

Chapter 6: IRS Representation and Procedures

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Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

AUDIT RECONSIDERATION¹

6

The IRS's Information Returns Processing (IRP) System² receives data submitted by employers and other third-party payers that report payments made to taxpayers during the year. Such data includes wages, pensions, interest, and dividends. This information is validated and stored in the Information Return Master File (IRMF). IRP also has two correlation projects that attempt to match the income reported by the third-party payers to the income reported by taxpayers on their individual income tax returns.

If no match is discovered, the potential nonfiler cases are referred to the IRS collection division for possible action.³ If the IRS determines that the taxpayer should have filed a return, the IRS follows a number of specific steps to get the taxpayer to file a return. If these steps go unheeded and no return is filed, the IRS may prepare a substitute for the unfiled return on the taxpayer's behalf.⁴ This return will **not** be taxpayer-friendly. After the IRS prepares the substitute return, it issues Letter 1085, *30-Day Letter Proposed 6020(b) Assessment*, to the taxpayer.⁵ The letter notifies the taxpayer of the unpaid taxes and that the IRS intends to levy to collect the amount owed.

If a match is discovered but indicates significant underreported income, an **underreporter** case is created and routed to the examination division for review.⁶ The IRS then issues Notice CP 2000, which provides a computation of the proposed adjustments to the tax return.⁷

The IRS also selects a certain number of returns for examination each year.⁸ If taxpayers fail to respond to the audit notice, the IRS will propose changes to the return based on the taxpayer's failure to provide supporting documents and information requested in the audit.

¹ IRS Pub. 3598, *What You Should Know about the Audit Reconsideration Process*.

² *Information Returns Processing: Privacy Impact Assessment-Information Returns Processing (IRP)*. Apr. 8, 2014. [www.irs.gov/uac/Information>Returns-Processing] Accessed on Jul. 3, 2014.

³ Ibid.

⁴ IRC §6020(b).

⁵ *Letters and Notices Offering an Appeal Opportunity*. Apr. 15, 2013. [www.irs.gov/Individuals/Letters-and-Notices-Offering-an-Appeal-Opportunity] Accessed on Jul. 3, 2014.

⁶ *Information Returns Processing: Privacy Impact Assessment-Information Returns Processing (IRP)*. Apr. 8, 2014. [www.irs.gov/uac/Information>Returns-Processing] Accessed on Jul. 3, 2014.

⁷ *Letters and Notices Offering an Appeal Opportunity*. Apr. 15, 2013. [www.irs.gov/Individuals/Letters-and-Notices-Offering-an-Appeal-Opportunity] Accessed on Jul. 3, 2014.

⁸ See IRS Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, for information about the return examination selection criteria.

When taxpayers ignore or do not receive the IRS's correspondence, the IRS assesses the additional tax as well as penalties and interest. When a taxpayer finds out about an assessment (usually through the collection procedure), the taxpayer often approaches their tax professional with a sense of urgency.

Example 1. Jan Johnson contacts her tax preparer, Ethan, after she receives a letter from the IRS requesting a payment of \$2,500 in additional taxes for the 2012 tax year. Ethan looks back through his file and finds no indication of what the additional tax is for. After obtaining a Form 2848, *Power of Attorney and Declaration of Representative*, from Jan, he contacts the IRS and discovers that an audit notice was sent to Jan at a previous address and that she did not respond to the request. The IRS disallowed all the expenses claimed on Jan's Schedule C, *Profit or Loss From Business*, resulting in the additional \$2,500 of tax.

THE AUDIT RECONSIDERATION PROCESS⁹

As long as the tax remains unpaid, a taxpayer can participate in the audit reconsideration process to attempt to eliminate or reduce the amount assessed as the result of an audit. The IRS accepts an audit reconsideration request in the following circumstances.

- The taxpayer submits additional information that the IRS has not previously considered that might change the amount of tax owed or credit due.
- The taxpayer files a return after the IRS completed a substitute return for the taxpayer.
- The taxpayer believes the IRS made a computational or processing error in assessing their tax.
- The liability is unpaid or credits are denied.

Example 2. Use the same facts as **Example 1**. Jan indicates to Ethan that she has all the necessary documentation to support her Schedule C expenses. Ethan compiles the information and submits an audit reconsideration request along with the documentation that the IRS has not previously considered.

Following are some of the situations for which the IRS does **not accept** an audit reconsideration request.

- The taxpayer previously agreed to pay the tax by executing Form 906, *Closing Agreement on Final Determination Covering Specific Matters*; a compromise agreement; or an agreement with the Office of Appeals on Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment*.
- The amount of tax owed is the result of a final partnership item adjustment made under the Tax Equity and Fiscal Responsibility Act (TEFRA).
- A final determination has been issued by the United States Tax Court or other court.

The following are the steps that need to be followed by tax professionals who have clients who have gone through an examination and want to address the unresolved issues through the audit reconsideration process.

1. Obtain a copy of the examination report to determine which items are incorrect.
2. Gather the documentation needed to support the correct position.
3. Verify the documentation is **new** information that has not been presented before and is for the correct tax year. If the tax professional is unsure whether the information was previously submitted, the information should be submitted to the IRS.
4. Prepare a letter requesting an audit reconsideration and attach photocopies of the new documentation. This letter should clearly state the areas for which the client is requesting reconsideration as well as the phone numbers at which the IRS can contact the tax professional if more information is needed. A copy of the examination report (Form 4549) should also be attached, if available.

⁹ IRS Pub. 3598, *What You Should Know about the Audit Reconsideration Process*.

5. To enable the IRS to directly communicate with the tax professional, a Form 2848 should also be completed and included with the response.
6. The letter/documentation can either be mailed to the IRS address shown on the examination report or faxed to that office. If documents are faxed, **each** page should contain the taxpayer identification number (TIN) and tax year.

After the IRS evaluates the information sent as part of the audit reconsideration proposal, additional information may be requested. If the taxpayer receives a request for additional information, the information should be submitted as quickly as possible (generally within 30 days). If the taxpayer needs additional time to submit the requested information, the taxpayer or the tax professional should contact the IRS and request an extension of time.

The IRS has the discretion to delay collection activity during the time an audit reconsideration is under way. If additional information is requested and is **not** timely provided, the IRS will likely resume collection activity. For those taxpayers currently making payments under an installment agreement, the payments **must** continue to be made during the time the audit reconsideration is being reviewed. In certain circumstances, such as when a hardship exists, the taxpayer may contact the Taxpayer Advocate Service (1-877-777-4778 or TTY/TTD: 1-800-829-4059) for possible payment relief during the audit reconsideration process.

Once the IRS completes the review, it informs the taxpayer of one of the following results.

- All information submitted was accepted, and the tax previously assessed is eliminated.
- Part of the information submitted was accepted, and the tax assessment is recomputed accordingly.
- None of the information submitted was accepted, and the tax as previously assessed remains the same.

If the taxpayer agrees with the IRS determination, the remaining balance due (if any) should be paid in full, or payment arrangements should be made (such as an installment agreement). If the taxpayer **does not** agree with the determination, the taxpayer can do one of the following.

- Request an appeals conference
- Pay the amount due in full and file a formal claim
- Do nothing, in which case the IRS will send a bill for the amount due

Preparing a Request for Appeal¹⁰

To request a conference with the Office of Appeals, the taxpayer must file a written protest indicating that they are requesting an appeals conference. Generally, this protest must be filed within 30 days of receiving the audit reconsideration determination from the IRS. The taxpayer may represent themselves or have professional representation. If the taxpayer wants the IRS to communicate and provide information to the authorized representative, a completed Form 2848 must be submitted on behalf of the taxpayer.

Small Case Request. A small case request can be filed instead of a written protest if the total of the taxes and penalties charged by the IRS is \$25,000 or less for any one tax period. The following steps should be taken to file a small case request.

- Send a letter requesting consideration by the Office of Appeals.
- Indicate the disputed changes and the reason the proposed change is improper.

¹⁰ *Examination*. Jan. 23, 2014. [www.irs.gov/Individuals/Examination-1] Accessed on Jul. 4, 2014.

For specific guidance in preparing a small case request or protest, refer to Form 12203, *Request for Appeals Review*. Instead of Form 12203, the letter from the IRS may indicate that a different form should be used to file the protest.¹¹ A brief written statement containing all of the required information may also be submitted instead of any specific forms.¹²

Formal Written Protest. A formal written protest should be prepared for all of the following circumstances.

- Situations in which the total amount of taxes and penalties for any one tax period is greater than \$25,000
- Employee plan and exempt organization cases, regardless of the dollar amount at issue
- Partnership and S corporation cases, regardless of the dollar amount at issue

When filing a formal written protest, all of the following information must be included.

- The taxpayer's name, address, and a daytime telephone number
- A statement indicating that the taxpayer wants to appeal the IRS findings to the Office of Appeals
- A copy of the letter that shows the proposed changes
- A list of tax periods or years involved
- A list of each proposed item with which the taxpayer disagrees
- The reasons for disagreement for each item
- The facts supporting the taxpayer's position on each item
- The authority or law, if any, that supports the taxpayer's position on each item
- The following statement: "Under the penalties of perjury, I declare that the facts stated in this protest and any accompanying documents are true, correct, and complete to the best of my knowledge and belief."
- The taxpayer's signature under the perjury statement

Representatives who prepare and sign the protest for the taxpayer must substitute the following declaration for the perjury statement.¹³

- That they submitted the protest and any accompanying documents
- Whether they know personally that the facts stated in the protest and any accompanying documents are true and correct

Bypassing the Appeals Process¹⁴

If the taxpayer and the IRS still disagree after the appeals conference, the taxpayer may be entitled to take their case to the U.S. Tax Court, the U.S. Court of Federal Claims, or a U.S. District Court. If the taxpayer elects to bypass the IRS's appeals system in this way, they should be aware that a case petitioned to the U.S. Tax Court will normally be considered for settlement by an appeals officer before the Tax Court hears the case.

¹¹ *Preparing a Request for Appeals*. Jan. 16, 2014. [www.irs.gov/Individuals/Preparing-a-Request-for-Appeals-1] Accessed on Jul. 4, 2014.

¹² Ibid.

¹³ Ibid.

¹⁴ IRS Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

Formal Claims for Refund

Another option that taxpayers have is to pay the tax in full and then file a claim for refund. Formal claims for refund may be filed using either Form 1040X, *Amended U.S. Individual Tax Return*, or Form 843, *Claim for Refund and Request for Abatement*. The claim should be mailed to the IRS Service Center where the original return was filed.

A separate form should be filed for each year or period involved. Each form should include an explanation of each item of income, deduction, or credit on which the taxpayer is basing the claim. The separate forms should be mailed to the IRS with a cover letter identifying the years for the attached forms.

Claims must be filed for a credit or refund within three years from the date the original return was filed or two years from the date the tax was paid, whichever is later.

Observation. Providing very specific and detailed information to the IRS increases the likelihood that the IRS will address the case in a timely manner.

FORM 1099-K LETTERS TO TAXPAYERS

6

Form 1099-K, *Payment Card and Third Party Network Transactions*, is an information return used by the IRS to increase voluntary tax compliance and improve collections.¹⁵ This form reports payments received through credit cards, debit cards, stored-value cards, and third-party payment networks.¹⁶

The reporting provisions require banks and other payment settlement entities (PSE) to file Form 1099-K for certain transactions, including payments made with bank cards and e-commerce payments (e.g., PayPal and Bill Me Later). For third-party settlement organizations, a de minimis standard applies. Reporting via a Form 1099-K is required only if the gross amount of total reportable payment transactions paid by an organization to a particular payee exceeds \$20,000 and the total number of such transactions exceeds 200 for the calendar year.¹⁷

A **third-party settlement organization**¹⁸ is the central organization that has the contractual obligation to make payments to participating payees (generally, a merchant or business) in a third-party payment network. Characteristics of a third-party payment network include the following.¹⁹

- There is a central organization with whom a substantial number of providers of goods and services have established accounts.
- The organization is not related to the providers.
- There is an agreement between the central organization and the providers to settle transactions between the providers and purchasers.
- Standards and mechanisms are established for settling such transactions.
- Payment in settlement of such transactions is guaranteed.

¹⁵ *General FAQs on Payment Card and Third Party Network Transactions*. Mar. 20, 2014. [www.irs.gov/uac/General-FAQs-on-New-Payment-Card-Reporting-Requirements] Accessed on Jul. 4, 2014.

¹⁶ TD 9496, 2010-43 IRB 484.

¹⁷ *General FAQs on Payment Card and Third Party Network Transactions*. Mar. 20, 2014. [www.irs.gov/uac/General-FAQs-on-New-Payment-Card-Reporting-Requirements] Accessed on Jul. 4, 2014.

¹⁸ Treas. Reg. §1.6050W-1(c).

¹⁹ *Third Party Network Transactions FAQs*. Mar. 20, 2014. [www.irs.gov/uac/Third-Party-Network-Transactions-FAQs] Accessed on Jul. 4, 2014.

One of the most common examples of a third-party settlement organization is an online auction-payment facilitator.²⁰ The online auction-payment facilitator operates only as an intermediary between buyer and seller by transferring funds between accounts in settlement of an auction purchase. They charge sellers a fee for facilitating the transaction.

The following transactions are specifically **excluded** from the Form 1099-K reporting requirements.²¹

- Withdrawal of funds at an automated teller machine (ATM) via payment cards, cash advances, or loans against the cardholder's account
- A check issued in connection with a payment card that is accepted by a merchant or other payee
- Any transaction in which a payment card is accepted as payment by a merchant or other payee who is related to the issuer of the payment card

Form 1099-K can be confusing to recipients. Many PSEs have contracted with an electronic payment facilitator (EPF) or third-party payer (TPP) to make the actual payments.²² If a merchant receives a Form 1099-K and has questions regarding the information it contains, the IRS directs the merchant to contact the filer whose information appears on the upper left corner of the form. If they do not recognize the filer, they should contact the PSE whose information appears on the lower left side above the account number.

Forms 1099-K are due to merchants by January 31 following the end of the tax year.²³ These forms are due to the IRS on February 28 (if paper filed) or March 31 (if electronically filed).²⁴

Form 1099-K is included in the IRS's document matching process (discussed earlier). If the matching process shows an unusually high portion of receipts reported on Form 1099-K compared to the total gross receipts reported on the taxpayer's tax return, the IRS may issue a letter to the taxpayer.²⁵

Observation. The business activity code, which identifies the type of business, allows the IRS to do this type of analysis. Misclassifying the activity might cause the IRS to conclude that the receipts are disproportionate when they are, in fact, standard for that industry.

LETTER 5035

Letter 5035 (which follows) advises the taxpayer that their gross receipts may be underreported. The letter lists the total amounts reported as gross receipts on the tax return, along with each Form 1099-K issued to the taxpayer and the amount reported in box 1.

If the taxpayer receives Letter 5035 and determines that the receipts were reported accurately on the tax return, no additional action must be taken. However, if the taxpayer determines that the income was understated, an amended return should be prepared and submitted as soon as possible.

²⁰ Ibid.

²¹ Treas. Reg. §1.6050W-1(b)(5).

²² Instructions for payee on Form 1099-K, *Payment Card and Third Party Network Transactions*.

²³ Treas. Reg. §1.6050W-1(h)(1).

²⁴ Treas. Reg. §1.6050W-1(g).

²⁵ *New Notices Related to Form 1099-K*. Aug. 27, 2013. [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/New-Notices-Related-to-Form-1099-K] Accessed on Jul. 4, 2014.



Department of the Treasury
Internal Revenue Service

Date:

Taxpayer identification number:

Form:

Tax period(s) ended:

Person to contact:

Contact telephone number:

Contact hours:

Contact fax number:

Notification of Possible Income Underreporting

Why you are receiving this letter

Your gross receipts may be underreported. We received Form(s) 1099-K, *Merchant Card and Third Party Network Payments*, showing your total payments from Merchant Card and Third Party Network transactions. The information from these form(s) and your tax return show an unusually high portion of gross receipts from card payments and other Form 1099-K reportable transactions. Your type of business consistently has a much lower portion of gross receipts from card payments and other Form 1099-K reportable transactions, and a higher portion of gross receipts from other sources (e.g., cash and checks).

Listed below is the information reported to us:

- Your reported gross receipts are: \$
- Your gross amount of merchant card and third party network payments from Form(s) 1099-K are: \$

Below are the Form(s) 1099-K we received for your business and the corresponding Gross Merchant Card and Third Party Network payments for each form:

Form 1099-K Filers	Reported 20	Gross Amount of Merchant Card and Third Party Network Payments (Box 1)
	\$	
	\$	
	\$	
	\$	
	\$	

Letter 5035 (11-2012)
Catalog Number 59959C

2014 Workbook

What you need to do

Please review the information above for accuracy. Additionally, review your computation of gross receipts for your business(es) as reported on your 20 tax return. Make sure that you fully reported receipts from all sources, including card, cash, and checks.

What happens next

If you don't find any inaccuracies in your review, no further action is required at this time. When you file next year's tax return, remember to include receipts from all income sources.

For additional information regarding Form 1099-K reporting, you can refer to the information available at www.irs.gov by searching key words, "Third Party Reporting Information Center."

If you have questions, you can call us at the number shown above.

Thank you for your cooperation.

Sincerely yours,

[Signature_Name]
[Signature_Title]

Letter 5035 (11-2012)
Catalog Number 59959C

LETTER 5036²⁶

The first page of **Letter 5036** provides the same information as Letter 5035. However, this letter **requires** that the taxpayer respond to the IRS within 30 days, even if the return is filed correctly.

The first step after receiving Letter 5036 is to determine whether the Form 1099-K information reported to the IRS is accurate. If it is not, the taxpayer must write to the IRS and indicate which information on the Forms 1099-K is incorrect.

The taxpayer should also review all of the information used to prepare the original return to verify that all of the income was reported. In particular, the taxpayer should verify that all noncard sources such as cash and checks are included in income.

Letter 5036 recommends that the taxpayer consider the following issues before responding to the IRS.

- Do gross receipts include all of the following?
 - ♦ Sales from all sources, including goods and services
 - ♦ All payment types, including card payments, cash, checks, and other noncard amounts
- How does the percentage of cash, check, and other noncard amounts that are included in gross receipts compare to the types of payments the business accepts?
- If the business has online sales, what is the total percentage of online sales compared with over-the-counter sales?
- Did the business share a card terminal with any other persons or businesses during the year? If so, does the Form 1099-K include transactions belonging to another person or business?
- Did the business include sales tax collected as part of gross receipts? Did the business take a deduction for sales taxes paid?
- Does the taxpayer's business have any unique situations that might explain why the amount of gross receipts from transactions reported on Form 1099-K are disproportionate to other businesses in the same industry?

If the taxpayer responds that the return that was filed is correct, the IRS will review the information and do one of the following.

- Request additional information or clarification
- Send a follow-up letter stating that no further action is required
- Propose an adjustment to the tax amount due

If the taxpayer determines that their return is not correct, an amended return should be prepared. The amended return should be sent to the IRS address indicated on the letter. A copy of Letter 5036 should be attached, along with an explanation of what changes were made as the result of this correspondence.

²⁶ Letter 5036 (Rev. 3-2013). [www.irs.gov/pub/irs-utl/L5036_IRDM_Amended_Return_Initial_Contact_Letter.pdf] Accessed on Jul. 4, 2014.

LETTER 5039²⁷

Letter 5039 is very similar to Letter 5035 but does not contain the Form 1099-K information provided to the IRS. Instead, a Form 14420, *Verification of Reported Income*,²⁸ is enclosed. The taxpayer is asked to complete Form 14420 in its entirety to explain why the portion of the taxpayer's gross receipts from noncard payments appears unusually low for this type of business. Once the IRS receives the taxpayer's response, the IRS determines whether additional information is needed. It may then close the case with no changes needed or propose an adjustment to the tax amount due based on the information submitted.

Example 3. Jack Mason received a Form 1099-K showing information for credit card sales at his clothing store. The IRS subsequently issued Letter 5039 to Jack.

After receiving the letter, Jack contacts his tax professional, Debbie, and together they do the following.

- Complete Form 14420
- Review his tax records to determine whether his gross receipts were accurately reported
- Contact the IRS with their questions about how to complete Form 14420

After reviewing all the relevant information, Debbie determines that Jack has underreported his gross receipts by \$1,405 due to a math error. Debbie prepares an amended return that includes the additional \$1,405 as income and Jack pays the additional tax due. The letter Debbie prepares explains the discrepancy in the income reported.

Jack's Form 1099-K, original Schedule C, Letter 5039, and Form 14420 follow.

FILER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no.		FILER'S federal identification no.	OMB No. 1545-2205	Payment Card and Third Party Network Transactions
First National Bank 102 West Elm Notown, IL 62115		47-012511	2013 Form 1099-K	
Check to indicate if FILER is a (an): Payment settlement entity (PSE) <input checked="" type="checkbox"/> Electronic Payment Facilitator (EPF)/Other third party <input type="checkbox"/>		PAYEE'S taxpayer identification no. 34-8449500	1 Gross amount of payment card/third party network transactions \$ 11670.03	Copy B For Payee This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Check to indicate transactions reported are: Payment card <input checked="" type="checkbox"/> Third party network <input type="checkbox"/>		2 Merchant category code 5691	3 Number of payment transactions 157	
PAYEE'S name Jack Mason Street address (including apt. no.) 515 Carter Street City or town, province or state, country, and ZIP or foreign postal code Smalltown, IL 60110		4 Federal income tax withheld \$	5a January \$ 438.73	
		5b February \$ 612.82		
		5c March \$ 445.51		
		5d April \$ 1782.61		
		5e May \$ 1118.83		
		5f June \$ 996.63		
		5g July \$ 2206.75		
		5h August \$ 1252.33		
PSE'S name and telephone number First National Bank		5i September \$ 1163.30	5j October \$ 502.48	
Account number (see instructions) Tracking #: 105876873		5k November \$ 724.83	5l December \$ 425.21	
		6 State IL	7 State identification no. -----	8 State income tax withheld \$

Form **1099-K**

(Keep for your records)

www.irs.gov/form1099k

Department of the Treasury - Internal Revenue Service

²⁷ Letter 5039 (Rev. 3-2013). [www.irs.gov/pub/irs-utl/L5039_IRDM_Worksheet_Initial_Contact.pdf] Accessed on Jul. 4, 2014.

²⁸ Form 14420 (Rev. 1-2014) [www.irs.gov/pub/irs-pdf/f14420.pdf] Accessed on Jul. 4, 2014.

For Example 3

**SCHEDULE C
(Form 1040)**Department of the Treasury
Internal Revenue Service (99)**Profit or Loss From Business**
(Sole Proprietorship)► For information on Schedule C and its instructions, go to www.irs.gov/schedulec.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2013
Attachment
Sequence No. **09**

Name of proprietor

Jack Mason

Social security number (SSN)

111-11-1111**A** Principal business or profession, including product or service (see instructions)**Men's Clothing Store****B** Enter code from instructions► **4 4 8 1 1 0****C** Business name. If no separate business name, leave blank.**Jack's Apparel****D** Employer ID number (EIN), (see instr.)**3 4 8 4 4 9 5 0 0****E** Business address (including suite or room no.) ► **515 Carter Street**City, town or post office, state, and ZIP code **Smalltown, IL 60110****F** Accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ►**G** Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on losses . ☒ Yes ☐ No**H** If you started or acquired this business during 2013, check here . ☐**I** Did you make any payments in 2013 that would require you to file Form(s) 1099? (see instructions) . ☐ Yes ☒ No**J** If "Yes," did you or will you file required Forms 1099? . ☐ Yes ☐ No**Part I Income**

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked	► <input type="checkbox"/>	1	22,080
2	Returns and allowances		2	
3	Subtract line 2 from line 1		3	22,080
4	Cost of goods sold (from line 42)		4	14,500
5	Gross profit. Subtract line 4 from line 3		5	7,580
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)		6	
7	Gross income. Add lines 5 and 6	►	7	7,580

Part II Expenses**Enter expenses for business use of your home only on line 30.**

8	Advertising	8	250	18	Office expense (see instructions)	18	180
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	2,500
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	6,925	21	Repairs and maintenance	21	345
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15	475	23	Taxes and licenses	23	1,380
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17	250	25	Utilities	25	3,300
28	Total expenses before expenses for business use of home. Add lines 8 through 27a	►		26	Wages (less employment credits)	26	
29	Tentative profit or (loss). Subtract line 28 from line 7			27a	Other expenses (from line 48)	27a	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30			b	Reserved for future use	27b	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.			28		28	15,605
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.			29		29	(8,025)
				30		30	
				31		31	(8,025)

32a ☒ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2013

For Example 3



Department of the Treasury
Internal Revenue Service

Jack Mason
515 Carter St.
Smalltown, IL 60110

Date: **12-15-14**
Taxpayer identification number:
34-8449500
Form:
1040
Tax period(s) ended:
Dec. 31, 2013
Person to contact:
J Madison
Contact telephone number:
(202) 829-1120
Contact hours:
8:00am - 4:30pm EST
Contact fax number:
(202) 829-1129

Notification of Possible Income Underreporting

Why you are receiving this letter

Your gross receipts may be underreported. Your return, when compared to your total payments from Form(s) 1099-K, *Merchant Card and Third Party Network Payments*, reflects an unusually high portion of gross receipts from card payments and other Form 1099-K reportable transactions. Businesses of your type in comparable locations consistently report a larger portion of gross receipts from non-card sources, including cash and checks. Given the amount of Form 1099-K reportable transactions attributed to your business, a larger amount of noncard revenue would be expected.

Listed below is the information reported to us:

- Your reported gross receipts are: \$ **22,080.00**
- Your gross amount of merchant card and third party network payments from Form(s) 1099-K are: \$ **11,670.03**

What you need to do

You must respond within 30 days from the date of this letter. Failure to furnish a complete, accurate response may result in further compliance action.

Review all information used in preparing your tax return to make sure you are fully reporting receipts from all sources, including payment card and non-card sources such as cash and checks. We are enclosing Form 14420, *Verification of Reported Income*, which you should complete in its entirety to explain why the portion of your gross receipts from non-card payments appears unusually low for your type of business. Return the completed Form 14420 and a copy of this letter in the enclosed envelope.

Letter 5039 (Rev. 3-2013)
Catalog Number 59964V

For Example 3

Form 14420 (January 2014)	Department of the Treasury - Internal Revenue Service Verification of Reported Income	OMB Number 1545-2236
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Taxpayer name Jack Mason	Taxpayer Identification Number 34-8449500	For tax period ending 2013
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This form provides additional information to help explain why the portion of your gross receipts from card sales and other Form 1099-K reportable transactions is higher than expected.

Step 1 – Review the Form 1099-K information below and note any corrections.

Filer's Name	Filer's Federal ID Number	Reported Gross Amount from Form 1099-K (Box 1)	Reported Merchant Category Code (MCC) and industry (Box 2)	Number of purchase transactions (Box 3)
1. First National Bank	47-0125111	\$ 11,670	5691	157
2.		\$		
3.		\$		
4.		\$		
5.		\$		

Review the following questions and indicate your answers in the comment box for Step 1.

- If any of the payments shown above were not made to you, list the Form(s) 1099-K that do not belong to you.
 - In addition, if you shared/leased your card terminal with/to the business(es) that received the payments, note this in the "comments for Step 1" box and complete Step 3.
- If you received a Form 1099-K from any filer not listed above, please add the details of this Form 1099-K in the table above or in the Comments section below. If you require additional space, please attach a separate sheet. Please return a copy of the Form 1099-K with this worksheet.
 - If you have received Forms 1099-K from more than five filers, verify that the Reported Gross Amount on the fifth row is the total of the gross amounts for the fifth and beyond filers. If the total Reported Gross Amount is correct, you do not need to return a Form 1099-K for any filer combined in the fifth row.
- If a listed Merchant Category Code (MCC) in column 4 of the table above is not representative of your business' primary industry, please note the error below and describe your business' primary industry. Additionally, inform your merchant acquirer that your Merchant Category Code (MCC) classification requires change.
- If the Number of purchase transactions (column 5) is blank for any row, please include the number (#) of purchase transactions during the tax period for the given filer (typically available on your merchant acquirer statements). If this information is unavailable, leave blank.
- If any other error was found (e.g. the amount on the Form 1099-K is incorrect), identify the error and provide the corrected information.

Comments for Step 1

I only received 1 Form 1099-K.

Step 2 - Please provide dollar estimates of your annual gross sales for the types of sales noted in Steps 2a - 2c. If you are a sole proprietor and filed more than one Schedule C for this tax period, provide the total amount across all businesses. Include any details, if relevant, in the comment box for Step 2.

2a. Estimated gross sales from remote payments made by card (e.g. online sales, orders taken and paid over phone)	\$ 11,670
2b. Estimated gross sales from gift cards	\$ 1,500
2c. Estimated gross sales from lottery tickets	\$ 0

Catalog Number 59955K

For Paperwork Reduction Act Notice, see page 3.

Form **14420** (Rev. 1-2014)

2014 Workbook

For Example 3

Page 2 of 4

Taxpayer name Jack Mason	Taxpayer Identification Number 34-8449500
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Comments for Step 2

I do not sell lottery tickets. I only sell a few gift cards each year and some of those are never brought in and redeemed. I include them in income only when they are cashed in. If they are never redeemed, I do not believe I have to include them in my income.

Step 3 - If you shared your card terminal(s) with other persons or businesses at any time during the tax year, complete the section below.

- In the table below, list the names, taxpayer identification numbers, and dollar amounts of payment card receipts attributable to any persons or businesses you shared or leased your terminal and indicate whether or not you filed a Form 1099 for these businesses. If you shared/leased your card terminal(s) with more than four other persons or businesses, provide the details on the fifth and subsequent persons/businesses in the comment box for Step 3 or on a separate sheet.
- Provide a brief explanation of how these businesses are related to your own in the comment box for Step 3 or on a separate sheet.

Name of Person or Business	Taxpayer Identification Number (SSN or EIN)	Payment Card Receipts	Did you file a Form 1099 showing these receipts for this person or business
		\$	<input type="checkbox"/> Yes <input type="checkbox"/> No
		\$	<input type="checkbox"/> Yes <input type="checkbox"/> No
		\$	<input type="checkbox"/> Yes <input type="checkbox"/> No
		\$	<input type="checkbox"/> Yes <input type="checkbox"/> No

Comments for Step 3

I am the only one who uses this terminal.

Step 4 – Indicate whether you included the following non-income items in the Gross Receipts line on your tax return. If you included them in your Gross Receipts, please provide the dollar amounts below. Include any details, if relevant, in the comment box for Step 4.

4a. Sales tax included in the Gross Receipts line	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
4b. Total sales taxes paid during tax period	\$
4c. Merchant acquirer fees included in the Gross Receipts line	<input type="checkbox"/> Yes <input type="checkbox"/> No
4d. Total merchant acquirer fees paid during tax period	\$

Comments for Step 4

I do not include the sales tax in gross receipts. I take a deduction for sales tax I pay on line 23 of Schedule C.

For Example 3

Page 3 of 4

Taxpayer name Jack Mason	Taxpayer Identification Number 34-8449500
Step 5 - Does your business have a website? If so, please provide the business web address below and a brief description of your online business in the comment box for Step 5.	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
Web address www.JacksApparel.com	
Comments for Step 5 I sell men's clothing online.	

Step 6 - In the comment box (or attach a separate sheet) please provide any other information to explain why cash and checks seem to account for a lower portion of your reported gross receipts than expected for your type of business, given the amount of card payments you received.

Comments for Step 6

My store is only open on weekends, except during the holiday shopping season. Therefore, I have more online sales compared to in-store sales than other stores in the industry.

Step 7 - Provide the taxpayer's contact information. If the contact person is not the taxpayer or an officer of the business and a valid Form 2848, *Power of Attorney and Declaration of Representative*, has not previously been submitted, please include a signed Form 2848 with your response.

Name and title of taxpayer Jack Mason	Telephone number 847-555-1234	Contact hours 9 AM - 3 PM
	Telephone number	Contact hours
Name and title of authorized representative (if applicable)	Telephone number	Contact hours
	Telephone number	Contact hours

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. Providing this information is voluntary. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping** No additional time beyond that required to prepare the tax return; **Learning about the law or the form** 2-4 hrs; **Preparing, copying and sending the form to the IRS** 3-6 hrs.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Catalog Number 59955K

Form **14420** (Rev. 1-2014)

LETTER 5043²⁹

Letter 5043 contains the same information as Letter 5036 but omits the paragraph asking the taxpayer to review the Form 1099-K for accuracy. Everything else — including the 30-day requirement, the list of documents to review, and the issues to consider — is the same.

If the taxpayer determines that the tax return was filed correctly, they should respond with a written explanation of why the amount of gross receipts from noncard payments appears unusually low. If the return filed was incorrect, an amended return should be sent along with Letter 5043. The amended return should contain an explanation of what changes are being made along with the reasons for these changes.

IRS LETTERS TO TAX PROFESSIONALS

The IRS estimates that almost 60% of tax returns filed are prepared by paid practitioners.³⁰ By contacting preparers directly, the IRS hopes that it will increase compliance more effectively than by targeting individual taxpayers.³¹ In November 2013, the agency began its fifth year of a direct effort to heighten awareness within the professional community about preparer responsibilities and thereby improve the accuracy and quality of tax returns prepared by paid professionals.³²

The IRS uses several ways to identify preparers who may not be preparing returns correctly. Tax return preparers may receive a variety of letters from the IRS.

LETTER 5105³³

Letter 5105 explains that the IRS has reviewed tax returns prepared by the practitioner during the past year and has found that many of the returns have a high percentage of traits the IRS believes typically indicate errors on Schedule C. This letter reminds tax professionals of their **due diligence responsibilities** in this area and provides educational assistance. It also warns the recipient that **both the preparer and their clients could face negative consequences** from inaccurate returns.

²⁹ Letter 5043 (Rev. 3-2013). [www.irs.gov/pub/irs-utl/L5043_Notification_of_Possible_Income_Underreporting_Initial_Contact_Letter.pdf] Accessed on Jul. 4, 2014.

³⁰ IRS Pub. 4832, *Return Preparer Review*.

³¹ Ibid.

³² *IRS Letters and Visits to Return Preparers*. Dec. 19, 2013. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits-to-Return-Preparers] Accessed on Jul. 4, 2014.

³³ *IRS Letters and Visits — Letter 5105*. Dec. 2, 2013. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits--Letter-5105] Accessed on Jul. 4, 2014.

IRS Letters and Visits - Letter 5105

Note: The following is the text of Letter 5105 the IRS sent out to selected tax return preparers nationwide in December 2013.

We reviewed tax returns you prepared in the past year and found that many have a high percentage of traits we believe typically indicate errors on Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship). This letter reminds you of your responsibilities in this area and provides educational assistance. As a paid preparer, you are responsible for ensuring your clients' returns are accurate. We ask that you pay special attention to these schedules next filing season.

Due diligence responsibilities

A paid tax return preparer must take multiple steps to prepare accurate tax returns on behalf of clients. These steps are a preparer's due diligence and include reviewing the applicable tax law to establish the relevance and reasonableness of income, credits, expenses, and deductions on a return. In general, you can rely in good faith without verification on information your client provides. However, you can't ignore the implication of the information you have. You must make reasonable inquiries if the information appears to be incorrect, inconsistent or incomplete.

Schedule C reminders

To prepare an accurate Schedule C, you must ask your clients relevant and probing questions to help you determine if the expenses are allowable. Taxpayers may not fully understand the tax laws and may incorrectly believe they can claim deductions for non-qualifying expenses. You should also ask your clients if they have receipts to support the expenses and instruct them to keep them in case we request supporting documentation.

Helpful resources

We provide information about the Schedule C on our website at www.irs.gov, keyword: Recommended Reading for Small Businesses. In addition, we recommend you review:

- Schedule C instructions
- Circular 230, Section 10.22, Diligence as to accuracy
- Circular 230, Section 10.34, Standards with respect to tax returns and documents, affidavits, and other papers

Potential consequences

In the future, both you and your clients could face negative consequences from inaccurate returns. We'll be looking for improvement in future returns you prepare. Inaccurate returns may result in any of the following consequences:

- If we examine your clients' returns and find inaccuracies, your clients may be liable for additional tax, interest, additions to tax, and penalties.
- If you prepare a client return that has an understatement of tax liability due to an unreasonable position, we can assess you a minimum penalty of \$1,000 per return (IRC Section 6694(a)).
- If you prepare a client return that has an understatement of tax liability due to reckless or intentional disregard of rules or regulations by the tax preparer, we can assess a minimum penalty of \$5,000 per return (IRC section 6694(b)).

I hope this letter has increased your awareness of your responsibilities as a paid tax return preparer and provided you with information on preparing accurate Schedules C for your clients.

Thank you for your attention to this matter.

Sincerely,

Carol A. Campbell
Director, Return Preparer Office

LETTER 4810³⁴

Like Letter 5105, Letter 4810 explains that the IRS has reviewed tax returns prepared by the practitioner during the past year and has found that many of the returns have a high percentage of traits the IRS believes typically indicate errors on Schedule C. However, instead of simply reminding preparers of their obligations, this letter informs the recipient that the IRS wants to schedule an **educational visit** with the preparer to review their responsibilities in person.

LETTERS 5271 AND 5272³⁵

Letters 5271 and 5272 are issued to tax professionals who prepared income tax returns that claim the **child tax credit** and **additional child tax credit**. These letters remind tax professionals of their responsibilities in this area and provide educational assistance. Both letters remind the recipient to ask clients relevant and probing questions to help determine whether the credit is allowable. These letters also reference due diligence responsibilities. The difference in the two letters is that Letter 5272 targets practitioners who have prepared returns on which the dependents have individual tax identification numbers (ITIN) instead of social security numbers.

LETTER 4911³⁶

Letter 4911³⁷ is issued to notify tax professionals that the IRS Return Preparer Office (RPO) is aware that they are not in compliance with their individual or business federal tax filing and/or payment obligations.

If the tax professional has delinquent returns, the returns should be filed immediately. If the tax professional agrees that they have outstanding balances, they should make arrangements to pay the balances in full or enter into an installment agreement. If the matters are addressed, it is not necessary for the practitioner to contact the IRS to respond to the letter.

This letter is an awareness notice and there are no actionable dates associated with it. However, the IRS will continue to monitor the tax professional's account and, if the issue remains unresolved, the tax professional will receive additional correspondence from the RPO with clear response dates indicated. Failure to respond to this letter or resolve the tax issue may result in the case being referred to the Office of Professional Responsibility (OPR) and/or possible revocation of the tax professional's preparer tax identification number (PTIN).

³⁴ *Return Preparer Letter — Filing Season 2013*. Dec. 2, 2013. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits-Return-Preparer-Letter] Accessed on Jul. 4, 2014.

³⁵ Ibid.

³⁶ *IRS Letters and Visits to Return Preparers — FAQs*. Dec. 2, 2013. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits-to-Return-Preparers-FAQs] Accessed on Jul. 4, 2014.

³⁷ *IRS Letters and Visits — Letter 4911*. Dec. 2, 2013. [www.irs.gov/Tax-Professionals/IRS-Letters-and-Visits--Letter-4911] Accessed on Jul. 4, 2014.

Example 4. Jane Jones receives the following Letter 4911. What should Jane do next?

This letter relates to the Preparer Tax Identification Number (PTIN) issued to you. IRC Section 1.6109-2(f) authorizes the IRS to confirm your compliance with federal tax filing and payment requirements in connection with your PTIN application or renewal.

IRS records show you are not in compliance with your individual and/or business federal tax filing and/or payment obligations. Failure to comply with these requirements may result in escalation of your case and/or possible revocation of your PTIN.

What you need to do

- Take steps to become compliant with your federal tax obligations. This includes:
 - If you have unfiled returns, file them
 - If you have outstanding balances, pay the amount due or make arrangements to pay
- Call 1-800-829-1040 for more information about your federal tax compliance issues and to resolve these issues
- After you become compliant, continue to file and pay timely
- We will continue to monitor your account(s) to ensure compliance

Additional information

- View IRS.gov, key words “filing late” or “paying late”
- For tax forms, instructions, and publications, visit IRS.gov or call 1-800-TAX-FORM (1-800-829-3676)
- Visit IRS.gov/ptin for information about the IRS’ tax return preparer program
- View Treasury Department Circular 230, which contains the regulations governing practice before the IRS, at IRS.gov/taxpros
- Keep this letter for your records
- If you believe you have received this letter in error, please contact us at the email address provided at the top of this letter

After reviewing the letter, Jane needs to **determine whether she has met all her filing obligations** before responding to the IRS. She may be required to file a number of different tax returns. If she has not met all of her filing obligations, she should take immediate steps to resolve these matters.

If she determines that she has appropriately met all her filing obligations, she should review her accounts to ensure that all of her tax payments are current and that all of the payments have been properly credited to her accounts. If she still has tax obligations, she should either pay the balances in full or make arrangements for a payment plan.

If she believes that she is in compliance with all filing and payment obligations, she should immediately contact the IRS RPO to determine why the IRS believes she is not in compliance. Letter 4911 provides a telephone number for her to contact the IRS.

REDUCING EIC ERRORS THROUGH DUE DILIGENCE

Each year, taxpayers **erroneously** claim billions of earned income credits (EIC). Over the past eleven years, the IRS has paid an estimated **\$148.2 billion in fraudulent EIC claims**.³⁸ In a recent Treasury Inspector General for Tax Administration (TIGTA) report, the IRS was commended for implementing numerous processes to educate taxpayers and tax preparers and to identify and prevent improper EIC payments.³⁹ However, a report issued in March 2014⁴⁰ noted that, for the third year, the IRS still has not met the following mandated goals.

- Publishing annual reduction targets for the EIC and discussing progress toward meeting those targets
- Lowering the improper payment rate for the EIC to less than 10%

Continued failure to meet these goals may result in funding cutbacks for the IRS.

Note. Cuts to the IRS's budget have made it increasingly difficult for them to meet their goals. As Nina Olson, the National Taxpayer Advocate, wrote in her June 25, 2013, preface to the "Taxpayer Advocate Service — Fiscal Year 2014 Objectives" report to Congress, "The IRS is an institution in crisis. In my view, however, the real crisis is not the one generating headlines. The real crisis facing the IRS — and therefore taxpayers — is a radically transformed mission coupled with inadequate funding to accomplish that mission. As a consequence of this crisis, the IRS gives limited consideration to taxpayer rights or fundamental tax administration principles as it struggles to get its job done."

The IRS estimates that 21–25% of all 2012 EIC payments were erroneous, which means that \$11.6 to \$13.6 billion was paid to taxpayers who should not have received the credit or received the wrong amount.⁴¹ For 2013, the IRS estimated 22–26% of all EIC claims have some type of mistake, costing the government between \$13.3 and \$15.6 billion.⁴²

Approximately 60% of the EIC errors are found in three categories.⁴³

1. Claiming a child who does not meet the age, relationship, and residency tests (discussed later)
2. Filing as single or head of household when legally married
3. Over- or under-reporting income or business expenses to maximize the credit

³⁸ *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply with the Improper Payments Elimination and Recovery Act*. Mar. 31, 2014. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/auditreports/2014reports/201440027fr.pdf] Accessed on Jul. 8, 2014.

³⁹ *The Internal Revenue Service Was Not in Compliance With All Requirements of the Improper Payments Elimination and Recovery Act for Fiscal Year 2012*. Treasury Inspector General for Tax Administration. Feb. 25, 2013. [www.treasury.gov/tigta/auditreports/2013reports/201340024fr.html] Accessed on Jul. 8, 2014.

⁴⁰ *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act*. Mar. 31, 2014. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/auditreports/2014reports/201440027fr.pdf] Accessed on Jul. 8, 2014.

⁴¹ Ibid.

⁴² Ibid.

⁴³ *EITC & Other Refundable Credits: Handling the Most Common Errors*. Jun. 4, 2014. [www.eitc.irs.gov/Tax-Preparer-Toolkit/toolsandtips/mostcommonerrors] Accessed on Jul. 5, 2014.

DUE DILIGENCE REQUIREMENTS

Treasury regulations mandate the following four due diligence requirements for tax professionals to follow when preparing returns with EIC claims.⁴⁴ Three of these address recordkeeping and form completion. The other requires tax professionals to thoroughly understand the EIC laws and ask reasonable questions.

1. Form 8867, *Paid Preparer's EIC Checklist*, must be completed and submitted.

- The form must be completed for **each** return that claims the EIC.
- The form must be based on information provided by the client or clients, or on information reasonably obtained by the tax return preparer.
- For returns or claims for refund filed electronically, Form 8867 must be submitted electronically with the return.
- For returns or claims for refund **not** filed electronically, Form 8867 must be given to the client as an attachment to the paper return.
- When the preparer of the EIC claim is not the tax return preparer who will sign the return, the EIC preparer must provide the signing tax return preparer with the completed Form 8867 for inclusion with the filed tax return or claim for refund. The completed form may be provided in either electronic or paper format.

2. The EIC Worksheet showing the computation method must be completed.

- The EIC Worksheet found in the Form 1040 instructions and in IRS Pub. 596, *Earned Income Credit (EIC)*, must be completed to properly compute the credit. In lieu of the worksheet, the tax return preparer may use an equivalent method, as long as the paper or electronic files retained by the preparer show the method and the information used to make the computation. The worksheet must show what is included in earned income, such as self-employment income and wages. It also must show that the investment income and AGI tests were met. Most tax preparation software has the computation worksheet embedded, and it is not necessary to submit the computation to the IRS.
- The worksheet must be based on information provided by the taxpayer or otherwise reasonably obtained by the tax return preparer.

3. The tax return preparer must not know, or have reason to know, that the EIC claim is erroneous.

- The **knowledge requirement** applies to both the taxpayer's eligibility and the calculation of the credit.
- The tax return preparer must not ignore the implications of information furnished to or known by the preparer.
- The preparer must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete.
- The tax return preparer must contemporaneously document the reasonable inquiries made and the responses to those inquiries.

⁴⁴ Treas. Reg. §1.6695-2(b).

Note. To satisfy the knowledge requirement,⁴⁵ the tax preparer must know the EIC requirements and understand the proper application of the rules to their clients. If a reasonable and well-informed tax return preparer would have known that the information provided by the taxpayer was incomplete, incorrect, or inconsistent, the preparer must demonstrate that they made additional inquiries.

For examples of how a reasonable and well-informed preparer would satisfy this requirement in various situations, see the IRS Tax Preparer Toolkit at www.eitc.irs.gov/Tax-Preparer-Toolkit/toolsandtips/commonduediligencesituations. For additional information, Treas. Reg. §1.6695-2 provides the tax return preparer due diligence requirements for determining EIC eligibility.

4. The tax return preparer must retain supporting documentation.

- The following documentation must be retained either on paper or in electronic form.
 - ♦ Copies of Form 8867 and the EIC worksheet used to calculate the amount of the credit
 - ♦ A record of how and when the information used to complete the form and worksheet was acquired
 - ♦ The identity of any person furnishing the information
 - ♦ Copies of any documentation provided by the taxpayer that was used in determining the taxpayer's qualifications for EIC and the amount of EIC

Note. The records should show any additional questions the tax preparer asked the client and the client's answers to those questions. The EIC Tax Preparer Toolkit also advises tax professionals to verify the identity of the person providing the information.⁴⁶

- The records must be kept for three years from the **latest** of the following dates.
 - ♦ The original due date of the tax return (without regard to extensions)
 - ♦ The date the tax return or claim for refund is filed, if the return is electronically filed by the tax return preparer
 - ♦ The date the return is provided to the taxpayer for signature, if the return or claim for refund is **not** filed electronically
 - ♦ The date the nonsigning preparer submits the information to the signing tax return preparer, if the practitioner who prepares the EIC claim is not the signing preparer

Penalties for Failure to Exercise Due Diligence⁴⁷

As a result of the astounding numbers of errors found in EIC claims, Congress created a penalty specifically aimed at preparation of EIC claims. This penalty is **\$500** for **each** return tax professionals prepare without following due diligence requirements.⁴⁸ The most common reason for assessing due diligence penalties against tax professionals is failure to comply with the **knowledge** requirement.

⁴⁵ *EITC & Other Refundable Credits: EITC Due Diligence Law and Regulations*. Jun. 12, 2014. [www.eitc.irs.gov/Tax-Preparer-Toolkit/dd/lawandregs] Accessed on Jul. 5, 2014.

⁴⁶ Ibid.

⁴⁷ *EITC & Other Refundable Credits: EITC Due Diligence and Self-Employed Taxpayers*. Nov. 15, 2013. [www.eitc.irs.gov/Tax-Preparer-Toolkit/sctraining/taxpayers] Accessed on Jul. 6, 2014.

⁴⁸ IRC §6695(g).

In addition to the \$500 penalty, practitioners may face any of the following consequences based on the severity of their neglect.

- Assessment of return preparer penalties ranging from \$1,000 to \$5,000 for intentional disregard of the rules and regulations
- Suspension of the preparer from participation in the IRS e-File program
- Injunctions barring the preparer from preparing tax returns
- Referral for criminal investigation
- Disciplinary action by the IRS Office of Professional Responsibility

Note. Tax preparation software cannot substitute for a tax professional's knowledge of the law or of the taxpayer's situation. Preparers must be able to prove that they acted reasonably based on the information they were provided.

In addition, tax preparation firms must show that they have reasonable and appropriate procedures in place to ensure compliance with the due diligence requirements. Failure to design and enforce such procedures may subject the firm to penalties in addition to the penalties imposed on the tax return preparer.⁴⁹

6

Avoiding Penalties. As stated earlier, most preparer penalties are related to failure to meet the knowledge requirements. The IRS recommends that preparers do all of the following in order to meet the knowledge standards.⁵⁰

- Know the law.
- Ask the right questions, especially when the client gives information that appears incorrect, inconsistent, or incomplete.
- Document the questions asked and the responses given by the client.
- Obtain all the relevant facts to make sure the client truly qualifies for EIC.

Tax professionals and firms can also avoid penalties by implementing office procedures that are reasonably designed and routinely followed to ensure compliance with due diligence requirements. Penalties are not likely to be assessed when the failure to perform due diligence is an isolated instance or inadvertent error.⁵¹

IRS EFFORTS TO INCREASE DUE DILIGENCE⁵²

The first step in the IRS's strategy to increase EIC compliance is education of and outreach to tax professionals. The IRS sees this as their most important tool to help practitioners prepare accurate EIC claims. The focus is letting tax professionals know about available resources and helping them understand their due diligence responsibilities.

Note. Practitioners seeking training specifically tailored to EIC should visit the IRS's website dedicated to the EIC at www.eitc.irs.gov/Tax-Preparer-Toolkit/main.

⁴⁹ Treas. Reg. §1.6695-2(c).

⁵⁰ Ibid.

⁵¹ Treas. Reg. §1.6695-2(d).

⁵² *EITC & Other Refundable Credits: Reaching Out to Preparers*. Jun. 3, 2014. [www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/reachingout] Accessed on Jul. 6, 2014.

Another step in the outreach and educational part of the IRS's **EITC preparer compliance** program is letters directed to specific preparers. The IRS looks at the number of returns with a high likelihood of EIC errors completed by the same preparer. Letters are sent to preparers who have a high number of these returns. The letters do the following.

- Acknowledge that the IRS believes the preparer submitted inaccurate returns
- Pinpoint the primary issues identified as questionable on the returns
- Highlight the consequences of filing inaccurate EIC claims
- Outline EIC due diligence responsibilities
- Provide tips on preparing accurate returns and point to online EIC tools, information, and other resources
- Inform the preparer that the IRS will be monitoring their future returns

Return preparers who file returns with EIC errors or questionable claims may receive one or more of the following letters.

- **Letter 4833** is sent to preparers who prepared a large number of tax returns claiming the EIC that the IRS suspects have errors. The letter warns the practitioner that the IRS will monitor the returns they prepare during the upcoming filing season. If those returns do not improve significantly in quality, the practitioner may be subject to follow-up procedures.
- **Letters 5025, 5025-C, 5025-D, and 5025-Q** are more severe than Letter 4833. They begin with the statement **“You may have violated tax law by submitting inaccurate returns”** in bold at the top of the letter. The letters identify the particular issues that the IRS found questionable in the returns prepared by the recipient. In addition, these letters list more of the potential adverse consequences to the tax return preparer for violating the due diligence requirements.

After these letters are sent to the tax practitioner, the IRS continues to monitor the returns filed by the recipients to determine whether accuracy improves. If there is no improvement, the IRS may follow up with phone calls, additional letters, due diligence visits, or compliance audits.

Due Diligence Visits⁵³

Educational visits to preparers is another part of the IRS's EITC preparer compliance program. A revenue agent and criminal investigator visit preparers who filed EIC claims with a high likelihood of error. The visits are educational.

The goal is to help preparers understand the errors and how to avoid them. During these outreach and education visits, the IRS representatives:

- Talk about the errors on the claims,
- Offer tips and tools for improving accuracy,
- Answer any questions, and
- Explain the potential costs of not improving accuracy.

The IRS does not charge these preparers penalties because of these visits. However, future returns with EIC claims are monitored to determine whether accuracy improved after the visit. If a preparer does not show improvement, the IRS may perform a due diligence audit.

⁵³ *EITC & Other Refundable Credits: Visiting Preparers Filing Highly Questionable Returns*. Nov. 26, 2013. [www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/visits] Accessed on Jul. 6, 2014.

Due Diligence Audits⁵⁴

Audits for compliance with EIC due diligence requirements are another part of the IRS's EITC preparer compliance program. The IRS looks at returns with a high likelihood of errors completed by the same preparer and use that information to select preparers for audits. The IRS may have contacted the preparer using another tactic of the preparer compliance program but they **do not use all** of them for every preparer.

The IRS conducts due diligence audits of prior year returns after sending letters notifying the preparer that they have been selected for audit. In addition, the IRS may drop in on preparers without pre-scheduling the visit to audit returns being prepared. Before resorting to unannounced visits, the IRS will have made other efforts to increase the preparer's level of compliance, including, at a minimum, sending the preparer Letter 4833.

Caution. All IRS employees have an official IRS picture ID.

During these audits, the IRS examiner reviews at least 25 EIC returns for the following information.

- The preparer's due diligence records
- The probing questions that were asked and the client responses
- All questionnaires, checklists, and worksheets

The IRS specifically looks for evidence that the preparer met the knowledge standard. While auditing for due diligence, the IRS also ensures that the preparer is in compliance with the PTIN requirements and their personal tax return filing requirements.

If the IRS finds the preparer did not comply with the EIC due diligence requirements, the preparer will most likely be penalized. Over 90% of the preparers audited under the new compliance program have been penalized.⁵⁵

ERRORS RELATED TO THE AGE, RELATIONSHIP, AND RESIDENCY TESTS⁵⁶

As mentioned previously, claiming a child who did not meet the age, relationship, or residency tests is one of the most common reasons for EIC errors. The following is a brief review of these three tests and the fourth condition that must be satisfied to be a qualifying child for EIC purposes. For more information on all aspects of the EIC, see IRS Pub. 596.

There are four tests that must be met for a child to be a **qualifying child of the taxpayer for EIC** purposes.

1. **Relationship.** The child must be related to the taxpayer in one of the following ways.
 - a. **Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them** (for example, a grandchild)
 - b. **Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them** (for example, a niece or nephew)
 - c. **Foster child⁵⁷** (A foster child is a qualifying child if **the child is placed** with the taxpayer by an **authorized placement agency** or by **order of the court**.)

⁵⁴ *EITC & Other Refundable Credits: Auditing for Due Diligence Compliance*. Apr. 8, 2014. [www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/auditing] Accessed on Jul. 6, 2014.

⁵⁵ Ibid.

⁵⁶ IRS Pub. 596, *Earned Income Credit (EIC)*.

⁵⁷ See IRS Pub. 596, *Earned Income Credit (EIC)*, for examples of authorized placement agencies and court orders.

2. **Age.** The child must be one of the following.
 - a. Under age 19 at the end of the tax year and younger than the taxpayer (or younger than the taxpayer's spouse if filing MFJ)
 - b. A full-time student under age 24 at the end of the tax year and younger than the taxpayer (or younger than the taxpayer's spouse if filing MFJ)
 - c. Permanently and totally disabled at any time during the tax year, regardless of age
3. **Residency.** The child must have lived with the taxpayer for more than half of the tax year, with the exception of temporary absences.
4. **Joint return.** The child must not file a joint return for the tax year, **unless** the child is only filing the joint return to claim a refund of income tax withheld or estimated tax paid.

Note. To meet the **uniform definition of qualifying child**, the child must not have provided over half of their own support for the year.⁵⁸ This test does **not** apply for EIC purposes.⁵⁹

A taxpayer who is a qualifying child of another taxpayer is ineligible to claim the EIC.⁶⁰

Qualifying Children of More than One Taxpayer⁶¹

Another important (and often misunderstood) aspect of EIC eligibility concerns children who meet the definition of qualifying child for more than one taxpayer. In general, **if the taxpayers can agree** on who will claim the child for EIC and the other related tax benefits, any one of the qualified taxpayers can use the child for EIC purposes. However, if the person claiming the child is **not the child's parent**, their AGI must be higher than any other taxpayer who qualifies to use the child for EIC purposes.

Example 5. Toni has been preparing Frank's returns for several years. Before this year, Frank has always filed as single with no dependents. When Frank visits Toni to have his 2014 return prepared, he tells her that his girlfriend and her child have been living with him and that he is going to file as head of household, claim both of them as dependents, and get the EIC this year. Toni must determine whether Frank meets the tests for each benefit. For EIC purposes, the first question she should ask is whether the girlfriend and/or the child are legally related to Frank by blood or marriage. If they are not related to Frank under the relationship rules, he cannot claim either of them for EIC purposes.

Note. For more information about this issue, see the 2011 *University of Illinois Federal Tax Fundamentals*, Chapter 3: Filing Status and Dependency Exemptions. This can be found at www.taxschool.illinois.edu/taxbookarchive.

⁵⁸ IRC §152(c)(1)(D).

⁵⁹ IRC §32(c)(3)(A).

⁶⁰ IRC §32(c)(1)(B).

⁶¹ IRC §32(c)(3)(A) (referencing IRC §152(c)(4)).

Example 6. Amber is 22 years old and single. She and her 2-year-old son both reside with her parents for all of 2014. She earns \$5,000 for the year and wants to claim the EIC.

From these facts, Amber's tax professional Grayson knows that Amber meets the relationship and residency tests for her parents. He also knows that she is not filing a joint return. Grayson needs to ask additional questions to determine whether Amber meets the age test for her parents. If she meets all four tests, she is a qualifying child of her parents and she may not claim the EIC. Some of the questions that Grayson should consider asking Amber include the following.

- Was Amber a full-time student during 2014?
- Did Amber provide over half of her own support?
- Has she given her parents permission to use her son as a qualifying child for the dependency exemption or any other tax purpose on their 2014 return?

Example 7. Allen is 25 years old and claims to have a **14-year-old daughter**, Mary Theresa, who is his qualifying child for EIC purposes. Because the age of Allen's daughter appears inconsistent with his age, his tax professional Peter should ask appropriate questions and request documentation to determine whether the child is really his. The questions that Peter should ask include the following.

- Is Mary Theresa his stepchild, adopted child, or natural child? Can he provide appropriate documentation?
- Did Mary Theresa live with any other parent during the year?
- How long has Mary Theresa lived with him?
- Can Allen prove that Mary Theresa lived with him during the time he says that she did?

Peter completes the following Form 8867.

For Example 7

Form 8867 Department of the Treasury Internal Revenue Service	Paid Preparer's Earned Income Credit Checklist ▶ To be completed by preparer and filed with Form 1040, 1040A, or 1040EZ. ▶ Information about Form 8867 and its separate instructions is at www.irs.gov/form8867 .	OMB No. 1545-1629 <div style="text-align: center; font-size: 24pt; font-weight: bold;">2013</div> Attachment Sequence No. 177
Taxpayer name(s) shown on return Allen		Taxpayer's social security number 345-45-3345
For the definitions of the following terms, see Pub. 596 . <div style="display: flex; justify-content: space-around; font-weight: bold;"> • Investment Income • Qualifying Child • Earned Income • Full-time Student </div>		
Part I All Taxpayers		
1 Enter preparer's name and PTIN ▶ Peter Rabbit P345500922		
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 checked="" 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 checked="" type="checkbox"/> Yes <input type="checkbox"/> No
4 Is the taxpayer (or the taxpayer's spouse if filing jointly) filing Form 2555 or 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 checked="" type="checkbox"/> No
5a Was the taxpayer (or the taxpayer's spouse) a nonresident alien for any part of 2013? ▶ 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 checked="" 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 \$3,300? See Rule 6 in Pub. 596 before answering ▶ If you checked "Yes" on line 6, stop ; the taxpayer cannot take the EIC. Otherwise, continue.		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
7 Could the taxpayer be a qualifying child of another person for 2013? If the taxpayer's filing status is married filing jointly, check "No." Otherwise, see Rule 10 (Rule 13 if the taxpayer does not have a qualifying child) in Pub. 596 before answering ▶ 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 checked="" type="checkbox"/> No

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 26142H Form **8867** (2013)

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Part II Taxpayers With a Child

	Child 1	Child 2	Child 3
8 Child's name	Mary Theresa		
9 Is the child the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
10 Was the child unmarried at the end of 2013? If the child was married at the end of 2013, see the instructions before answering	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<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 2013? See the instructions before answering	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
12 Was the child (at the end of 2013)— • Under age 19 and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), • Under age 24, a full-time student, and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), or • Any age and permanently and totally disabled? ▶ 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; see the instructions for line 12.	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
13a Do you or the taxpayer know of another person who could check "Yes" on lines 9, 10, 11, and 12 for the child? (If the only other person is the taxpayer's spouse, see the instructions before answering.) ▶ If you checked "No" on line 13a, go to line 14. Otherwise, go to line 13b.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<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 Under the tiebreaker rules, is the child treated as the taxpayer's qualifying child? See the instructions before answering ▶ If you checked "Yes" on line 13c, go to line 14. If you checked "No," 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, see the Note at the bottom of this page. If you checked "Don't know," explain to the taxpayer that, under the tiebreaker rules, the taxpayer's EIC and other tax 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, see the Note at the bottom of this page.	<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	<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 ▶ If you checked "No" on line 14, the taxpayer cannot take the EIC based on this child and cannot take the EIC available to taxpayers without a qualifying child. If there is more than one child, see the Note at the bottom of this page. If you checked "Yes" on line 14, continue.	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<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 2013? See Pub. 596 for the limit ▶ 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 or three 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.			<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
Note. If you checked "No" on line 13c or 14 but there is more than one child, complete lines 8 through 14 for the other child(ren) (but for no more than three qualifying children). Also do this if you checked "Don't know" on line 13c and the taxpayer is not taking the EIC based on this child.			

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Part III Taxpayers Without a Qualifying Child

<p>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.)</p> <p style="padding-left: 20px;">▶ If you checked "No" on line 16, stop; the taxpayer cannot take the EIC. Otherwise, continue.</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No </div>
<p>17 Was the taxpayer, or the taxpayer's spouse if filing jointly, at least age 25 but under age 65 at the end of 2013? See the instructions before answering</p> <p style="padding-left: 20px;">▶ If you checked "No" on line 17, stop; the taxpayer cannot take the EIC. Otherwise, continue.</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No </div>
<p>18 Is the taxpayer eligible to be claimed as a dependent on anyone else's federal income tax return for 2013? If the taxpayer's filing status is married filing jointly, check "No".</p> <p style="padding-left: 20px;">▶ If you checked "Yes" on line 18, stop; the taxpayer cannot take the EIC. Otherwise, continue.</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No </div>
<p>19 Are the taxpayer's earned income and adjusted gross income each less than the limit that applies to the taxpayer for 2013? See Pub. 596 for the limit</p> <p style="padding-left: 20px;">▶ If you checked "No" on line 19, stop; 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.</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No </div> <div style="background-color: #cccccc; height: 40px; width: 100%;"></div>

Part IV Due Diligence Requirements

<p>20 Did you complete Form 8867 based on current information provided by the taxpayer or reasonably obtained by you?</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No </div>
<p>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)?</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No </div>
<p>22 If any qualifying child was not the taxpayer's son or daughter, do you know or did you ask why the parents were not claiming the child?</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Does not apply </div>
<p>23 If the answer to question 13a is "Yes" (indicating that the child lived for more than half the year with someone else who could claim the child for the EIC), did you explain the tiebreaker rules and possible consequences of another person claiming your client's qualifying child?</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Does not apply </div>
<p>24 Did you ask this taxpayer any additional questions that are necessary to meet your knowledge requirement? See the instructions before answering</p> <p style="padding-left: 20px;">To comply with the EIC knowledge requirement, you must not know or have reason to know that any information you 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 you or known by you, and you must make reasonable inquiries if the information furnished to you appears to be incorrect, inconsistent, or incomplete. At the time you make these inquiries, you must document in your files the inquiries you made and the taxpayer's responses.</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input type="checkbox"/> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/> Does not apply </div> <div style="background-color: #cccccc; height: 80px; width: 100%;"></div>
<p>25 Did you document (a) the taxpayer's answer to question 22 (if applicable), (b) whether you explained the tiebreaker rules to the taxpayer and any additional information you got from the taxpayer as a result, and (c) any additional questions you asked and the taxpayer's answers?</p>	<div style="border: 1px solid black; padding: 5px; text-align: right;"> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Does not apply </div> <div style="background-color: #cccccc; height: 100px; width: 100%;"></div>
<p>▶ You have complied with all the due diligence requirements if you:</p> <ol style="list-style-type: none"> 1. Completed the actions described on lines 20 and 21 and checked "Yes" on those lines, 2. Completed the actions described on lines 22, 23, 24, and 25 (if they apply) and checked "Yes" (or "Does not apply") on those lines, 3. Submit Form 8867 in the manner required, and 4. Keep all five of the following records for 3 years from the latest of the dates specified in the instructions under <i>Document Retention</i>: <ol style="list-style-type: none"> a. Form 8867, Paid Preparer's Earned Income Credit Checklist, b. The EIC worksheet(s) or your own worksheet(s), c. Copies of any taxpayer documents you relied on to determine eligibility for or amount of EIC, d. A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained, and e. A record of any additional questions you asked and your client's answers. <p>▶ You have not complied with all the due diligence requirements if you checked "No" on line 20, 21, 22, 23, 24, or 25. You may have to pay a \$500 penalty for each failure to comply.</p>	

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Part V Documents Provided to You

- 26** Identify below any document that the taxpayer provided to you and that you relied on to determine the taxpayer's EIC eligibility. Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no qualifying child, check box a. If there is no disabled child, check box o.

Residency of Qualifying Child(ren)

- | | |
|--|---|
| <input type="checkbox"/> a No qualifying child | <input type="checkbox"/> i Place of worship statement |
| <input checked="" type="checkbox"/> b School records or statement | <input type="checkbox"/> j Indian tribal official statement |
| <input checked="" type="checkbox"/> c Landlord or property management statement | <input type="checkbox"/> k Employer statement |
| <input checked="" type="checkbox"/> d Health care provider statement | <input type="checkbox"/> l Other (specify) ▼ |
| <input type="checkbox"/> e Medical records | |
| <input checked="" type="checkbox"/> f Child care provider records | |
| <input type="checkbox"/> g Placement agency statement | |
| <input type="checkbox"/> h Social service records or statement | <input type="checkbox"/> m Did not rely on any documents, but made notes in file |
| | <input type="checkbox"/> n Did not rely on any documents |

Disability of Qualifying Child(ren)

- | | |
|---|---|
| <input checked="" type="checkbox"/> o No disabled child | <input type="checkbox"/> s Other (specify) ▼ |
| <input type="checkbox"/> p Doctor statement | |
| <input type="checkbox"/> q Other health care provider statement | |
| <input type="checkbox"/> r Social services agency or program statement | <input type="checkbox"/> t Did not rely on any documents, but made notes in file |
| | <input type="checkbox"/> u Did not rely on any documents |

- 27** If a Schedule C is included with this return, identify below the information that the taxpayer provided to you and that you relied on to prepare the Schedule C. Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no Schedule C, check box a.

Documents or Other Information

- | | |
|--|---|
| <input type="checkbox"/> a No Schedule C | <input type="checkbox"/> h Bank statements |
| <input type="checkbox"/> b Business license | <input type="checkbox"/> i Reconstruction of income and expenses |
| <input checked="" type="checkbox"/> c Forms 1099 | <input type="checkbox"/> j Other (specify) ▼ |
| <input type="checkbox"/> d Records of gross receipts provided by taxpayer | |
| <input type="checkbox"/> e Taxpayer summary of income | |
| <input type="checkbox"/> f Records of expenses provided by taxpayer | <input type="checkbox"/> k Did not rely on any documents, but made notes in file |
| <input type="checkbox"/> g Taxpayer summary of expenses | <input type="checkbox"/> l Did not rely on any documents |

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Note. Tax professionals should use caution when selecting “Did not rely on any documents” (line 26, box n or u; line 27, box l). Checking these boxes may create a red flag at the IRS. If the preparer believes that it is not necessary to review any additional documentation, they may explain the circumstances by selecting “Other” (line 26, box l or s; line 27, box j).

ANNUAL FILING SEASON PROGRAM

In February 2014, the D.C. Circuit Court of Appeals ruled that the registered tax return preparer (RTRP) program was invalid.⁶² Because the RTRP program is no longer in effect, the IRS has initiated a formal effort to obtain legislative authority from Congress to regulate tax preparers. It may take considerable time to obtain that authority from Congress. In the interim, the IRS developed the Annual Filing Season Program (AFSP), which was announced on June 26, 2014.⁶³

Note. The details provided in this section are all the information available at the time this book was published. Other guidance will undoubtedly be provided at a later time.

The goals of this program are to enhance the accuracy of professional return preparers, improve tax compliance, and protect taxpayers from preparer errors. The AFSP is designed to provide noncredentialed tax return preparers with updated tax information necessary for the completion of returns each year. The program is **voluntary**. Generally, those who choose to participate in the AFSP are required to complete 18 hours of continuing education (CE) annually. The CE must be obtained from an IRS-approved CE provider.

CONTINUING EDUCATION

Noncredentialed tax return preparers must successfully complete 18 hours of CE during the calendar year, after which they will obtain a record of completion (discussed later). This annual 18-hour CE requirement consists of the following.

- 10 hours of federal tax law topics
- 2 hours of ethics or professional responsibility
- 6 hours of federal tax law updates (refresher course)

In order to be eligible to participate in the AFSP, a noncredentialed tax return preparer must complete a 6-hour federal tax filing season refresher course. The 6-hour refresher course consists of material covering tax law and filing requirements relevant to personal tax returns. The refresher course is followed by an examination of at least 100 questions about the course material. A minimum of 70% of the questions must be answered correctly in order to pass the test. For noncredentialed preparers, the initial completion of the 6-hour refresher course (and associated test) is a prerequisite for participation in the AFSP.

The AFSP is intended for noncredentialed tax return preparers, but CPAs, attorneys, and enrolled agents (EAs) may also voluntarily participate. CPAs, attorneys, EAs, preparers who have previously passed the RTRP examination, return preparers who have passed the Oregon and California examinations, VITA volunteers, and those who have passed the Accreditation Council ABA or ATP examinations, are exempt from the 6-hour refresher course requirement. In order to obtain a record of completion, preparers exempt from the 6-hour refresher course must complete the 15-hour annual CE requirement that consists of the following.

- 10 hours of federal tax law topics
- 2 hours of ethics or professional responsibility
- 3 hours of federal tax law updates

⁶² *Loving v. IRS*, 742 F.3d 1013 (D.C. Ct. App. 2014).

⁶³ Rev. Proc. 2014-42, 2014-29 IRB 192.

Special Transition Relief Rule for 2014

The AFSP is available for the first time for the 2015 tax preparation season (in connection with the preparation of tax returns for the 2014 tax year). Because the AFSP was not announced until mid-2014, there is a special transition rule regarding the necessary CE for participants who wish to participate in the AFSP in its initial year of availability.

Noncredentialed tax return preparers must complete 11 CE hours before the end of 2014 in order to obtain their record of completion for the 2015 filing season. The 11-hour CE requirement for noncredentialed preparers consists of the following.

- 6-hour refresher course
- 2 hours of ethics or professional responsibility
- 3 hours of federal tax law topics

Applicants who are exempt from the refresher course have an 8-hour CE requirement for 2014 that includes the following.

- 3 hours of federal tax law topics
- 3 hours of federal tax law updates
- 2 hours of ethics or professional responsibility

After final guidance is issued, IRS-approved CE providers will begin offering the applicable courses. These must be completed before the end of 2014. AFSP records of completion are offered when the 2015 PTIN renewal season commences.

Record of Completion

Upon completion of the required CE hours each year, the participant can download and print an AFSP record of completion as long as the participant maintains a PTIN. The AFSP record of completion is printed from the PTIN holder's online account after the participant agrees to adhere to subpart B and §10.51 of Circular 230.

Note. Subpart B of Circular 230 includes sections §10.20 through §10.38. These sections comprise most of the key tax practitioner rules of conduct.

A record of completion is generally valid for a calendar year and must be renewed annually. The record of completion is valid for the period that begins on the later of January 1 or the date during the year in which the record of completion is issued and ends on December 31 of that year.

LIMITED PRACTICE BEFORE THE IRS

A noncredentialed tax return preparer who has an AFSP record of completion **may represent** a taxpayer before the IRS **during a return examination** or with respect to a refund claim, as long as the noncredentialed tax return preparer completed and signed the tax return or claim. In order to represent the taxpayer, the tax return preparer must have an AFSP record of completion for the year in which the return or refund claim was prepared and signed and also must have an AFSP record of completion for the year in which the representation occurs.⁶⁴

However, a noncredentialed tax return preparer with an AFSP record of completion **may not represent** a taxpayer **before appeals officers, revenue officers, IRS counsel, or similar officers or employees of the IRS.**

⁶⁴ Rev. Proc. 2014-42, 2014-29 IRB 192.

Example 8. Wiley completes the requirements of the AFSP program in 2014 and obtains his record of completion. He prepares Fred 2014 tax return. In late 2015, Fred receives a collection notice in connection with his 2014 return. The IRS assigns Johann, an IRS revenue officer, to resolve the outstanding balance due. Even though Wiley completed Fred's 2014 return and was the signing preparer, he cannot represent Fred in the collection discussion before a revenue officer. Fred must obtain representation from another person who is entitled to practice before the IRS and can represent a taxpayer before a revenue officer.

Observation. The District of Columbia Court of Appeals ruling⁶⁵ served to put an end to the RTRP program because the IRS did not have legal authority to regulate tax preparers. Despite the fact that the AFSP is a voluntary program, the limitations placed on holders of an AFSP record of completion constitute the regulation of tax preparers in a fashion similar to the RTRP regulation.

INELIGIBLE INDIVIDUALS

Individuals who are disbarred, suspended, or disqualified from practice before the IRS are not eligible to participate in the AFSP during the term of disbarment, suspension, or disqualification. In addition, an individual who has had an AFSP record of completion revoked may not participate for the period of time determined by the IRS.

An individual convicted of a felony that involved a financial or tax matter or other violation of the public trust may not participate if that conviction occurred within the 5-year period preceding the date that the individual applies to participate in the AFSP. In addition, an individual who is prevented by injunction from representing persons before the IRS or who engaged in misconduct that would have been a violation of Circular 230 (even though the individual is not subject to Circular 230 standards) is likewise precluded from AFSP participation.

Moreover, an individual who is not in compliance with the filing of their own tax returns may not participate in the AFSP. However, the following situations will not prevent participation by an individual under this rule.

- A dispute with the IRS regarding a tax liability
- An offer in compromise
- An installment agreement

MARKETING CONSIDERATIONS

An individual who obtains an AFSP record of completion is precluded from using the following three terms to describe the AFSP designation.

- Certified
- Enrolled
- Licensed

In addition, a preparer who has an AFSP record of completion may not imply that there is an employment relationship with the IRS or indicate that the IRS has endorsed the preparer. However, they may indicate that they hold a valid AFSP record of completion or that they have met the requirements to obtain one.

Note. On July 15, 2014, the American Institute of Certified Public Accountants (AICPA) filed suit against the IRS in connection with the AFSP. In this suit, the AICPA alleges that the IRS does not have the statutory authority to regulate tax return preparers with such a program. The suit cites *Loving v. IRS*⁶⁶ as precedent for the absence of any statutory authority.

⁶⁵ *Loving v. IRS*, 742 F.3d 1013 (D.C. Ct. App. 2014).

⁶⁶ *Ibid.*

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA)⁶⁷

TIGTA was organized by Congress after the Restructuring and Reform Act of 1998 (RRA 98) to provide independent oversight of IRS activities. TIGTA performs comprehensive audits and investigations with the ultimate goal of improving IRS operations.⁶⁸ TIGTA's oversight extends to the IRS, IRS Chief Counsel, and the IRS Oversight Board. TIGTA serves as an independent voice reporting directly to the Treasury Secretary and Congress.⁶⁹

TIGTA's mission is to provide quality professional audit, investigative, inspection, and evaluation services that promote integrity, economy, and efficiency in the administration of the U.S. tax system.⁷⁰ To achieve this mission, it conducts a variety of audits and investigations of all aspects of tax administration. TIGTA activities are designed to accomplish the following goals.⁷¹

- Promote economy, efficiency, and effectiveness in the administration of the nation's tax system
- Detect and deter fraud and abuse in IRS programs and operations
- Protect the IRS against external attempts to corrupt or threaten its employees
- Review and make recommendations about existing and proposed legislation and regulations related to IRS and TIGTA programs and operations
- Prevent fraud, abuse, and deficiencies in IRS programs and operations
- Inform the Treasury Secretary and Congress of problems and the progress made to resolve them

TIGTA has **two main functional areas**: the Office of Audit and the Office of Investigations.⁷²

OFFICE OF AUDIT⁷³

The Office of Audit (OA) identifies opportunities to improve the administration of the U.S. tax laws by conducting comprehensive, independent audits of IRS programs, operations, and activities. These audits evaluate the performance of the IRS and financial aspects of IRS administration. The audit program includes reviews mandated by statute or regulation, as well as reviews identified through TIGTA's planning and evaluation process. The OA strategically evaluates IRS programs, activities, and functions so that resources are expended in the areas of highest vulnerability to the tax system.

⁶⁷ Treasury Inspector General for Tax Administration. Jun. 11, 2014. [www.treasury.gov/tigta] Accessed on Jul. 6, 2014.

⁶⁸ *What is TIGTA*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/about_what.shtml] Accessed on Jul. 6, 2014.

⁶⁹ *Office of Investigations (OI)*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/oi.shtml] Accessed on Jul. 6, 2014.

⁷⁰ *About TIGTA*. May 30, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/about.shtml] Accessed on Jul. 6, 2014.

⁷¹ *What is TIGTA*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/about_what.shtml] Accessed on Jul. 6, 2014.

⁷² *Organizational Chart*. Apr. 23, 2008. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/about_orgchart.shtml] Accessed on Jul. 6, 2014.

⁷³ *Office of Audit (OA)*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/oa.shtml] Accessed on Jul. 6, 2014; and *What Is TIGTA*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/about_what.shtml] Accessed on Jul. 6, 2014.

The TIGTA audit process usually begins with an engagement letter clearly laying out the objectives of the review as well as an estimated completion date. After receipt of the engagement letter, an opening conference takes place between TIGTA and IRS management to ensure IRS management understands the upcoming audit objectives. Subsequently, fieldwork is conducted. Fieldwork includes the following.

- Interviews with IRS personnel
- Reviews of files and documents
- Tests of systems and processes, which are conducted in accordance with government auditing standards

Upon the conclusion of the fieldwork, a draft discussion report summarizing the audit findings, conclusions, and recommendations is prepared. An exit conference is held between the audit staff and IRS management before the formal draft report is issued. The draft is given to the IRS Commissioner for a formal response. A final report is issued after the IRS Commissioner responds. In most cases, the final report incorporates the Commissioner's formal response. Copies of the report are distributed to appropriate IRS officials and made available to the public as appropriate.

OFFICE OF INVESTIGATION⁷⁴

The Office of Investigation (OI) has the responsibility for investigating activities related to fraud, waste, abuse, and mismanagement of the tax system at all levels. OI also protects the IRS against attempts to corrupt or threaten its employees.

Field offices conduct investigations involving criminal wrongdoing and administrative misconduct by IRS employees. They also investigate outside individuals who attempt to interfere with or corrupt the tax system. This includes investigations of bribery, assaults, threats, impersonations, or other unlawful actions that may affect IRS employees and impede tax administration. Investigations may also include unauthorized disclosure or misuse of tax information by non-IRS employees, complaints against tax practitioners, and accidents involving IRS personnel or property.

There are three divisions within the OI with distinct responsibilities.

1. The Special Inquiries and Intelligence Division (SIID) has three missions.
 - a. Conducting sensitive investigations involving TIGTA employees, IRS oversight board members, IRS senior executives, IRS Chief Counsel employees, IRS Criminal Investigation Division employees, and IRS international employees located in Washington, D.C., and U.S. embassies abroad
 - b. Investigating allegations of fraud, waste, and abuse involving IRS procurements and procurement-related misconduct by IRS employees and persons outside of the agency
 - c. Coordinating TIGTA's collection and dissemination of information on criminal matters
2. The Strategic Enforcement Division is responsible for TIGTA's proactive approach to identifying fraud and other wrongdoing that would otherwise go undetected. The objective of the division is to aggressively detect and deter fraud.
3. The Operations Division includes the Complaint Management Team, which operates a toll-free hotline and central post office box through which anyone can anonymously **report suspicions of fraud, waste, abuse, or misconduct.**

⁷⁴ *Office of Investigations (OI)*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/oi.shtml] Accessed on Jul. 6, 2014.

REPORTING MISCONDUCT

Any person who has reason to believe that a violation has occurred that may affect the integrity of the federal tax administration should inform TIGTA directly about the incident. Taxpayers are encouraged to notify TIGTA about the following situations.

- Misconduct by an IRS employee
- Fraud and/or false claims by outside contractors who are attempting to defraud the IRS
- Identity theft that involves someone impersonating the IRS or an IRS employee or someone using words, letters, symbols, or IRS emblems and attempting to illegally obtain personal, confidential, or private financial information
- Schemes involving the use of computer technology or mail to impersonate the IRS or IRS personnel
- Attempts by taxpayers to bribe IRS personnel
- IRS personnel who misuse their position within the IRS or try to use extortion against others by exploiting their position within the IRS
- Assaults and/or threats by taxpayers against IRS personnel
- Misconduct by tax practitioners, including falsification of qualifications, theft of IRS tax remittances, and theft of IRS tax refunds

Taxpayers can use any of the following options to contact TIGTA about specific allegations.

- Complete the online form at www.treasury.gov/tigta/contact_report.shtml#theform
- Email the TIGTA Hotline Complaints Unit at Complaints@tigta.treas.gov
- Call the toll-free hotline at (800) 366-4484
- Fax the information to (202) 927-7018
- Mail the information to the following address

Treasury Inspector General for Tax Administration Hotline
P.O. Box 589
Ben Franklin Station
Washington, DC 20044-0589

CURRENT TIGTA HAPPENINGS

In the semi-annual report⁷⁵ covering April 1, 2013, through September 30, 2013,⁷⁶ J. Russell George, the Inspector General (IG), noted in his message to Congress that:

... several TIGTA reports have brought the IRS under some of the most intense scrutiny that it has experienced since the events leading up to the passage of RRA 98. Our report on the IRS's use of inappropriate criteria to review applications for tax-exempt status stands out for having drawn the most attention to internal IRS procedures of any reports during my tenure as Inspector General.

Note. Mr. George's tenure began in November of 2004.⁷⁷

⁷⁵ For downloadable copies of the semiannual reports, see www.treasury.gov/tigta/publications_semi.shtml.

⁷⁶ *Treasury Inspector General for Tax Administration Semiannual Report to Congress*. Apr. 1, 2013–Sep. 30, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/semiannual/semiannual_sept2013.pdf] Accessed on Jul. 8, 2014.

⁷⁷ *Meet the IG: J. Russell George*. May 24, 2013. Treasury Inspector General for Tax Administration. [www.treasury.gov/tigta/oi.shtml] Accessed on Jul. 6, 2014.

The IG's message also noted that other TIGTA audits and evaluations raised important questions about the **IRS's spending on travel and training**. Specifically, he cited reports in which TIGTA had identified the following.

- The IRS's Small Business/Self-Employed Division spent \$4.1 million on a conference in Anaheim, California.
- The IRS purchase card program lacked consistent oversight to identify and address inappropriate use, leading to inappropriate and illegal purchases by IRS employees.
- The IRS spent \$9.5 million on executive travel over a 2-year period, much of it to and from Washington, D.C.

A recent TIGTA audit report,⁷⁸ issued in March 2014, identified a \$2.3 billion gap between the amount of **alimony deductions** claimed by taxpayers in 2010 as compared with corresponding income reported. This investigation was initiated to determine whether a reporting gap exists and whether the IRS has controls in place to promote alimony reporting compliance. As a result of its examination, TIGTA recommended that the IRS do the following.

- Evaluate current examination filters to ensure that potentially high-risk tax returns are not inappropriately excluded from examination
- Develop a strategy to address the significant alimony compliance gap
- Revise its processes to verify that all tax returns claiming an alimony deduction include a valid recipient TIN
- Correct errors in the IRS processing instructions to ensure that a penalty is accurately assessed on all tax returns on which a valid recipient TIN is not provided

The IRS Commissioner's response stated that the IRS was unable to legally deny the alimony deduction if the recipient's TIN is not present or is invalid because the Code does not contain that requirement. The IRS agreed with the other recommendations and had already enhanced its filters for the 2013 returns filed in 2014.

In 2011, TIGTA assessed the effectiveness of IRS processes to identify erroneous claims for the American opportunity credit (AOC) from January 1 through May 28, 2010. Their audit concluded that there was potentially \$3.2 billion of erroneous AOC claims during this period. As a result of their audit, they made eleven recommendations.

One of these recommendations was to revise Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*. Their specific recommendations for this form included the following.

- Requiring taxpayers to provide the name, address, and employer identification number of the educational institution that the student or students attended
- Asking the taxpayer specific questions regarding key eligibility requirements (TIGTA noted that these questions would verify that the requirements were met and would function as a deterrent for those taxpayers who intentionally erroneously claimed the credits.)

The IRS agreed with these recommendations, and Form 8863 was revised for the 2012 tax year accordingly.

TIGTA **continues to address issues** on an as-needed basis. TIGTA's audit reports can be accessed at www.treasury.gov/tigta/oa_auditreports.shtml. In addition, the website provides links to its annual letters to the Treasury Secretary presenting TIGTA's views on the management and performance challenges facing the IRS in the current fiscal year. These letters can be found at www.treasury.gov/tigta/oa_management.shtml.

⁷⁸ *Significant Discrepancies Exist between Alimony Deductions Claimed by Payers and Income Reported by Recipient*. Mar. 31, 2014. Treasury Inspector General for Tax Administration. [http://ip6v6.treasury.gov/tigta/auditreports/2014reports/201440022_oa_highlights.pdf] Accessed on Jul. 8, 2014.

2014 Workbook

The following table contains a sample of the audit reports that were issued recently.⁷⁹

Report Date	Title	Reference Number
03/31/2014	Significant Discrepancies Exist Between Alimony Deductions Claimed by Payers and Income Reported by Recipients	2014-40-022
03/21/2014	The Awards Program Complied With Federal Regulations, but Some Employees With Tax and Conduct Issues Received Awards	2014-10-007
12/30/2013	Affordable Care Act: The Customer Service Strategy Sufficiently Addresses Tax Provisions; However, Changes in Implementation Will Create Challenges	2014-43-006
09/30/2013	Late Legislation Delayed the Filing of Tax Returns and Issuance of Refunds for the 2013 Filing Season	2013-40-124
09/27/2013	Affordable Care Act: Improvements Are Needed to Strengthen Systems Development Controls for the Premium Tax Credit Project	2013-23-119
09/27/2013	The Online Payment Agreement Program Benefits Taxpayers and the Internal Revenue Service, but More Could Be Done to Expand Its Use	2013-30-121
09/26/2013	The Law Which Penalizes Erroneous Refund and Credit Claims Was Not Properly Implemented	2013-40-123
09/20/2013	Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds	2013-40-122
09/17/2013	The Office of Appeals Continues to Experience Difficulties in the Handling of Collection Due Process Cases	2013-10-103
09/09/2013	Improvements Are Needed in Assessing and Enforcing Internal Revenue Code Section 6694 Paid Preparer Penalties	2013-30-075

Note. See the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Rulings and Cases, for an analysis of TIGTA Reports 2013-40-123 and 2014-10-007.

⁷⁹ These reports can be found at www.treasury.gov/tigta/oa_auditreports_fy14.shtml and www.treasury.gov/tigta/oa_auditreports_fy13.shtml.

FOREIGN BANK AND FINANCIAL ACCOUNTS REPORTING (FBAR)

REQUIREMENT TO FILE

The Bank Secrecy Act (BSA)⁸⁰ requires an annual report to the Treasury Secretary⁸¹ from “United States persons” who have financial interests in or signature authority over foreign financial accounts. The Financial Crimes Enforcement Network (FinCEN) is the bureau within the Treasury Department with the responsibility to implement, administer, and enforce compliance with the BSA.

FinCEN’s purpose is stated as follows.⁸²

FinCEN’s mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.

Under FinCEN regulations, U.S. persons are required to file a report with the Treasury Department if:⁸³

- They had a financial interest in or signature authority over at least one financial account located outside of the United States, and
- The aggregate value of all foreign financial accounts exceeded \$10,000 **at any time** during the calendar year to be reported.

U.S. persons subject to this filing requirement include U.S. citizens, residents, and entities. Entities include corporations, partnerships, or limited liability companies created or organized in the United States or under the laws of the United States. Entities also include trusts or estates formed under the laws of the United States.

This requirement covers the following types of foreign financial holdings.⁸⁴

- Any account maintained with a financial institution or body performing the services of a financial institution, such as the following
 - ♦ A securities account
 - ♦ Brokerage account
 - ♦ Savings account
 - ♦ Demand account
 - ♦ Checking account
 - ♦ Deposit account
 - ♦ Time deposit account
- A commodity futures or options account
- An insurance policy with a cash value (such as a whole life insurance policy)

⁸⁰ Titles I and II of PL 91-508, as amended, codified at 12 USC 1829b, 12 USC 1951–1959, and 31 USC 5311–314 and 5316–5332.

⁸¹ 31 CFR 1010.

⁸² Home Page. Financial Crimes Enforcement Network. [www.fincen.gov] Accessed on Jul. 6, 2014.

⁸³ 31 CFR 103.27.

⁸⁴ 31 CFR 1010.350(c); *BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts* (FinCEN Form 114). Jun. 2014. Financial Crimes Enforcement Network. [www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Jul. 8, 2014.

- An annuity policy with a cash value
- Shares in a mutual fund or similar pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions)

The following are **exceptions**⁸⁵ to the reporting requirements.

- Certain foreign financial accounts (FFA) jointly owned by spouses if the spouse has reported the holding in their annual report (among other requirements)
- U.S. entities included in a consolidated report
- Correspondent accounts
- Nostro accounts (used solely for bank-to-bank settlements)
- FFAs owned by a U.S. governmental entity
- FFAs owned by an international financial institution if the U.S. government is a member
- FFAs held in an IRA
- FFAs held by or on behalf of qualified retirement plans⁸⁶
- Certain individuals with signature authority over, but no financial interest in, an FFA
- Trust beneficiaries (but only if a U.S. person reports the account on an FBAR filed on behalf of the trust)
- FFAs maintained with a financial institution located on a U.S. military installation

PENALTIES⁸⁷

A person who is required to file an annual report under this law and fails to properly file may be subject to a civil penalty not to exceed \$10,000 per violation. If there is reasonable cause for the failure **and** the balance in the account is properly reported, no penalty will be imposed.

A person who **willfully** fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of \$100,000 or 50% of the balance in the account at the time of the violation.⁸⁸ Willful violations may also be subject to criminal penalties under 31 USC §5322(a) and (b) or 18 USC §1001.

Caution. The IRS has taken the unofficial position that individuals who have signature authority for foreign accounts in their capacity **as agents** must also meet the FBAR filing requirements. According to an example in the IRS reference guide,⁸⁹ a child holding a power of attorney (POA) for her parents, who have investments in foreign accounts, must file the annual report for **herself** because as the POA she **could** exercise control over those accounts. Furthermore, the IRS asserts that the obligation to file exists even if the POA does **not** exercise such control. Practitioners should discuss this issue with clients who have POAs that cover people with foreign accounts.

In addition, practitioners who act as estate planners often have such authority over their clients' accounts. Those who do should take appropriate action to protect themselves from penalties associated with failure to file the annual report.

⁸⁵ *BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts* (FinCEN Form 114). Jun. 2014. Financial Crimes Enforcement Network. [www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Jul. 8, 2014.

⁸⁶ IRC §§401(a), 403(a) and (b).

⁸⁷ *BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts* (FinCEN Form 114). Jun. 2014. Financial Crimes Enforcement Network. [www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Jul. 8, 2014.

⁸⁸ See 31 USC §5321(a)(5).

⁸⁹ *IRS FBAR Reference Guide*. [www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf] Accessed on Aug. 7, 2014.

FBAR REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS⁹⁰

FinCEN Form 114, *Report of Foreign Bank and Financial Accounts*, (FBAR) is used to file the required annual report. (This form supersedes TD F 90-22.1.) It is due by June 30 of the year following the calendar year being reported. **There is no provision to request an extension of time to file an FBAR form.**

Note. FinCEN Notice 2013-1 extended the due date **for reporting signature authority** by certain individuals with signature authority over, but no financial interest in, foreign financial accounts of their employer or a closely related entity, to June 30, 2015. **For all other individuals with an FBAR filing obligation, the filing due date remains unchanged.**

The FBAR form is only available through the BSA e-filing system website at <http://bsaefiling.fincen.treas.gov/main.html>.

The system allows the filer to enter the calendar year reported, including past years, to the online FinCEN Form 114. The first page of the online form offers users an **option to explain a late filing**. If the filer selects “other” from the drop-down list, they will be able to enter up to 750 characters of explanation. Filers may also indicate in this spot if the report is being filed in conjunction with one of the IRS compliance programs discussed later in the chapter.

Practitioners who will be filing FBARs on behalf of their clients must pre-register with FinCEN’s BSA e-filing system. Instructions for registering can be found at http://bsaefiling.fincen.treas.gov/Enroll_Now_Step_01.html.

A new form, FinCEN Form 114a, *Record of Authorization to Electronically File FBARs*, is available for filers who:

1. Submit FBARs jointly with spouses, or
2. Wish to have a third-party preparer file their FBARs on their behalf.

FinCEN Form 114a is not submitted with the filing; it is maintained with the FBAR records by the filer and the account owner. If requested, it must be made available to FinCEN or the IRS.

FinCEN Form 114 and FinCEN Form 114a are shown on the following pages.

⁹⁰ BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114). Jun. 2014. Financial Crimes Enforcement Network. [www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Jul. 8, 2014.

Report of Foreign Bank and Financial Accounts

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Report of Foreign Bank and Financial Accounts

Version Number: 1.0

FinCEN Form 114 OMB No. 1506-0009 Effective October 1, 2013

The FBAR must be received by the Department of Treasury on or before June 30th of the year immediately following the calendar year being reported. The June 30th filing date may not be extended.

IMPORTANT : After you have completed this FBAR, you must **Sign the Form** and **Save** in order to activate the **Ready to File** button, which will direct you to a page where you can attach and submit your report. Click **Validate** to identify missing or incorrectly formatted data at any time during preparation of this report. Click **Print** to print a copy of this report for record keeping purposes.

Filing name (e.g. SMITH FBAR 2013)

[Sign the Form](#)
[Save](#)
[Validate](#)
[Print](#)
[Ready To File](#)

If this report is being filed late, select the reason for filing late

This form should be used to report a financial interest in, signature authority, or other authority over one or more financial accounts in foreign countries, as required by the Department of the Treasury Regulations 31 CFR 1010.350. No report is required if the aggregate value of the accounts did not exceed \$10,000. See help text Instructions For Definitions.

PRIVACY ACT AND PAPERWORK REDUCTION ACT NOTICE

Pursuant to the requirements of Public Law 93-579 (Privacy Act of 1974), notice is hereby given that the authority to collect information on FinCEN 114 in accordance with 5 USC 552a (e) is Public Law 91-508; 31 USC 5314; 5 USC 301; 31 CFR 1010.350. The principal purpose for collecting the information is to assure maintenance of reports where such reports or records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The information collected may be provided to those officers and employees of any constituent unit of the Department of the Treasury who have a need for the records in the performance of their duties. The records may be referred to any other department or agency of the United States upon the request of the head of such department or agency for use in a criminal, tax, or regulatory investigation or proceeding. The information collected may also be provided to appropriate state, local, and foreign law enforcement and regulatory personnel in the performance of their official duties. Disclosure of this information is mandatory. Civil and criminal penalties, including in certain circumstances a fine of not more than \$500,000 and imprisonment of not more than five years, are provided for failure to file a report, supply information, and for filing a false or fraudulent report. Disclosure of the Social Security number is mandatory. The authority to collect is 31 CFR 1010.350 (formerly 31 CFR 103.24). The Social Security number will be used as a means to identify the individual who files the report. The estimated average burden associated with this collection of information is 20 minutes per respondent or record keeper, depending on individual circumstances. Comments regarding the accuracy of this burden estimate, and suggestions for reducing the burden should be directed to the Financial Crimes Enforcement Network, P. O. Box 39, Vienna, VA 22183, Attn: Office of Regulatory Policy.

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Report of Foreign Bank and Financial Accounts

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Filer
Information

Financial Account Owned
Separately/Jointly

No Financial Interest
Account Information

Consolidated
Report

Signature
Information

1 This report is for calendar year ended 12/31 Amended ☐ Prior Report BSA Identifier

Part I Filer Information

2 Type of filer

3 U.S. Taxpayer Identification Number

3a TIN type

4 Foreign identification

a Type

b Number

c Country of issue

5 Individual's date of birth

6 Last name or organization's name

7 First name

8 Middle name

8a Suffix

9 Address

10 City

11 State

12 ZIP/postal code

13 Country

14a Does the filer have a financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts

☐ No

If "Yes" is checked do not complete Part II or Part III, but retain records of this information

14b Does the filer have signature authority over but no financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts

☐ No

If "Yes" is checked Complete Part IV items 34 through 43 for each person on whose behalf the filer has signature authority.

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Part II Information on Financial Account(s) Owned Separately 1 of 1

+ -

15 Maximum account value	<input type="text"/>	15a Maximum account value unknown	<input type="checkbox"/>
16 Type of account	<input type="text"/>	<input type="text"/>	
17 Financial institution name	<input type="text"/>		
18 Account number or other designation	<input type="text"/>		
19 Address	<input type="text"/>		
20 City	<input type="text"/>	21 State	<input type="text"/>
22 Foreign postal code	<input type="text"/>	23 Country	<input type="text"/>

Part III Information on Financial Account(s) Owned Jointly 1 of 1

+ -

Account Information

15 Maximum account value	<input type="text"/>	15a Maximum account value unknown	<input type="checkbox"/>
16 Type of account	<input type="text"/>	<input type="text"/>	
17 Financial institution name	<input type="text"/>		
18 Account number or other designation	<input type="text"/>		
19 Address	<input type="text"/>		
20 City	<input type="text"/>	21 State	<input type="text"/>
22 Foreign postal code	<input type="text"/>	23 Country	<input type="text"/>
24 Number of joint owners	<input type="text"/>		

Principal Joint Owner Information

25 Taxpayer Identification Number (TIN)	<input type="text"/>	25 a TIN type	<input type="text"/>
26 Last name or organization name	<input type="text"/>		
27 First name	<input type="text"/>		
28 Middle name	<input type="text"/>		
28a Suffix	<input type="text"/>		
29 Address	<input type="text"/>		
30 City	<input type="text"/>	31 State	<input type="text"/>
32 ZIP/postal code	<input type="text"/>	33 Country	<input type="text"/>

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Information](#)

Part IV Information on Financial Account(s) Where Filer has Signature or Other Authority but No financial Interest in the Account(s) 1 of 1

+

-

Account Information

15 Maximum account value	<input type="text"/>	15a Maximum account value unknown	<input type="checkbox"/>
16 Type of account	<input type="text"/>	<input type="text"/>	
17 Financial institution name	<input type="text"/>		
18 Account number or other designation	<input type="text"/>		
19 Address	<input type="text"/>		
20 City	<input type="text"/>	21 State	<input type="text"/>
22 Foreign postal code	<input type="text"/>	23 Country	<input type="text"/>

Owner Information

+

-

34 Last name or organization name	<input type="text"/>		
35 Taxpayer Identification Number (TIN)	<input type="text"/>	35 a TIN type	<input type="text"/>
36 First name	<input type="text"/>		
37 Middle name	<input type="text"/>		
37a Suffix	<input type="text"/>		
38 Address	<input type="text"/>		
39 City	<input type="text"/>		
40 State/territory/province	<input type="text"/>		
41 ZIP/postal code	<input type="text"/>		
42 Country	<input type="text"/>		
43 Filer's title with this owner	<input type="text"/>		

Report of Foreign Bank and Financial Accounts			
Home	Filer Information	Financial Account Owned Separately/Jointly	No Financial Interest Account Information
		Consolidated Report	Signature Information

Part V Information on Financial Account(s) Where Filer is Filing a Consolidated Report 1 of 1 + -

Account Information

15 Maximum account value

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

22 Foreign postal code

15a Maximum account value unknown ☐

21 State

23 Country

Owner Information + -

34 Organization name

35 Taxpayer Identification Number (TIN)

38 Address

39 City

40 State/territory/province

41 ZIP/postal code

42 Country

35 a TIN type

Report of Foreign Bank and Financial Accounts

[Home](#)[Filer
Information](#)[Financial Account Owned
Separately/Jointly](#)[No Financial Interest
Account Information](#)[Consolidated
Report](#)[Signature
Information](#)

Signature 44a Click here ☐ if this report is completed by a third party preparer, complete the third party preparer section.

44 Filer signature **Please return to the Home tab to sign the report.**

45 Filer title

46 Date of signature (Date of signature will be auto-populated when the report is signed.)

Third Party Preparer Use Only

47 Preparer's last name

48 First name

49 Middle name/initial

50 Check ☐ if self employed

51 Preparer's TIN

51a TIN type

52 Contact phone number

52a Extension

53 Firm's name

54 Firm's TIN

54a TIN type

55 Address

56 City

57 State

58 ZIP/postal code

59 Country

[Back to Home](#)

<p style="text-align: center;">Form 114a</p> <p style="text-align: center;">Department of the Treasury Financial Crimes Enforcement Network (FinCEN)</p> <p style="text-align: center;">October 2013</p>	<h2 style="margin: 0;">Record of Authorization to Electronically File FBARs</h2> <p style="margin: 0;">(See instructions below for completion)</p> <p style="margin: 10px 0 0 0;"><u>Do not send to FinCEN. Retain this form for your records.</u></p>	
Part I Persons who have an obligation to file a Report of Foreign Bank and Financial Account(s)		
1. Owner last name or entity's legal name	2. Owner first name	3. Owner M. I.
4. Spouse last name (if jointly filing FBAR - see instructions below)	5. Spouse first name	6. Spouse M. I.
<p>I/we declare that I/we have provided information concerning _____ (enter number of accounts) foreign bank and financial account(s) for the filing year ending December 31, _____ to the preparer listed in Part II; that this information is to the best of my/our knowledge true, correct, and complete; that I/we authorize the preparer listed in Part II to complete and submit to the Financial Crimes Enforcement Network (FinCEN) a Report of Foreign Bank and Financial Accounts (FBAR) based on the information that I/we have provided; and that I/we authorize the preparer listed in Part II to receive information from FinCEN, answer inquiries and resolve issues relating to this submission. I/we acknowledge that, notwithstanding this declaration, it is my/our legal responsibility, not that of the preparer listed in Part II, to timely file an FBAR if required by law to do so.</p>		
7. Owner signature (Authorized representative if entity)	8 Date <div style="border-bottom: 1px solid black; display: flex; justify-content: space-between; width: 100px; margin: 0;">MM DD YYYY</div>	9 Owner or entity TIN
11. Spouse signature	12 Date <div style="border-bottom: 1px solid black; display: flex; justify-content: space-between; width: 100px; margin: 0;">MM DD YYYY</div>	13 Spouse TIN
		10 TIN type a <input type="checkbox"/> EIN b <input type="checkbox"/> SSN/ITIN c <input type="checkbox"/> Foreign
		14 TIN type a <input type="checkbox"/> EIN b <input type="checkbox"/> SSN/ITIN c <input type="checkbox"/> Foreign
Part II Individual or Entity Authorized to File FBAR on behalf of Persons who have an obligation to file.		
15. Preparer last name	16. Preparer first name	17. Preparer M.I.
18. Preparer PTIN		
19 Address	20 City	21 State
		22 ZIP/postal code
23 Country code	24 Preparer's (item 15) employer's (Entity) name	25. Employer EIN
26. Preparer's signature		
<p style="text-align: center;">Instructions for completing the FBAR Signature Authorization Record</p> <p style="text-align: center;">This is a fill and print form using Adobe Reader</p> <p>This record may be completed by the individual or entity granting such authorization (Part I) <u>OR</u> the individual/entity authorized to perform such services. The completed record <u>must</u> be signed by the individual(s)/entity granting the authorization (Part I) and the individual/entity that will file the FBAR. The Preparer/filing entity must be registered with FinCEN BSA E-File system. (See http://bsaefiling.fincen.treas.gov/main.html for registration).</p> <p>Read and complete the account owner statement in Part I.</p> <p>To authorize a third party to file the Foreign Bank and Financial Accounts Report (FBAR), the account owner should complete Part I, items 1 through 3 (as required), sign and date the document in Part I, Items 7/8 and complete items 9 and 10.</p> <p><u>Accounts Jointly Owned by Spouses (see exceptions in the FBAR instructions)</u></p> <p>If the account owner is filing an FBAR jointly with his/her spouse, the spouse must also complete Part I, items 4 through 6. The spouse must also sign and date the report in items 11/12, and complete items 13 and 14. A third party preparer may be one of the spouses of the jointly owned foreign account. In this case, both spouses must complete Part I of form 114a in its entirety. The third party preparer (spouse) that will file the FBAR on behalf of both spouses will complete Part II in its entirety (do not use such terms as <i>see above</i>, or <i>same as item number x</i>).</p> <p>Complete Part II, items 15 through 18 with the preparer's information. The address, items 19 through 23, is that of the preparer or the preparer's employer if the preparer is an employee. Record the employer's information (if any) in items 24 and 25. If the preparer does not have a PTIN, leave item 18 blank. The third party preparer <u>must</u> sign in item 26 of Part II indicating that the FBAR will be filed as directed by the authorizing authority.</p> <p>The person(s) listed in Part I, and the person listed in Part II as authorized to file on behalf of the person(s) listed in Part I, should retain copies of this record of authorization and the filing itself, both for a period of 5 years. See 31 CFR 1010.430(d).</p> <p style="text-align: center;">DO NOT SEND THIS RECORD TO FinCEN UNLESS REQUESTED TO DO SO.</p>		

Rev. 10.5 Nov 6, 2013

OTHER REPORTING REQUIREMENTS RELATED TO FOREIGN ASSETS⁹¹

In addition to the FBAR submitted to FinCEN, some people may have to report their foreign income and/or holdings to the IRS.

U.S. citizens and resident aliens are required to report income from all sources within and outside of the United States. This is true regardless of whether they receive a Form W-2, *Wage and Tax Statement*, a Form 1099, or the foreign equivalents.⁹²

In addition, Part III of **Schedule B, *Interest and Ordinary Dividends***, contains three screening questions designed to alert taxpayers and the IRS when additional reporting may be required. This portion of the 2014 Schedule B follows.

on that form

Note. If income is over \$1,500, you must complete Part III.

You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

	Yes	No
Part III Foreign Accounts and Trusts (See instructions on back.)		
7a At any time during 2014, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		
b If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ▶		
8 During 2014, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N Schedule B (Form 1040A or 1040) 2014

Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*,⁹³ is used by U.S. persons and executors of estates of U.S. decedents to report the following information.

- Certain transactions with foreign trusts
- Ownership of foreign trusts under the rules of IRC §§671 through 679 (relating to grantor trusts, substantial owner trusts, and foreign trusts having one or more U.S. beneficiaries)
- Receipt of certain large gifts or bequests from certain foreign persons and trusts

Penalties⁹⁴ related to Form 3520 apply if the form is not timely filed or if the information is incomplete or incorrect. Generally, the initial penalty is equal to the greater of \$10,000 or:

- 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust,
- 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution, or
- 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the person to report the U.S. owner's information.

Additional penalties are imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting. However, no penalties are imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

⁹¹ Instructions for Form 8938.

⁹² *Income from Abroad Is Taxable*. Nov. 29, 2013. [www.irs.gov/Businesses/Income-from-Abroad-is-Taxable] Accessed on Jul. 6, 2014.

⁹³ Instructions for Form 3520.

⁹⁴ IRC §6677.

Taxpayers with specified foreign financial assets that exceed certain thresholds must report those assets to the IRS on **Form 8938, *Statement of Specified Foreign Financial Assets***.

Form 8938 is filed with the taxpayer's income tax return. If the person is not required to file a return, they are also not required to file Form 8938.⁹⁵ If a person's FFAs exceed the following thresholds at yearend or at any time during the year, they are probably required to file Form 8938. However, different thresholds apply for taxpayers living outside of the United States. The additional thresholds are listed in the Form 8938 instructions.

Filing Status	If Value on Last Day of Year Exceeds...	If Value at Any Time During Year Exceeds...
Single	\$ 50,000	\$ 75,000
MFJ	100,000	150,000
MFS	50,000	75,000

The following chart compares Form 8938 with FinCEN Form 114.⁹⁶ This chart provides a list of specified FFAs.

⁹⁵ *Basic Questions and Answers on Form 8938*. Jan. 10, 2014. [www.irs.gov/Businesses/Corporations/Basic-Questions-and-Answers-on-Form-8938] Accessed on Jul. 6, 2014.

⁹⁶ *Comparison of Form 8938 and FBAR Requirements*. Feb. 10, 2014. [www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements] Accessed on Jul. 21, 2014.

Comparison of Form 8938 and FBAR Requirements

The new Form 8938 filing requirement does not replace or otherwise affect a taxpayer's obligation to file FinCEN Form 114 (Report of Foreign Bank and Financial Accounts). Individuals must file each form for which they meet the relevant reporting threshold.

	Form 8938, Statement of Specified Foreign Financial Assets	FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR)
Who Must File?	Specified individuals, which include U.S. citizens, resident aliens, and certain non-resident aliens that have an interest in specified foreign financial assets and meet the reporting threshold	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR reporting
Reporting Threshold (Total Value of Assets)	\$50,000 on the last day of the tax year or \$75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)	\$10,000 at any time during the calendar year
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	Financial interest: you are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: you have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is Reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.
When Due?	By due date, including extension, if any, for income tax return	Received by June 30 (no extensions of time granted)
Where to File?	File with income tax return pursuant to instructions for filing the return	File electronically through FinCEN's BSA E-Filing System . The FBAR is not filed with a federal tax return.
Penalties	Up to \$10,000 for failure to disclose and an additional \$10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of \$60,000; criminal penalties may also apply	If non-willful, up to \$10,000; if willful, up to the greater of \$100,000 or 50 percent of account balances; criminal penalties may also apply

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Types of Foreign Assets and Whether They are Reportable

Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above	Yes, subject to exceptions
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported	The account itself is subject to reporting, but the contents of the account do not have to be separately reported
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50 percent interest) in the entity. See instructions for further detail.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign non-account investment assets	Yes, as to foreign accounts
Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate	No
Foreign currency held directly	No	No
Precious Metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No
'Social Security'- type program benefits provided by a foreign government	No	No

Page Last Reviewed or Updated: 10-Feb-2014

IRS OFFSHORE EFFORTS⁹⁷

Stopping offshore tax cheating and bringing individuals, especially high net-worth individuals, back into the tax system has been a top priority of the IRS for several years. The IRS's Offshore Voluntary Disclosure Program (OVDP) is designed to encourage taxpayers with undisclosed offshore assets to become current with their tax obligations. The program is part of a wider effort to stop offshore tax evasion, which includes enhanced enforcement, criminal prosecutions, and implementation of third-party reporting via the Foreign Account Tax Compliance Act (FATCA).

In general, the program offers participants the chance to become compliant on their filing obligations (including their FBAR filing obligations) and pay one penalty instead of waiting for the system to catch them. If the participants are caught before they voluntarily comply, they face criminal prosecution, civil penalties, and/or criminal penalties.

The following table shows the base penalties and IRS results realized in recent years.

Program	Penalty ^a	Number of Participants	Back Taxes, Interest and Penalties Paid
2009 OVDP	20%	18,000	\$3.4 billion
2011 Offshore Voluntary Disclosure Initiative	5%, 12.5%, or 25%	15,000	\$1.6 billion
2012 OVDP	5%, 12.5%, or 27.5%	12,000	\$1.5 billion
2014 OVDP	5%, 12.5%, 27.5%, or 50%		

^a Calculated on the highest aggregate value of offshore accounts over certain years.

2014 Offshore Voluntary Disclosure Program⁹⁸

The 2014 OVDP is a modified version of the 2012 program. The new provisions went into effect on July 1, 2014. The IRS hopes that its new streamlined procedures will make it easier for more noncompliant taxpayers to pay their past-due tax obligations. Under the new procedures, the penalty may be waived for qualified applicants entirely. However, for some taxpayers, the penalty will be much higher. Before the new provisions, the highest penalty was 27.5%. The penalty rate can now be as high as 50% if it becomes public knowledge that a financial institution or another facilitator is under investigation by the IRS or Department of Justice before the taxpayer joins the program.

Procedures for Noncompliant Taxpayers

There are four sets of procedures designed for noncompliant taxpayers. The streamlined filing compliance procedures (SFCP) and the OVDP are designed for taxpayers who need to file delinquent or amended tax returns and to report and pay additional tax. Taxpayers may use only one of these methods. The other two sets of procedures are for people who do not owe any tax but who are not in compliance with their filing requirements concerning foreign assets.

Note. The IRS webpage at www.irs.gov/Individuals/International-Taxpayers/Options-Available-For-U-S--Taxpayers-with-Undisclosed-Foreign-Financial-Assets offers links to all four sets of procedures.

Note. Although the current program does not have a closing date, the IRS may change or end the program at any time.

⁹⁷ *IRS Offshore Voluntary Disclosure Efforts Produce \$6.5 Billion; 45,000 Taxpayers Participate.* Jun. 18, 2014. [www.irs.gov/uac/Newsroom/IRS-Offshore-Voluntary-Disclosure-Efforts-Produce-\$6.5-Billion;-45,000-Taxpayers-Participate] Accessed on Jul. 7, 2014.

⁹⁸ *2012 Offshore Voluntary Disclosure Program.* Jun. 18, 2014. [www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program] Accessed on Jul. 7, 2014.

Streamlined Filing Compliance Procedures.⁹⁹ The eligibility criteria for the SFCP includes the following.

- Only individual taxpayers and estates of individual taxpayers may apply.
- Both resident and nonresident U.S. individual taxpayers qualify.
- Participating taxpayers must **certify** that the failure to report all income, pay all tax, and submit all required information returns, including FBARs, was due to nonwillful conduct. (This requirement is new.) Nonwillful conduct is conduct that is due to negligence, inadvertence, or mistake, or conduct that is the result of a good faith misunderstanding of the requirements of the law.¹⁰⁰
- Taxpayers under examination by the IRS or under criminal investigation are **not** eligible.

All tax returns submitted under the streamlined procedures must have a valid TIN. Tax returns submitted without a valid social security number or ITIN will not be processed under the streamlined procedures unless accompanied by a complete ITIN application.

Tax returns submitted under this program are processed like any other return submitted to the IRS. Consequently, receipt of the returns will not be acknowledged by the IRS, nor will the process culminate in the signing of a closing agreement with the IRS.

Returns submitted are **not automatically** subject to IRS audit, but they may be selected for audit under the existing audit selection processes applicable to any U.S. tax return. In addition, the returns are subject to the IRP procedures discussed at the beginning of the chapter. Thus, returns submitted under the streamlined procedures may be subject to IRS examination, additional civil penalties, and even criminal liability, if appropriate.

After taxpayers have completed the streamlined filing compliance procedures, they are expected to comply with U.S. law for all future years and file returns according to regular filing procedures.

The method of applying under the SFCP depends on the taxpayer's residency.

1. **Residents** of the United States must follow the steps outlined at www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States.
2. **Nonresidents** of the United States must follow the steps outlined at www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States.

Taxpayers who are concerned that their failure to report income, pay tax, and submit required information returns may be considered willful conduct, and who therefore seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties, should consider participating in the OVDP instead of using the SFCP.

Offshore Voluntary Disclosure Program.¹⁰¹ Taxpayers or their representatives must notify the IRS Criminal Investigation Lead Development Center of their request to participate in the program. The taxpayer's name, date of birth, social security number, and address must be faxed to (267) 941-1115. If the taxpayer is represented by a tax professional, Form 2848 must be included with this fax.

⁹⁹ *Streamlined Filing Compliance Procedures*. Jun. 18, 2014. [www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures] Accessed on Jul. 7, 2014.

¹⁰⁰ *U.S. Taxpayers Residing in the United States*. Jun. 26, 2014. [www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States] Accessed on Jul. 7, 2014.

¹⁰¹ *How to Make an Offshore Voluntary Disclosure*. Mar. 24, 2014. [www.irs.gov/uac/How-to-Make-an-Offshore-Voluntary-Disclosure] Accessed on Jul. 7, 2014.

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The IRS Criminal Investigation Office will then notify taxpayers or their representatives via fax whether the taxpayers have been cleared to make a voluntary disclosure. Taxpayers or representatives with questions regarding the pre-clearance can call (267) 941-1607 or contact their nearest Criminal Investigation Office.

Note. Pre-clearance does not guarantee a taxpayer acceptance into the OVDP.

For taxpayers who choose to submit a pre-clearance request, the taxpayer will have 30 days after receipt of the pre-clearance fax notification to complete the offshore voluntary disclosure letter (OVDL) and the related attachments. If the taxpayer chooses to bypass the pre-clearance process, the taxpayer must mail the OVDL to the following address.

**Internal Revenue Service
Criminal Investigation
ATTN: Offshore Voluntary Disclosure Coordinator
Philadelphia Lead Development Center
1-D04-100
2970 Market Street
Philadelphia, PA 19104**

The IRS reviews the information submitted and notifies the taxpayer or representative by mail as to whether the voluntary disclosure has been **preliminarily** accepted or declined. Once the voluntary disclosure has been preliminarily accepted, the taxpayer should send the full **voluntary disclosure package** to the following address.

**Internal Revenue Service
ATTN: 2011 Offshore Voluntary Disclosure Initiative
3651 S. I H 35 Stop 4301 AUSC
Austin, TX 78741**

Links to the letter and the package can be found at www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program.