an elementary school, a junior or senior high school, a college or university, or d) a technical, trade, or mechanical school.

Student—A student, for EIC purposes, includes a person who, during some part of each of any five calendar months during the calendar year was a full-time student or a student taking a full-time, on-farm training course given by a school or state, county or local government.

Tiebreaker rules—EIC rules that apply when more than one person has the same qualifying child.

Appendix A – Worksheet A

Worksheet A – 20XX EIC – Lines 66a and 66b

Before you begin: ✓ Be sure you are using the correct worksheet. Use this worksheet only if you Answered "No" to Step 5, question 2. Otherwise use Worksheet B.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5. 1
2. Look up the amount on line 1 above in the EIC Table (right after Worksheet B) to find the credit. Be sure to use the correct column for your filing status and the number of children you have. Enter the credit here. 2
If line 2 is zero, **STOP**. You cannot take the credit.
Enter "No" on the dotted line next to line 66a.
3. Enter the amount from Form 1040, line 38. 3
4. Are the amounts on lines 3 and 1 the same?
☐ **Yes**. Skip line 5; enter the amount from line 2 on line 6.
☐ **No**. Go to line 5.

Part 2

Filers Who Answered "No" on Line 4

5. If you have:
 - No qualifying children, is the amount on line 3 less than \$8,650 (\$14,450 if married filing jointly)?
 - 1 or more qualifying children, is the amount on line 3 less than \$19,030 (\$24,820 if married filing jointly)?☐ **Yes**. Leave line 5 blank; enter the amount from line 2 on line 6.
☐ **No**. Look up the amount on line 3 of the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. 5
 Look at the amounts on lines 5 and 2.
 Then, enter the **smaller** amount on line 6.

Part 3

Your Earned Income Credit

6. This is your earned income credit. 6
Enter this amount on Form 1040.

Reminder—

- ✓ If you have a qualifying child, complete and attach Schedule EIC.

If your EIC for a year after 1996 was reduced or disallowed, see Form 8862, who must file, earlier, to find out if you must file Form 8862 to take the credit for 20XX.

Appendix B – Worksheet B

Worksheet B – 20XX EIC – Lines 66a and 66b

Use this worksheet if you answered "Yes" to Step 5, question 2.

- ✓ Complete the parts below (Parts 1 through 3) that apply to you. Then, continue to Part 4.
- ✓ If you are married filing a joint return, include your spouse's amounts, if any, with yours to figure the amounts to enter in Parts 1 through 3.

Part 1

Self-Employed,
Members of the
Clergy, and People
With Church
Employee Income
Filing Schedule SE

1a.	Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies.		1a	
b.	Enter any amount from Schedule SE, Section B, line 4b, and line 5a.	+	1b	
c.	Combine lines 1a and 1b.	=	1c	
d.	Enter the amount from Schedule SE, Section A, line 6, or Section B, line 13, whichever applies.	-	1d	
e.	Subtract line 1d from 1c.	=	1e	

Part 2

Self-Employed
NOT Required
To File Schedule
SE

2.	Do not include on these lines any statutory employee income, any net profit from services performed as a notary public, any amount exempt from self-employment tax as a result of the filing and approval of Form 4029 or Form 4361, or any other amounts exempt from self-employment tax.			
a.	Enter any net farm profit or (loss) from Schedule F, line 34, and from farm partnerships, Schedule K-1 (Form 1065), box 14, code A*.		2a	
b.	Enter any net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1*.	+	2b	
c.	Combine lines 2a and 2b.	=	2c	

*If you have any Schedule K-1 amounts, complete the appropriate line(s) of Schedule SE, Section A. Reduce the Schedule K-1 amounts as described in the Partner's Instructions for Schedule K-1. Enter your name and social security number on Schedule SE and attach it to your return.

Part 3

Statutory Employees
Filing Schedule C or
C-EZ

3.	Enter the amount from Schedule C, line 1, or Schedule C-EZ, line 1, that you are filing as a statutory employee.	3	
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Part 4

All Filers Using
Worksheet B

4a.	Enter your earned income from Step 5.	4a	
b.	Combine lines 1e, 2c, 3, and 4a. This is your total earned income.	4b	

If line 4b is zero or less, **STOP**. You cannot take the credit. Enter "No" on the dotted line on Form 1040.

5. If you have:

- 3 or more qualifying children, is line 4b less than \$50,162 (\$55,952 if married filing jointly)?
- 2 qualifying children, is line 4b less than \$46,703 (\$52,493 if married filing jointly)?
- 1 qualifying child, is line 4b less than \$41,094 (\$46,488 if married filing jointly)?
- No qualifying children, is line 4b less than \$15,570 (\$21,370 if married filing jointly)?

☐ **Yes.** If you want the IRS to figure your credit, see *Credit figured by the IRS*, earlier. If you want to figure the credit yourself, enter the amount from line 4b on line 6 of this worksheet.

☐ **No. STOP.** You cannot take the credit. Enter "No" on the dotted line on Form 1040.

Worksheet B – 20XX EIC – Lines 66a and 66b – Continued

Part 5

All Filers Using Worksheet B

6. Enter your total earned income from Part 4, line 4b. 6
7. Look up the amount on line 6 above in the EIC Table to find the credit. Be sure to use the correct column for your filing status and the number of children you have. Enter the credit here. 7
- If line 7 is zero, **STOP**. You cannot take the credit.
Enter "No" on the dotted line next to line 66a.
8. Enter the amount from Form 1040, line 38. 8
9. Are the amounts on lines 8 and 6 the same?
☐ **Yes.** Skip line 10; enter the amount from line 7 on line 11.
☐ **No.** Go to line 10.

Part 6

Filers Who Answered "No" on Line 9

10. If you have:
- No qualifying children, is the amount on line 8 less than \$8,650 (\$14,450 if married filing jointly)?
 - 1 or more qualifying children, is the amount on line 8 less than \$19,030 (\$24,820 if married filing jointly)?
- ☐ **Yes.** Leave line 10 blank; enter the amount from line 7 on line 11.
- ☐ **No.** Look up the amount on line 8 of the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
- Look at the amounts on lines 10 and 7. 10
- Then, enter the **smaller** amount on line 11.

Part 7

Your Earned Income Credit

11. **This is your earned income credit.** 11

Reminder—

- ✓ If you have a qualifying child, complete and attach Schedule EIC.

Enter this amount on Form 1040.

If your EIC for a year after 1996 was reduced or disallowed, see Form 8862, who must file, earlier, to find out if you must file Form 8862 to take the credit for 20xx.

End Notes

¹ SOI Tax Stats-Individual Income Tax Returns may be accessed at: <https://www.irs.gov/uac/soi-tax-stats-individual-income-tax-returns>.

² Robert Greenstein and John Wancheck, "Earned Income Credit Overpayment and Error Issues," April 19, 2011, Center on Budget and Policy Priorities. <http://www.cbpp.org/cms/?fa=view&id=3445>.

³ Ibid.





TAX PREPARER'S NOTES



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