Four QR Classics and How to Avoid Them

What do you check when you do quality review? Filing status? Who's claiming whom? How the names are spelled? SSNs? EINs? All those little boxes on the W-2s? All of this and more? There seems to be an infinite number of ways a tax return can go wrong, and in the time pressure at a busy tax site, it's almost impossible to catch it all.

The important thing is to focus on the errors that are serious in nature but will likely never be caught by any computer or by IRS processing. Focusing on those errors is of the utmost importance in quality review. It's great to fix the transposed SSNs and speed the processing along, but when something like that is missed in review, some computer will catch it down the road.

Today's *Tax Prep Dispatch* explores four of these serious errors – classic mistakes often made by volunteers that definitely affect the tax return outcome. These errors must be caught during the quality review process or, in most cases, will never be remedied. Notice that none of these errors would cause rejects and that most require a conversation with the taxpayer.

1. NONEMPLOYEE COMPENSATION

Error: Form 1099-MISC, Nonemployee compensation (box 7), is entered on Schedule 1, line 21, Other income. This income should be reported as self-employment on Schedule C-EZ or Schedule C.

How You Find It: Always question any entry on Form 1040, line 21. In the VITA world there aren't many types of income that correctly go on line 21. Gambling and cancelled debt would be the most common and are likely identified as such on line 21.

Why It Happens: Often the taxpayer just doesn't think of the income as business income. Volunteers tend to take clients at their word on this. Newer and less experienced volunteers may also have forgotten that box 7, Nonemployee compensation, is almost always self-employment. And, sometimes, volunteers will try it both ways, and assume that line 21 is better because it means no self-employment tax and results in a lower tax liability. Maybe it is just some work on the side, but to the IRS that income means that the taxpayer is a self-employed sole proprietor.

The Conversation: You want to find out enough about the income to make sure that it isn't hobby income or a misclassified worker situation. (It's unlikely that it is.)

Reviewer: I see that you have $2,100 income reported on this Form 1099-MISC. What kind of work did you do for this?

Taxpayer: Last summer my buddy who runs a construction company got his company to pay me to do some painting. I liked it and the pay was good, so I'm advertising with other construction companies to do more painting this year.

Reviewer: Did you have any expenses related to this work?

Taxpayer: I had to buy my own brushes and safety masks and some other supplies.

Reviewer: This income is really self-employment income, which means that in addition to income tax you have to pay self-employment tax, which is about 15% of the income. The good news is that you can deduct your business expenses.

What Happens If QR Doesn't Find It: Based on recent experience, the IRS will assess the self-employment tax on the gross income on line 21 and will not treat it as earned income for the EITC. And, of course, there will be no deduction of business expenses.

Comment: If it turns out to actually be hobby income or the taxpayer is a misclassified worker, the return is out of scope for VITA.

2. COMMUTING

Error: Commuting mileage is deducted as a business expense on Schedule C-EZ or Schedule C.

How You Find It: Always ask how the taxpayer (and preparer) arrived at the number of business miles – particularly when there is nothing entered in the spot for commuting miles. No commuting mileage could be an indication that something is wonky with the business miles.

Why It Happens: Folks seem to assume that someone who is self-employed can deduct any miles driven related to the business activity.

The Conversation: Unless the taxpayer drives to more than one business location during a work day or drives out of town, he probably doesn't have any deductible business miles.

<u>Reviewer</u>: I see you reported 500 business miles on your Schedule C-EZ. Tell me how you came up with this number.

<u>Taxpayer</u>: My office job – that W-2 there - is my regular Monday through Friday work. But last July I started doing translation services for another company on Saturdays. They had me drive to a different place every Saturday and they didn't give me any reimbursement. It was 10 – 30 miles round trip every Saturday. The total was 500 miles.

<u>Reviewer</u>: When you drive from your home to a workplace, it's considered commuting and commuting miles aren't deductible. I'm wondering if they ever sent you to more than one location in the same day or out of town.

<u>Taxpayer</u>: No, just one place in town every Saturday. But my neighbor's sister is an accountant and she said that since I'm self-employed I can deduct all my miles.

<u>Reviewer</u>: No, miles can only be deducted when you drive from one business location to another. So if they ever send you to more than one place, make a note of the number of miles between the two locations.

What Happens If QR Doesn't Find It: Hard to say if IRS would catch it. But it would seem that any return that lists zero commuting miles and no business use of home is ripe for an audit.

Comment: The situation changes when a taxpayer has qualified business use of the home because then any trip to a business location is business miles. (The morning commute is just staggering from bed to the home office.) But the rules are strict and most taxpayers do not qualify for business use of the home - and if they do, the return is out of scope for VITA.

3. INCORRECT SHARED RESPONSIBILITY PAYMENT

Error: Incorrect Individual Shared Responsibility payment on Form 1040, line 61.

How You Find It: Always review line 61 on Schedule 4. If there is any entry, make sure that the health insurance questions were answered correctly and the taxpayer does not qualify for any exemption.

Why It Happens: The Affordable Care Act is complex, to say the least.

The Conversation: When you see an Individual Shared Responsibility Payment, you want to make sure that you understand who in the family was covered for which months and that all likely exemptions were considered.

Reviewer: I see that the taxpayer is being charged a penalty for not having insurance.

Preparer: Right. He told me he and his wife didn't have any health insurance all year. The kids were covered under a state health insurance plan all year.

Reviewer: I notice that both taxpayers have ITINs instead of a social security numbers. There's an exemption for noncitizens. I'll show you how to find the list of exemptions and the codes in Publication 4012.

Preparer: I'm sorry! I forgot about that. What can I do?

Reviewer: You just need to enter code C in the health insurance section of the return. I'll help you with that.

What Happens If QR Doesn't Find It: This would seem to be an easy error for IRS to catch. So it's possible that the taxpayer would receive a letter requesting more information. Whether the taxpayer responds to such a letter and the penalty is eventually lifted is hard to say.

Comment: This is included here as a classic error. It has quickly achieved classic status because it is quite easy to overlook ACA exemptions or to answer a question wrong and cause an incorrect penalty to be assessed.

4. NO EARNED INCOME TAX CREDIT

Error: The taxpayer qualifies for EITC but no EITC is generated on page 2 of the Form 1040, line 17a.

How You Find It: When there is no EITC on line 17a, figure out why. Always.

Why It Happens: There's a lot of nuances to qualifying for the EITC. That means that one erroneous piece of information - one wrong little click - and the EITC will not calculate.

The Conversation: If the Form 13614-C is complete and correct, the reviewer will probably have sufficient information and this won't require an additional conversation. But carefully consider the factors that could contribute to zero EITC and then determine if they apply. That is, zero EITC might be due to a data entry error or maybe the taxpayer doesn't qualify and the software is correct. Here are the common reasons that a VITA taxpayer will not qualify for EITC.

- The taxpayer (and/or taxpayer's spouse on a joint return) has an ITIN.
- The taxpayer had no earned income.
- The taxpayer had over $3,400 in investment income.
- The taxpayer can be claimed as a dependent.

- The taxpayer or spouse was a nonresident alien during the tax year.
- The taxpayer's income is too high. This is a tricky one since the maximum income depends on filing status and number of qualifying children. Don't hesitate to look at the EITC tables.
- The taxpayer is under age 25 or age 65 or older and has no qualifying child for the EITC.

When none of these items apply, it's time to start reviewing all entries related to EITC to find the mistake.

What Happens If QR Doesn't Find It: Unless the taxpayer starts comparing the return to last year's return or otherwise gets suspicious or next year's preparer notices that it doesn't look right and does an amended return, that money is probably gone forever.

Comment: In general, less than 40% of VITA returns qualify for EITC. So reviewers will frequently encounter returns where there is correctly no EITC. But it is important to go through this review process on every return. Every time. If this error is not caught in quality review, which could mean that the taxpayer loses thousands of dollars of EITC.

<u>**SUMMARY**</u>

This, of course, is just four of the myriad errors that may be made on a VITA return. But they are doozies that occur with some frequency and each one can make a big difference on a return. The message here is to look at each entry on the Form 1040 and ask yourself, *"Based on all the information the taxpayer gave us does this make sense?"* And when the answer, is, *"No,"* - follow up.