

MSP
#9**EARNED INCOME TAX CREDIT: The IRS Inappropriately Bans
Many Taxpayers from Claiming EITC****RESPONSIBLE OFFICIALS**

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DEFINITION OF PROBLEM

Section 32(k) of the Internal Revenue Code (IRC) authorizes the IRS to ban taxpayers from claiming the earned income tax credit (EITC) for two years if the IRS determines they claimed the credit improperly due to reckless or intentional disregard of rules and regulations.¹ This standard requires more than mere negligence on the part of the taxpayer.² According to IRS Chief Counsel guidance, a taxpayer's failure to participate in an EITC audit does not justify imposing the ban.³ Once the IRS imposes the ban, any EITC claimed in the next two years will be disallowed even if the taxpayer is otherwise eligible for the credit.

IRS data shows:

- The IRS imposed the ban improperly almost 40 percent of the time in 2011;⁴
- Taxpayers who were (but for the 2011 ban) eligible for the credit in the following two years were deprived of a tax benefit that averaged more than \$4,600 for the two years combined.⁵

In a representative sample of two-year ban cases, the Taxpayer Advocate Service (TAS) found:

- In 19 percent of the cases, the IRS imposed the ban solely because EITC had been disallowed in a previous year;⁶
- In only ten percent of the cases did a taxpayer's response to the audit raise the *possibility* that he or she had the requisite state of mind to justify the two-year ban;⁷

1 IRC § 32(k)(1)(B)(ii) provides for a two-year "disallowance period" of "2 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to reckless or intentional disregard of rules and regulations."

2 For example, as discussed below, for purposes of the accuracy-related penalty under IRC § 6662, "negligence" includes "any failure to make a reasonable attempt to comply with the provisions of this title" and is distinguished from a "disregard" which is "reckless" or "intentional." IRC § 6662(c).

3 IRS Service Center Advisory SCA 200245051 (Nov. 8, 2002). As discussed below, IRS procedures permitted *automatic* imposition of the ban in some in which the taxpayer did not respond to IRS audit notices.

4 Of the 5,438 taxpayers on whom the IRS imposed the ban in 2011, the accounts of 2,121 are designated on IRS records as "no show/no response" or carry the notation that mail sent to them was returned as undelivered. 2,121 out of 5,438 is 39 percent. IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File (Tax Year 2011).

5 The average amount of EITC for eligible taxpayers was \$2,274 in 2012 and \$2,358 in 2013. The combined average was \$4,632. IRS response to TAS fact check (Dec. 20, 2013).

6 In 62 cases out of 333, the *only* explanation for imposing the ban was the prior year's disallowance. Sixty two out of 333 is 19 percent. As described below, the IRS assigned project codes to some audits that resulted in *automatic* imposition of the two-year ban because of a previous disallowance of the credit.

7 Of the 330 cases in which the IRS requested substantiation of claimed EITC, the taxpayer responded by submitting documents that were clearly insufficient in 32 cases. Thirty two out of 330 is ten percent.

- In 69 percent of the cases, the ban was imposed without required managerial approval;⁸
- In almost 90 percent of the cases, neither IRS work papers nor communications to the taxpayer contained the required explanation of why the ban was imposed;⁹ and
- Taxpayers' average income was about \$15,500.¹⁰

Low income taxpayers face unique obstacles in learning EITC rules and substantiating their entitlement to the credit, but IRS procedures do not take this into account. Instead, the IRS applies the two-year ban on the basis of unexamined assumptions about the taxpayer's state of mind or even *presupposes* reckless or intentional disregard of the rules and regulations, potentially causing significant harm to taxpayers who may be entitled to EITC in a subsequent year.

Addressing the inaccurate and unsupported application of the two-year bans is even more urgent and necessary if the Administration's proposal to permit the IRS to use math error authority in the context of these bans is adopted by Congress.¹¹ The National Taxpayer Advocate does not support such a proposal unless and until the IRS improves its procedures to ensure its auditors make affirmative and reasonable determinations that a taxpayer acted with reckless or intentional disregard of rules or regulations before imposing the two-year ban. Moreover, Congress should clarify that IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.

ANALYSIS OF PROBLEM

Background

IRC § 32(k) Authorizes a Two-Year Ban on Claiming EITC, But Only If the IRS Determines the Taxpayer's Actions or Intent Meets Statutory Criteria.

IRC § 32(k)(1)(B)(ii) disallows EITC claims for two taxable years if there has been "a *final determination* that the taxpayer's claim of credit was due to *reckless or intentional disregard of rules and regulations*."¹²

Neither section 32 nor its regulations define the terms "reckless or intentional disregard," nor is there any judicial interpretation of the subsection.¹³ However, IRS Chief Counsel guidance provides that if EITC

8 Internal Revenue Manual (IRM) 4.19.14.6.1 (Jan. 1, 2013). Of the 333 cases in the sample, there was no evidence of managerial approval of the ban in 229 cases. Two hundred twenty nine out of 333 is 69 percent.

9 IRM 4.19.14.6.1 (Jan. 1, 2013). Of the 333 cases in the sample, there was no explanation (or there was only a conclusory or cursory statement that the ban applied, or the "explanation" for imposing the ban was that EITC had been disallowed in a previous year) in 295 cases. Two hundred ninety five out of 333 is 89 percent.

10 The average adjusted gross income for the 333 taxpayers in the sample was \$15,478. TAS Research, CDW, Individual Returns Transaction File.

11 Budget of the United States Government, Fiscal Year 2014 212, 219, available at <http://www.whitehouse.gov/omb/budget/Overview>. Under IRC § 6213(b), the IRS may correct mathematical or clerical errors on returns and send notices to taxpayers explaining the changes. Taxpayers who do not request an abatement of the resulting tax within 60 days after the notice is issued are assessed the additional tax and they do not have the right to petition the Tax Court on the basis of the notice.

12 IRC § 32(k)(1)(B)(ii) (emphasis added). IRC § 32(k) was enacted as part of the Tax Reform Act of 1997, Pub. L. No. 105-34, § 1085(a)(1), 111 Stat. 788, 956. IRC § 32(k)(1)(B)(i) authorizes the IRS to impose a ten-year ban on taxpayers who fraudulently claim EITC, but the IRS imposes the ten-year ban infrequently (13 times, 27 times, and 17 times in 2009, 2010, and 2011 respectively). IRS CDW, *Individual Returns Transaction File* (Tax Years 2009, 2010, 2011).

13 Neither the statute nor the regulations cross reference any other Code section (such as IRC § 6662) or regulations that contain similar language. Under IRC § 6662(b)(1), an accuracy-related penalty may be imposed on certain underpayments due to "negligence or disregard of rules or regulations." IRC § 6662(c) provides: "For purposes of this section, the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard." Treas. Reg. § 1.6662-3(b)(2) provides: "A disregard is 'reckless' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is 'intentional' if the taxpayer knows of the rule or regulation that is disregarded."

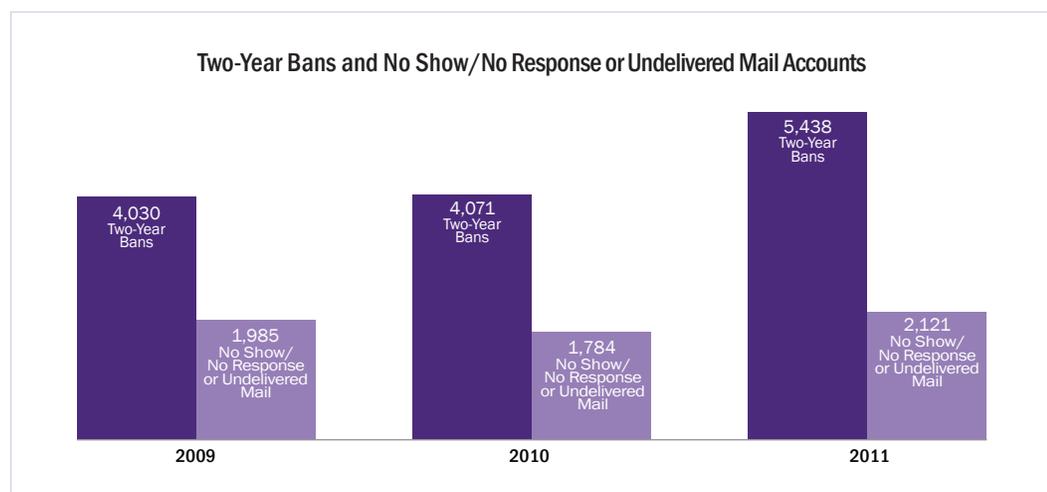
was disallowed because the taxpayer did not respond (or did not respond adequately) to a request for substantiation of claimed EITC, the ban should not be imposed.¹⁴

Recognizing that “each case may have a different reason for asserting the penalty/ban,” the IRM requires examiners who propose the two-year ban to note in their work papers the reason for the decision.¹⁵ A manager must approve all two-year bans.¹⁶

IRS Data Shows the IRS Frequently Imposes the Two-Year Ban Inappropriately.

TAS research of IRS databases shows that the IRS imposed the two-year EITC ban in tax years 2009-2011 as follows:

FIGURE 1.9.1, Total Number of Two-Year Bans and Number of Accounts Designated as No Show/No Response or Undelivered Mail¹⁷



With startling frequency, the IRS imposed the ban on taxpayers with whom it had had no interaction 49 percent of the time in 2009, 44 percent of the time in 2010, and 39 percent in 2011. There was no occasion on which the IRS could ascertain anything about these taxpayers’ states of mind. As discussed below, IRS procedures permitted *automatic* imposition of the ban in some cases because the taxpayer did not respond to IRS audit notices, despite Chief Counsel guidance to the contrary.

Analysis of a Random Sample of EITC Ban Cases Also Shows the IRS Frequently Imposes the Two-Year Ban Inappropriately.

To learn more about how the IRS handles the two-year ban, TAS Research extracted a random, statistically valid sample of 333 instances of the 5,438 cases in which the IRS imposed the two-year ban in

¹⁴ IRS SCA 200245051 (Nov. 8, 2002).

¹⁵ IRM 4.19.14.6.1 (Jan. 1, 2013).

¹⁶ *Id.* The 2013 version of this IRM cross references to IRM 20.1.5.1.6, which describes managerial approval as mandated by IRC § 6751(b).

¹⁷ TAS Research, CDW, Audit Information Management System (AIMS) Closed Case Database (Tax Year 2011). As described below, for tax year 2011, the TAS sample only found 28 percent (with margin of +/- about 5 percent) of accounts were designated as “no show/ no response” or “undelivered mail.”

2011.¹⁸ The TAS team reviewed records stored on IRS databases and ordered hardcopy files from IRS storage facilities as necessary.¹⁹ Among the study's principal findings:

- Of the 333 two-year ban cases in the sample, almost 80 percent stemmed from audits of tax year 2011.²⁰
- The average adjusted gross income of taxpayers in the sample was \$15,478.²¹
- The average amount of denied EITC was \$3,731, or 24 percent of adjusted gross income on average.²²
- In almost 30 percent of the sample cases, the taxpayer did not participate in the audit (*i.e.*, did not respond to notices or requests for information).²³
- In almost 90 percent of the cases, there was no clear explanation of why the ban was imposed or the “explanation” was that EITC had been disallowed in a prior year.²⁴

Part of the reason satisfactory explanations were so infrequent may be because some bans were imposed *systemically*. When the IRS disallows claimed EITC for a particular tax year, it places an indicator on the taxpayer's account and if the taxpayer claims EITC in a later year, the IRS requests the taxpayer to recertify eligibility for the credit.²⁵ If the recertification is not submitted and the case is selected for audit, the case is assigned a project code. Two project codes are:

- PC 0027 - Full scope EITC with 2 year ban proposed
- PC 0028 - Schedule C and full scope EITC with 2 year ban proposed.

A separate IRM provision explains how the IRS handles cases assigned project codes 27 or 28:

These cases will be worked as EITC Recertification cases; using existing aging and purging time frames, however both the initial contact letter and report will propose a 2 year EITC ban. If the taxpayer does not reply the 2 year EITC ban will post to Master File along with the EITC disallowance. If the taxpayer replies, evaluate the documentation and determine if

18 A TAS Examination Senior Technical Analyst, together with a team of TAS employees consisting mainly of three experienced Internal Revenue Agent Technical Advisors, developed a data collection instrument to analyze cases in the sample. The sample is statistically valid at the 95 percent confidence level with a margin of error of about five percent, which allows study findings to be projected to the population. TAS originally intended to review 365 cases but succeeded in getting all relevant information for 333.

19 Among other databases, the TAS team consulted the IRS Correspondence Examination Automation Support (CEAS) database that includes copies of correspondence with taxpayers. Where CEAS records did not contain an explanation of why the ban was imposed, the team ordered the paper case file and reviewed it for the missing information.

20 In the sample cases, 261 of the bans stemmed from audits of tax year 2011, 63 stemmed from audits of tax year 2010, eight stemmed from audits of tax year 2009, and one stemmed from a 2008 audit. 261 out of 333 is 78 percent. Most of the audits (206 or 62 percent), were handled by the Wage and Investment division (W&I), while 127 or 38 percent were handled by the Small Business/Self Employed divisions (SB/SE). TAS Research, CDW, AIMS Closed Case Database.

21 TAS Research, CDW, Individual Returns Transaction File.

22 TAS Research, CDW, Individual Master File.

23 Out of 333 cases in the sample, 92 or 28 percent were no-response cases — there was no interaction between the IRS and the taxpayer.

24 There were 233 cases in which there was no clear explanation for imposing the ban other than the prior year's disallowance. There were 62 cases in which the *only* explanation for imposing the ban was the prior year's disallowance. Two hundred thirty-three + 62 is 295, and 295 out of 333 is 89 percent. A typical statement in a communication to a taxpayer was simply: “Based upon the information we have available, we propose that you should be restricted from receiving the EITC for the following 2 years. This 2-year ban is asserted for the reckless or intentional disregard of the rules and regulations regarding the EITC under IRC Section 32(k)(1)(B)(ii).” Moreover, the TAS team reviewing the cases in the sample reported that IRS examiners sometimes indicated they were imposing the ban because they believed the taxpayer acted *negligently* (as opposed to *recklessly* or with *intentional* disregard of the EITC rules). The team did not quantify the number of cases in which the examiner gave this explanation for imposing the ban and therefore we cannot project the frequency with which it occurs. However, this terminology certainly suggests inappropriate application of the ban.

25 IRM 4.19.14.6, *Recertifications* (Jan.1, 2013).

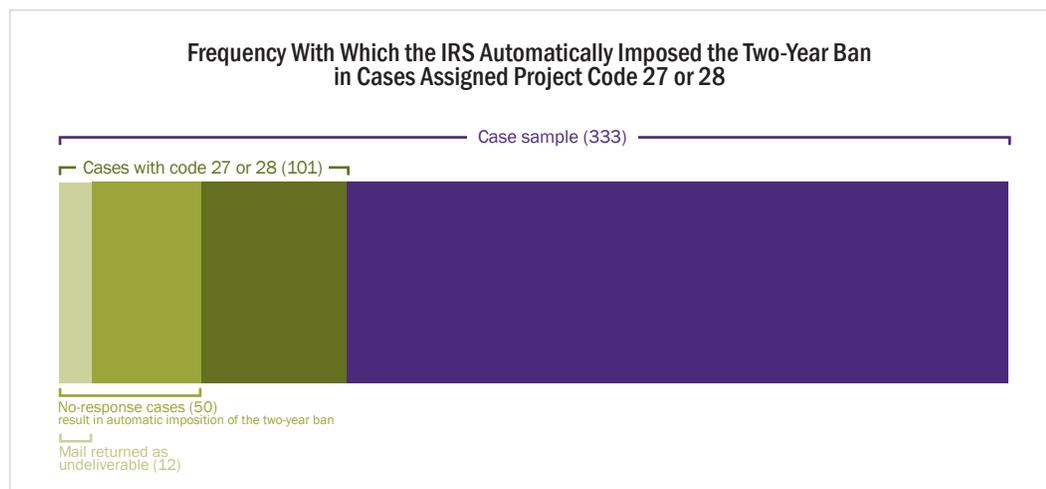
circumstances exist not to assert the 2 year EITC ban. If taxpayers request a Reconsideration of PC 0027 or 0028 cases, use existing Reconsideration guidelines for taxpayers with a 2 year EITC ban.²⁶

This IRM provision means the IRS will *automatically* impose the two-year ban on certain taxpayers who do not respond to audit notifications: taxpayers who were required to recertify eligibility for EITC and whose audits are assigned project codes 27 or 28. There is no attempt to ascertain whether the reason for the previous disallowance is different from the reason for the current year's disallowance (*e.g.*, whether the same children were claimed as qualifying children), or whether there was ever any contact with the taxpayer from which to surmise he or she understood the reason for either disallowance. According to this provision, if these taxpayers do respond to audit notifications, it is their burden to show that two-year ban should not apply, rather than the IRS's burden to show that it does apply.²⁷

IRS data show that the IRS imposed the ban improperly almost 40 percent of the time in 2011.

As Figure 1.9.2 shows, of the 333 cases in the sample, taxpayers' audits were designated with project code 27 or 28, and the taxpayer did not participate in the audit, in 50 cases, or in 15 percent of the cases in the sample. This resulted in *automatic* imposition of the two-year ban. In some cases, mail to the taxpayer had been returned as undeliverable — the taxpayer may have never realized he or she was being audited.

FIGURE 1.9.2, Frequency with Which the IRS Imposed the Two-Year Ban in Cases Assigned Project Code 27 or 28²⁸



²⁶ IRM 4.19.14.6.1.5 *Project Codes 0027 and 0028 – EITC Recertification with a Proposed 2 Year EITC Ban* (Jan. 1, 2013).

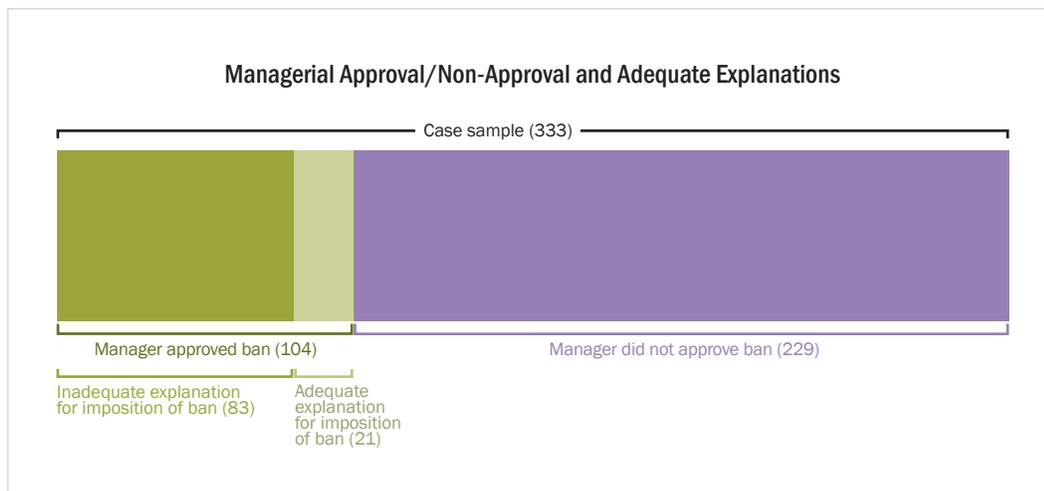
²⁷ The National Taxpayer Advocate recommends that Congress amend IRC § 32 to clarify that the burden is on the IRS to show the ban should apply. See Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit*, *infra*.

²⁸ In the TAS sample of cases, 101 cases had been assigned project code 27 or 28. Of these 101 cases, 50 were no-response cases, 12 of them with undelivered mail. Fifty out of 333 is 15 percent.

The IRS rarely follows its own procedures for imposing the two-year ban. Specifically, the TAS study found:

- In more than two-thirds of the sample cases, the required managerial approval of the ban was not secured.²⁹
- When a manager approved the ban, the explanation was insufficient 80 percent of the time.³⁰
- *In only six percent of the cases did the IRS follow its own procedures by adequately explaining why the ban was imposed and obtaining managerial approval.*³¹

FIGURE 1.9.3, Managerial Approval/Non-Approval and Adequate Explanations



In terms of IRS requests for substantiation, analysis of the sample cases showed that the IRS almost always (in 330 out of 333 cases) requested documentation from the taxpayer to substantiate the claimed EITC.

In these 330 cases:

- In 122 cases, or almost 40 percent of the time, it appeared from the documents submitted that the taxpayer actually believed he or she qualified for the EITC.³² An example of a case in this category is one in which a taxpayer claimed the credit with respect to her children and provided birth certificates to show the qualifying relationship. The documentation the taxpayer initially submitted to satisfy the residency was for a year other than the year under exam. The taxpayer then provided a letter from the children's school that showed where the children resided for the year under exam, but did not show the children lived with the taxpayer.

29 Of the 333 cases in the sample, there was no evidence of managerial approval of the ban in 229 cases, or 69 percent.

30 In the 104 cases in which a manager approved the ban, in 83 cases the explanation was not clear explanation or the only explanation was that EITC had been disallowed in a prior year. Eighty three out of 104 is 80 percent.

31 Only 21 cases contained an adequate explanation of why the ban was imposed (other than because EITC had been disallowed in a prior year) and had the required managerial approval. Twenty one out of 333 is six percent.

32 Of the 330 cases in which the IRS requested substantiation, the taxpayer responded by submitting documents that were reasonable attempts to substantiate the claimed credit in 122 cases, or 37 percent of the time.

- About 50 percent of the time, it was unclear whether the taxpayer understood whether he or she qualified for the credit.³³ For example, in an audit that encompassed 2009-2011, the taxpayer submitted birth certificates for two children and his marriage certificate, which substantiated a qualifying relationship for only one child. The taxpayer also submitted school records and receipts for rent and after-school care for both children, but only for 2010. In this instance, the taxpayer made an effort to provide some substantiating documentation, but not for both children and not for all audit years, although it is not clear whether he understood the law or the procedural requirements.
- In only ten percent of the cases were the documents clearly insufficient to support the claimed EITC, raising the *possibility* that the taxpayer had the requisite state of mind to justify the two-year ban.³⁴ For example, a taxpayer submitted copies of school records that did not reflect the taxpayer's address, paperwork from a doctor's office showing the other parent's address, and a birth certificate that appeared to have been typed.³⁵

IRS Procedures Do Not Take Into Account That the Unique Challenges Low Income Taxpayers Face in Substantiating Claimed EITC May Shed Light on these Taxpayers' State of Mind or Actions.

The National Taxpayer Advocate has repeatedly described the unique difficulties low income taxpayers face in attempting to comply with IRS requests for substantiation of claimed EITC.³⁶ Each year, the composition of the EITC population changes by about a third.³⁷ A chart prepared by the Treasury Inspector General for Tax Administration (TIGTA), reproduced below as Figure 1.9.4, shows how taxpayers move in and out of EITC.³⁸ Thirty-seven percent are intermittent or first-time filers, meaning they do not have any experience in claiming the credit or they have no recent experience.³⁹ Only 20 percent of taxpayers are termed "continual filers" who might be expected to have learned from their experience.⁴⁰

33 Of the 330 cases in which the IRS requested substantiation, in 176 cases, or 53 percent, it was unclear whether the taxpayer believed he or she was entitled to the claimed EITC.

34 Of the 330 cases in which the IRS requested substantiation, the taxpayer responded by submitting documents that were clearly insufficient in 32 cases, or ten percent of the time.

35 When questioned, the taxpayer admitted the children lived with their other parent five days a week.

36 See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*) ("IRS letters are legalistic, not tailored to the taxpayer's particular situation, and do not discuss alternate sources of documentation. Low income persons may live without written leases or may not have school records for their children because of their living situation or patterns of moving. Migratory living patterns, lack of education, lack of time (e.g. holding multiple jobs), lack of transportation, and limited access to technology (internet, faxes, etc.) add to the difficulty of finding and submitting documents."); National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*) ("Although a diverse population, low income taxpayers do share common characteristics. Low income taxpayers are found more frequently among the elderly, the disabled, Native Americans, and taxpayers who may have limited English proficiency (LEP) relative to the general Wage and Investment (W&I) taxpayer population. Many require extra assistance to understand tax law changes, as demonstrated by the widespread confusion about the 2008 Economic Stimulus Payment (ESP) and the resulting flood of calls to the IRS toll-free line. Low income taxpayers tend to be more transitory than the general population, with 27.5 percent of those below the poverty level moving in 2007 while only 15 percent of the general population moved during the same time.")

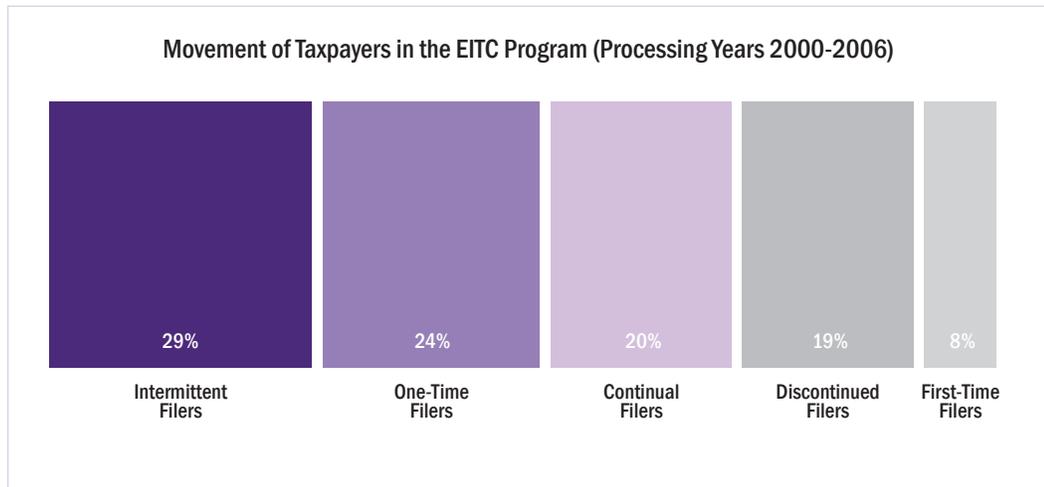
37 Kathleen M. Carley, *Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study*, prepared for the National Taxpayer Advocate. National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2.137.

38 Treasury Inspector General for Tax Administration (TIGTA) Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments 2* (2008), available at <http://www.treas.gov/tigta/auditreports/2009reports/200940024fr.pdf>. The report refers to taxpayers who claim EITC as being "in the EITC program."

39 Intermittent Filers are taxpayers who claim the EITC in one year but not the next, then file and claim the credit again at a later time.

40 Discontinued Filers are taxpayers who had consistently claimed the EITC but who stopped filing a tax return or no longer qualified for the EITC.

FIGURE 1.9.4, Movement of Taxpayers in the EITC Program (Processing Years 2000–2006)



These taxpayers' circumstances would be relevant to a determination under other Code sections, such as the innocent spouse provisions of IRC § 6015 or with respect to certain penalty provisions.⁴¹ In other areas of the law, these circumstances might establish the absence of negligence (and necessarily the absence of recklessness or intentional disregard).⁴² For purposes of the two-year ban, however, IRS procedures do not take these factors into account or adequately consider that taxpayers claiming EITC may be in “learning mode.” In fact, the applicable IRM provisions result in the IRS punishing EITC taxpayers while they are learning these complex rules.⁴³ A better approach, in view of the shifting population of EITC claimants and the consequent need to continuously educate taxpayers about the rules for EITC eligibility, would be for the IRS to regard the EITC audit as an opportunity. If the education is effective, taxpayers not only understand whether they are eligible to claim EITC in the audit year, but they can also remain compliant or avoid future noncompliance as their circumstances change.

41. IRC § 6015(f), for example, allows for relief from liability for a taxpayer who did not know or have reason to know, of an understatement of tax shown on a joint return, or of an underpayment of the tax. Rev. Proc. 2013-34, 2013-43 I.R.B. 397, § 4.03(2)(c)(iii) provides “[t]he facts and circumstances that are considered in determining whether the requesting spouse had reason to know of an understatement, or reason to know whether the nonrequesting spouse could or would pay the reported tax liability, include, but are not limited to, the requesting spouse’s level of education, any deceit or evasiveness of the nonrequesting spouse, the requesting spouse’s degree of involvement in the activity generating the income tax liability, the requesting spouse’s involvement in business or household financial matters, the requesting spouse’s business or financial expertise, and any lavish or unusual expenditures compared with past spending levels.” IRC § 6664 provides that reasonable cause for an underpayment and the taxpayer acting in good faith with respect to the underpayment may constitute a defense to imposition of the IRC § 6662 accuracy related penalty. Treas. Reg. § 1.6664-4(b) provides that “[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.” The regulation also provides that reliance on the advice of a professional tax advisor may constitute reasonable cause and good faith. As discussed below, most of the returns in our sample of cases were prepared by paid tax preparers.
42. See, e.g., Restatement 2d of Torts § 283, which provides “[u]nless the actor is a child, the standard of conduct to which he must conform to avoid being negligent is that of a reasonable man under like circumstances.” Comment d notes that “[i]n determining whether the actor should realize the risk which his conduct involves, the qualities which are of importance are those which are necessary for the perception of the circumstances existing at the time of his act or omission and such intelligence, knowledge, and experience as are necessary to enable him to recognize the chance of harm to others involved therein.”
43. IRS employees, who apply these complex rules by relying on IRM lists of “acceptable documentation” to substantiate claimed EITC, may not evaluate the claim accurately and completely. See National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 71, *Study of Tax Court Cases in Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*; National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 77 *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*. Historically, taxpayers often recover substantially all of the credit when the IRS takes a “second look” at denied EITC claims. In the 2004 EITC Audit Reconsideration study, TAS Research found that in audit reconsiderations, 40 percent of EITC claimants working with IRS Exam employees, and 45 percent of those working with TAS, recovered EITC payments. The 2010 TAS *EITC No Relief, No Response Review* showed that on average, TAS obtains full or partial relief in approximately 48 percent of EITC cases. See TAS Business Performance Review, 2nd Qtr. 2011, 15 (Mar. 2011).

IRM Provisions May be Leading IRS Employees to Impose Bans Inappropriately.

The main IRM provision that explains when to impose the two-year ban clarifies that first-time disallowance of EITC should not generally trigger the ban and, in an “if/then” formulation, gives eight scenarios in which the examiner *should* impose it.⁴⁴ Two of these scenarios are reasonable formulations — they presume the examiner actually spoke with the taxpayer and gathered enough information to ascertain the taxpayer’s state of mind.⁴⁵ Two other scenarios at least remind the examiner that the decision to impose the ban depends on the facts and circumstances of the case.⁴⁶ Three of the scenarios, however, contain unexamined assumptions about the taxpayer’s state of mind or even *presuppose* reckless or intentional disregard of the rules and regulations.⁴⁷

One scenario in the IRM table merges the substantive requirements for claiming EITC with the requirements for imposing the ban, and reflects a misconception of the law. It provides:

“**IF** The taxpayer filed MFJ [married filing a joint return] in prior tax years, is now filing as HOH [head of household], and our records show the taxpayers still live at the same address and/or *are still married* (emphasis added), **AND** Is unable to establish he/she is divorced or legally separated (They may be splitting the children to maximize the EITC) **THEN** The two year ban should be imposed.”

Actually, divorce or legal separation is not required for a taxpayer living apart from his or her spouse to be considered as not married, so a taxpayer described by this “if/then” sequence could still be entitled to claim EITC as a head of household.⁴⁸ An examiner who disallows EITC in this scenario without ascertaining more about the taxpayer’s situation may very well be misapplying the law. When this error occurs, it disproportionately affects racial and ethnic minorities, who predominate in the group of

44 IRM 4.19.14.6.1(7) (Jan. 1, 2013). The scenarios are shown in a table, referred to as a nonexclusive “starting point to help determine if the two-year ban is appropriate,” but no additional analytical framework is provided.

45 IRM 4.19.14.6.1(7) (Jan. 1, 2013). The first example, which would justify imposing the ban even on a first-time disallowance, is: “During a conversation, the taxpayer admits he/she knew they did not meet the eligibility requirements but decided to ‘try it anyway.’ In this instance, the ban would be justified because the taxpayer intentionally disregarded the rules and regulations.” TAS found that this occurred in seven of the 333 sample cases. The second example is: “If the taxpayer is claiming different qualifying children each year and when asked to identify the qualifying children, the taxpayer does not know who they are claiming,” then “[t]he two year ban should be imposed.”

46 The first scenario is: if “[t]his is a Recertification case [i.e., the taxpayer’s claimed EITC was previously denied and the taxpayer is now required, per Treas. Reg. § 1.32-3(c), to file Form 8862, *Information To Claim Earned Income Credit After Disallowance*], and “[i]nadequate documentation is received from the taxpayer and the case results in the EITC being disallowed again,” then “[b]ased on facts and circumstances presented apply the two-year ban.” The example also says, however, “The taxpayer was previously informed of the requirements and the specific rules and regulations pertaining to EITC.” This may or may not be true — the taxpayer may not have received any explanation for the previous disallowance, or may not have understood an explanation that was received. Moreover, the reason for the second disallowance may differ from the reason for the first disallowance. The second scenario is: if “[a] decedent’s SSN is used for a qualifying child” and “[t]he person died before the year under examination,” then “[b]ased on facts and circumstances presented apply the two-year ban.”

47 They are: if “[t]he technician can determine the taxpayer’s claim was due to reckless or intentional disregard rather than misunderstanding or confusion of the rules” then the two year ban should be imposed; if “[t]here is a lack of acceptable records” and “[t]he taxpayer understood what types of documentation could be accepted” the ban should be imposed; if “[t]he taxpayer agreed with the assessment and denial of EITC in the previous tax year(s)” and “[i]s again unable to verify eligibility for claiming the EITC and qualifying children” the ban should be imposed.

48 A married taxpayer need only be “treated as” not married within the meaning of IRC § 7703(b) to file a separate return using a filing status of Head of Household, if the other requirements of IRC § 2(b) are also met. IRC § 2(c), *Certain married individuals living apart*, provides: “For purposes of this part, an individual shall be treated as not married at the close of the taxable year if such individual is so treated under the provisions of section 7703(b).” IRC § 7703(b)(3) provides that married taxpayers who are not members of the same household for the last six months of the year may be considered as not married if the requirements of IRC § 7703(b)(1) and (2) (pertaining to maintaining a household) are also met.

married-but-indefinitely-separated taxpayers.⁴⁹ This single IRM provision invites examiners to first disallow EITC by misapplying the law, and to then compound the error by imposing the two-year ban.⁵⁰

The Avenues Available to a Taxpayer to Challenge an IRS Application of the Two-year Ban Are Procedurally Complex.

When the IRS audits a taxpayer's return and determines to disallow claimed EITC and impose the ban, it issues a statutory notice of deficiency which includes notice of the IRS's determination to impose the two-year ban.⁵¹ The taxpayer may petition the Tax Court for review of the disallowed EITC as well as the determination to impose the ban.⁵² If the taxpayer petitions the Tax Court, he or she may bear the burden of proving the IRS erred in imposing the ban.⁵³ If the taxpayer does not timely file a Tax Court petition, the additional tax, if any, will be assessed and the two-year ban will remain uncontested. IRS records will reflect the two-year ban, and if the taxpayer claims EITC the following year, the credit will be automatically disallowed even if the taxpayer otherwise qualifies for it.⁵⁴ The same deficiency procedures also apply to a later year's disallowance.⁵⁵ If the taxpayer files a Tax Court petition for review of a later disallowance due to the ban, the court may consider whether the ban was properly imposed in the earlier year because this is relevant to determining the tax for the later year, but the court would not have jurisdiction to redetermine the tax for the earlier year when the ban was imposed.⁵⁶

We note that the Treasury Department's fiscal year (FY) 2014 revenue proposals would allow the IRS to use math error authority to disallow EITC if the taxpayer claimed the credit while subject to the two-year ban.⁵⁷ Math error authority permits the IRS to assess a tax deficiency without issuing a statutory notice

49 See, e.g., The Ohio State University Research and Innovation Communications, *Marital Separations an Alternative to Divorce for Poor Couples* (Aug. 13, 2012), available at <http://researchnews.osu.edu/archive/maritalsep.htm> (last visited Sept. 12, 2013). The research, carried out by Dmitry Tumin and Zhenchao Qian showed that 15 percent of separations did not end in either divorce or reconciliation within ten years and that couples in these prolonged separations tended to be racial and ethnic minorities. These couples also tended to have young children. and low family income — the very population EITC is intended to reach.

50 The error is perpetuated in the IRM audit reconsideration provisions. IRM 4.13.3.18 (Sept. 30, 2010) describes the audit reconsideration procedures and makes clear that the IRS can remove the ban and reverse disallowance of the EITC. However, it provides that “[i]f the taxpayer failed to substantiate EITC entitlement for the year that triggered the ban, the audit reconsideration will be disallowed.” The provision seems illogical because if the taxpayer initially substantiated entitlement to EITC the IRS would have allowed the EITC and not imposed the ban. Moreover, the provision would appear to prevent audit reconsideration of bans imposed on taxpayers who simply did not respond to IRS requests for information or whose mail was returned as undelivered.

51 The statutory notice of deficiency, authorized by IRC § 6212, informs the taxpayer of the additional amount of tax the IRS believes he or she owes and advises of the right to petition the Tax Court for review of that determination. IRM 4.19.14.6.1.1 (6), (11) (Jan. 1, 2013); IRM 4.13.3.18 (Sept. 30, 2010).

52 See, e.g., *Garcia v. Comm’r*, T.C. Summ. Op. 2013-28 (Apr. 3, 2013) for the facts contained therein; under IRC § 7463(b), the opinion is not precedent for any other case.

53 Tax Court Rule of Practice and Procedure 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). The National Taxpayer Advocate recommends that Congress amend IRC § 32 to clarify that the burden of showing the appropriateness of the ban is on the IRS. See Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit*, *infra*.

54 IRM 4.19.14.6.1.1 (6), (11) (Jan. 1, 2013).

55 IRM 4.19.14.6.1.1 (11) (Jan. 1, 2013).

56 IRC § 6214(b) provides that the Tax Court “in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.” IRM 4.19.14.6.1.3 (Jan. 1, 2007) instructs employees that if the taxpayer petitions the Tax Court, they should provide Chief Counsel attorneys with the complete case file for the year that is the subject of the Tax Court petition as well as the year in which the ban was imposed.

57 Budget of the United States Government, Fiscal Year 2014 212, 219, available at <http://www.whitehouse.gov/omb/budget/Overview>; Perspectives, Budget of the United States Government, Fiscal Year 2014 205, available at http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

of deficiency with the attendant right to petition the Tax Court for review.⁵⁸ The National Taxpayer Advocate does not support the Treasury Department's proposal to extend the use of math error authority in this manner unless and until: 1) the IRS adopts procedures that ensure IRS auditors make a considered (as opposed to automated or presumed) determination that reckless or intentional disregard of rules or regulations occurred; and 2) Congress clarifies that the IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.⁵⁹

The IRS Has Imposed More Stringent Due Diligence Requirements on Paid Preparers who Prepare Returns that Claim EITC, and These Requirements May Increase Compliance.

Paid return preparers were involved in about 71 percent of the returns in the TAS sample of two-year ban cases.⁶⁰ In more than half (27) of the 50 cases in which the IRS automatically imposed the ban because EITC had been disallowed in a previous year and the taxpayer did not respond to audit notices, the tax return was prepared by a paid preparer. IRC § 6695(g) provides that:

[a]ny person who is a tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of \$500 for each such failure.⁶¹

Under the regulations, for returns filed after December 31, 2011, preparers must demonstrate they exercised due diligence in determining earned income eligibility by submitting Form 8867, *Paid Preparer's Earned Income Credit Checklist*, or "Alternative Eligibility Record" and file it with the return or claim for refund.⁶² The IRS imposed the section 6695(g) penalty on almost 900 individuals in fiscal year 2012 and the average amount of penalty assessed in each case exceeded \$10,000.⁶³ Unsurprisingly, it appears that preparers subject to the penalty prepared multiple returns.

The 2012 version of Form 8867, in Part IV, "Due Diligence Requirements," poses two new questions that relate to relationship and residency of any qualifying

By not articulating the reason for imposing the ban and securing managerial approval, the IRS does not adhere to its own procedures.

58 IRC § 6213(b)(1). The analysis that accompanies the President's budget proposal explains, "[t]he IRS may correct certain mathematical or clerical errors made on tax returns to reflect the taxpayer's correct tax liability (this authority is generally referred to as 'math error authority')." Perspectives, Budget of the United States Government, Fiscal Year 2014 205, available at http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

59 See Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit*, *infra*.

60 In 237 out of 333 cases, a paid preparer signed the return or there are other indications, such as a refund anticipation loan, that indicate a paid preparer was involved.

61 The United States-Korea Free Trade Agreement Implementation Act, Pub. L. No. 112-41, § 501, 125 Stat 428, amended IRC § 6695(g) by increasing the amount of the penalty from \$100 to \$500 for returns filed after December 31, 2011. See Treas. Reg. § 1.6695-2(a). The National Taxpayer Advocate recommended increasing the amount of the preparer penalty in 2003. See National Taxpayer Advocate 2003 Annual Report to Congress 272 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*).

62 Treas. Reg. § 1.6695-2(b)(1). Most of the returns in the TAS sample cases were filed after Dec. 31, 2011. Although a 2009 version of Form 8867 was available, preparers of returns filed before Dec. 31, 2011, were not required to file Form 8867 with the returns they prepared.

63 The penalty was imposed against 881 individuals in FY 2012. IRS response to TAS fact check (Dec. 20, 2013).

children with respect to whom the credit is being claimed.⁶⁴ The same portion of the form now asks the preparer to identify, from a list of documents, which one(s) he or she relied on to determine the residence or disability of a qualifying child and which documents supported any claimed Schedule C income or expenses. The preparer can also indicate, by checking a box, that he or she relied on “other” unspecified documents, “did not rely on any documents, but made notes in file,” or simply “did not rely on any documents.”⁶⁵ The preparer is instructed that due diligence requires that he or she keep for three years:

- Form 8867, *Paid Preparer’s Earned Income Credit Checklist*;
- The EIC worksheet(s) or the preparer’s own worksheet(s);
- Copies of any taxpayer documents the preparer relied on to determine eligibility for or amount of EIC;
- A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained; and
- A record of any additional questions the preparer asked and the client’s answers.⁶⁶

The National Taxpayer Advocate applauds the IRS for finalizing the regulation that requires preparers to submit Form 8867 with returns they prepare and for revising Form 8867 to not only reflect the new regulation but also facilitate preparer due diligence.⁶⁷

64 One question is: “If any qualifying child was not the taxpayer’s son or daughter, did you ask why the parents were not claiming the child and document the answer?” Another question is “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?” A “qualifying child” is a person who among other things meets age requirements, bears a specified relationship to the taxpayer, and has the same principal residence as the taxpayer for more than half the year. IRC §§ 32(c)(3), 152(c). The last two components of EITC eligibility — relationship and residency — can be particularly difficult to substantiate. National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*).

65 This format, which serves as a prompt for the preparer by suggesting documents that might be appropriate substantiation, appeared for the first time on the 2012 version of the form.

66 These directions correspond to the requirements of Treas. Reg. 1.6695-2(b)(4) that the preparer submit with the return “(A) A copy of the completed Form 8867 (or successor form); (B) A copy of the completed Earned Income Credit Worksheet (or other record of the tax return preparer’s EIC computation permitted under paragraph (b)(2)(i)(B) of this section); and (C) A record of how and when the information used to complete Form 8867 (or successor form) and the Earned Income Credit Worksheet (or other record of the tax return preparer’s EIC computation permitted under paragraph (b)(2)(i)(B) of this section) was obtained by the tax return preparer, including the identity of any person furnishing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 (or successor form) or the Earned Income Credit Worksheet (or other record of the tax return preparer’s EIC computation permitted under paragraph (b)(2)(i)(B) of this section).”

67 The National Taxpayer Advocate first recommended that the IRS impose broader due diligence requirements on EITC return preparers in 2003 (see National Taxpayer Advocate 2003 Annual Report to Congress 36 (Most Serious Problem: *Earned Income Tax Credit Compliance Strategy*). She also in 2003 recommended that Congress amend IRC § 6695(g) to impose the same requirements the Treasury regulation now imposes. National Taxpayer Advocate 2003 Annual Report to Congress 272 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*). The National Taxpayer Advocate renewed these recommendations over the years. See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 56 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*). We note, however, that attorneys, certified public accountants, enrolled agents, or enrolled actuaries, all of whom are regulated by the IRS, may not be willing to prepare returns that claim EITC because of the additional burden Treas. Reg. 1.6695-2(b)(4) and the revised Form 8867 imposes on them. To the extent regulated return preparers are unwilling to prepare returns claiming EITC, the returns may be prepared by unenrolled return preparers (i.e., preparers with no recognized credentials to prepare returns and over whom the IRS does not have regulatory authority). See *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. 2013); Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS is Enjoined from Continuing Its Efforts to Effectively Regulate Return Preparers*, *supra*.

CONCLUSION

IRC § 32(k) is a unique penalty provision because it permits the IRS to sanction taxpayers not only for the year they improperly claim EITC, but also for two subsequent tax years, whether or not the taxpayers become eligible for EITC in those later years. Because of its reach, the statute applies only where the taxpayer noncompliance was egregious or is attributable to a particular state of mind, *i.e.*, due to reckless or intentional disregard of the EITC rules. The IRS, by imposing — sometimes automatically — the ban on taxpayers who did not participate in the audit or who submitted documents demonstrating they believed they were entitled to the claimed EITC, does not act within the statutory confines. By not articulating the reason for imposing the ban and securing managerial approval, the IRS does not adhere to its own IRM and acts arbitrarily and capriciously.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Immediately suspend the application of IRM provisions (*e.g.*, IRM 4.19.14.6.1.5) that permit automatic imposition of the two-year EITC ban or require the taxpayer to show why the ban should not be imposed.
2. In collaboration and consultation with the National Taxpayer Advocate, include on the Treasury Guidance Priority List regulations that explain when the IRS should impose EITC bans.⁶⁸
3. Revise, in consultation with the National Taxpayer Advocate, the IRM provisions on the two-year ban to take into account what is reasonable to expect of taxpayers who claim EITC. At a minimum, before imposing the two-year ban, examiners should be required to:
 - a. Attempt to speak with the taxpayer;
 - b. Determine whether the substantiation the taxpayer submitted is probative of the EITC claim or shows a sincere effort to prove the elements of EITC, even if the documentation is not listed in the IRM as acceptable substantiation or the documentation is insufficient, and
 - c. Consider the role, if any, of a paid preparer in claiming disallowed EITC.
4. Conduct quality reviews of every case in which the IRS proposes to impose the two-year ban. One hundred percent quality reviews should continue for at least three years and until the IRS's failure to adhere to the terms of the statute and the IRM is corrected.

⁶⁸ The Treasury Department's Office of Tax Policy and the IRS use the Annual Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. See IRM 32.1, Chief Counsel Regulation Handbook. The National Taxpayer Advocate's proposal that guidance to determine whether EITC was claimed in "reckless or intentional disregard of rules and regulations" for purposes of IRC § 32(k)(1)(B)(ii) be included in the 2013-2014 Guidance Priority Plan was not adopted. See 2013-2014 Priority Guidance Plan, *available at* <http://www.irs.gov/uac/Priority-Guidance-Plan> (Aug. 9, 2013).