

Area of
Focus #6**TAS Continues to Pursue Improvements to the IRS's
Administration of the Earned Income Tax Credit (EITC),
Particularly With Recent Changes to the Law****TAXPAYER RIGHTS IMPACTED¹**

- *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*

DISCUSSION

The Earned Income Tax Credit (EITC) was enacted as a work incentive in the Tax Reduction Act of 1975.² It has become one of the government's largest means-tested anti-poverty programs.³ In tax year (TY) 2015, over 27 million taxpayers received about \$67 billion in EITC benefits.⁴ 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. However, the easy application process of the EITC is also associated with a high improper payment rate.⁵ In addition, the Department of Treasury has noted that "[EITC] rules are complex and lead to high overclaim error rates for these credits."⁶ The National Taxpayer Advocate has long advocated for changes that could reduce the improper payment rate while ensuring taxpayers eligible for the EITC receive it.⁷

- 1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR 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 Congressional Budget Office, *Federal Means-Tested Programs and Tax Credits – Infographic* (Feb. 11, 2013), <https://www.cbo.gov/publication/43935>.
- 4 IRS, *About Earned Income Tax Credit (EITC)*, <https://www.eitc.irs.gov/EITC-Central/abouteitc>.
- 5 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). The IRS estimates that for fiscal year (FY) 2016, between 22.2 percent (\$15.5 billion) and 25.9 percent (\$18.1 billion) of the total EITC program payments of \$69.8 billion were improper. Department of Treasury, *Agency Financial Report Fiscal Year 2016* 49 (Nov. 2016).
- 6 Department of Treasury, *Agency Financial Report Fiscal Year 2016* 161 (Nov. 2016).
- 7 National Taxpayer Advocate 2016 Annual Report to Congress 325-57; National Taxpayer Advocate 2016 Annual Report to Congress 138-50; National Taxpayer Advocate 2015 Annual Report to Congress 248-60; National Taxpayer Advocate 2012 Annual Report to Congress 103-15; National Taxpayer Advocate 2011 Annual Report to Congress 296-312; National Taxpayer Advocate 2008 Annual Report to Congress 227-42; National Taxpayer Advocate 2007 Annual Report to Congress 222-41; National Taxpayer Advocate 2005 Annual Report to Congress 94-122; National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 8-45.

Congress Mandated a Delay in Earned Income Tax Credit Refunds to Reduce the EITC Improper Payment Rate

To address the EITC improper payment rate, Congress mandated a delay of any refund that includes the EITC or the refundable portion of the Child Tax Credit until February 15 of each filing year.⁸ The National Taxpayer Advocate previously made a similar recommendation.⁹ This change could be useful in reducing the improper payment rate, particularly since National Research Program (NRP) data found that 51 percent of returns with an EITC overclaim contained income misreporting as the sole error (with the average claim being \$673).¹⁰ Even though it had to hold the refunds until February 15, the IRS informed taxpayers this year not to expect the refunds until the week of February 27 because banking and financial systems needed time to process the deposits.¹¹ The National Consumer Law Center has warned that such delay may create financial hardships for low income taxpayers.¹² In addition, delayed refunds may have a negative effect on the timing and level of consumer spending.¹³

EITC Returns Undergo Several Levels of Review

Each return filed has the potential to go through many layers of review. Figure 3.6.1 presents a flowchart for the processing of an electronic EITC return.

1. A return is prepared (either by the taxpayer, a paid preparer, or a service such as a Volunteer Income Tax Assistance site).
2. The return is transmitted to the IRS Modernized e-file system (MeF). At this point, the system checks for any duplicate Taxpayer Identification Numbers (TINs) used and established consistency checks. In this process, the return may be rejected before IRS accepts the return information. If the return is not accepted, it will receive a rejection code, and the taxpayer will receive a written explanation.
3. The return passes initial checks and moves to the Error Resolution System (ERS). This review may include incorrect or unverifiable line entries (such as transposed numbers or wages listed on the wrong line) and incorrect or missing schedules on the return. Some errors can be resolved without contacting the taxpayer and will be fixed manually. If there is an unresolved error, the return is posted and a math error notice is issued at this stage. If the ERS cannot resolve the problem, taxpayer contact is necessary, which will further delay resolution.
4. A return claiming a refund then moves to three filters concurrently: Dependent Database (DDb), Return Review Program (RRP), and Exam Scoring. The return is subject to identity theft scoring in DDb. RRP scores the likelihood of each Form W-2 being invalid or fraudulent and also screens for potential identity theft. Exam Scoring is the method by which the IRS selects returns to be audited. The IRS uses different filters to score for identity theft and examination selection.

8 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, §201, 129 Stat. 3076 (2015) (codified at IRC § 6402(m)). This applies to refunds made after December 31, 2016. IRC § 6402(m). For a full discussion of the filing season and the February 15 refund delay, see *Review of the 2017 Filing Season*, *supra*.

9 *The National Taxpayer Advocate's 2014 Annual Report to Congress: Hearing before the H.Subcomm. on Government Operations Committee on Oversight and Government Reform*, 114th Cong. 27 (2015) (written statement of Nina E. Olson, National Taxpayer Advocate).

10 IRS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 16 (Aug. 2014).

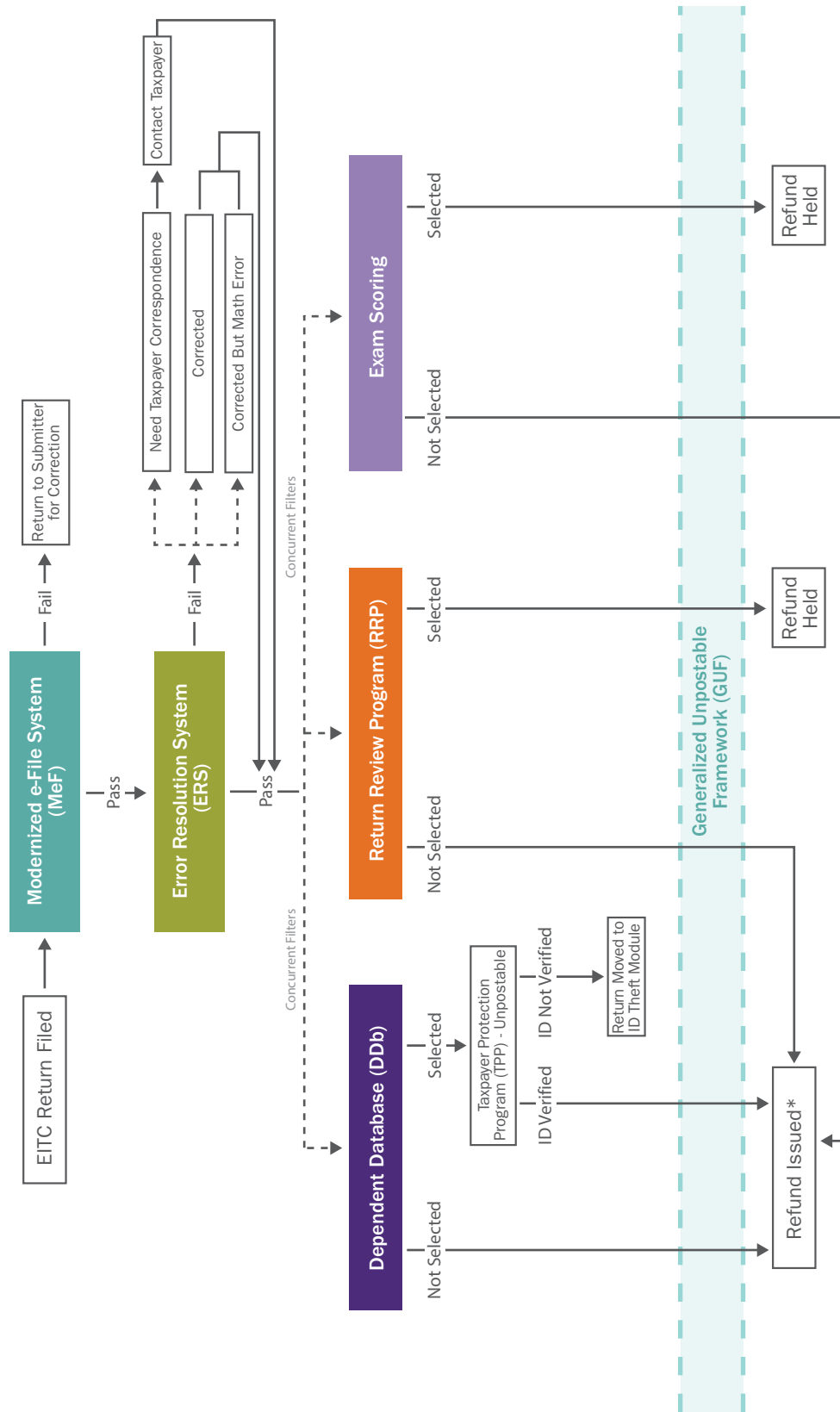
11 IRS, *Refund Timing for Earned Income Tax Credit and Additional Child Tax Credit Filers*, <https://www.irs.gov/individuals/refund-timing>.

12 National Consumer Law Center, *Tax Time Kick-Off: Delays and Risks Await Many Taxpayers This Year* (Jan. 23, 2017), <https://www.nclc.org/media-center/delays-risks-await-many-taxpayers.html>.

13 Steven Russolillo, *Equities – Ahead of the Tape: A Taxing Effect on Retailers' Revenue*, THE WALL STREET JOURNAL (Mar. 15, 2017).

FIGURE 3.6.1, Processing of an Electronic Earned Income Tax Credit Refund Return

Processing of an Electronic Earned Income Tax Credit Refund Return



*Unless selected by one of the other two programs

5. The return at this point is reviewed simultaneously by the Generalized Unpostable Framework (GUF). GUF simply determines if the return can post and works to correct returns that cannot post. If the return can be corrected, it will be posted.

TAS Has Not Identified Any Specific Problems With the Refund Freeze, Yet the IRS Must Remain Aware of Potential Problems for Taxpayers

Based on an analysis of IRS data from filing season 2017, it appears that all computer-generated freezes related to the Protecting Americans from Tax Hikes Act (PATH Act) of 2015 released as anticipated.¹⁴ Furthermore, TAS compared the number of EITC refunds issued week-by-week in filing season 2016 to the comparable period in filing season 2017. TAS found that by the fourth week of filing season 2016, the IRS had issued 13.6 million refunds. In comparison, by the fourth week of filing season 2017 (the first week in which EITC refunds were issued), the IRS had issued refunds to slightly less than 11.3 million taxpayers. See Figure 3.6.2.

FIGURE 3.6.2, Comparison of Refund Issuance Dates on Returns Receiving the Earned Income Tax Credit Between Filing Seasons 2016 and 2017¹⁵

Week Ending	2016 Cumulative	2017 Cumulative	Percentage Difference
Jan. 26, 2017	855,083		
Feb. 2, 2017	7,424,783		
Feb. 9, 2017	11,104,413		
Feb. 16, 2017	13,627,831	11,260,446	-17.4%
Feb. 23, 2017	15,533,821	13,367,603	-13.9%
Mar. 2, 2017	16,995,981	15,265,718	-10.2%
Mar. 9, 2017	18,166,010	16,691,389	-8.1%
Mar. 16, 2017	19,134,737	17,814,073	-6.9%
Mar. 23, 2017	19,971,655	18,775,735	-6.0%
Mar. 30, 2017	20,713,482	19,635,955	-5.2%
Apr. 6, 2017	21,468,224	20,459,066	-4.7%
Apr. 13, 2017	22,323,775	21,351,318	-4.4%
Apr. 20, 2017	23,494,074	22,534,564	-4.1%

TAS also compared the period of time between when a return posted and when the refund was issued in filing seasons 2016 and 2017. For filing season 2016, about 239,000 taxpayers had to wait two weeks or more for the IRS to issue their refunds after their returns posted. This number climbed to more than seven million taxpayers in filing season 2017 (a 2,858 percent increase).¹⁶ However, the increase in waiting time declined as filing season 2017 progressed. For taxpayers who had delays of four weeks or more, there was a 31 percent increase between filing seasons 2016 and 2017 (over 108,000 taxpayers

14 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, §201, 129 Stat. 3076 (2015) (codified at IRC § 6402(m)).

15 The 2017 figures differ slightly from those TAS reported in recent testimony. Hearing Before the H. Comm. on Appropriations, Subcomm. on Financial Services and General Government, 114th Cong. 34-35 (2017) (written testimony of Nina E. Olson, National Taxpayer Advocate). The data presented here were generated June 5, 2017, and while we are unsure why the data differ, the order of magnitude and percentage change is the same.

16 TAS review of Individual Returns Transaction File and the Individual Master File.

in filing season 2016 compared to over 141,000 taxpayers in filing season 2017). The average delay was about a week longer in 2017 than 2016 (through the end of March 2017).

The number of frozen EITC returns between filing seasons 2016 and 2017 increased by nearly 260 percent (from about 41,000 to 148,000), and EITC dollars frozen increased by about 225 percent (from \$147 million to \$479 million).¹⁷ The dollars frozen in filing season 2017 constitute a potential 2.1 percent decrease in improper payments from filing season 2016 to 2017.¹⁸ This is not surprising because although income misreporting is the most frequent source of EITC errors, it does not account for the largest dollar amount of EITC errors.¹⁹ Because EITC noncompliance is attributable to multiple causes, there is no single solution; instead, it will take multiple approaches to bring down the improper payment rate.

Some Barriers May Prevent the IRS From Fully Benefiting From the Refund Freeze

Of those taxpayers whose refund returns posted by February 15, a Form W-2 was available for 85 percent of EITC claimants (approximately 11.6 million EITC returns filed, with 9.9 million matches) and 83 percent of non-EITC claimants (approximately 21.3 million non-EITC returns filed, with approximately 17.7 million matches with a Form W-2).²⁰ However, the Government Accountability Office (GAO) reports that the IRS was able to verify the wage information for only over 35 percent of the frozen EITC returns before February 15.²¹ The IRS reprocessed about one million returns during the freeze period as new data became available; however, the IRS was unable to verify wage information for more than 58 percent of EITC returns before February 15.²² The GAO reports three reasons for the inability to verify all W-2 information:

- The IRS receives electronic W-2 data from the Social Security Administration (SSA) daily but because of older IRS technology, it could only load the information on a weekly basis;
- Some employers requested extensions beyond the new deadline of January 31 or missed the deadline; and
- W-2 information in paper form was not sent by the SSA until March 2017.²³

17 TAS review of Individual Returns Transaction File and the Individual Master File. Data includes taxpayers whose tax year (TY) 2015 refunds were processed by March 2016 and whose TY 2016 returns were processed by March 2017 and scheduled to receive EITC after IRS math error processing, but prior to audit.

18 This percentage is calculated as the additional \$332 million of EITC not refunded divided by the FY 2016 lower bound EITC improper payment estimate of \$15.5 billion. We will not know the exact decrease in the improper payment rate until the IRS has made a final determination on each case where the EITC was frozen as a result of the wage verification process.

19 IRS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (Aug. 2014). See also National Taxpayer Advocate 2016 Annual Report to Congress 325-57 (Legislative Recommendation: *Tax Reform: Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*).

20 As of the 13th week of 2017, there were 21,255,911 non-EITC returns filed around February 15, 2017, with 17,676,337 of those returns having a matched Form W-2. There were about 11,634,573 EITC returns filed around February 15, 2017, with about 9,907,286 matched to a Form W-2. These results are for a match on primary Taxpayer Identification Number (TIN) only and a match indicates that at least one Form W-2 was filed for the primary taxpayer. Individual Returns Transaction File and the Information Returns Master file for TY 2016 returns.

21 *2017 Filing Season: Hearing Before the H. Subcomm. on Oversight of the H. Comm. on Ways and Means*, 115th Cong. 7 (2017) (written statement of Jessica Lucas-Judy, Government Accountability Office Acting Director, Strategic Issues).

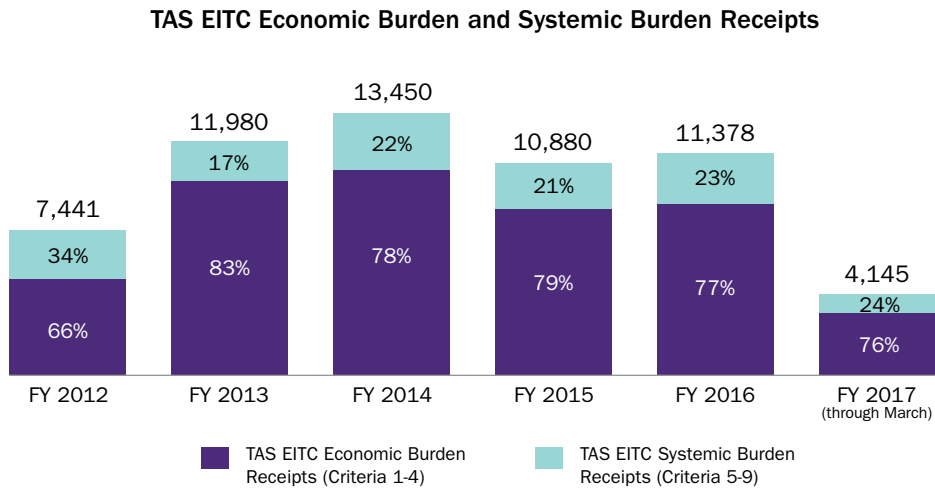
22 *Id.*

23 *Id.* at 8.

Ultimately, IRS officials report that the initial W-2 verification process for all returns with a frozen refund allowed the IRS to identify approximately 162,000 potentially fraudulent returns, representing about \$863 million in refunds.²⁴

The IRS and TAS will continue to analyze the 2017 filing season data to determine what impact freezing EITC refunds until February 15 had on the EITC overpayment rate. Additionally, TAS will monitor its caseload to ensure the IRS minimized any unnecessary hardships due to the February 15 freeze. The majority of TAS cases related to the EITC are consistently based on economic hardship, as shown in Figure 3.6.3.²⁵ In fact, the GAO reported the IRS opted to not hold all refunds until February 15 because of the burden such an action could have on the economy.²⁶

FIGURE 3.6.3²⁷



The Joint EITC Audit Improvement Team Continues to Make Improvements for Taxpayers Claiming the EITC

The List of Acceptable Documentation to Substantiate an EITC Claim Has Been Expanded

TAS is an active participant on a collaborative IRS team dedicated to identifying ways to improve the audit process for taxpayers claiming the EITC. One area of improvement includes the identification of acceptable documents for substantiating EITC claims, which are particular to the circumstances of low

24 2017 Filing Season: Hearing Before the H. Subcomm. on Oversight of the H. Comm. on Ways and Means, 115th Cong. 9 (2017) (written statement of Jessica Lucas-Judy, Government Accountability Office Acting Director, Strategic Issues).

25 TAS receives cases that fall into four categories: economic hardship, systemic burden, best interest of the taxpayer, and TAS public policy. Internal Revenue Manual (IRM) 13.1.7.1 (Feb. 4, 2015). Economic burden cases are those involving a financial difficulty to the taxpayer: an IRS action or inaction has caused or will cause negative financial consequences or have a long-term adverse impact on the taxpayer. Systemic burden cases are those in which an IRS process, system, or procedure has failed to operate as intended, and as a result the IRS has failed to timely respond to or resolve a taxpayer issue. IRM 13.1.7.2 (Feb. 4, 2015).

26 2017 Filing Season: Hearing Before the H. Subcomm. on Oversight of the H. Comm. on Ways and Means, 115th Cong. 7 (2017) (written statement of Jessica Lucas-Judy, Government Accountability Office Acting Director, Strategic Issues).

27 In 2017, TAS generally did not accept cases where the taxpayer sought assistance getting an EITC refund frozen under the PATH Act expedited. However, there were six exceptions to this rule, which among other things, involved accepting the case if it required case building while the refund was frozen. TAS, 2017 Filing Season - PATH Act Section 201 2-3 (2017).

Because Earned Income Tax Credit noncompliance is attributable to multiple causes, there is no single solution; instead, it will take multiple approaches to bring down the improper payment rate.

income taxpayers. This is something for which the National Taxpayer Advocate has consistently advocated.²⁸ Previous internal guidance provided a list of acceptable documentation to substantiate an EITC claim; however, the list was very narrow and did not reflect the types of documentation and methods of proof that would most likely be available or best-suited for taxpayers claiming the EITC.

Through the work of the EITC Audit Improvement Team, Internal Revenue Manual (IRM) 4.19.14-1 was added in July 2016. This IRM section will foster acceptance of substantiating documentation outside of the traditional EITC documentation, which typically includes letters from schools and doctors' offices. In addition to listing various "new" documents for Exam employees to consider, such as paternity test results, eviction notices, and statements from homeless shelters, the internal guidance informs exam employees that this list is not all-inclusive. The National Taxpayer Advocate will continue to work to have even more alternative documents listed in IRM 4.19.14-1.

TAS Continues to Advocate For Affidavits As a Tool For Taxpayers to Substantiate EITC Claims

The EITC Audit Improvement Team is considering how to incorporate the use of affidavits in EITC audits. Data from the IRS NRP reveals that the IRS should be focusing its efforts on EITC claims that involve qualifying child errors. While only 15 percent of returns with an EITC overclaim contained just a qualifying child error, the average claim was \$2,327, which is one of the largest dollar sources for EITC errors.²⁹ The NRP data broke the errors down even further and found that by far, the residency test is the highest source of errors. The data show that at least 75 percent of the children known to be claimed in error fail the residency test.³⁰ Compared to residency, only 20 percent of children known to be claimed in error failed the relationship test.³¹

In 2005, the IRS studied the use of affidavits as part of its EITC Qualifying Child Residency Certification Study.³² For the study, the IRS mailed documents to taxpayers (the test group) who had claimed the EITC with qualifying children in the previous tax year, but for whom the IRS could not establish qualifying child residency through available data. The documents sent to the taxpayer explained the certification requirements and included Form 8836, *Qualifying Child Residency Statement*, an affidavit form, and educational publications.³³ To certify their claim, the taxpayers in the study could submit any combination of documents described in Form 8836 (medical and school records, a letter on official letterhead, etc.) or the affidavit. The study found that affidavits had the highest rate of acceptance at 82 percent, compared to an overall acceptance rate of 64 percent for all document types.³⁴ The study concluded that this outcome was reasonable because affidavits had dedicated lines for all of the

28 National Taxpayer Advocate 2015 Annual Report to Congress 253-54; National Taxpayer Advocate 2011 Annual Report to Congress 305; National Taxpayer Advocate 2007 Annual Report to Congress 225; National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 20.

29 The National Research Program (NRP) conducted EITC audits in order to gather information about the nature of errors taxpayers made when claiming the EITC in tax years 2006 through 2008. IRS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 16 (Aug. 2014).

30 *Id.* at 22.

31 *Id.* at 23.

32 IRS, *IRS Earned Income Tax Credit (EITC) Initiative Final Report to Congress* 7 (Oct. 2005).

33 *Id.*

34 *Id.* at 33.

information, explaining “as long as the affidavit was filled out completely, it would contain all the required information to be accepted.”³⁵

The National Taxpayer Advocate believes that the affidavit should be incorporated into the EITC audit process as a tool for any taxpayer to use for substantiating his or her claim, and will help reduce the improper payment rate. It is an option that TAS is advancing through its participation on the joint EITC Audit Improvement Team. While keeping in mind that the National Taxpayer Advocate would like affidavits available to all EITC taxpayers, the EITC Audit Improvement Team is currently reviewing which particular group of EITC taxpayers could most benefit from receiving an affidavit early in the audit process.

TAS also plans to offer training to its employees during the months of June, July, and September. The training, which is entitled *EITC: Advocating With and For Taxpayers*, is based on a training developed by the EITC Audit Improvement Team for IRS employees. The training will discuss how to use communication skills to create a partnership with EITC taxpayers during the initial telephone contact.

TAS Will Continue Its Study to Research How Increased Education Can Improve Compliance

In January 2016, the National Taxpayer Advocate sent about 7,100 letters to the taxpayers who were not audited but appeared to have erroneously claimed EITC on their 2014 returns.³⁶ The letters were specifically designed to inform and educate taxpayers with targeted and specific information about EITC eligibility rules, geared to the error the IRS identified. The letters explained their purely educational purpose and clearly stated that this contact was not an audit. For those taxpayers who received Title IV benefits (Temporary Assistance for Needy Families, etc.), the letter included a sentence reminding them that the eligibility rules for EITC were different from the rules for Title IV benefits, so a taxpayer could receive Title IV benefits for a child and yet not be eligible for the EITC with respect to that same child. TAS then compared the level of compliance shown on taxpayers’ 2016 returns among three groups:

- Taxpayers who were not audited but were sent the TAS letter;
- A representative sample of taxpayers whose 2014 returns were audited; and
- A representative sample of taxpayers whose 2014 returns appeared to erroneously claim the EITC but who were not audited and did not receive the TAS letter.³⁷

The TAS letter, intended to educate taxpayers about the requirements for claiming EITC, appeared to help taxpayers avoid repeating their mistakes.³⁸ Taxpayers who were sent the TAS letter because they appeared to not meet the relationship test on their 2014 returns were less likely to repeat that error on their 2015 returns. Those who did not receive the TAS letter repeated their error 77.3 percent of the time, compared to 74.7 percent for the TAS group, an improvement of 2.6 percent.³⁹ There were about 1.2 million returns for 2014 that appeared to erroneously claim EITC because the relationship

35 IRS, *IRS Earned Income Tax Credit (EITC) Initiative Final Report to Congress* 33 (Oct. 2005).

36 National Taxpayer Advocate 2016 Annual Report to Congress vol. 2, 32-51 (Research Study: *Study of Subsequent Filing Behavior of Taxpayers Who Claimed Earned Income Tax Credits Apparently in Error and Were Sent an Educational Letter From the National Taxpayer Advocate*). Over 500 letters were returned to TAS as undeliverable.

37 *Id.*

38 *Id.* at 47.

39 *Id.* at 45.

requirement had not been met. If the TAS letter had been sent to all of those taxpayers, the projected savings would be about \$47 million.⁴⁰

TAS is repeating the letter test in the 2017 filing season. TAS added an additional sample of taxpayers who are offered, in the letter, the availability of a dedicated “Extra Help” line staffed by trained TAS employees who can answer taxpayer questions about the letter and the EITC eligibility rules. TAS is tracking the compliance behavior of that cohort as well and will report on that in the 2017 Annual Report to Congress.

CONCLUSION

As mentioned above, the EITC suffers from a high improper payment rate. However, since the EITC provides a benefit to so many low income taxpayers, any approach to reduce the improper payment rate must be balanced with minimal disruption to low income taxpayers, who rely on this credit for their day-to-day survival. The IRS has recently adopted new measures that will benefit both the improper payment rate and low income taxpayers.

FOCUS FOR FISCAL YEAR 2018

In Fiscal Year 2018, TAS will:

- Propose a Legislative Recommendation based on a thorough review of the extended refund issuance date;
- Coordinate with the IRS to implement the use of affidavits for all taxpayers who need to recertify for the EITC; and
- Complete the second year of the study addressing the impact of education on noncompliance.

⁴⁰ There were 1,197,374 returns processed in 2015 (which generally equates to returns filed for TY 2014) that appeared to contain this error. Data is from a Business Object interface with the Dependent Database (DDb), showing returns claiming EITC scored by the DDb for processing year 2015, which generally corresponds to returns filed for TY 2014. National Taxpayer Advocate 2016 Annual Report to Congress vol. 2, 44.