

**Area of Focus #5** **Earned Income Tax Credit Reform Could Reduce the EITC Improper Payment Rate Without Reducing Participation by Eligible Taxpayers**

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Retain Representation*
- *The Right to a Fair and Just Tax System*

### Background

The Earned Income Tax Credit (EITC), enacted as a work incentive in the Tax Reduction Act of 1975, has become one of the government's largest means-tested anti-poverty programs.<sup>2</sup> Unlike traditional anti-poverty and welfare programs, the EITC was designed to have an easy “application” process by allowing an individual to claim the benefit on his or her tax return. This approach dramatically lowered administrative costs, since it did not require an infrastructure of case workers and local agencies to make eligibility determinations. Because the relatively easy application process eliminated administrative barriers, the EITC's participation rate is higher than many other anti-poverty programs.<sup>3</sup>

However, the EITC is associated with a high improper payment rate.<sup>4</sup> The IRS currently estimates that the EITC improper payment rate is about 24 percent (which accounts for an estimated \$15.6 billion in

- 1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975).
- 3 When measured for tax year (TY) 2012, the EITC participation rate was 80 percent. IRS, *ACS Match-Center for Administrative Records Research and Applications*, <https://www.eitc.irs.gov/EITC-Central/Participation-Rate> (last visited June 3, 2016). The Supplemental Nutritional Assistance Program (SNAP) had a nearly as high 79 percent participation rate (measured in Fiscal Year (FY) 2011). USDA, *Supplemental Nutrition Assistance Program Participation Rates: Fiscal Years 2010 and 2011* (Feb. 2014). However, other social benefit programs have smaller participation rates. The Women, Infants, and Children Program (WIC — measured in 2010) has a participation rate of 63 percent; however the Temporary Assistance for Needy Families (TANF — measured in 2009) only has a participation rate of 32 percent. Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) Eligibles and Coverage – 2010: National and State Level Estimates of the Population of Women, Infants, and Children Eligible for WIC Benefits Executive Summary (2013) and Department of Health and Human Services, Administration for Children and Families Office of Family Assistance, *Temporary Assistance for Needy Families Program 10th Ann. Rep.* (2013).
- 4 An improper payment is defined as “any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements” and “any payment to an ineligible recipient.” Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204, § 2(e) (2010) amending Improper Payments Information Act of 2002, Pub. L. No. 107-300 (2002) by striking § 2(f) and adding (f)(2).

improper payments).<sup>5</sup> Despite much attention to this issue, the current improper payment rate has only decreased slightly from the improper payment rate measured in 2004, when it was 25 percent.<sup>6</sup>

The National Taxpayer Advocate has dedicated significant time and resources to studying how administration of the EITC can be improved.<sup>7</sup> Most recently, the National Taxpayer Advocate made the following recommendations:

- Provide education and outreach targeted at low income taxpayers;<sup>8</sup>
- Reevaluate the selection of audited cases to improve compliance and lessen taxpayer burden;<sup>9</sup> and
- Improve the EITC Return Preparer Strategy in conjunction with an educational campaign for taxpayers.<sup>10</sup>

While adopting the National Taxpayer Advocate's specific recommendations will improve EITC compliance, more fundamental changes to EITC legislation and administration are required in order to significantly improve EITC compliance and the improper payment rate.

### EITC Eligibility Requirements and IRS Guidance No Longer Reflect the Household Arrangements of Many Low Income Taxpayers

The EITC is a complex law that involves eligibility rules based on a taxpayer's income, marital status, and parental or other caretaker arrangements, which can often change on a year-to-year basis. The population claiming the EITC is constantly in flux, with approximately one-third of the eligible population changing every year.<sup>11</sup> At the same time, the population of taxpayers who rely on the EITC often share a common set of characteristics, such as limited education and high transiency, which create challenges for taxpayer compliance.<sup>12</sup>

5 *Projected Improper Payments for Earned Income Tax Credit (EITC)*, <https://paymentaccuracy.gov/tabular-data/projected-by-program/420>.

6 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance with the Improper Payment Reporting Requirements in Fiscal Year 2014* 9 (Apr. 27, 2015). The lowest improper payment measurement since 2004 was 23 percent, which occurred in 2012. *Id.*

7 See, e.g., National Taxpayer Advocate 2012 Annual Report to Congress 103-15; (Most Serious Problem: *Despite Some Improvement, the IRS Continues to Harm Taxpayers By Unreasonably Delaying the Processing of Valid Refund Claims That Happen to Trigger Systemic Filters*); National Taxpayer Advocate 2011 Annual Report to Congress 296-312 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*); National Taxpayer Advocate 2008 Annual Report to Congress 227-42 (Most Serious Problem: *Suitability of the Examination Process*); National Taxpayer Advocate 2007 Annual Report to Congress 222-41 (Most Serious Problem: *EITC Examinations and the Impact of Taxpayer Representation*); National Taxpayer Advocate 2005 Annual Report to Congress 94-122 (Most Serious Problem: *Earned Income Tax Credit Exam Issues*); National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 8-45 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

8 National Taxpayer Advocate 2015 Annual Report to Congress 240-47 (Most Serious Problem: *The IRS Does Not Do Enough Taxpayer Education in the Pre-Filing Environment to Improve EITC Compliance and Should Establish a Telephone Helpline Dedicated to Answering Pre-Filing Questions From Low Income Taxpayers About Their EITC Eligibility*).

9 National Taxpayer Advocate 2015 Annual Report to Congress 248-60 (Most Serious Problem: *The IRS Is Not Adequately Using the EITC Examination Process As an Educational Tool and Is Not Auditing Returns With the Greatest Indirect Potential for Improving EITC Compliance*).

10 National Taxpayer Advocate 2015 Annual Report to Congress 261-83 (Most Serious Problem: *The IRS's EITC Return Preparer Strategy Does Not Adequately Address the Role of Preparers in EITC Noncompliance*).

11 IRS, *EITC Fast Facts*, <https://www.eitc.irs.gov/Partner-Toolkit/basicmaterials/ff> (last visited Mar. 31, 2016). For more information on the changing population of taxpayers eligible for EITC, see National Taxpayer Advocate 2013 Annual Report to Congress 109-10.

12 National Taxpayer Advocate 2015 Annual Report to Congress 235-39.

For EITC purposes, any child being claimed must be a “qualifying child,” which in part requires that the child meet relationship and residency tests.<sup>13</sup> A child is considered related to the taxpayer if he or she is:

- A child of the taxpayer or a descendant of such a child;
- A brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative;
- A stepson or stepdaughter;
- An adopted child; or
- An eligible foster child<sup>14</sup>

The child is considered to meet the residency test if he or she lives with the taxpayer for more than one half of the year.<sup>15</sup>

These rules generally provide a facially reasonable, structured approach to EITC eligibility. However, they increasingly exclude taxpayers and children we might want to assist for policy reasons, because the rules do not line up with the changes taking place in U.S. family and household dynamics. Some divorced or separated couples may share custody informally regardless of what their formal custody agreement may state. Additionally, some children may spend extended periods of time in the home of another family member or a family friend.

A recent paper by the Tax Policy Center (hereinafter TPC Study) found that the number of families made up of “traditional” families (married parents with only biological children) has declined while alternative family types, such as families led by a single parent and cohabitating parents, has increased.<sup>16</sup> The TPC Study found that between 1996 and 2008, the proportion of children living with married couples dropped from 70.9 percent to 67.3 percent and the number living with cohabitating parents increased from 3.6 percent to 6.2 percent.<sup>17</sup> Furthermore, the TPC Study found that in 2008, nearly 20 percent of children living in single-parent households also lived in multigenerational households.<sup>18</sup> Neither the U.S. Tax Code nor the IRS has kept up with these changes.

Taxpayers who do not fit neatly into a set category for eligibility often will face two major obstacles: navigating the tiebreaker rules and substantiating eligibility for the EITC. The tiebreaker rules address situations where more than one taxpayer may be eligible to claim the child.<sup>19</sup> The tiebreaker rule attempts to address competing claims from potentially eligible taxpayers, but because family relationships are complex, the rule itself is very complex. First, if both parents claim the child, the child is the qualifying child of the parent with whom the child lived the longest. If residency is split equally between both parents, then the parent with the highest adjusted gross income (AGI) may claim the child. Second, when a parent and a non-parent claim the same child, the parent of the child gets priority. If the parent does not claim the child, then whoever had the highest AGI may claim the child.

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13 IRC § 32(c)(3).

14 IRC § 152(c)(2),(f).

15 IRC § 152(c)(1)(B).

16 Elaine Maag, H. Elizabeth Peters, and Sara Edelstein, Tax Policy Center, *Increasing Family Complexity and Volatility: the Difficulty in Determining Child Tax Benefits* 19 (Mar. 3, 2016). The TPC Study analyzed the December panel from the 1996 and 2008 Census Bureau Survey of Income and Program Participation (SIPP) data

17 *Id.* at 10.

18 *Id.* at 18.

19 IRC § 152(c)(4).

These rules do not adapt well to family living arrangements that may change multiple times during the year. The rules may also lead to counter-intuitive results. For instance, perhaps in a multigenerational home there is a grandmother and mother caring for a granddaughter. The granddaughter is a qualifying child for both the mother and grandmother, but under the tie breaker rules, only one person may claim the granddaughter for purposes of the EITC. Further, even if the grandmother provides all of the care for the granddaughter and the mother does not claim the child, the grandmother may not claim her granddaughter for EITC purposes if her AGI is not higher than that of her daughter. Whereas, if the facts are the same except that the daughter was in and out of the household throughout the year and did not satisfy the residency test, then the grandmother could claim her granddaughter as a qualifying child, even if her AGI was not higher than her daughter's.

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Assuming that taxpayers living in nontraditional households can understand the rules for eligibility and they determine accurately that they may claim a qualifying child for EITC, they must then be able to provide substantiating documentation if the IRS questions their claim in the audit process. While the IRS has guidance for analyzing documentation submitted by taxpayers in EITC cases, adopting a more flexible approach to alternative documentation would help low income taxpayers.

Internal Revenue Manual (IRM) 4.19.14.5.4 provides IRS employees with a chart for analyzing EITC cases involving qualifying children.<sup>20</sup> However, the list provided is very narrow and does not reflect the types of documentation and methods of proof that may most likely be available or best-suited for taxpayers claiming the EITC, especially taxpayers in nontraditional households or with children who move a lot. For example, as a “traditional document,” the IRM guidance suggests that IRS employees accept school or medical records to prove residency for a qualifying child. However, this may not work easily for a taxpayer who has relocated often. Additionally, medical records may not be possible for a family member who has informally cared for the child. The current internal guidance also lacks specific instruction for tax examiners to consider alternative documentation.<sup>21</sup> Alternative documentation can include things such as letters from landlords or school officials, bills, and public assistance records.

In 2013, the National Taxpayer Advocate issued internal guidance to TAS employees related to EITC issues.<sup>22</sup> This guidance included a list of 50 alternative documents that could be used to substantiate an EITC claim.<sup>23</sup> While not exhaustive, it created a more flexible approach to analyzing documents in EITC cases.<sup>24</sup> The IRS team dedicated to improving the EITC audit process, of which TAS is a member, will address the issue of incorporating alternative documentation into internal guidance in FY 2016.

20 IRM 4.19.14.5.4, *EITC Qualifying Children* (Jan. 1, 2015). IRS employees are directed to IRM 4.19.14.5.6 for a list of acceptable documents to prove requirements for a qualifying child.

21 Memorandum from Matthew A. Weir, Deputy National Taxpayer Advocate, for all Taxpayer Advocate Service employees, *Reissuance of Interim Guidance on Advocating for Taxpayers Claiming Earned Income Tax Credit (EITC) with Respect to a Qualifying Child* (Dec. 23, 2013).

22 *Id.*

23 *Id.*

24 TAS uses the Taxpayer Assistance Order (TAO) process and provides alternative documentation while advocating for taxpayers whose EITC claims were denied by the IRS. In FY 2014, TAS issued 24 EITC TAOs, of which the IRS complied with 21. In FY 2015, ten EITC TAOs were issued and the IRS complied with all ten. In FY 2016, TAS issued one EITC-related TAO and the IRS complied with the requested actions. Data obtained from the Taxpayer Advocate Management Information System (TAMIS) (Oct. 1, 2014; Oct. 1, 2015; June 1, 2016).

### The IRS Could Look to Other Countries for Improved Implementation of the EITC

Australia offers a similar tax credit to the EITC, called the Family Tax Benefit (FTB). The eligibility rules for the FTB are more expansive than the EITC's. For instance, a child qualifies if he or she meets these general rules:

- Must be in the adult's care;
- Must meet residency standards;
- Must not meet any exceptions; and
- When more than one adult is involved, the child must be in the adult's care for at least 35 percent of the time.<sup>25</sup>

The Australian system emphasizes care of the child and it does not adhere strictly to the idea that only one person can care for a child or that the person caring for the child needs to be related in a way required in the United States. In fact, the FTB allows a child to be claimed by an adult who is not the biological parent. In guidance issued by the Australian Department of Social Services, the following example is provided as a possible "care arrangement" for a child under the age of 18:

Emily lives primarily with her parent Dave and his new partner Anthony. Emily is an FTB child of both Dave and Anthony. They agree that Anthony should receive FTB for Emily, as he is the stay-at-home parent.<sup>26</sup>

Furthermore, the act of caring for a child in Australia counts for more than just the amount of time the adult resides with the child. The "primary carer" is considered the "member of a couple" having the greater responsibility for the child. This is determined by identifying who has major daily responsibility for the child, looks after the child's needs (such as dressing and bathing), makes appointments for the child, is the primary contact for daycare or school, and transports the child to and from school.<sup>27</sup> When it is determined that more than one adult cares for a child, the percentage of FTB allocated to each individual is based on "issues of fairness and appropriateness, taking into account equity considerations and sharing and pooling within a family unit that can result in a 50:50 split in FTB."<sup>28</sup> Under this system there is an acknowledgement that many families operate on a fluid day-to-day basis, where the care of a child does not just fall on one relative.

### The IRS Could Partner With Other Agencies in Making the Eligibility Determination

Another approach is to substitute for the IRS, in whole or in part, another agency or agencies better suited for the role of making the personal inquiries into family composition. The IRS would then revert to its traditional tax collection function.<sup>29</sup> As a result of the Affordable Care Act, the federal government and many states are now operating exchanges to which millions of individuals apply for insurance and the

25 Australian Department of Social Services, *Family Assistance Guide*, 2.1.1.10, *FTB Child*, <https://guides.dss.gov.au/family-assistance-guide/2/1/1/10>.

26 Australian Department of Social Services, *Family Assistance Guide*, 2.1.1.10, *Circumstances Surrounding Legal Responsibility for an FTB Child Under 18*, <https://guides.dss.gov.au/family-assistance-guide/2/1/1/10>.

27 Australian Department of Social Services, *Family Assistance Guide*, 1.1.P.120, *Primary Carer (FTB, Baby Bonus)*, <http://guides.dss.gov.au/family-assistance-guide/1/1/p/120>.

28 Australian Department of Social Services, *Family Assistance Guide*, 2.1.1.25, *Shared Care of an FTB Child*, <http://guides.dss.gov.au/family-assistance-guide/2/1/1/25>.

29 The National Taxpayer Advocate has made this observation on previous occasions. *National Taxpayer Advocate's 2014 Annual Report to Congress: Hearing Before the H. Subcomm. on Government Operations*, 114th Cong. 24-33 (2015) (written statement of Nina E. Olson, National Taxpayer Advocate).

Advanced Premium Tax Credit (APTC).<sup>30</sup> The assistors in the exchanges make the substantive determination regarding eligibility for the APTC and certain exemptions from the Individual Shared Responsibility Payment, most notably the hardship exemption. The exchanges notify the IRS about applicants' household composition, and the IRS verifies household income to the exchange. The IRS also receives the end-of-year reconciliation forms and third-party information reports regarding coverage. It also refunds any unclaimed Premium Tax Credit (PTC) due to the taxpayer and collects PTC overclaims.<sup>31</sup>

Of the 27,521,132 taxpayers who received the EITC (prior to any audit of the tax return) in tax year (TY) 2014, 1,151,789 taxpayers — or slightly over four percent — also claimed the PTC.<sup>32</sup> While this is not a large number of taxpayers, it is still a population of taxpayers who are already working with trained assistors who could be in a better position to analyze the residence and relationship aspects of EITC eligibility.

The definition of an eligible child for EITC purposes might also be revised to allow the IRS to accept the determination by another federal or state agency of a taxpayer's eligibility for Title 4 payments such as food stamps, or Title 8 housing assistance. While the definition of a household under these programs may not be identical to that determined under the EITC, and their public policy goals may differ, the former programs utilize a more intensive application process. Thus, it is worth exploring whether the EITC should be revised to accept another state or federal agency's determination of eligibility for other benefits as evidence of eligibility for the EITC.

## FOCUS FOR FISCAL YEAR 2017

In Fiscal Year 2017, TAS will continue to:

- Work with the IRS to develop flexible guidance for acceptance of alternative documentation; and
- Encourage Local Taxpayer Advocates to issue TAOs in cases where the IRS is not taking a flexible approach to determining EITC eligibility.

The National Taxpayer Advocate will make a legislative recommendation in the 2016 Annual Report to Congress to reform the structure and administration of, and eligibility requirements for, the EITC in order to minimize improper payments while maintaining its high participation rate.

30 The APTC is an advanced credit that can help consumers pay for health insurance throughout the year. In addition to a financial determination, it requires that the consumer report changes in circumstances throughout the year. 42 U.S.C. § 18082. Consumers learn if they qualify for the APTC when they apply for insurance in the Health Insurance Marketplace. U.S. Department of Health and Human Services, *Advanced Premium Tax Credits (APTC)*, <https://www.healthcare.gov/glossary/advanced-premium-tax-credit/>. In TY 2014, 3.1 million returns claimed the APTC. Wage & Investment Research and Analysis (WIRA), *ACA Fact Sheet* (Oct. 8, 2015) (returns processed through August 27, 2015, Cycle 34). This data is based on amounts claimed on returns that had posted as of August 27, 2015, and is preliminary and subject to change as the IRS reviews the data, processes additional TY 2014 returns and conducts compliance activities. IRS Compliance Data Warehouse (CDW), *Individual Returns Transaction File (IRTF) for TY 2014 (through cycle 201534)*.

31 For information on the PTC, see IRC § 36B.

32 IRS CDW, IRTF for TY 2014 returns processed by the end of 2015.