

M. The Earned Income Tax Credit is an Effective Anti-Poverty Tool That Requires a Non-Traditional Compliance Approach by the IRS

The Earned Income Tax Credit (EITC) is a refundable credit, enacted as a work incentive in the Tax Reduction Act of 1975.¹ Low income taxpayers use the credit to supplement their wages to pay for basic living expenses such as food, housing, and transportation. Most importantly, the EITC is now one of the largest federal anti-poverty programs.

Unlike traditional anti-poverty programs, which require an application process to determine eligibility, taxpayers “apply” for the EITC by filing a tax return. This means that the upfront administrative costs typically found in a welfare program have shifted to post-claim compliance costs, which can include audits, audit reconsiderations, and even judicial review by the United States Tax Court.

Reducing post-claim compliance costs is important for both taxpayers and the IRS. For low income taxpayers who are already struggling to make ends meet, defending an EITC claim is an additional burden. On the other hand, the IRS has a responsibility to reduce program costs.² It is important for the IRS to adopt a comprehensive education and compliance strategy to address EITC errors based on research.

The EITC population has a unique set of attributes, setting these taxpayers apart from the average taxpayer. For example, the average low income taxpayer may have:

- Limited English proficiency;
- Limited computer access;
- Low literacy rates;
- Low education levels; or
- Disabilities.³

The correspondence audit is the primary compliance tool that the IRS uses for EITC cases. This audit process often involves automated notices that fail to identify a specific contact person for the taxpayer. TAS has drawn much attention to the needs of low income

1 See Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975). For a detailed history of the EITC, see Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, *The National Tax Journal*, 983-1026 (Dec. 2000).

2 See GAO, GAO-09-628T, *Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments*, App. 1, at 20 (Apr. 22, 2009) (identifying EITC as the Treasury improper payment).

3 See 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*).

taxpayers, how the audit process creates barriers, and why it will not be as effective with this taxpayer population.⁴

The IRS Harms Low Income Taxpayers and Future Compliance When It Does Not Integrate Research Results Into Its EITC Strategy.

The National Commission on Restructuring the Internal Revenue Service emphasized research to prevent noncompliance, urging the IRS to incorporate research findings into audit selection.⁵ A TAS analysis of data from the Dependent Data Base (DDB) and the IRS National Research Program (NRP) shows the IRS does not focus on EITC errors with the highest level of noncompliance and misses an opportunity to educate taxpayers about the requirements for claiming EITC and preventing future noncompliance.

Low audit participation rates also prevent some taxpayers with valid claims from receiving the credit to which they are entitled, while the IRS misses an opportunity to educate those who erroneously claimed the credit about EITC requirements.

One area of concern is a low EITC audit participation rate, which prevents an understanding of the true causes of errors. The current non-response rate in EITC audits is over 40 percent.⁶ Low audit participation rates also prevent some taxpayers with valid claims from receiving the credit to which they are entitled, while the IRS misses an opportunity to educate those who erroneously claimed the credit about EITC requirements.

TAS recently conducted a study of the IRS audit process in collaboration with the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) divisions' correspondence examination units (the "Enhanced Communication Study").⁷ A test group of about 900 taxpayers underwent EITC audits that

involved two or more outbound call attempts, which are not usually part of the correspondence examination process (Phase 1). A control group of about 2,500 taxpayers underwent traditional correspondence examination processing, which is primarily automated and gen-

⁴ 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*) ("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."); National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*) ("In more than 40 percent of the cases [analyzed for the study], difficulties with IRS documentation requirements were identified as the reason for EITC audit reconsideration. Communication challenges . . . were the trigger 38 percent of the time.")

⁵ The Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 26-28 (June 25, 1997).

⁶ IRS, Compliance Data Warehouse, Audit Information Management System, Closed Case Database - FY 2013. The National Taxpayer Advocate has recommended increasing the EITC audit response rate as a key way to improve EITC compliance. See *Internal Revenue Service Oversight, Hearing Before the H. Subcommittee on Financial Services and General Government Committee on Appropriations*, 113th Cong. (2014) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://www.finance.senate.gov/imo/media/doc/Olson%20Testimony1.pdf>.

⁷ Taxpayer Advocate Service, *Enhanced EITC Communication Project* (Nov. 2013) (unpublished report, on file with the Taxpayer Advocate Service). See also National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 63-90 (*Research Study: An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

erally involves no outbound call attempts.⁸ When the audit resulted in disallowance of all or part of the EITC claimed on the original return and the taxpayer did not agree with the audit findings, a TAS Case Advocate contacted the taxpayer and offered assistance (Phase 2).⁹

Significant findings from the study include:

- In Phase 1, Exam successfully contacted 24 percent of the taxpayers in the test group (which received outbound calls). The response rate for these taxpayers was 61 percent (129 cases) compared to 43 percent (1,075 cases) for the control group (which did not receive any outbound calls, in line with typical examination procedures).
- In Phase 2, TAS employed additional databases (such as Accurant) and Internet searches that Exam had not used, as well as information from the tax returns filed after the return that was audited. TAS was able to successfully contact the taxpayer by phone or letter in 243 of the 662 cases (36.7 percent). In 131 (53.9 percent) of these contacts, Exam had not been able to reach the taxpayer.

Additionally, data from the National Research Program (NRP) show how attributes of the EITC population and the complex eligibility rules impact compliance.¹⁰ The NRP Individual Income Tax study is based on a multi-year random sample of federal individual income tax returns. The IRS has completed a study of tax year (TY) 2006, 2007, and 2008 returns claiming the EITC. Since this study involves a random sample of returns claiming EITC, its results can be accurately projected to the entire population of returns claiming EITC.¹¹

The NRP audit approach is more suited to accurately determining the audit results of the low income population by generally providing for in-person (instead of correspondence) audits. Since it provides information about the sources of EITC noncompliance, NRP data should be driving the IRS's EITC compliance, education, and outreach efforts. Currently, however, Examination receives most of its EITC cases from the Dependent Data Base (DDB).¹² Returns are scored in this program by comparing the return information against various business rules established by the IRS, with the highest-scoring returns selected for audits. Accordingly, returns that fail both DDB residency and relationship rules comprise the majority of EITC returns selected for audit.

8 IRM 4.19.20.1 (May 21, 2013).

9 Taxpayer Advocate Service, Enhanced EITC Communication Project (Nov. 2013) (unpublished report, on file with the Taxpayer Advocate Service).

10 Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 4 (Feb. 12, 2014) (unpublished). Unlike the IRS's typical EITC audits, which are conducted via correspondence with a population that has limited literacy and high transiency and thus has a very high no-response rate, 95 percent of NRP EITC audits are conducted in a face-to-face environment in the office or field. They have a response rate of about 86 percent when a qualifying child is involved. The no response rate for EITC audits is just over 40 percent. For more information on NRP data and how it relates to EITC compliance, see *TAS Research Initiatives, infra*.

11 Returns claiming EITC are a subset of all Federal Individual Income Tax returns in the NRP sample.

12 IRM 4.19.14.1(2) (Nov. 25, 2011).

TAS analyzed DDB audits for tax year (TY) 2012, and preliminary data show that about 75 percent of the returns selected for audit failed both the residency and relationship DDB audit rules. However, EITC returns with qualifying children that DDB indicates as not meeting the residency and relationship rules only comprise 20 percent of all returns that broke an EITC DDB rule.¹³ TAS also found that only 16 percent of the audited returns failed the residency test but not the relationship test for all children claimed, even though these returns represent about 33 percent of the returns that failed or partially failed a DDB test. This data suggests that the IRS should focus more of its audit efforts on returns that have qualifying children with only residency issues, instead of primarily focusing on returns with qualifying children having both relationship and residency issues.¹⁴

TAS has also compared NRP data to DDB data. Preliminary results suggest that based on residency and relationship, most noncompliant taxpayers were not detected by the DDB. Of all returns in the NRP EITC study with at least one child failing EITC eligibility for residency, only approximately 25 percent also failed a DDB residency rule (for at least one child). Likewise, of all the returns in the NRP EITC study with at least one child failing EITC eligibility for relationship, only 28 percent also failed a DDB relationship rule.

According to this NRP analysis, most returns failing EITC residency and relationship requirements are not being detected by the DDB rules. The NRP EITC study indicates that qualifying child errors are the most expensive, and account for at least 40 percent of the overclaims.¹⁵ NRP data also show that over three-quarters of the qualifying child errors stem from failing the residency requirements, while only 20 percent result from relationship requirements. The IRS is routinely selecting returns for audit that appear to not meet residency and relationship criteria. However, the IRS does not have a significant audit coverage of those who only fail EITC residency rules, even though the NRP indicates that most children are not qualified for EITC as a result of residency criteria only.

The IRS largely relies on the DDB tests for its selection of cases to audit. However, the data show that the IRS is not selecting most of the appropriate cases and is missing many that could truly impact compliance. This also means that the taxpayers who wrongfully claim the credit miss out on an educational opportunity and may continue to file erroneous claims.

13 In order for a taxpayer to claim a child with the EITC, that child must be a “qualifying child” as defined by IRC § 152(c). Two aspects of qualifying child include relationship and residency. To be related, the child must be the child of the taxpayer or a descendent of such a child or a brother, sister, stepbrother, stepsister of the taxpayer or a descendent of any such relative. IRC § 152(c)(2). This includes relationships by marriage and by law, such as adoptions. The residency test generally requires that the child live with the taxpayer for more than half of the tax year. IRC § 152(c)(1)(B). The DDB also selects returns for audit because the taxpayer is required to recertify EITC eligibility because of prior non-compliance with EITC eligibility rules.

14 Audit strategies that are designed to maximize revenue do not necessarily maximize future voluntary compliance, *i.e.*, most of the noncompliance may be in areas the IRS is currently not good at detecting. Development of audit selection approaches that more effectively identify the largest pockets of noncompliance is an on-going challenge for the IRS.

15 Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 4 (Feb. 12, 2014) (unpublished).

TAS research shows that low income taxpayers struggle to navigate the audit process.¹⁶ Some taxpayers with a legitimate claim may be deemed ineligible because they could not navigate the audit process without help. Lastly, until the IRS is auditing the appropriate cases, its audits will have limited impact on future EITC compliance, and the EITC will continue to be associated with high improper payment rates.¹⁷

Ongoing TAS Advocacy Efforts

TAS continues to advocate for low income taxpayers through its casework. For fiscal year 2014 (through March), TAS has issued ten Taxpayer Assistance Orders (TAO) on EITC cases, with two pending.¹⁸ To further the work done by TAS case advocates, the National

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Taxpayer Advocate issued guidance for working EITC cases.¹⁹ This interim guidance acknowledged that low income taxpayers often struggle with the audit process and accordingly, instructed case advocates to “listen to the taxpayer and attempt to identify any barriers to him or her obtaining documentation.”²⁰

The National Taxpayer Advocate has also testified before Congress regarding the EITC and the needs of low income taxpayers. In particular, the National Taxpayer Advocate has drawn attention to the connection between the work of unenrolled preparers and the EITC compliance rate.²¹ The National Taxpayer Advocate also offered recommendations for improving the EITC program.²² TAS is collaborating with Return Integrity and Correspondence Service (RICS) on the EITC Audit Improvement Team, which is looking at ways to improve the audit process, correspondence, and educational materials, including videos, for taxpayers. The potential alignment of EITC exam under RICS creates an opportunity to implement some of the non-traditional

16 See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

17 Improper payments include “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” as well as “any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts.” Improper Payments Information Act of 2002, Pub. L. No. 107-300 § 2351, 116 Stat. 2350 (2002).

18 Taxpayer Advocate Management Information System (TAMIS) data. The National Taxpayer Advocate (or her designee) may issue a TAO in cases where it is determined that the taxpayer is “suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary.” See IRC § 7811(a)(1)(A).

19 See National Taxpayer Advocate, *Reissuance of Interim Guidance on Advocacy for Taxpayers Claiming Earned Income Tax Credit (EITC) with Respect to a Qualifying Child*, TAS-13-1213-011 (Dec. 23, 2013).

20 *Id.* This guidance also provided fifty alternative documents that could satisfy the age and relationship test.

21 See *Internal Revenue Service Oversight, Hearing Before the H. Subcommittee on Financial Services and General Government Committee on Appropriations*, 113th Cong. (2014) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://www.finance.senate.gov/imo/media/doc/Olson%20Testimony1.pdf>.

22 See *Improper Payments in the Administration of Refundable Credits, Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate); See also *Internal Revenue Service Oversight, Hearing Before the H. Subcommittee on Financial Services and General Government Committee on Appropriations*, 113th Cong. (2014) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://www.finance.senate.gov/imo/media/doc/Olson%20Testimony1.pdf>.

and specialized approaches to EITC audits that the National Taxpayer Advocate has championed over the years.²³

In FY 2015, TAS will:

- Continue research to determine the causes of EITC errors based on a thorough examination of the data from NRP and the Enhanced Communication Study.
- Provide an extensive and comprehensive review of the initial intent of the EITC and its economic impact on low income taxpayers, especially the working poor.
- Work with the IRS on redesigning the EITC audit selection process to increase the response rate and to educate taxpayers.
- Engage Low Income Taxpayer Clinics in reviewing the causes of noncompliance in the EITC arena. The National Taxpayer Advocate is planning to report the results of this comprehensive research project in her 2014 Annual Report to Congress.
- Continue to advocate for improved audit processes that drive responses, including the use of additional contacts, the Residency Affidavit, and alternate address databases.²⁴
- Include as a FY15 performance commitment for each Local Taxpayer Advocate (LTA) to actively include EITC as an outreach topic and conduct local reviews of EITC cases to identify potential systemic issues and report as appropriate. Additionally, the FY 2015 TAS Program Letter will require consistent advocacy and processing of EITC-related cases. The focused case reviews will target no-relief and partial relief EITC, with the results included in the Area and local office Operational Reviews.
- Continue to focus on the IRS's procedures and actions in inappropriately banning taxpayers from receiving the credit under IRC § 32(k).²⁵

23 See IRM 1.1.13.6.4 (Oct. 7, 2013).

24 For information on the Residency Affidavit, see *Internal Revenue Service Oversight, Hearing Before the H. Subcommittee on Financial Services and General Government Committee on Appropriations*, 113th Cong. (2014) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://www.finance.senate.gov/imo/media/doc/Olson%20Testimony1.pdf>; National Taxpayer Advocate 2011 Annual Report to Congress (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 2005 Annual Report to Congress (Most Serious Problem: *Earned Income Tax Credit and Exam Issues*).

25 See National Taxpayer Advocate 2013 Annual Report to Congress (Most Serious Problem: *The IRS Inappropriately Bans Many From Claiming EITC*).