

**TXSEA**

TEXAS SOCIETY  
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POWERING AMERICA'S TAX EXPERTS

# Diligence Demons

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# Objectives

- Focus on diligence documentation concepts, and the challenges,
- Frame the law, regulations and nuances, &
- Encourage creative sharing of methods that can enhance compliance and protect competent practitioners.

## 26 CFR 1.6695-2T - TAX RETURN PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN CREDITS (TEMPORARY).

(a) Penalty for failure to meet due diligence requirements -

(1) In general.

A person who is a tax return preparer (as defined in section 7701(a)(36)) of a tax return or claim for refund under the Internal Revenue Code with respect to determining the eligibility for, or the amount of,

# § 1.6695-2T TAX RETURN PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN CREDITS (TEMPORARY)

The child tax credit (CTC) and

The additional child tax credit (ACTC) under section 24,

The American opportunity tax credit (AOTC) under section 25A(i), or

The earned income credit (EIC) under section 32

## § 1.6695-2T TAX RETURN PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN CREDITS (TEMPORARY)

and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty as prescribed in section 6695(g) (indexed for inflation under section 6695(h)) for each failure.

## § 1.6695-2T TAX RETURN PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN CREDITS (TEMPORARY)

A separate penalty applies with respect to each credit claimed on a return or claim for refund for which the due diligence requirements of this section are not satisfied and for which the exception to penalty provided by paragraph (d) of this section does not apply.



# § 1.6695-2T TAX RETURN PREPARER DUE DILIGENCE REQUIREMENTS FOR CERTAIN CREDITS (TEMPORARY)

For tax year 2016, this is a \$510 penalty for every return with at least one failure.

IF IRS finds 25 returns that fail to meet the EITC due diligence requirements, the penalty for tax year 2016 is \$12,750.

If those same returns **also** failed to meet the CTC/ACTC and the AOTC due diligence requirements, the penalty is \$38,250

## Before

### Identify Client

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- ID Verification; We ID Clients, &
- IRS IDs Practitioners

## During

### Document Credits and Dependents

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- Demonstrate knowledge of the laws – retain proof of inquiries and interviews;
- Punch lists, flow charts, questionnaires;
- E-Signatures.

## After

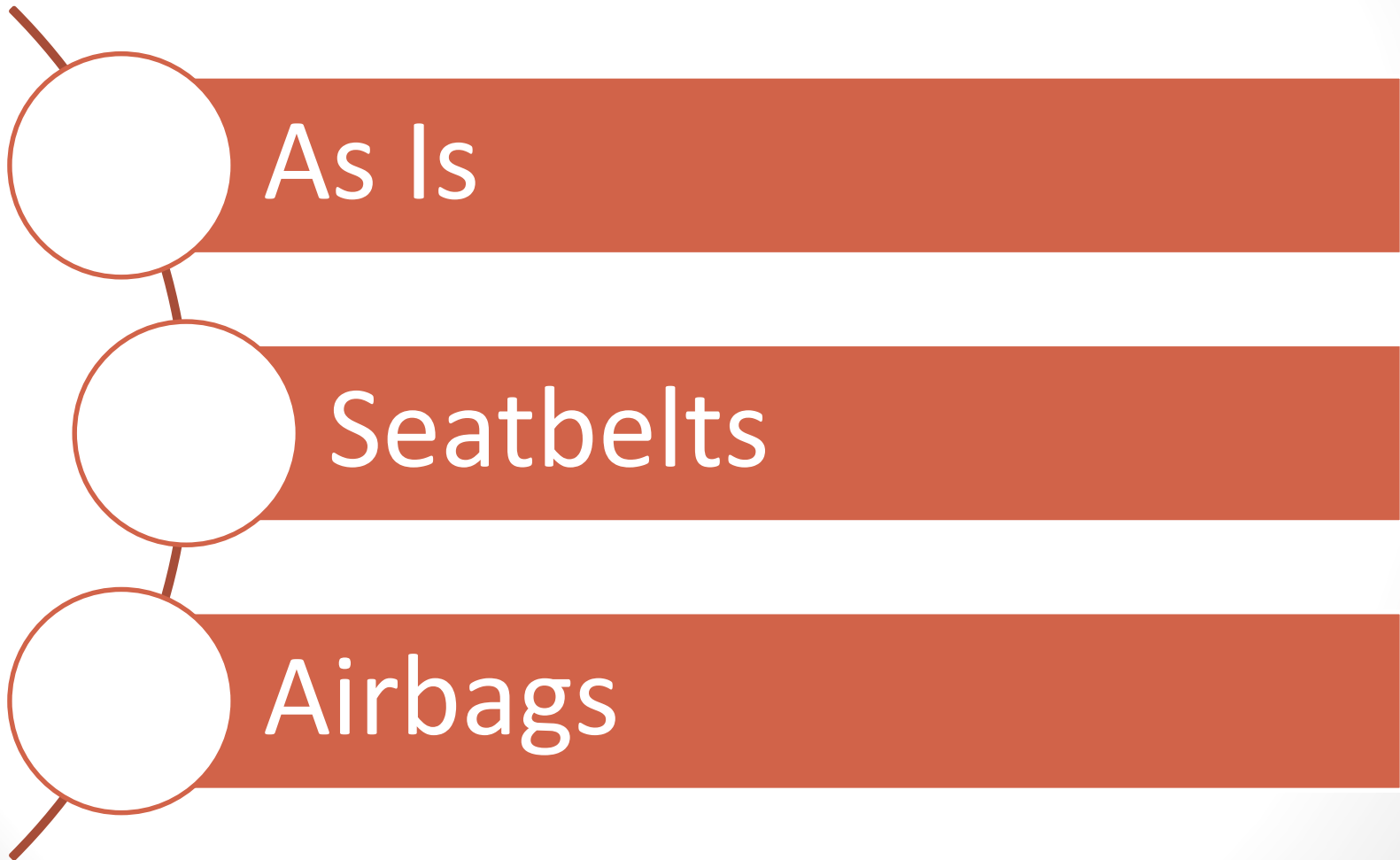
### ERO Office Practice Requirements

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- Document retention, advertising, file security, all acknowledgements retrieved, all clients copied? PTINs and CEs up to date? Reject ratios?

# VERIFICATION

# Software Security Evolution





# Tax Software 2016

- Strong passwords every 90 days,
- Lockout if program idle for a few minutes, and
- Stronger verification of user, retail or professional.

# Data Elements – Security!

- Individual Master File (IMF) categorizes return sources as from:
  - (D) Desktop
  - (O) Online Filers
  - (P) Pro Side
- Self prepared returns getting ID checks
  - Email addresses & cell phone #s need to be furnished
  - Software provider verifies id with credit, other background checks prior to transmission.



# Classifying Customers (DOP)

- New customer – must verify;
- Customer returning to
  - Same preparer &/or brand of software, but
  - Not fully verified; or
- Returning *and* previously verified.



# Elements with BMF Returns

- 1041 - Name and SSN or EIN of fiduciary officer
- 1065, 1120, 1120S
  - Name and SSN of signer
  - If deducting wages, how many W2s?
- 1041, 1065, 1120, 1120S
  - Income from prior year
  - Other returns files
  - EFTPS confirmation number



# Pros and Security

- E-Services Two Factor Authentication Renew;
- Set-up Individual Online Account, cell phone number key
- If corporate owned phone, then verbal screening, providing details of recent return.

\*If you get a new phone, renew authentication

# Know Taxpayer's Status

- US citizen,
- Resident alien,
- NRA.

*Everything from tax credits to estate tax planning depends on this information!*



# Suggestions for Established Practices

- DL or State ID mandatory for new, and returning clients of under 3 years, and any clients filing state tax returns, and
- For all clients, confirming documents for life changing events like marriage, divorce, birth and death, and
- SS/ ATIN / ITIN cards or confirmation letters for all new arrivals in the taxpayer's life.

# Paid Preparer's Due Diligence Checklist

## FORM 8867

# EITC      CTC/ACTC      AOTC

Yes  No

Yes  No

Yes  No

There are four requirements needed to be filled.

- Completion and submission of Form 8867
- Computation of credit or credits
- Knowledge
- Records retention

# EITC      CTC/ACTC      AOTC

Yes No

Yes No

Yes No

- Of the four due diligence requirements, three have to do with completing worksheets and forms, and with recordkeeping.
- The fourth is the knowledge requirement, requiring one to:
  - Know the EITC, CTC and AOTC laws thoroughly,
  - Evaluate client's information,
  - Question client to determine each's personal situation and eligibility, and
  - Document both the questions asked and the client's responses.



# Evidence to Retain

- Due diligence records, usually software driven worksheets,
- The probing questions asked and the clients responses,
- All questionnaires, checklists and worksheets, and
- Copies of any client provided documents relied upon to
  - determine eligibility for EITC, ATC or AOTC, or
  - to compute the amount of these credits.



# Q & A Proof

- Questionnaires & Organizers
- Emails
- Handwritten, typed or computer entry notes
- Voice recordings\*
- Hybrid technology,\* such as
  - Microsoft OneNote using Record Audio
  - Mac/Iphone Ap: Notability by Ginger Labs

\*Transcripts likely required if examined.



# Like a Reporter

- Who was interviewed
- What questions were asked and answered
- When, by whom
- Where – in the office, in person, by phone, by email?
- Why – framing
  - Dependents
  - Filing status
  - Refundable Credits

# DEPENDENTS

# Questions for All

- Was the taxpayer, or spouse, a nonresident alien for any part of the year?
- Could the taxpayer, or spouse if filing jointly, be a qualifying child or qualifying relative of another person for the year?
- Was the taxpayer's main home, and the main home of the spouse if filing jointly, in the US for more than half the year?

# One Suite of Benefits Per Child

- Special rules apply to children of divorced or separated parents; otherwise,
- Only one person can use the same qualifying child (QC), as qualifier for :
  - EITC with a QC
  - Dependency Exemption for the child
  - Child Tax Credit
  - HOH filing status
  - Credit for child and dependent care expenses, and
  - Exclusion for DCB.

**If more than one person claims these tax benefits using the same child, the tie breaker rules kick in.**

# 5 Requirements for Dependents

- Citizenship
  - US citizen
  - Resident of US, Canada or Mexico for part of the year
  - Legally adopted foreign child now residing in US, or
  - Adopted child living with you the entire year.
- Relationship
- Gross Income
- Support
- Not filing joint returns other than for refunds.

# Qualifying Child (QC)

- Is the taxpayer's child, stepchild, foster child, sibling, half sibling or a descendent of any of them,
- Is younger than the taxpayer (or tp's spouse if filing jointly,)
- Is under age 19 at the end of the year, or under age 24 at end of year and full time student, or
- Is any age if permanently and totally disabled, and
- Must have lived with the taxpayer over half the year, and
- Must not have provided more than half of his or her own support for the year, and
- Must not file a joint return for that year unless only to claim a refund.

# QC Tie Breaker Rules

- **The child is treated as the QC Only By:**
  - The parents, if filing jointly;
  - 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 parent;
  - The parent with the highest AGI if the child lived with each for the same amount of time,
  - The person with the highest AGI, if no parent can claim the child as a qualifying child; or
  - A person with the higher AGI than any parent who can claim the child as a qualifying child but does not.

# Qualifying Relative (QR)

- Cannot be a QC,
- Must live with the taxpayer as a member of the household for the entire year, (with relationship not violating local law,) or
- Be related under IRC Sec 152(d)(2)(A)-(G),
- Have gross income less than the exemption for the year, and
- The taxpayer must provide over half the person's total support for the year.



# QR §152 List

- Child or descendant of a child,
- Sibling or step sibling,
- Parent or ancestor of either,
- Stepparent,
- A child of a sibling,
- A sibling of a parent,
- A child-in-law, parent-in-law, or sibling-in-law.

***Who's not included?!***



# Support or Not

- Food,
- shelter,
- clothing,
- health care,
- Education
- Transportation
- Vacations
- investments
- scholarships
- funerals

# Residency Exceptions

- Temporary absences,
  - School
  - Vacations
  - Pre-conviction incarceration
  - Hospitalization
- Birth/death during year,
- Divorced/separated parents,
- Kidnapped children.

# Gross Income Quirks

- Gross income for the QR support test means gross income as defined under IRC 61 – everything not otherwise exempted.

# Gross Income Quirks

- A taxpayer who had income allocated to her by a trust, even though the income was not distributed, had to count that as towards her own support, and her daughter could not claim her as a dependent.

# Gross Income Quirks

- Social security is specifically excluded from the calculation of gross income, except where it is included in AGI by other required income computations; its exempt proceeds still count in determining who provided what amounts of support.

# Suggestion

- List all members of the household, and
- Their contributions to the household,
- Noting dates in or out, as occurred,
- List capabilities of each to be the
  - Claiming taxpayer,
  - Qualifying Child or
  - Qualifying Relative of each.

# Example #1

- In 2017, Q, a 22-year-old taxpayer, engages Preparer C to prepare Q's 2016 federal income tax return.
- Q completes Preparer C's standard intake questionnaire and states that she has never been married and has two sons, ages 10 and 11.
- Based on the intake sheet and other information that Q provides, including information that shows that the boys lived with Q throughout 2016,
- Preparer C believes that Q may be eligible to claim each boy as a qualifying child for purposes of the EIC and the CTC. However, Q provides no information to Preparer C, and Preparer C does not have any information from other sources, to verify the relationship between Q and the boys.



# Example #1

- However, Q provides no information to Preparer C, and Preparer C does not have any information from other sources, to verify the relationship between Q and the boys.
- To meet the knowledge requirement, Preparer C must make reasonable inquiries to determine whether each boy is a qualifying child of Q for purposes of the EIC and the CTC, including reasonable inquiries to verify Q's relationship to the boys, and
- Preparer C must contemporaneously document these inquiries and the responses.

# Example #2

- Assume the same facts as in Example 1.
- In addition, as part of preparing Q's 2016 federal income tax return, Preparer C made sufficient reasonable inquiries to verify that the boys were Q's legally adopted children
- In 2018, Q engages Preparer C to prepare her 2017 federal income tax return. When preparing Q's 2017 federal income tax return,
- Preparer C is not required to make additional inquiries to determine the boys relationship to Q for purposes of the knowledge requirement.

# REFUNDABLE CREDITS

# EITC - With or Without Child

1. Qualifying low income;
2. Taxpayer(s) must have valid SSN(s) obtained by the due date of the return, including extensions;
3. Filing status is S, MFJ, QW or HOH (if spouse is NRA, must be filing MFJ);
4. Not excluding foreign earned income (Form 2555);
5. Investment income is \$3,400 or less;
6. Qualifying total earned income at least a dollar but less than EITC limits;
7. Taxpayer not someone else's qualifying child.

# EITC Specifics

- **EITC if with QC**
  - Child has valid (“for work”) SSN by return’s due date including extensions, and,
  - Meets relationship, age, residency and joint return tests, and
  - Is exclusively the taxpayer’s QC, or taxpayer is the tie breaker if more than one TP.
- **EITC without Children**
  - Ages range from 25 to 65,
  - Cannot be claimed as another’s dependent, and
  - Taxpayer’s home was main home in the US for more than half the year.

# New Rule: EITC for Two

- **Households can now encompass**
  - One TP with EITC due to QC, and
  - Another TP allowed to receive EITC under rules for those without children.
- Amended returns for prior years can be filed if statute still open.

# Child Tax Credit

- Child must have an SSN or an ATIN by return's due date including extensions and lived in the US with taxpayer at least half the year, or,
- Child must have ITIN by return's due date including extensions and have lived in the US with taxpayer at least half the year and meet the substantial presence test, and
- Child must be under age 17,
- Child must not have provided at least half of its own support, and
- Child must meet the joint return test, and
- Child must meet the same relationship tests as a QC.

# Additional CTC

- Taxpayer cannot have filed Form 2555/2555EZ excluding foreign earned income, otherwise,
- After determining the CTC not used due to eliminating tax liability, a set of math rules apply to see if that amount can be made refundable.



# American Opportunity TC

- Claimed no more than 4 years,
- Student must be enrolled at least half time,
- Education must be in a degree related (or other recognized educational) program,
- Student cannot have felony drug conviction on record,
- Must have form 1098-T

# Claiming AOTC

- Taxpayer's filing status cannot be MFS;
- Taxpayer cannot be listed as a dependent on another return;
- Taxpayer or spouse cannot be NRA for any part of year (unless meeting a Pub. 519 exception;)

# 1098-T Issues

- The mandated 1098-T is inadequate for determining amounts paid, since
- Educational Institutions have two more years to comply with the rule to furnish amounts paid;
- The bursars' statement or accounting transcript must be requested and retained;
- Furthermore, institutions do not have to issue a form 1098-T if scholarships and grants equal tuition, stranding taxpayers paying for required course material.

# Unique Challenges

- No confirmation document or W-2 Box 12 code for employment sponsored education assistance under §127,
- Students who did not complete degrees by age 24, and who later renew their efforts to get their degrees:
  - Parents may be unable to review their old tax returns to count the years, if any, the credit was taken, or even
  - Recall how the costs got paid;
  - We think the years AOTC claimed should be carried by IRS in the record of account of the parents and the students, just like it carries the house tax credit history.
- Additional backup needed to schedule costs for students with combinations of scholarship assistance and/or and 529 funds.

# Example #3

- Y, who is 32 years old, engages Preparer G to prepare his federal income tax return. Y completes Preparer G's standard intake questionnaire and states that he has never been married.
- As part of Preparer G's client intake process, Y provides Preparer G with a copy of the Form 1098-T Y received showing that University M billed \$4,000 of qualified tuition and related expenses for Y's enrollment or attendance at the university and that Y was at least a half-time undergraduate student.

# Example #3

- Preparer G believes that Y may be eligible for the AOTC.
- Since Form 1098-T does not contain all the information needed to determine eligibility for the AOTC or to calculate the amount of the credit if Y is eligible,
- To meet the knowledge requirements, Preparer G must make reasonable inquiries to determine whether Y is eligible for the AOTC, and contemporaneously document these inquiries and the responses.

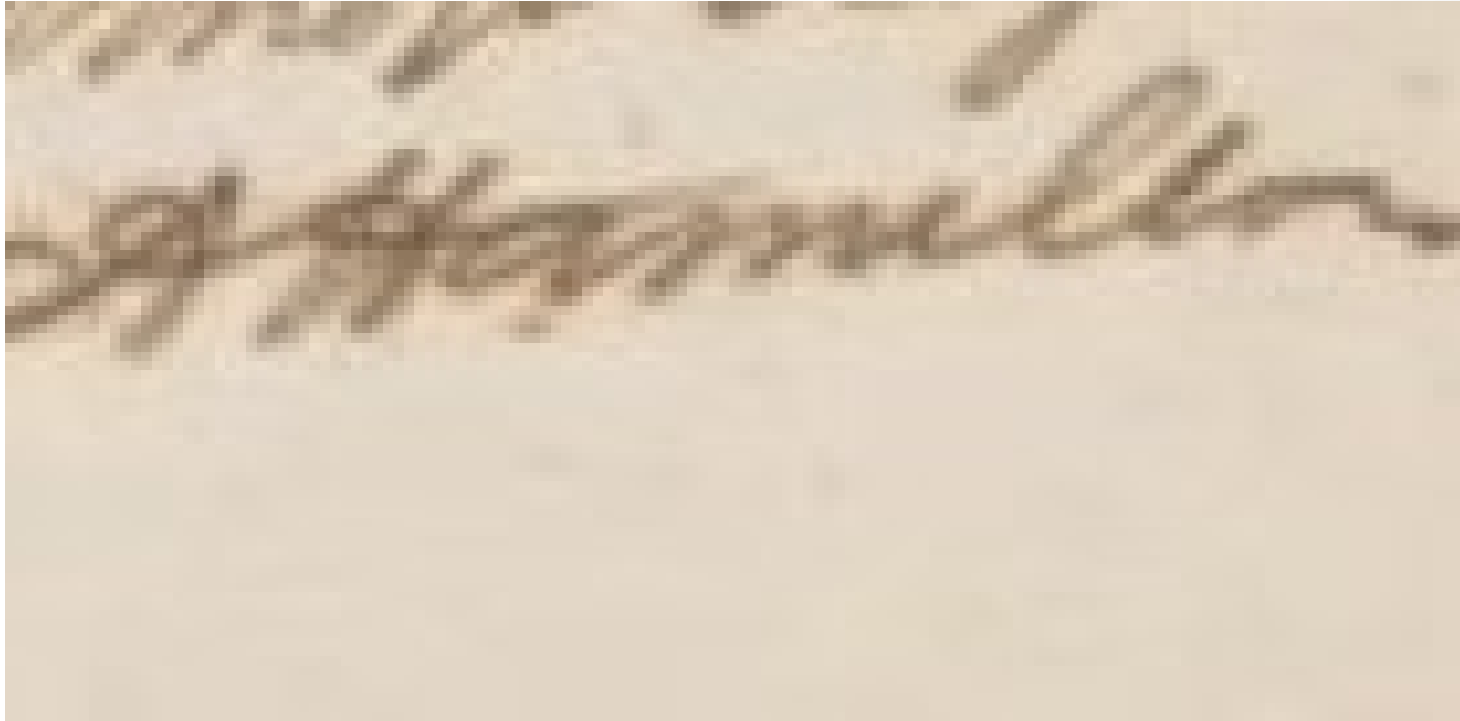
# Example #4

- *My children have different last names because I left my first husband and kept the child but I never got divorced because we were never really married even though we told people we were and we lived in a common-law state and since it was a common-law state we thought we could tell people we were divorced and that would be the divorce since it is a common law state and anyway.*
- *I did remarry and that is where my other child, my stepson actually, is from and that is why his name is different too, but he left me and I think he is dead so I am a common-law widow since I presented myself as a widow in a common-law state.*

# Suggestions

- Principle and staff take IRS online due diligence course annually,
- Use flow charts from pubs (like pub 4012) as interview tools for documenting inquiry paths,
- Compare key points of 8867 issues with ones' own annual client questionnaire and expand as needed to include citizenship, household composition, felony drug convictions of dependents, and credit disallowances.





# SIGNATURES

# Self-Select Pin

- Requires taxpayers to provide prior year AGI and/or PIN; used
- Primarily with self-prepared returns.



# Online Tools Hacked

- IRS announced in February of 2016 that cyber criminals obtained over 100 thousand PINs with this PIN assigning tool, and so,
- IRS discontinued the online PIN assigning tool in June of 2016.
- Thieves retrieved tax information via:
  - **StudentLoans.gov** and
  - **FAFSA.gov**
- The Student Loan Data Retrieval Tool was shut down early in 2017 should again be available by October 2017, after the IRS and the Department of Education make updates.

# Practitioner Pin

- Forms 8878 & 8879 manually signed by taxpayer, **pen to paper:**
  - In person, or returned to ERO by
    - Hand delivery
    - Mail
    - Fax
    - Email
    - Internet Portal
- Forms 8878 & 8879 signed by signature pad **in the ERO's office only.**



# Electronic Signatures

- Software must record and retain:
  - Digital image of the signed form, and
  - Date and time of the signature, and
  - Method used to sign the record, such as
    - Handwritten with stylus on signature pad, or
    - Mark or command on display screen, or
    - Digitized signature attached to record, or
    - Mark captured as scalable graphic.



# Remote E-Signature

- Involving remotely signed electronic signatures, with the return transmitting software
  - Retaining taxpayer's IP address,
  - Retaining taxpayer's login identification user name,
  - Verifying taxpayer's ID using TP's knowledge based results, and
  - Verify name, SSN, address, date of birth and other personal information are consistent.



# In House E-Signatures

- The ERO must verify the identity of the taxpayer(s) signing the return.
- Inspect government ID, such as a drivers license, employer, school, state, military, voter ID, visa or passport.
- If a multi-year business relationship, identify and authenticate the taxpayer.

# If E-Sig Unverifiable

- One gets three attempts to verify the electronic signature;
- After that, obtain handwritten signature.



# Suggestion

- Only use remote e-signatures if offered by your Income Tax Preparation software.
- Even if you can make it “work” with your pdf signature documents, using a **3<sup>rd</sup> party** program is no guarantee of IRS verification requirements being met.

# ERO Inspections Chat

I may end up getting fined like heck for not having enough documentation but a lot of the documentation don't prove what is required to qualify.

I ask the questions to complete the tax return and the due diligence screens and I have a few questions printed off that I ask some people when I think it's needed;

1) anyone else live in the house that is not included on the return?

2) did anyone other than you contribute financially to the household bills and if so how much?

# ERO Inspections Chats

- 3) If any of the kids on the tax return has a different last name that the taxpayers explain why.
- 4) If any child on the tax return is not the taxpayers child then where are the parents and why are they not claiming the child?
- 5) If you are Separated, Widow / Widower or divorced, when did it occur?

# ERO Inspections Chats

- 6) Have you ever released the right to claim a child to another person via Form 8332?
- 7) If requested could you provide documentation to substantiate that the children claimed on your return is related to you and lived with you as indicated, such as school and or medical records?
- 8) Have you ever had the EITC, CTC, ACTC or AOTC disallowed or reduced in a prior year?

# ERO Inspections

- Forms 8879, W2, W2G and 1099R retained?
- Forms 8879 within \$50 income or \$14 tax of the filed 1040?
- Document copies sent with return as a pdf or mailed via 8453 retained?
- Are taxpayers provided with copies of their returns, signed 8878 or 8879 forms, pdf attachments or 8453 copies as mailed with their returns?
- Are the signature rules followed?
- Are the 8879 forms signed prior to transmission?
- Are the acknowledgement files maintained?
- Are the acknowledgements promptly retrieved?
- **Are the clients notified that their returns are accepted?**

# ERO Inspections

- DO clients answer a set questionnaire?
- Are copies of clients receipts for claimed expenses kept?
- If not, why not?
- Are all preparers identified, with PTINs and up to date CE?
- Are returns e-filed for other preparers?
- If so, list those preparers.
- Does each of those preparers have a valid EFIN?
- Do you validate if they are in good standing with IRS and have a valid EFIN?
- Do you offer bank products?

# ERO Inspections

- What fees do you charge for:
  - Return prep,
  - E-file only,
  - Both,
  - Direct deposit?
- What security measures do you take with your files, passwords and computers?
- What type of advertisements do you use?
- Provide samples
- Do you prepare returns claiming wages and withholding without a W2?
- Explain.

# ERO Inspections

- Do you indicate altered, handwritten or typed forms W2 as “non-standard” in your tax software?
- If no, explain.
- How many employees prepare returns?
- Have any ever been suspended from the e-file program?
- Provide names and SSNs of your employees who prepare returns.
- How are they trained?
- Each employee is asked about the responsibilities for return accuracy, and many of the same documentation, retention and client return copy questions asked of the owner.



# ERO Inspections

- Can combine ERO inspection with EITC Due Diligence inspection.
- Copies of verification documents such as SSN cards, divorce decrees, driver licenses would be requested.
- Copies of 8867 requested. IF it or (pre 2016 years) an alternative eligibility checklist not producible, a referral is initiated. These are random, unannounced follow-up visits.
- Issues are listed on their own punch list, such as
  - Stockpiling returns
  - Untimely 8453s
  - Unacceptable cumulative Error Rates
  - Failure to provide taxpayer with acknowledgement

# DD References

- Trade Preferences Extension Act
- Protecting Americans from Tax Hikes Act
- Proposed Regs ITINs and 1098-Ts
- Temporary Regs on Due Diligence
- Childless EITC and Tiebreaker Changes

# Resources

- IRS Preparer Toolkit
- EITC-CTC Comparison Chart
- VITA PUBs 4012 and 4491
- Pub 4687
- IRS Interactive Tax Assistant
- E-Filer Pubs 1345 and 3112

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