

Chapter 8: IRS Update

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Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

EMPLOYMENT TAX RETURNS ADJUSTMENTS

Both tax practitioners and taxpayers have difficulty correcting payroll tax report errors. Currently, all corrections to payroll tax reporting forms are made on Form 941c, *Supporting Statement to Correct Information*. Form 941c must be attached to the current reporting form or Form 843, *Claim for Refund and Request for Abatement*. It is used to correct the amounts previously reported on Forms 941, 943, 944, and 945. Form 941c is complex and does not correspond directly to any employment tax returns. Consequently, mistakes are often made when completing and filing the form. This frequently results in processing errors and delays.

Additionally, because the employer files Form 941c with a current return, the IRS adjusts the current tax period instead of the period requiring the correction. This makes it difficult for both the employers and the IRS to track taxpayers' account activity.

A new series of forms is being developed to reduce the error rate and the burden for employers and payers who need to correct information previously reported. These new forms will be used to correct errors on the following:

- Form 941, *Employer's QUARTERLY Federal Tax Return*
- Form 944, *Employer's ANNUAL Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 945, *Annual Return of Withheld Federal Income Tax*
- Form CT-1, *Employer's Annual Railroad Retirement Tax Return*

The IRS, with stakeholder input, is making the new forms as user friendly as possible.

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THE PROCESS THROUGH THE END OF 2008

No changes in the process will be made in 2008 for correcting errors. Employers and taxpayers will continue to:

- Use Form 941c to correct the amounts they previously reported on Forms 941, 943, 944, and 945; and
- Attach Form 941c to current employment tax return when making adjustments or to Form 843 when claiming a refund of overpaid employment taxes.

THE PROCESS BEGINNING JANUARY 1, 2009

Beginning in 2009, the process for correcting errors becomes easier and more accurate. Each stand-alone form corresponds line-by-line with the employment tax return it is correcting. For example, an employer who discovers an underpayment or overpayment error on a previously-filed Form 941 will use Form 941X to make a correction. The titles of the new forms have the “X” suffix after the form number. The description title includes the word “Adjusted” at the beginning, and “or Claim for Refund” at the end. For example, Form 941X corresponds with Form 941. Its title is *Adjusted Employer’s QUARTERLY Federal Tax Return or Claim for Refund*.

Because these are stand-alone forms, employers and payers can file them as soon as they discover an error. They do not have to wait until they file their next tax return.

Form 941 and other employment tax returns for the 2009 tax year are being revised to eliminate prior-period adjustment lines that no longer apply with the implementation of the new forms. Therefore, the implementation of the new series of forms makes Form 941c obsolete.

Form 940, *Employer’s Annual Federal Unemployment (FUTA) Tax Return*, is not being revised. Employers can continue to use Form 940 to file an amended return.

The new forms can be downloaded on www.irs.gov beginning January 2009.

Note. Spanish versions of the new forms (Forms 941-PR, 944-PR, and 944(SP)) are being developed as well.

OVERPAYMENT

Beginning in 2009, an employer correcting only an overpayment reported on Form 941 makes an adjustment and applies a credit to the quarter in which the Form 941X is filed. The Form 941X is also used to claim a refund.

Overpayments **and** underpayments made on the same Form 941X are treated as adjustments only. No refund is given to the taxpayer. Credit is given on the next Form 941 filed.

BALANCE DUE

Corrections with a balance due can be paid using EFTPS, a credit card, or the filer can send a check along with Form 941X.

INTEREST-FREE ADJUSTMENTS

On July 1, 2008, the IRS published the final regulations on employment tax adjustments and refund claims.¹ The final regulations mirror the proposed regulations with some revisions.

The final regulations allow for interest-free adjustments for underpayments of employment taxes. This applies when a return is filed and less than the correct amount of employee or employer portions of FICA or RRTA tax is reported. If the employer discovers an error after filing the return, he must adjust the resulting underpayment of tax by reporting the additional amount due on an adjusted return for the return period in which the wages or compensation was paid. The adjustment must be made by the due date of the return for the return period in which the error is ascertained, and the amount of the underpayment must be paid by the time the adjustment is made. If not, interest begins to accrue from that date. An underpayment adjustment may only be made in the period of limitations for assessment. If an incorrect amount of income tax is withheld, an adjustment may be made only for errors ascertained during the calendar year in which the wages were paid.

The final regulations also provide a process by which an employer can make an interest-free adjustment if he fails to file a return for a period solely because he failed to treat any individuals as employees. The interest-free adjustment for the reclassified workers is made by filing an original return and attaching an adjusted return reporting the correct amount of tax.

IRS ACTION

The IRS applies both the tax and wage corrections to the actual tax period being corrected. This results in a more accurate account.

Example 1. When preparing 2008 Forms W-2, the bookkeeper for Ever Ready Machine Shop discovered that he failed to report on Form 941 a paycheck that was given to one of the employees. He filed the Form 941 for the quarter ending December 31, 2008, on January 15, 2009.

Form 941X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*, is filed to correct errors discovered after January 1, 2009. It is completed and submitted as soon as the error is discovered. The 2008 Form W-2 for the employee is completed using the correct 2008 information.

¹. TD 9405 (July 1, 2008)

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Form 941X: Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund

(January 2009)

Department of the Treasury — Internal Revenue Service

OMB No. 1545-XXXX

Employer Identification Number (EIN) -

Name (not your trade name)

Trade name (if any)

Address

Number Street Suite or room number

City State ZIP code

Use this form to correct errors made on Form 941 or Form 941-SS, Employer's QUARTERLY Federal Tax Return, for one quarter only. Please type or print within the boxes.

You MUST complete all three pages. Read the instructions before you complete this form.

Part 1: Select ONLY one process.

- ☐ 1. **Adjusted employment tax return.** Check this box if you underreported or overreported amounts and you would like to use the adjustment process to correct the errors. You must check this box if you are correcting both underreported and overreported amounts on this form. The amount shown on line 17, if less than 0, may only be applied as a credit to your Form 941, Form 941-SS, Form 944, or Form 944-SS for the tax period in which you are filing this form.
- ☐ 2. **Claim for refund of employment taxes.** Check this box if you overreported amounts only and you would like to use the claim process to ask for a refund or abatement for the amount shown on line 17. Do not check this box if you are correcting ANY underreported amounts on this form.

Return You Are Correcting ...

Check the type of return you are correcting:

- ☐ 941
☐ 941-SS

Check the ONE quarter you are correcting:

- ☐ 1: January, February, March
☐ 2: April, May, June
☐ 3: July, August, September
☐ 4: October, November, December

Enter the Calendar Year of the quarter you are correcting:

(YYYY)

Enter the date you discovered errors:

/ /
(MM / DD / YYYY)

Part 2: Complete the certifications.

- ☐ 3. **I certify that I have filed or will file Forms W-2, Wage and Tax Statement, or Forms W-2c, Corrected Wage and Tax Statement, as required.**

Note: If you are correcting underreported amounts only, go to Part 3 (Skip lines 4 and 5).

4. **If you checked line 1 because you are adjusting overreported amounts, check all that apply.** (Check at least one.)

I certify that...

- ☐ a. I repaid or reimbursed each affected employee for the overcollected federal income tax for the current year and the overcollected social security and Medicare tax for current and prior years. For adjustments of employee social security and Medicare tax overcollected in prior years, I have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.
- ☐ b. the adjustment of social security tax and Medicare tax is for the employer's share only. I could not find the affected employees or each employee did not give me a written statement that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.
- ☐ c. the adjustment is for federal income tax, social security tax, and Medicare tax that I did not withhold from employee wages.

5. **If you checked line 2 because you are claiming a refund or abatement of overreported employment taxes, check all that apply.** (Check at least one.)

I certify that...

- ☐ a. I repaid or reimbursed each affected employee for the overcollected social security and Medicare tax. For refund claims of employee social security and Medicare tax overcollected in prior years, I have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.
- ☐ b. I have a written consent from each affected employee stating that I may file this refund claim for the employee's share of social security and Medicare tax. For refunds of employee social security and Medicare tax overcollected in prior years, I also have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.
- ☐ c. the refund claim for social security tax and Medicare tax is for the employer's share only. I could not find the affected employees; or each employee did not give me a written consent to file a refund claim for the employee's share of social security and Medicare tax; or each employee did not give me a written statement that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.
- ☐ d. the refund claim is for federal income tax, social security tax, and Medicare tax that I did not withhold from employee wages.

For Privacy Act and Paperwork Reduction Act Notice, see xxxxxxxxxxxxxxxx.

Cat. No. XXXXXX

Form 941X (1-2009)

Next

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Name (not your trade name)	Employer Identification Number (EIN)	Quarter (1,2,3,4)
		Calendar Year (YYYY)

3: Enter the corrections for this quarter. If any line does not apply, leave it blank.

	Column 1 Total corrected amount (For ALL employees)	Column 2 Amount originally reported or as previously corrected (For ALL employees)	Column 3 Difference (If this amount is a negative number, use a minus sign.)	Column 4 Tax correction
6. Wages, tips and other compensation (from line 2 of Form 941)	<input type="text"/>	<input type="text"/>	<input type="text"/>	Use the amount in Column 1 when you prepare your Forms W-2 or Forms W-2c.
7. Income tax withheld from wages, tips, and other compensation (from line 3 of Form 941)	<input type="text"/>	<input type="text"/>	<input type="text"/>	Copy Column 3 here ▶▶ <input type="text"/>
8. Taxable social security wages (from line 5a, Column 1 of Form 941 or Form 941-SS)	<input type="text"/>	<input type="text"/>	<input type="text"/>	X .124* = <input type="text"/>
9. Taxable social security tips (from line 5b, Column 1 of Form 941 or Form 941-SS)	<input type="text"/>	<input type="text"/>	<input type="text"/>	X .124* = <input type="text"/>
10. Taxable Medicare wages and tips (from line 5c, Column 1 of Form 941 or Form 941-SS)	<input type="text"/>	<input type="text"/>	<input type="text"/>	X .029* = <input type="text"/>
11. Tax adjustments (from lines 7a through 7c of Form 941 or Form 941-SS)	<input type="text"/>	<input type="text"/>	<input type="text"/>	Copy Column 3 here ▶▶ <input type="text"/>
12. Special addition to wages for federal income tax	<input type="text"/>	<input type="text"/>	<input type="text"/>	See instructions <input type="text"/>
13. Special addition to wages for social security taxes	<input type="text"/>	<input type="text"/>	<input type="text"/>	See instructions <input type="text"/>
14. Special addition to wages for Medicare taxes	<input type="text"/>	<input type="text"/>	<input type="text"/>	See instructions <input type="text"/>
15. Subtotal: Combine the amounts on lines 7–14 of Column 4.....				<input type="text"/>
16. Advance earned income credit (EIC) payments made to employees (from line 9 of Form 941)	<input type="text"/>	<input type="text"/>	<input type="text"/>	See instructions <input type="text"/>
17. Total: Combine the amounts in lines 15 and 16 of Column 4.....				<input type="text"/>

If line 17 is less than 0...

- If you checked line 1, this is the amount you want applied as a credit to your Form 941 or Form 941-SS for the tax period in which you are filing this form. (If you are currently filing a Form 944 or Form 944-SS, Employer's ANNUAL Federal Tax Return, see the instructions.)
- If you checked line 2, this is the amount you want refunded.

If line 17 is more than 0, this is the amount you owe. Pay this amount when you file this return. Go to *Amount You Owe* on page 5 of the instructions.

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Name (not your trade name)	Employer Identification Number (EIN)	Quarter (1,2,3,4)
		Calendar Year (YYYY)

Part 4: Explain your corrections for this quarter.

- ☐ 18. Check here if any corrections you entered for this quarter include both underreported and overreported amounts. Explain both your underreported and overreported amounts on line 20.
- ☐ 19. Check here if any corrections involve reclassified workers. Explain on line 20.
20. You must give us a detailed explanation of how you determined your corrections. (See the instructions.)

[illegible]

Part 5: Sign here. You must fill out all three pages of this form and sign it.

Under penalties of perjury, I declare that I have filed an original Form 941 or Form 941-SS and that I have examined this adjusted return or claim for refund and any schedules or statements that are attached and to the best of my knowledge and belief, they are true, correct, and complete.

Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

X Sign your name here

Vision Draft 6/3/08

Date _____

	/	/
--	---	---

Best daytime phone

() --

Paid preparer's use only

Paid Preparer's signature

Firm's name (or yours if self-employed)
Address

Date _____

		EIN	
		ZIP code	
/ /	Phone () --	SSN/PTIN	

☐ Check if you are self employed

NONFILERS

REDUCING THE FEDERAL TAX GAP

In an August 2, 2007 report, the IRS discussed its new compliance goals.² For 2001, the IRS estimated over 86% of all tax liabilities were collected. However, the amount of unpaid tax for 2001 was estimated to be approximately \$345 billion. The unpaid tax is referred to as the **tax gap**. After enforcement efforts and late payments, this gap was reduced by \$55 billion to \$290 billion. The IRS considers this unacceptably large. Such a large gap places a disproportionate share of the revenue burden on compliant taxpayers.

Note. Much of the information included in this section was obtained from the August 2007 report.

In order to determine sources of the tax gap, the IRS implemented the National Research Program (NRP). The NRP allows the IRS to gather audit information. To date, the program has focused on individual and S corporation returns.

The IRS recognizes that the causes for noncompliance are numerous, and only a portion is due to intentional avoidance or evasion of the law. An important part of the compliance problem stems from the growing complexity of the tax laws, which continues to frustrate efforts to improve compliance.

In order for taxpayers to be considered compliant, the Code places three primary obligations on them:

1. To **file** timely returns,
2. To **make accurate reports** on those returns, and
3. To **pay** the required tax voluntarily and timely.

Noncompliance results when taxpayers do not fulfill these obligations.

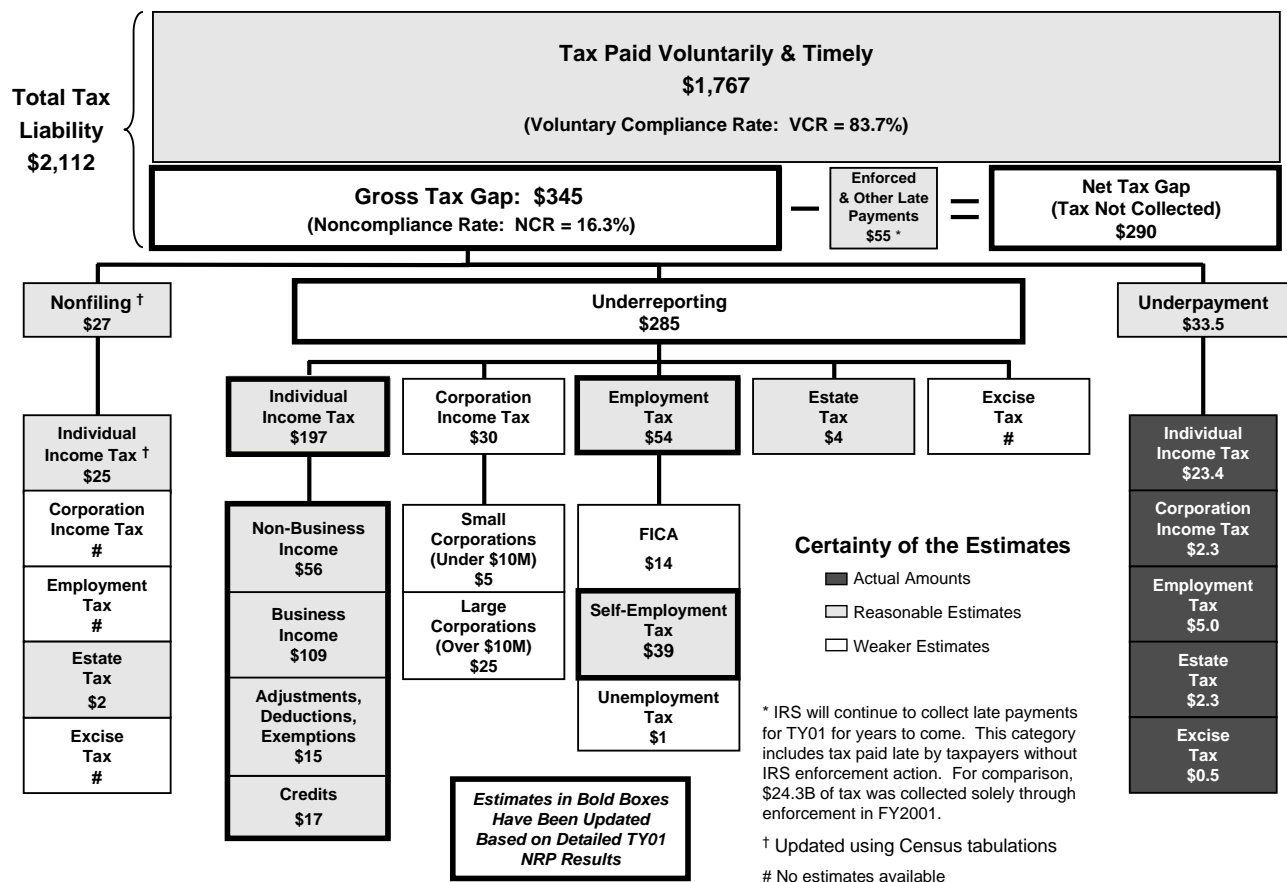
True tax liability refers to the amount of tax that would be assessed if all relevant aspects of the tax law are correctly applied to all the relevant facts of that taxpayer's situation. For a variety of reasons, this amount can differ from the amount of tax that a taxpayer reports on a return.

The IRS defines **nonfiler** as a taxpayer who must file a tax return, but has not filed timely either by the original due date or the approved extension date. Many of these taxpayers eventually file returns and are reclassified as **late filers**. An estimated \$25 billion of the 2001 tax gap is due to individual nonfilers.

² IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Aug. 2, 2007)

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TAX GAP MAP for Tax Year 2001 (in \$ Billions)



TYPES OF NONFILERS

Nonfilers fall into one of several categories:

- **Repeat nonfilers** are noncompliant in the year they are identified and one or both of the previous two tax years.
- **Skip filers** file in some years and not in others.
- **Stop filers** filed for a number of years, and then stopped filing.

PREPARING NONFILER RETURNS

As the IRS continues its quest to reduce the tax gap, tax practitioners can expect to see more effort placed on locating nonfilers. Consequently, they can expect more nonfilers to seek their services.

The first step in completing a return for a nonfiler is conducting a thorough interview. The preparer must understand the nature of the client's business in order to determine the information that may be available to complete the return.

For the self-employed nonfiler, supporting information includes bank statements and canceled checks. If these are unavailable, the client can ask his bank to reproduce this information. If the nonfiler does not have a bank account, the preparer must ask questions to arrive at an estimate of the nonfiler's gross income. Typical questions include:

1. How much do you charge for an average job?
2. How long does an average job take?
3. How many jobs do you typically complete in a week?

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4. How many weeks per year do you work?
5. Did you maintain a calendar showing your jobs for all or part of the year?
6. Did you file sales tax returns for the year?
7. Did you file employment tax returns?
8. Is your insurance coverage based on the gross receipts of the business? If so, what information did you provide to your insurance company?
9. What type of expenses do you incur for the average job?
10. Are you involved in a partnership or corporation? (If so, request these returns.)

Other information that is needed to complete the return may not be available from the nonfiler. The practitioner may request Information Return Program (IRP) transcripts from the IRS. Payers of certain types of income are required to file information returns with the IRS, and they are generally available for individual taxpayers for a period of six years. Examples of information returns include Forms W-2, 1099-INT, 1099-DIV, 1099-MISC, and so forth. The preparer must file a Form 2848, *Power of Attorney and Declaration of Representative (POA)*, before the IRS can release this information to anyone other than the taxpayer.

Note. If the nonfiler has a business and the tax preparer is not familiar with the type of business, she may want to refer to the IRS audit technique guide (ATG) for that industry. These are generally available on the IRS website.

Once the information is collected, the practitioner should subject the information to a reasonability test. The practitioner should consider whether the income is sufficient to support the lifestyle of the nonfiler.

Example 2. Based on the information provided by a new client, the net income of the client's Schedule C business is \$6,000. The preparer's discussion with the client reveals the spouse does not work and the couple has three children, who all attend private school. The house they reside in has mortgage payments of \$1,100 per month. They have no other loans. A quick computation should tell the preparer that the net income is not sufficient to pay the client's yearly personal living expenses.

Generally, the **oldest** returns should be filed first. However, if there is a refund due, it may be held, pending resolution of any unfiled required tax return subsequent to the refund year. A return claiming a refund must be filed before the expiration of the statute for claiming a refund, which is three years from the due date of the delinquent return. For example, the refund statute for tax year 2004 expired on April 15, 2008.

All required returns should be filed according to filing requirements and thresholds established for each tax year.

Before giving the completed returns to the nonfiler, the preparer should require the client to sign a statement that declares the information presented is complete and accurate. The preparer should also collect his preparation fee at this time.

Note. The 2005 *University of Illinois Federal Tax Workbook*, pages 73–86, has an excellent description of the indirect method the IRS may use to determine unreported income. This same technique is available to the tax practitioner if he suspects that all information is not being reported.

Although there is no stated policy, the IRS typically is most concerned with the six prior years' returns. Taxpayer information from these years is available in an IRP transcript.

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Example 3. Stu Dias walks into Megan’s office and asks what it will cost to have a tax return prepared. Her typical answer is, “it all depends.” In order to determine the cost of providing the service, she must know the complexity of the return and what information is available.

After a moment of silence, Stu informs Megan that he has not filed a tax return for the previous 10 years. In addition, he no longer has any records available for the prior nine years. He explains that he is attempting to borrow money and the lender is requiring three years of tax returns. Consequently, he needs these returns within seven days. Stu also tells Megan that he recently received a letter from the IRS inquiring about unfiled returns. Stu is quick to point out that this is not his fault.

The first step Megan takes after submitting a valid POA is to request an IRP transcript from the IRS. She then begins a long interview process. The transcript is shown below.

Wage and Income Transcript

Request Date: 05-31-2008
Response Date: 06-05-2008
Employee Number: xxxxx
Tracking Number: 123456789

SSN Provided: 123-45-6789

Tax Period Requested: December 2005

Form W-2 Wage and Tax Statement

Employer:

Employer Identification Number (EIN):22-2222222

Read & Learn LLC

25 South St

Anywhere, IA 55555

Employee:

Employee’s SSN: 123-45-6789

Stu Dias

99 Sunset Strip

Anywhere, IA 55555

Submission Type:

ORIGINAL SUBMISSION

Wages, Tips and Other Compensation:

\$25,715.00

Federal Income Tax withheld:

\$2,830.00

Social Security Wages:

\$25,715.00

Social Security Tax Withheld:

\$1,594.33

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Medicare Wages and Tips:	\$25,715.00
Medicare Tax Withheld:	\$372.87
Social Security Tips:	.00
Allocated Tips:	.00
Advanced EIC Payment:	.00
Dependent Care Benefits:	.00
Code "Q" Military Pay:	.00
Code "R" Employer's Contribution to MSA:	.00
Code "S" Employer's Contribution to Simple Account:	.00
Code "T" Expenses Incurred for Qualified Adoptions:	.00
Third Party Sick Pay Indicator:	.00
Retirement Plan Indicator:	Yes
Statutory Employee:	Not Statutory Employee

8

Form 1099-INT

Payer:

Payer's Identification Number (EIN): 33-33333333

Last Bank of Iowa

17 Water Street

Anywhere, IA 55555

Recipient:

Recipient's SSN: 123-45-6789

Stu Dias

99 Sunset Strip

Anywhere, IA 55555

Submission Type:

ORIGINAL SUBMISSION

Account Number (Optional): 000555555500

Interest: \$124.00

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Tax Withheld:	.00
Savings Bonds:	.00
Investment Expense:	.00
Interest Forfeiture:	.00
Second Notice Indicator:	No second notice

Form 1099-MISC

Payer:

Payer's Identification Number (EIN): 44-44444444

Henry's Construction

47 Upland Blvd.

Anywhere, IA 55555

Submission Type:

ORIGINAL SUBMISSION

Account Number (Optional):

Rents:

Royalties:

Other Income:

Federal Income Tax Withheld:

Fishing Boat Proceeds:

Medical and Health Care Payments:

Nonemployee Compensation:	\$6,200.00
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Substitute Payments in Lieu of Dividends or Interest:

Payer made direct sales of \$5,000 indicator:

Crop Insurance Proceeds:

Section 409A deferrals:

Section 409A Income:

After looking at the IRP transcript, Megan may ask Stu these or other relevant questions prior to starting the return preparation:

1. The transcript shows you received wages from Read & Learn LLC. Did you work for anyone else during the year?
2. The transcript reports interest income from Last Bank of Iowa. Did you have any other checking, savings, or brokerage accounts?
3. The transcript also shows that you did some work for Henry's Construction as a self-employed person. Did you work for any other contractors?
4. Please describe your work with Henry's Construction. Where did you complete the jobs? Did you provide your own tools? What expenses did you incur for these jobs?
5. Did you have any income not reported on this transcript?
6. Can I see your bank statements? (If Stu's deposits to his checking account exceed the net income shown on the transcript, he should be questioned as to the source of the deposits.)
7. Did you have any loans during this time period? If so, please provide a copy of the loan liability ledger, which can be obtained from your lending institutions.

ADDRESSING NONFILER ISSUES

The Servicewide Nonfiler Executive Advisory Council is the primary coordination body for the IRS on matters related to nonfiling of tax returns across all IRS operating divisions. It also guides development of strategies for improving resource allocation to reduce noncompliance and the tax gap. This function is organizationally located under the deputy commissioner for Services and Enforcement.

The IRS is constantly using research to address nonfiler issues as well as looking at new treatment options. For instance, the High Income Nonfiler Initiative secures returns from individual taxpayers with higher than average annual incomes. Although this group represents only 17% of the total nonfiler population, it contributes to 80% of the total balance due from nonfilers. This is a classic example of the 80/20 rule. A small percentage of nonfilers accounts for the majority of noncompliance dollars.

When taxpayers do not respond to notices, the Automated Substitute for Return (ASFR) program assesses tax based on information-reporting documents. This automated process is essential to addressing the nonfiler population in the most efficient manner possible.

THE NONFILER PLAN

The IRS's plan for nonfiler compliance includes:

- Allocating resources based on a Servicewide approach to ensure end-to-end accountability for nonfiler treatment decisions;
- Developing and implementing consistent Servicewide performance and outcome measures to determine the effect on filing compliance;
- Implementing a Servicewide Nonfiler Communication Program that includes both an internal and external focus to address filing requirements;
- Expanding the use of third-party information and research tools to enhance identification, selection, and resolution of nonfiler cases;
- Ensuring that nonfiler cases meeting fraud criteria are recommended for civil fraud penalties and/or referred for criminal investigation; and
- Encouraging the development and submission of legislative proposals and other regulatory actions to increase filing compliance.

The IRS expects to fully implement the plan beginning in 2009.

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Expand Information Reporting

Third-party reporting is critical for ensuring voluntary compliance. Without third-party reporting, the IRS cannot easily detect errors without expensive and intrusive audits. Currently, the IRS receives over 1.5 billion information returns per year. These returns come from employers, financial institutions, third-party payers, and state and federal governments. However, the IRS still lacks reliable information on certain types of income, most notably income earned by small businesses and the self-employed. In order to increase the availability of information, the IRS proposes to:

- Require information reporting on payments to corporations,
- Require basis reporting on security sales,
- Require expanded broker information reporting,
- Require information reporting on merchant payments and reimbursements,
- Require a certified taxpayer identification number from contractors,
- Require increased information reporting for certain government payments for property and services, and
- Increase information return penalties.

Improving Compliance by Businesses

The IRS believes more efficient filing mechanisms, clearer rules on who is liable for employment taxes, and streamlined collection due process (CDP) will improve business tax compliance. To improve compliance, the IRS wants to:

- Require e-filing by certain large organizations,
- Implement standards clarifying when employee leasing companies can be held liable for their client's federal employment taxes, and
- Amend collection due process procedures for employment liabilities.

Strengthen Tax Administration

The IRS intends to strengthen tax administration through disclosure revisions and stronger penalties for nonfiling. It proposes to do the following:

- Expand the IRS's access to information in the National Directory of New Hires (NDNH) for tax administration purposes. This would require an amendment to the Social Security Act to expand the IRS's access to NDNH data.
- Permit disclosure of prison tax schemes. This would authorize the IRS to disclose certain limited information about tax violations by inmates so prison officials could punish and deter such conduct through administrative sanctions. This is expected to generate \$5 million over the next 10 years.
- Make repeated and willful failure to file a return a felony. A failure-to-file criminal penalty would be assessed on any person who willfully fails to file tax returns within three years of any 5-year period, if the aggregated tax liability is at least \$50,000. This is expected to generate \$12 million over the next 10 years.

Strengthening Preparer Penalties

Part of the tax gap is the result of incompetent or unscrupulous tax preparers. In its attempt to gain better compliance through accurate returns, the IRS proposes the following:

- **Expand Preparer Penalties.** Legislative changes signed on May 25, 2007, implement a version of this proposal. The increased penalties are anticipated to generate over \$80 million of revenue over the next 10 years.
- **Impose a Penalty for Failure to Comply with Electronic-Filing Requirement.** The IRS proposes to assess a \$25,000 penalty for corporations and \$5,000 for exempt organizations who fail to comply with e-filing requirements.
- **Create an Erroneous-Claim Penalty.** This is included in the May 25, 2007 legislation. The law imposes a 20% penalty for the disallowed portion of a claim for refund with no reasonable basis. The change is expected to generate \$80 million over the next 10 years.

Note. For additional discussion of these new and expanded preparer penalties, refer to the following chapters of the 2007 *University of Illinois Federal Tax Workbook*: Chapter 2, “Ethics;” Chapter 14, “New Legislation;” and page 568 of Chapter 15, “Rulings and Cases.” A review of the 2008 regulations related to preparer penalties is also included in Chapter 2, “Ethics,” of this workbook.

Other Goals

In addition to the above initiatives and proposals, the IRS developed these goals related to nonfilers:

- Continue efforts to help taxpayers understand and meet their tax obligations
- Focus on education and outreach to better assess factors that contribute to nonfiling
- Partner with external sources to develop effective outreach actions to reduce chronic nonfiling

Strengthening tax administration and return-preparer penalties are critical components to reducing the nonfiler tax gap numbers.

TAX AUTHORIZATIONS

POWER OF ATTORNEY

When a tax preparer works with the IRS on an examination or collection issue, a power of attorney (POA) is required. Because the legal and financial matters involved in taxation are complex, the IRS requires representatives who practice before the IRS to meet certain professional qualifications and standards. For example, CPAs, attorneys, EAs and enrolled actuaries may be granted authority to act on the taxpayer’s behalf through the use of a power of attorney.

Form 2848, *Power of Attorney and Declaration of Representative*, provides an individual with the authority to act on behalf of a taxpayer and to access returns and tax return information.³ Once Form 2848 is received, the IRS enters the information in the Centralized Authorization File (CAF). This allows an IRS employee to access the POA information and interact with the taxpayer’s representative.

If Form 2848 is faxed to the IRS, it will usually be added to the CAF within 48 hours. A mailed Form 2848 may take up to five days to process. Tax professionals eligible to use e-Services and who complete a Disclosure Authorization application can access client information immediately.

³. IRC §6103(e)(6)

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POA Uses

Once the IRS receives a valid POA, the named representative can:

- Represent the taxpayer before Counsel, Appeals, Collection, and the Automated Collection System;
- Execute closing agreements;
- Extend the statute of limitations;
- Execute waivers;
- Execute claims for refund;
- Negotiate and execute installment agreements; and
- Receive refund checks.

Limitations for Unenrolled Preparers. An unenrolled preparer's ability to practice before the IRS is limited. Generally, an unenrolled preparer is permitted to represent a taxpayer only before customer-service representatives, revenue agents, and other examiners in connection with information pertaining to the tax liability assessed on a return **they prepared**.

An unenrolled return preparer **cannot** perform any of the tasks that named representatives are allowed to do, as listed above.

Reasons for POA Rejection

Form 2848 may be rejected by the IRS for several reasons. They include the following:

- A missing representative and/or taxpayer signature or signature dates.
- A nonspecific identification of tax periods. This includes such wording as "all years" or "all future periods." Writing "2000, 2001, 2002" is recommended.
- When Box 4, *Specific Use Not Recorded on CAF*, is checked, the IRS attempts to contact the taxpayer to verify specific use intent. If the IRS is unable to make telephone contact, the form is rejected for clarification.
- On line 6, the name of the person authorized to receive refunds is listed and the initials of the taxpayer are not present.
- Box 8 is checked and no copy of the POA is attached to identify the retained representative. The revocation has the same years, periods, and tax matters as authorized on the CAF.
- No designation is shown.
- No jurisdiction is shown. This is applicable for designations A, B, C, or G.
- The title of the employee of the company being authorized is not shown.

Modifying Authority

Form 2848, line 5, is used by the taxpayer to grant additional authority or limit the authority provided in the form. When the taxpayer grants authority to more than one representative, but only wishes to modify the authority of one representative, it should be noted on line 5 along with the specific acts.

Unless otherwise specified, the modification applies to all representatives listed in Part II of Form 2848.

Other Types of POAs

Individuals may use a non-IRS power of attorney, provided it contains all information required by regulation. This flexibility becomes important when dealing with tax issues involving taxpayers who placed their financial matters in the hands of relatives (during military deployments), or in situations in which someone is handling the affairs of an elderly person, a minor, or a legally incompetent taxpayer.

The original power of attorney must include some type of language that authorizes the designee to handle federal tax matters. The regulations explain that language giving permission “to perform any and all acts” is sufficient to cover federal tax matters.

The regulations state that the IRS accepts and processes a durable power of attorney if “the attorney-in-fact attaches a statement (signed under penalty of perjury) to Form 2848 stating that the original power of attorney is valid under the laws of the governing jurisdiction.”

The non-IRS POA must include:

- Taxpayer’s name and address;
- Taxpayer’s SSN and/or EIN;
- Taxpayer’s employee plan number, if applicable;
- Name and address of taxpayer’s representative;
- Types of tax involved;
- Federal tax form number;
- Specific year(s) or period(s) involved;
- For estate matters, the decedent’s date of death;
- A clear expression of the taxpayer’s intention concerning the scope of authority granted to the representative; and
- Taxpayer’s signature and date.⁴

To record the authorization on the CAF, a general durable power of attorney valid under state law must be accompanied by Form 2848. More information regarding a non-IRS POA is found in IRS Pub. 947, *Practice Before the IRS and Power of Attorney*, page 8.

Revoking POAs

A POA is valid until it is revoked. It may be revoked by the taxpayer, withdrawn by the representative, or may be superseded by the filing of a new POA for the same type of tax and tax period. If a POA is listed on the CAF and the taxpayer desires to add another representative to the already-listed representative, Form 2848, line 8 must be checked. In addition, a copy of the original authorization for the representative wishing to be retained must be attached.

Example 4. The Bookworm, a sole proprietorship operated by Cornelius Franklin, has been in discussions with the IRS regarding filing his 2006 Form 940. He hired Josephine, a CPA, to help resolve the issue. Both Josephine and Cornelius must sign Form 2848, which follows.

⁴ IRS Pub. 947, *Practice Before the IRS and Power of Attorney* (rev. May 2004)

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For Example 4

Form 2848 (Rev. June 2008) Department of the Treasury Internal Revenue Service	Power of Attorney and Declaration of Representative ► Type or print. ► See the separate instructions.	OMB No. 1545-0150 For IRS Use Only Received by: Name _____ Telephone _____ Function _____ Date ____/____/____
Part I Power of Attorney Caution: Form 2848 will not be honored for any purpose other than representation before the IRS.		
1 Taxpayer information. Taxpayer(s) must sign and date this form on page 2, line 9.		
Taxpayer name(s) and address Cornelius Franklin dba The Bookworm 110 Main Street Anywhere, IA 55555	Social security number(s) _____ _____ Daytime telephone number (111) 555-1212	Employer identification number 11 111111 Plan number (if applicable)
hereby appoint(s) the following representative(s) as attorney(s)-in-fact:		
2 Representative(s) must sign and date this form on page 2, Part II.		
Name and address Josephine Representative 112 Downtown Ave. Anywhere, IA 55555	CAF No. 1111-12345Z Telephone No. 111-555-1213 Fax No. 111-555-9876 Check if new: Address <input type="checkbox"/> Telephone No. <input type="checkbox"/> Fax No. <input type="checkbox"/>	
Name and address	CAF No. _____ Telephone No. _____ Fax No. _____ Check if new: Address <input type="checkbox"/> Telephone No. <input type="checkbox"/> Fax No. <input type="checkbox"/>	
Name and address	CAF No. _____ Telephone No. _____ Fax No. _____ Check if new: Address <input type="checkbox"/> Telephone No. <input type="checkbox"/> Fax No. <input type="checkbox"/>	
to represent the taxpayer(s) before the Internal Revenue Service for the following tax matters:		
3 Tax matters		
Type of Tax (Income, Employment, Excise, etc.) or Civil Penalty (see the instructions for line 3)	Tax Form Number (1040, 941, 720, etc.)	Year(s) or Period(s) (see the instructions for line 3)
Employment Tax	940	2006
4 Specific use not recorded on Centralized Authorization File (CAF). If the power of attorney is for a specific use not recorded on CAF, check this box. See the instructions for Line 4. Specific Uses Not Recorded on CAF <input type="checkbox"/>		
5 Acts authorized. The representatives are authorized to receive and inspect confidential tax information and to perform any and all acts that I (we) can perform with respect to the tax matters described on line 3, for example, the authority to sign any agreements, consents, or other documents. The authority does not include the power to receive refund checks (see line 6 below), the power to substitute another representative or add additional representatives, the power to sign certain returns, or the power to execute a request for disclosure of tax returns or return information to a third party. See the line 5 instructions for more information. Exceptions. An unenrolled return preparer cannot sign any document for a taxpayer and may only represent taxpayers in limited situations. See Unenrolled Return Preparer on page 1 of the instructions. An enrolled actuary may only represent taxpayers to the extent provided in section 10.3(d) of Treasury Department Circular No. 230 (Circular 230). An enrolled retirement plan administrator may only represent taxpayers to the extent provided in section 10.3(e) of Circular 230. See the line 5 instructions for restrictions on tax matters partners. In most cases, the student practitioner's (levels k and l) authority is limited (for example, they may only practice under the supervision of another practitioner). List any specific additions or deletions to the acts otherwise authorized in this power of attorney: _____ _____ _____ _____		
6 Receipt of refund checks. If you want to authorize a representative named on line 2 to receive, BUT NOT TO ENDORSE OR CASH , refund checks, initial here CWF and list the name of that representative below. Name of representative to receive refund check(s) ► Josephine Representative		
For Privacy Act and Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 11980J Form 2848 (Rev. 6-2008)		

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For Example 4

Form 2848 (Rev. 6-2008)

Page **2**

7 Notices and communications. Original notices and other written communications will be sent to you and a copy to the first representative listed on line 2.

- a** If you also want the second representative listed to receive a copy of notices and communications, check this box ☐ **b** If you do not want any notices or communications sent to your representative(s), check this box ☐

8 Retention/revocation of prior power(s) of attorney. The filing of this power of attorney automatically revokes all earlier power(s) of attorney on file with the Internal Revenue Service for the same tax matters and years or periods covered by this document. If you **do not** want to revoke a prior power of attorney, check here. ☐

YOU MUST ATTACH A COPY OF ANY POWER OF ATTORNEY YOU WANT TO REMAIN IN EFFECT.

9 Signature of taxpayer(s). If a tax matter concerns a joint return, **both** husband and wife must sign if joint representation is requested, otherwise, see the instructions. If signed by a corporate officer, partner, guardian, tax matters partner, executor, receiver, administrator, or trustee on behalf of the taxpayer, I certify that I have the authority to execute this form on behalf of the taxpayer.

► **IF NOT SIGNED AND DATED, THIS POWER OF ATTORNEY WILL BE RETURNED.**

Signature	Date	Title (if applicable)
Print Name	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> PIN Number	Print name of taxpayer from line 1 if other than individual
Signature	Date	Title (if applicable)
Print Name	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> PIN Number	

Part II Declaration of Representative

Caution: Students with a special order to represent taxpayers in qualified Low Income Taxpayer Clinics or the Student Tax Clinic Program (levels k and l), see the instructions for Part II.

Under penalties of perjury, I declare that:

- I am not currently under suspension or disbarment from practice before the Internal Revenue Service;
- I am aware of regulations contained in Circular 230 (31 CFR, Part 10), as amended, concerning the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others;
- I am authorized to represent the taxpayer(s) identified in Part I for the tax matter(s) specified there; and
- I am one of the following:
 - a** Attorney—a member in good standing of the bar of the highest court of the jurisdiction shown below.
 - b** Certified Public Accountant—duly qualified to practice as a certified public accountant in the jurisdiction shown below.
 - c** Enrolled Agent—enrolled as an agent under the requirements of Circular 230.
 - d** Officer—a bona fide officer of the taxpayer's organization.
 - e** Full-Time Employee—a full-time employee of the taxpayer.
 - f** Family Member—a member of the taxpayer's immediate family (for example, spouse, parent, child, brother, or sister).
 - g** Enrolled Actuary—enrolled as an actuary by the Joint Board for the Enrollment of Actuaries under 29 U.S.C. 1242 (the authority to practice before the Internal Revenue Service is limited by section 10.3(d) of Circular 230).
 - h** Unenrolled Return Preparer—the authority to practice before the Internal Revenue Service is limited by Circular 230, section 10.7(c)(1)(viii). You must have prepared the return in question and the return must be under examination by the IRS. See **Unenrolled Return Preparer** on page 1 of the instructions.
 - k** Student Attorney—student who receives permission to practice before the IRS by virtue of their status as a law student under section 10.7(d) of Circular 230.
 - l** Student CPA—student who receives permission to practice before the IRS by virtue of their status as a CPA student under section 10.7(d) of Circular 230.
 - r** Enrolled Retirement Plan Agent—enrolled as a retirement plan agent under the requirements of Circular 230 (the authority to practice before the Internal Revenue Service is limited by section 10.3(e)).

► **IF THIS DECLARATION OF REPRESENTATIVE IS NOT SIGNED AND DATED, THE POWER OF ATTORNEY WILL BE RETURNED.** See the Part II instructions.

Designation—Insert above letter (a–r)	Jurisdiction (state) or identification	Signature	Date
b	Iowa		

Form **2848** (Rev. 6-2008)

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A Form 2848 is not necessary when an individual only needs to receive tax information. For that purpose, a Form 8821, *Tax Information Authorization*, is acceptable.

TAX INFORMATION AUTHORIZATION

At times, a representative only needs some specific information to resolve a tax issue. This information is available if a Form 8821, *Tax Information Authorization*, is filed.

Form 8821 allows an appointee to inspect and/or receive confidential tax information. It is generally limited to the specific tax matter described on the form. An appointee can be an individual, corporation, firm, organization, or partnership. Form 8821 does **not** allow the named individual to represent the taxpayer.

Form 8821 may be rejected for the following reasons:

- A missing taxpayer signature or date,
- Nonspecific identification of tax periods (tax matters), or
- An incorrect EIN/SSN that the IRS cannot identify or verify through their records.

A tax information authorization, submitted via Form 8821, is also valid until revoked. It may be revoked by the taxpayer or withdrawn by the representative. It is superseded by filing a new Form 8821, and it can coexist with a POA.

Example 5. Use the same facts as **Example 4**. The Bookworm only wants Josephine to resolve the amount of gross wages reported on the Form 940. Therefore, a Form 8821, *Tax Information Authorization*, can be used.

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For Example 5

Form 8821 (Rev. April 2004) Department of the Treasury Internal Revenue Service	Tax Information Authorization ▶ Do not use this form to request a copy or transcript of your tax return. Instead, use Form 4506 or Form 4506-T.	OMB No. 1545-1165 For IRS Use Only Received by: _____ Name _____ Telephone () _____ Function _____ Date ____/____/____
-------------------------------------------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------------------------------------

1 Taxpayer information. Taxpayer(s) must sign and date this form on line 7.

Taxpayer name(s) and address (type or print) Cornelius Franklin dba The Bookworm 110 Main Street Anywhere, IA 55555	Social security number(s) _____ _____ _____ Daytime telephone number (111) 555-1213	Employer identification number 11 : 1111111 Plan number (if applicable)
-----------------------------------------------------------------------------------------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------	----------------------------------------------------------------------------------------------

2 Appointee. If you wish to name more than one appointee, attach a list to this form.

Name and address Josephine Representative 112 Downtown Avenue Anywhere, IA 55555	CAF No. 1111-12345Z Telephone No. 111-555-1213 Fax No. 111-555-9876 Check if new: Address <input type="checkbox"/> Telephone No. <input type="checkbox"/> Fax No. <input type="checkbox"/>
----------------------------------------------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

3 Tax matters. The appointee is authorized to inspect and/or receive confidential tax information in any office of the IRS for the tax matters listed on this line. Do not use Form 8821 to request copies of tax returns.

(a) Type of Tax (Income, Employment, Excise, etc.) or Civil Penalty	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s) (see the instructions for line 3)	(d) Specific Tax Matters (see instr.)
Employment tax	940	2006	Resolve amount of wages reported

4 Specific use not recorded on Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions on page 3. If you check this box, skip lines 5 and 6. ▶ ☐

5 Disclosure of tax information (you **must** check a box on line 5a or 5b unless the box on line 4 is checked):

a If you want copies of tax information, notices, and other written communications sent to the appointee on an ongoing basis, check this box ▶ ☒

b If you do not want any copies of notices or communications sent to your appointee, check this box ▶ ☐

6 Retention/revocation of tax information authorizations. This tax information authorization automatically revokes all prior authorizations for the same tax matters you listed on line 3 above unless you checked the box on line 4. If you do not want to revoke a prior tax information authorization, you **must** attach a copy of any authorizations you want to remain in effect **and** check this box ▶ ☐
To revoke this tax information authorization, see the instructions on page 3.

7 Signature of taxpayer(s). If a tax matter applies to a joint return, **either** husband or wife must sign. If signed by a corporate officer, partner, guardian, executor, receiver, administrator, trustee, or party other than the taxpayer, I certify that I have the authority to execute this form with respect to the tax matters/periods on line 3 above.
▶ **IF NOT SIGNED AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED.**

<div style="border-bottom: 1px solid black; margin-bottom: 5px;"></div> Signature	<div style="border-bottom: 1px solid black; margin-bottom: 5px;"></div> Date	<div style="border-bottom: 1px solid black; margin-bottom: 5px;"></div> Signature	<div style="border-bottom: 1px solid black; margin-bottom: 5px;"></div> Date
Print Name	Title (if applicable)	Print Name	Title (if applicable)
□ □ □ □ □ PIN number for electronic signature		□ □ □ □ □ PIN number for electronic signature	

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 11596P **Form 8821** (Rev. 4-2004)

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Specific use on Form 8821, line 4, refers to authorizations that are intended to be used one time only, such as when resolving an EIN or address problem. Other examples include the following:

- Income verification;
- Small business elections;
- Deceased taxpayers;
- Form 56, *Notice Concerning Fiduciary Relationship*;
- Nonresident alien issues;
- Form 843, *Claim for Refund and Request for Abatement* claims; and
- Form 1096, *Annual Summary and Transmittal of U. S. Information returns* issues.

Special-use authorization is also submitted by probation officers, case workers, and professionals in similar situations. These authorizations are **not** posted to the CAF.

THIRD-PARTY DESIGNEE AUTHORIZATION

The IRS made it easier for taxpayers to authorize the tax practitioner to discuss a current return with the IRS. At the bottom of page 2 of Form 1040 is a checkbox where the taxpayer can make this authorization. The purpose of the third-party authorization is to allow the prompt resolution of tax matters that arise during the life of the authorization. It grants the designee the authority to exchange verbal information with the IRS regarding return processing, payment, and refund issues. The checkbox allows the designee to continue to exchange information with the IRS in order to resolve tax issues, and it allows the designee to receive written account information upon request.

The checkbox authorization expires on the 1-year anniversary of the due date of the tax return (not including extensions). The IRS **cannot** extend the third-party designation beyond the 12-month period.

USING e-SERVICES TO OBTAIN AUTHORIZATIONS

Unenrolled preparers who actively participant in the IRS e-file program and who e-file five or more accepted individual or business returns in a season are eligible to use the **e-Services Disclosure Authorization** application. Effective November 1, 2007, all Circular 230 enrolled preparers have unlimited access to the e-Service products whether or not they e-file their clients' returns.

Disclosure authorization allows tax professionals to electronically submit both Form 2848 and Form 8821. Eligible tax professionals may complete authorization forms, view and modify existing authorization application forms, and receive acknowledgement of accepted submissions immediately.

Professionals approved for e-Services can also use the **Electronic Account Resolution (EAR)** product and the **Transcript Delivery System (TDS)**.

REDUCING EIC ERRORS THROUGH DUE DILIGENCE

The IRS estimates that individual tax returns erroneously claim between \$10 billion and \$12 billion in earned income tax credits (EIC) each year. Although the IRS is committed to helping eligible taxpayers receive the EIC they deserve, the IRS is also committed to reducing incorrect claims.

COMMON ERRORS

Tax professionals prepare 70% of EIC claims. Part of the IRS's approach to reduce erroneous claims is ensuring that tax professionals are meeting their four EIC due-diligence requirements as mandated by IRC §6695(g). Due diligence compliance can help avoid the three most common errors:

- Claiming children who do not meet the age, relationship, and residency tests;
- Incorrectly claiming head-of-household filing status to qualify for the credit; and
- Over- or underreporting income to maximize the credit.

Age Test

In order to meet the age test for a qualifying child, the taxpayer's child must be:

1. Under age 19 at the end of the tax year;
2. Under age 24 at the end of the tax year if a full-time student; or
3. Permanently and totally disabled at any time during the tax year, regardless of age.

Example 6. Denzel turns 19 on December 10 and is not disabled or a full-time student. He is not a qualifying child.

Student Test

To qualify as a student, the child must, during some part of each of any five months during the calendar year, be:

1. A full-time student at a school that has a regular teaching staff, course of study, and regular student body; or
2. A student taking a full-time, on-farm training course given by a school as described in the first requirement, or by a state, county, or local government.

The five months need not be consecutive. A student is full-time if enrolled for the number of hours or courses the school considers full-time attendance.

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

Students who work in co-op jobs in private industry as part of a school's regular course of classroom and practical training are considered full-time students.

Permanently and Totally Disabled Test

A qualifying child is permanently and totally disabled if **both** of the following apply:

1. He cannot engage in any substantial gainful activity because of a physical or mental condition.
2. A doctor determines the condition has lasted or can be expected to last continuously for at least one year or can lead to death.

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Relationship Test

To be the taxpayer's qualifying child, the child must be the taxpayer's:

- Son, daughter, stepchild, foster child, or a descendent of any of these; or
- Brother, sister, half brother, half sister, stepbrother, stepsister, or a descendent of any of these.

The following definitions clarify the relationship test.

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

Foster Child. For the EIC, a person is the taxpayer's foster child if the child is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of the court of competent jurisdiction. Authorized placement agencies include state or local government agencies, tax-exempt organizations licensed by a state, and Indian tribal governments or organizations authorized by an Indian tribal government to place Indian children.

Example 7. Debbie is two years old. She was taken to a babysitter's home one year ago and abandoned. She still resides with the babysitter but is not considered a foster child. She was not placed by an agency. Therefore, Debbie does not meet the relationship test for the babysitter to claim the EIC.

Residency Tests

The child must live with the taxpayer in the United States for more than half of the year. The following definitions clarify the residency test.

United States. The United States includes the 50 states and the District of Columbia. It **does not** include Puerto Rico or U.S. possessions such as Guam.

Homeless Shelter. The taxpayer's home can be any location where he regularly lives. He does not need a traditional home. For example, if the child lived with the taxpayer more than half of the year in one or more homeless shelters, the child meets the residency test.

Military Personnel Stationed outside the United States. Military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period for purposes of the EIC.

Extended Active Duty. **Extended active duty** means the taxpayer is called or ordered to duty for an indefinite period or for a period of more than 90 days. Once the taxpayer begins serving his extended active duty, he is still considered on extended active duty even if he does not serve more than 90 days.

Birth or Death of a Child. A child who was born or died in 2008 is treated as having lived with the taxpayer for all of 2008, provided the taxpayer's home was the child's home for the entire time he was alive.

Temporary Absences. The time that the taxpayer and child are away from home on a temporary absence due to special circumstances counts as time the child lived with the taxpayer. Examples of special circumstances include illness, school attendance, business, vacation, military service, and detention in a juvenile facility.

Kidnapped Child. A kidnapped child is treated as living with the taxpayer for more than half the year if the child lived with the taxpayer more than half of the part of the year **before** the kidnapping occurred. The child must be presumed by law-enforcement authorities to have been kidnapped by someone who is not a member of the taxpayer's family or the child's family. This treatment applies for all years until the child is returned. However, the last year to which this treatment can apply is:

1. The year there is a determination that the child is dead, or
2. The year the child would have reached age 18.

If the taxpayer's qualifying child was kidnapped and meets these requirements, "EIC" is entered instead of a number on line 6 of Schedule EIC.

Married Child. If the taxpayer's child was married at the end of the year, he does not meet the relationship test unless either of these two situations applies to the taxpayer:

1. The taxpayer can claim the child's exemption, or
2. The reason the taxpayer cannot claim the child's exemption is that the taxpayer gave the right to the child's exemption to the other parent by signing Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*.

Filing Status

Married Filing Separately. If a taxpayer is married, he usually files a joint return to claim the EIC. For EIC purposes, the filing status cannot be married filing separately. In some circumstances, the taxpayer may file as head of household.

Head of Household. To qualify for head-of-household filing status, a taxpayer must be unmarried or considered unmarried on the last day of the year. The taxpayer is considered unmarried if the following tests are met:

1. He files a separate return.
2. He paid more than half the cost of maintaining a home for the tax year.
3. His spouse did not live in the taxpayer's home at any time during the last six months of the year. The spouse is considered to live in the taxpayer's home even if she is temporarily absent due to special circumstances.
4. The taxpayer's home was the main home of the taxpayer's child, stepchild, or foster child for more than half the year.
5. The taxpayer is able to claim an exemption for the child. However, this test is met if the taxpayer cannot claim the exemption only because the noncustodial parent can claim the child using the support test for divorced or separated parents.

DUE-DILIGENCE REQUIREMENTS

There are four due-diligence requirements. Three of them address form completion and recordkeeping. The fourth is the most challenging because it requires paid preparers to thoroughly understand the EIC tax laws and ask reasonable questions. The tax practitioner preparing the EIC claim **must meet all** the following due-diligence requirements:

1. Complete Form 8867, *Paid Preparer's EIC Checklist*, or an equivalent form, based on information either provided by the client or reasonably obtained by the preparer. Tax preparers are expected to ask, and explain as needed, each of the 19 questions designed to ensure consideration of all aspects that affect eligibility.
2. Complete the EIC worksheet in the Form 1040 series instructions, or an equivalent form. The preparer's records must reflect the information and computation method used in the EIC calculation.
3. Retain these records for three years after June 30 following the date the return was presented to the taxpayer for signature.
4. Have no knowledge (as well as no reason to know) that any information used in determining the taxpayer's eligibility for computing the EIC is incorrect. A tax practitioner cannot ignore the implication of information furnished to, or known by, the practitioner and must make reasonable inquiries if the information appears to be incorrect, inconsistent, or incomplete.

This fourth requirement, also called the **knowledge requirement**, compels tax preparers to evaluate information received from clients and apply a consistency and reasonableness standard to the information. **Tax preparation software programs generally do not address these issues and the preparer should not rely upon software to meet this requirement.**

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A paid preparer, knowledgeable in the tax law, must make additional inquiries when the information furnished by the client warrants questioning. More than **90%** of the due diligence penalties proposed against tax professionals last year were for failure to comply with the knowledge requirement.

The following examples show situations in which additional inquiries must be made to meet the due diligence knowledge requirement.

Example 8. Renee states that she is separated from her spouse. Her son lives with her, and she wants to claim EIC and head-of-household filing status.

The preparer must ask appropriate questions to determine the correct filing status and determine how long the child lived with each parent during the year. Possible questions include:

- Did you live with your spouse during the tax year?
- On what date did you or your spouse move out of your joint home?
- After you moved to separate living quarters, how many days did your son live with you? How many days did your son live with your spouse?

Example 9. Holly is an unmarried 18-year-old client. She mentions that she and her infant daughter live with her parents. She earned \$3,000 from a part-time job and wants to claim the EIC.

The preparer must ask appropriate questions to determine whether this taxpayer is a qualifying child of her parents (whether or not the parents claim her), and is therefore ineligible to claim the EIC. Possible questions include:

- How long did you live with your parents last year?
- Can anyone else claim the child?

Example 10. Thackeray is 22 years old. He claims to have two sons who are ages 10 and 11 that are his qualifying children for the EIC.

Because the ages of the children appear inconsistent with the client's age, the return preparer should ask appropriate questions and request adequate documentation to determine whether the children are really his. Possible questions include:

- Are these your natural children, adopted children, or stepchildren?
- Can anyone else claim these children as qualifying children?

The IRS annually visits tax professionals and conducts EIC due-diligence visits. Tax practitioners are selected for visits based on the high probability that the returns they prepare have EIC errors.

Tax practitioners who fail to comply with any of the four EIC due-diligence requirements can be assessed a \$100 penalty for each failure. The assessment of return-related penalties against a tax practitioner may result in disciplinary action by the IRS Office of Professional Responsibility. These penalties can also result in suspension or expulsion of the practitioner's firm from participation in the IRS e-file program, and injunction proceedings barring the practitioner from preparing tax returns.

The IRS does not propose due-diligence penalties if the preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with due-diligence requirements, and the failure to meet the requirements on a given return was isolated and inadvertent.

2008 Workbook

Form **8867**
(Rev. December 2006)
Department of the Treasury
Internal Revenue Service

Paid Preparer's Earned Income Credit Checklist

OMB No. 1545-1629

▶ Do not send to the IRS. Keep for your records.

For the definitions of the following terms, see Pub. 596 for the year for which you are completing this form.

- Investment Income • Qualifying Child • Earned Income

- A Taxpayer's name ▶
B If joint return, spouse's name ▶

Part I All Taxpayers

1	Year after 2005 for which you are completing this form ▶	
2	Is the taxpayer's filing status married filing separately? ▶ If you checked "Yes" on line 2, stop; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
3	Does the taxpayer (and the taxpayer's spouse if filing jointly) have a social security number (SSN) that allows him or her to work or is valid for EIC purposes? See the instructions before answering ▶ If you checked "No" on line 3, stop; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
4	Is the taxpayer filing Form 2555 or Form 2555-EZ (relating to the exclusion of foreign earned income)? ▶ If you checked "Yes" on line 4, stop; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
5a	Was the taxpayer a nonresident alien for any part of the year on line 1? ▶ If you checked "Yes" on line 5a, go to line 5b. Otherwise, skip line 5b and go to line 6.	<input type="checkbox"/> Yes <input type="checkbox"/> No
b	Is the taxpayer's filing status married filing jointly? ▶ If you checked "Yes" on line 5a and "No" on line 5b, stop; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
6	Is the taxpayer's investment income more than the limit that applies to the year on line 1? See Pub. 596 for the limit ▶ If you checked "Yes" on line 6, stop; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
7	Could the taxpayer, or the taxpayer's spouse if filing jointly, be a qualifying child of another person for the year on line 1? ▶ If you checked "Yes" on line 7, stop; the taxpayer cannot take the EIC. Otherwise, go to Part II or Part III, whichever applies.	<input type="checkbox"/> Yes <input type="checkbox"/> No

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 26142H

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Part II Taxpayers With a Child	Child 1	Child 2
Caution. If there are two children, complete lines 8 through 14 for one child before going to the next column.		
8 Child's name		
9 Is the child the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them?	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
10 Is either of the following true? <ul style="list-style-type: none"> • The child is unmarried, or • The child is married and can be claimed as the taxpayer's dependent. 	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
11 Did the child live with the taxpayer in the United States for over half of the year? See the instructions before answering.	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
12 Was the child (at the end of the year on line 1)— <ul style="list-style-type: none"> • Under age 19, • Under age 24 and a full-time student (see definition in Pub. 596), or • Any age and permanently and totally disabled? <p>► If you checked "Yes" on lines 9, 10, 11, and 12, the child is the taxpayer's qualifying child; go to line 13a. If you checked "No" on line 9, 10, 11, or 12, the child is not the taxpayer's qualifying child. If there is more than one child, complete lines 8 through 14 for the other child(ren) (but for no more than two qualifying children). If the taxpayer does not have a qualifying child, go to Part III to see if the taxpayer can take the EIC for taxpayers who do not have a qualifying child.</p>	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
13a Could any other person check "Yes" on lines 9, 10, 11, and 12 for the child? <p>► If you checked "No" on line 13a, go to line 14. Otherwise, go to line 13b.</p>	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
b Enter the child's relationship to the other person(s)		
c If the tiebreaker rules apply, would the child be treated as the taxpayer's qualifying child? See the instructions before answering <p>► If you checked "Yes" on line 13c, go to line 14. Otherwise, explain to the taxpayer that if both the taxpayer and the other person(s) claim any of the six tax benefits listed on page 4, the IRS will apply the tiebreaker rules, and the taxpayer's benefits may be disallowed. Then, if the taxpayer wants to take the EIC based on this child, complete lines 14 and 15. If not, and there are no other qualifying children, the taxpayer cannot take the EIC, including the EIC for taxpayers without a qualifying child; do not complete Part III. If there is more than one child, complete lines 8 through 14 for the other child(ren) (but for no more than two qualifying children).</p>	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Don't know	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Don't know
14 Does the qualifying child have an SSN that allows him or her to work or is valid for EIC purposes? See the instructions before answering <p>► If you checked "No" on line 14, the taxpayer cannot take the EIC based on this child and cannot take the EIC for taxpayers who do not have a qualifying child. If there is more than one child, complete lines 8 through 14 for the other child(ren) (but for no more than two qualifying children). If you checked "Yes" on line 14, continue.</p>	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
15 Are the taxpayer's earned income and adjusted gross income each less than the limit that applies to the taxpayer for the year on line 1? See Pub. 596 for the limit <p>► If you checked "No" on line 15, stop; the taxpayer cannot take the EIC. If you checked "Yes" on line 15, the taxpayer can take the EIC. Complete Schedule EIC and attach it to the taxpayer's return. If there are two qualifying children with valid SSNs, list them on Schedule EIC in the same order as they are listed here. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to see if Form 8862 must be filed. Go to line 20.</p>		<input type="checkbox"/> Yes <input type="checkbox"/> No

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Part III Taxpayers Without a Qualifying Child

16 Was the taxpayer's main home, and the main home of the taxpayer's spouse if filing jointly, in the United States for more than half the year? (Military personnel on extended active duty outside the United States are considered to be living in the United States during that duty period. See Pub. 596.) ▶ If you checked " No " on line 16, stop ; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
17 Was the taxpayer, or the taxpayer's spouse if filing jointly, at least age 25 but under age 65 at the end of the year on line 1? ▶ If you checked " No " on line 17, stop ; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
18 Is the taxpayer, or the taxpayer's spouse if filing jointly, eligible to be claimed as a dependent on anyone else's federal income tax return for the year on line 1? ▶ If you checked " Yes " on line 18, stop ; the taxpayer cannot take the EIC. Otherwise, continue.	<input type="checkbox"/> Yes <input type="checkbox"/> No
19 Are the taxpayer's earned income and adjusted gross income each less than the limit that applies to the taxpayer for the year on line 1? See Pub. 596 for the limit ▶ If you checked " No " on line 19, the taxpayer cannot take the EIC. If you checked " Yes " on line 19, the taxpayer can take the EIC. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to find out if Form 8862 must be filed. Go to line 20.	<input type="checkbox"/> Yes <input type="checkbox"/> No

Part IV Due Diligence Requirements

20 Did you complete Form 8867 based on information provided by the taxpayer or reasonably obtained by you?	<input type="checkbox"/> Yes <input type="checkbox"/> No
21 Did you complete the EIC worksheet found in the Form 1040, 1040A, or 1040EZ instructions (or your own worksheet that provides the same information as the 1040, 1040A, or 1040EZ worksheet)?	<input type="checkbox"/> Yes <input type="checkbox"/> No
22 Did you comply with the knowledge requirements? (To comply with the knowledge requirements, you must not know or have reason to know that any information used to determine the taxpayer's eligibility for, and the amount of, the EIC is incorrect. You may not ignore the implications of information furnished to or known by you, and you must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete.)	<input type="checkbox"/> Yes <input type="checkbox"/> No
23 Did you keep the following records? • Form 8867 (or your own form or files), • The EIC worksheet(s) or your own worksheet(s), and • A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained ▶ If you checked " Yes " on lines 20, 21, 22, and 23, and keep the records described on line 23 for 3 years (see instructions), you have complied with all the due diligence requirements. ▶ If you checked " No " on line 20, 21, 22, or 23, you have not complied with all the due diligence requirements and may have to pay a \$100 penalty for each failure to comply.	<input type="checkbox"/> Yes <input type="checkbox"/> No

General Instructions



Do not use this form for a year before 2006. Instead, use the November 2002 version of the form for years after 2001 but before 2006.

Purpose of Form

Paid preparers of federal income tax returns or claims for refund involving the earned income credit (EIC) must meet the due diligence requirements in determining if the taxpayer is eligible for, and the amount of, the EIC. Failure to do so could result in a \$100 penalty for each failure. See Internal Revenue Code section 6695(g) and Part IV of this form.

Specific Instructions

Line 2

If the taxpayer was married at the end of the year, he or she must usually file a joint return to take the EIC. However, if the taxpayer and his or her spouse did not live together for the last 6 months of the year, the taxpayer may be eligible to use the head of household filing status. See Pub. 501 for details.

Line 3

For purposes of taking the EIC, an SSN issued by the Social Security Administration (SSA) is not valid if "Not Valid for Employment" is printed on the social security card **and** the number was issued solely to apply for or receive a federally funded benefit. Any other SSN issued by the SSA is valid for EIC purposes. You may find it useful to look at the social security card.

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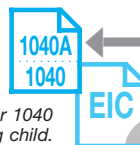
SCHEDULE EIC (Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on return

Earned Income Credit Qualifying Child Information

Complete and attach to Form 1040A or 1040
only if you have a qualifying child.



OMB No. 1545-0074

2008

Attachment
Sequence No. **43**

Your social security number

- Before you begin:**
- See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 65a and 65b, to make sure that (a) you can take the EIC, and (b) you have a qualifying child.
 - Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.



- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.

Qualifying Child Information

Child 1

Child 2

	First name	Last name	First name	Last name
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.				
2 Child's SSN The child must have an SSN as defined on page 41 of the Form 1040A instructions or page 47 of the Form 1040 instructions unless the child was born and died in 2008. If your child was born and died in 2008 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate, death certificate, or hospital medical records.				
3 Child's year of birth	Year ____		Year ____	
	<i>If born after 1989, skip lines 4a and 4b; go to line 5.</i>		<i>If born after 1989, skip lines 4a and 4b; go to line 5.</i>	
4 If the child was born before 1990—				
a Was the child under age 24 at the end of 2008 and a student?	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue.</i>	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue.</i>
b Was the child permanently and totally disabled during any part of 2008?	<input type="checkbox"/> Yes. <i>Continue.</i>	<input type="checkbox"/> No. The child is not a qualifying child.	<input type="checkbox"/> Yes. <i>Continue.</i>	<input type="checkbox"/> No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)				
6 Number of months child lived with you in the United States during 2008 <ul style="list-style-type: none"> • If the child lived with you for more than half of 2008 but less than 7 months, enter "7." • If the child was born or died in 2008 and your home was the child's home for the entire time he or she was alive during 2008, enter "12." 	_____ months <i>Do not enter more than 12 months.</i>		_____ months <i>Do not enter more than 12 months.</i>	



You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2008, and (b) is a U.S. citizen, U.S. National, or U.S. resident alien. For more details, see the instructions for line 41 of Form 1040A or line 67 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions.

Cat. No. 13339M

Schedule EIC (Form 1040A or 1040) 2008

Help and additional information is available online at **www.irs.gov**. Whether preparers need to check clients' qualifications for the EIC, market their EIC services, or ensure their tax practice complies with the EIC due-diligence requirements, they can find toolkits, interactive Web features, and resources online at any time. Preparers can walk clients through the qualification process with the EIC Assistant at **www.irs.gov/EIC**. Preparers can find the EIC Toolkit for tax professionals at **www.EITCfortaxpreparers.com**.

ELECTRONIC RECORDS

In an effort to reduce expenses and improve efficiency, many vendors now provide customers with electronic records in lieu of paper documents. For example, banks no longer return cancelled checks and may only provide an electronic bank statement. Some credit card companies e-mail an electronic monthly statement to their cardholders.

Many clients pay their bills electronically. Consequently, they do not have a paper copy of either the bill or the cancelled check. The new electronic world has created questions regarding how the IRS looks at these documents in the event of a client's audit.

RECORD REGULATIONS

The IRC provides little guidance on record requirements. If a person or business is liable for any tax, sufficient records must be kept, statements rendered, and returns produced. The person or business must comply with any rules and regulations as prescribed by the Secretary. The taxpayer must be able to show whether or not he is liable for the tax.⁵

The taxpayer must keep permanent books of account or records. This includes inventories, information sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on the tax return.⁶

Note. Farmers and wage earners are required to keep records that allow the IRS to determine the correct amount of income subject to tax. Neither is required to keep the books of account or records required of other taxpayers;⁷ however, they will likely want to keep their own records to ensure they get all possible deductions.

Books and records must be retained and be available for inspection by the IRS for as long as the contents are material to the administration of tax law.⁸

EMPLOYEE RECORDS

Even though most employees will receive a pay stub and a yearend W-2, it is advisable for all employees to keep a permanent and accurate record of wages. Items to retain include dates of pay, amount of each check, and name and address of employer.

IRS PUBLICATIONS

Other than the above, any further information regarding records and record retention comes from IRS pronouncements and publications. IRS Pub. 552, *Recordkeeping for Individuals*, explains, "If you use a computerized system, you must be able to produce legible records of the information needed to determine your correct tax liability. In addition to your computerized records, you must keep proof of payment, receipts, and other documents to prove the amounts shown on your tax return."⁹ Unfortunately, this does not indicate what must be retained if the source documents are also electronic.

⁵ IRC §6001

⁶ Treas. Reg. §1.6001-1(a)

⁷ Treas. Reg. §1.6001-1(b)

⁸ Treas. Reg. §1.6001-1(e)

⁹ IRS Pub. 552, *Recordkeeping for Individuals* (rev. Apr. 2005)

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IRS Pub. 583, *Starting a Business and Keeping Records*, does a better job explaining the records needed for taxpayers operating a business. It gives the following suggestions:¹⁰

1. Gross receipts can be verified with the following:
 - Cash register tapes
 - Bank deposit slips
 - Receipt books
 - Invoices
 - Credit card charge slips
 - Forms 1099-MISC
2. Purchases can be verified with the following:
 - Cancelled checks
 - Cash register tapes
 - Credit card slips
 - Invoices
3. Expenses can be verified with the following:
 - Cancelled checks
 - Cash register tapes
 - Account statements
 - Credit card slips
 - Invoices and petty cash slips for small cash purchases

Pub. 583 also answers the question, “What if I don’t have a cancelled check?” The publication indicates a taxpayer may be able to prove payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. The following table lists acceptable account statements.

If payment is by...	Then the statement must show the...
Check	<ul style="list-style-type: none">• Check number• Amount• Payee’s name• Date the check amount was posted to the account by the financial institution
Electronic funds transfer	<ul style="list-style-type: none">• Amount transferred• Payee’s name• Date the transfer was posted to the account by the financial institution
Credit card	<ul style="list-style-type: none">• Amount charged• Payee’s name• Transaction date

¹⁰ IRS Pub. 583, *Starting a Business and Keeping Records* (rev. Jan. 2007)

Note. Proof of payment of an amount, by itself, does not establish the taxpayer is entitled to a tax deduction. The taxpayer should keep other documents such as credit card sales slips and invoices to show that he also incurred the cost.¹¹

ELECTRONIC STORAGE SYSTEM

Pub. 583 explains that records maintained in an electronic storage system are accepted for recordkeeping purposes if the system complies with Rev. Proc. 97-22.¹² An electronic storage system is one that either images hardcopy (paper) books and records, or transfers computerized books and records to an electronic storage media.¹³

The electronic expense documents must show the date, name of the vendor, what was purchased, and the cost. The taxpayer must also be able to prove that the expense was paid.

RECORD RETENTION

Records must be retained as long as they are needed for tax administration. This is the period of time that the IRS can assess additional tax or the taxpayer can amend his return. While this is typically three years, the period may be longer in some cases. Retention periods are as follows:

If the taxpayer...	Then the period is...
1. Owes additional tax and situations (2), (3), and (4) do not apply	3 years
2. Does not report income that should have been reported, and it is more than 25% of the gross income shown on the return	6 years
3. Files a fraudulent return	Not limited
4. Does not file a return	Not limited
5. Files a claim for credit or refund after the return is filed	Later of 3 years after due date or 2 years after tax was paid
6. Files a claim for loss for a worthless security or a bad-debt deduction	7 years

Caution. Many tax preparers are eliminating paper in their offices. They only retain scanned documents and electronic copies of returns. As computer systems are updated, they must be sure these documents are accessible. In addition, they should keep an off-premise, back-up electronic copy of these records.

¹¹. Ibid

¹². Rev. Proc. 97-22, CB 1997-1

¹³. IRS Pub. 583, *Starting a Business and Keeping Records* (rev. Jan. 2007)

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