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#23**EARNED INCOME TAX CREDIT (EITC): 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****RESPONSIBLE OFFICIALS**

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

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

**DEFINITION OF PROBLEM**

The Earned Income Tax Credit (EITC) is a refundable credit, enacted as a work incentive in the Tax Reduction Act of 1975.<sup>2</sup> It has become one of the primary forms of public assistance for low income working taxpayers. Taxpayers eligible for the EITC often rely on the credit in order to make basic ends meet, such as to cover housing and transportation costs. The EITC is also associated with a high improper payment rate.<sup>3</sup> The IRS currently estimates that the EITC improper payment rate is 27 percent (which accounts for an estimated \$17.7 billion in improper payments).<sup>4</sup> Despite much attention to this issue, the current improper payment rate has increased slightly from 2004, when it was 25 percent.<sup>5</sup> Thus, the IRS must balance the obligation of making sure every taxpayer eligible for the EITC receives it, with the obligation to minimize mistakes and fraud.<sup>6</sup>

The EITC is a complex law that involves eligibility rules based on a taxpayer's income, marital status, and parental arrangements, which can often change on a year-to-year basis. The population claiming the

1 See Taxpayer Bill of Rights, available at [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights).

2 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*, 53 NAT'L. TAX J. 983-1026 (Dec. 2000).

3 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(f)(2) (2010).

4 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).

5 *Id.* The lowest improper payment measurement since 2004 was 25 percent, which occurred in 2012. *Id.*

6 For information on how the IRS is addressing the role that tax return preparers play in EITC noncompliance, see Most Serious Problem: *Earned Income Tax Credit (EITC): The IRS's EITC Return Preparer Strategy Does Not Adequately Address the Role of Preparers in EITC Noncompliance*, *infra*.

EITC is constantly in flux, with approximately one-third of the eligible population changing every year.<sup>7</sup> At the same time, the population of taxpayers who rely on the EITC share a common set of characteristics, such as low education and high transiency, which create challenges for taxpayer compliance.<sup>8</sup>

Notwithstanding these challenges the IRS persists in using traditional audits as its primary compliance tool. In fact, EITC audits make up 35 percent of all IRS audits despite the fact that EITC returns account for only 19 percent of all returns filed.<sup>9</sup> Because audits are resource-intensive, the IRS should focus its limited resources on audit methods proven to have the greatest direct and indirect effects on compliance in order to have the biggest impact on potentially erroneous EITC claims. The IRS primarily relies on the automated correspondence examination process to work EITC audits. TAS's review of this approach reveals the following concerns:

- The correspondence audit process creates barriers for low income taxpayers due to their unique attributes;
- The EITC audit program has a no-response rate of over 40 percent, raising questions about the accuracy of some default assessments and of the audit's effectiveness as an educational tool for future compliance;<sup>10</sup> and
- The IRS may not be auditing the group of EITC returns that have the most noncompliance, thereby diminishing the effectiveness of IRS efforts to improve future compliance and creating a burden for taxpayers.

Improving the EITC audit program is an important step to improving the improper payment rate, reducing taxpayer burden, and meeting Congress's expectations that the IRS "engage in the first top to bottom review since 1996 of how federal policies can better support work, strengthen families, and move America forward."<sup>11</sup> An improved audit process will also ensure procedural justice for low income taxpayers.<sup>12</sup>

7 IRS, *EITC Fast Facts*, <http://www.eitc.irs.gov/Partner-Toolkit/basicmaterials/ff> (last visited Sept. 16, 2015). For more information on the changing population of taxpayers eligible for EITC, see National Taxpayer Advocate 2013 Annual Report to Congress 109-10.

8 See Introduction: *The IRS Can Do More to Improve Its Administration of the Earned Income Tax Credit (EITC) and Increase Future Compliance Without Unduly Burdening Taxpayers and Undermining Taxpayer Rights*, *supra*.

9 IRS, *2014 Data Book*, table 9a, comparing the number of EITC returns filed and the number of EITC audits in footnote 5 of the same table.

10 For FY 2014, the exact no response rate is 45.6 percent. This calculation includes 255,286 default assessments minus 99,067 default assessments that involved some taxpayer contact, bringing the total of default assessments with no taxpayer contact to 156,219. In addition, 42,490 cases involving undeliverable mail were then added, for a total of 198,709 cases with either a default assessment and no contact or undeliverable notices. That number divided by the total of 435,639 equals 45.6 percent and represents the portion of taxpayers who did not respond to the EITC audit. Audit Information Management System Closed Case Database. See *Internal Revenue Service Oversight, Hearing Before the H. Subcomm. on Fin. Serv. and Gen. Gov't Comm. on Appropriations*, 113th Cong. 34 (2014) (statement of Nina E. Olson, National Taxpayer Advocate), available at <http://www.finance.senate.gov/imo/media/doc/Olson%20Testimony1.pdf>.

11 *Challenges Facing Low-Income Individuals and Families in Today's Economy: Hearing Before the Subcomm. on Human Res. of the H. Comm. on Ways and Means*, 114th Cong. (2015) (statement of Subcommittee Chairman Charles Boustany). Additionally, the President's FY 2016 budget includes "strategic reinvestments in the IRS," which among other things, are intended to "help increase audit and collection coverage." *Examining Federal Improper Payments and Errors in the Death Master File, Hearing before the S. Comm. on Homeland Security and Governmental Affairs*, 114th Cong. (Mar. 16, 2015) (statement of David Mader, United States Controller, Office of Management and Budget). If the IRS does receive additional funding, now is a good opportunity to evaluate its EITC audit effectiveness.

12 "Procedural justice" (or fairness) is a concept that considers how a taxpayer is treated by the IRS. It looks to more than just the outcome of the interaction, it also considers if the interaction was "nonjudgmental, polite, and respectful of the individual's rights." It is an important concept to consider when discussing EITC audits because a taxpayer's perception of procedural fairness will affect his or her perception of the agency's fairness. Nina E. Olson, *Procedural Justice for All: A Taxpayer Rights Analysis of IRS Earned Income Credit Compliance Strategy*, in 22 *ADVANCES IN TAXATION* 1, 3-4 (John Hasseldine ed., 2015).

## ANALYSIS OF THE PROBLEM

### The Correspondence Audit Process Creates Barriers for Low Income Taxpayers Due to Their Unique Attributes

As noted in the Introduction, EITC taxpayers face significant challenges in interacting with the IRS, including language, financial and computer literacy, transiency, and the other characteristics of low income and poverty populations.<sup>13</sup> Taxpayers claiming the EITC need to have a tailored examination process for a number of reasons, including language barriers, the inability to communicate clearly in writing, complexity of the tax law, and the volume of records required for verification.<sup>14</sup> The National Taxpayer Advocate has consistently argued that low income taxpayers need approaches fine-tuned for their specific needs and preferences.<sup>15</sup> The Treasury Inspector General for Tax Administration (TIGTA) also recently observed that “[IRS] compliance resources are limited, and additional alternatives to traditional compliance methods have not been developed. Consequently, the IRS does not address the majority of potentially erroneous EITC claims.”<sup>16</sup> The Government Accountability Office (GAO) reported that effectiveness of audits may be limited partly because of regular backlogs in the audits, which result in delays in responding to taxpayer responses and inquiries.<sup>17</sup> Moreover, practitioners have expressed concern about the suitability of the correspondence examination for taxpayers claiming the EITC:

The system itself of requiring the least sophisticated users to endure the most impersonal process creates many of the problems for low income taxpayers. In both the examination and collection phases of their case, low income taxpayers go from start straight through to levy without a person assigned individually to their case.<sup>18</sup>

### An EITC Denial May Not Effectively Reflect a Taxpayer’s Eligibility for the Credit

When the audit process does not meet taxpayer needs, any EITC denied to the taxpayer may reflect the taxpayer’s inability to navigate the audit process rather than an improper payment.<sup>19</sup> When taxpayers

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- 13 See Introduction: *The IRS Can Do More To Improve Its Administration of the Earned Income Tax Credit (EITC) and Increase Future Compliance Without Unduly Burdening Taxpayers and Undermining Taxpayer Rights*, *supra*.
- 14 National Taxpayer Advocate 2008 Annual Report to Congress 233. When it comes to complying with document requests, 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 2011 Annual Report to Congress 304.
- 15 For example, see National Taxpayer Advocate 2013 Annual Report to Congress 103-15 (Most Serious Problem: *Earned Income Tax Credit (EITC): The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*); 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*).
- 16 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). Recently, a new law was enacted which will require the IRS to modify the timeframe for people claiming the EITC to receive their refunds. The new timeframe would mean that taxpayers claiming the EITC could not receive their refunds before February 15, with the intention of reducing fraud and improper payments. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113 § 201 (2015).
- 17 GAO, *Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government’s Fiscal Position* 15 (Oct. 1, 2015). The GAO concludes that legislative action and “significant changes” in the IRS compliance processes would be necessary to reduce EITC improper payments. *Id.*
- 18 *Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform*, Hearing Before the S. Comm. on Fin., 114th Cong. (Mar. 10, 2015) (statement of Keith Fogg, Professor of Law and Director of Low Income Taxpayer Clinic (LITC) Villanova Law School).
- 19 National Taxpayer Advocate 2011 Annual Report to Congress 301.

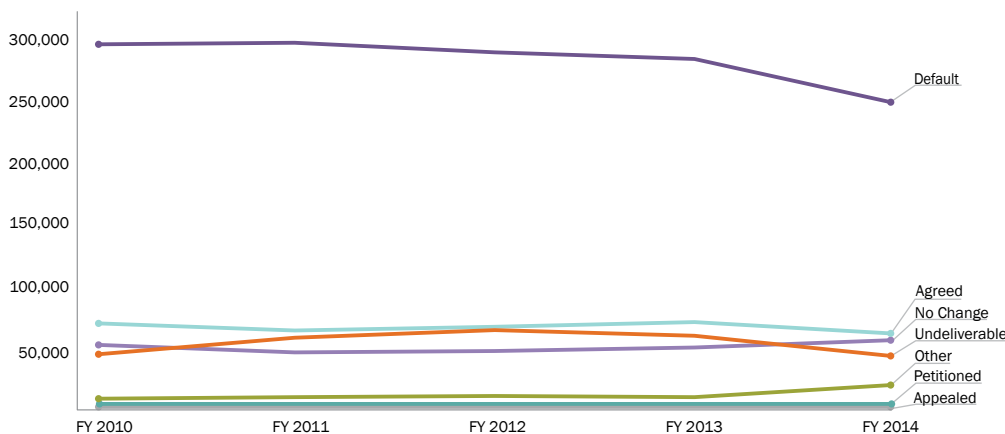
cannot obtain the information they need to substantiate a claim during an audit, they may not pursue the case and may not receive a benefit to which they are entitled. Even if the taxpayer is not eligible for the EITC in the year of audit, if they do not learn why they are ineligible through the audit process, they may just learn that they should not claim the EITC at all, despite being eligible in later years. Or the taxpayer may repeat the mistake in the following year, triggering the two-year ban under Internal Revenue Code (IRC) § 32(k).<sup>20</sup> Such a system does not promote future compliance.

Some taxpayers will appeal their EITC claim denials to the U.S. Tax Court. This increases systemic costs. The taxpayer may retain a *pro bono* attorney through his or her local Low Income Taxpayer Clinic.<sup>21</sup> Litigation will mean increased costs for the IRS in expanding the time of IRS attorneys and Appeals staff, in addition to the court's expenses. Litigation also creates a delay for the taxpayer to receive his or her refund. A TAS review conducted in 2012 examined a random sample of cases in which the taxpayer petitioned the Tax Court for review of IRS disallowance of the EITC and the IRS conceded the EITC issue in full without trial. On average, the taxpayers had to wait 513 days for their refund.<sup>22</sup> Furthermore, the IRS paid \$17,400 in interest on delayed refunds in 90 cases.<sup>23</sup>

Figure 1.23.1 shows the disposition of each EITC audit between fiscal years (FY) 2010 and 2014. The overall trends have stayed relatively consistent over the five years.

**FIGURE 1.23.1**<sup>24</sup>

**Disposition of EITC Audits for FYs 2010-2014**



20 A law has been recently enacted which will allow the IRS to use math error authority in situations where the taxpayer has claimed the EITC during a time that he or she is barred from doing so under IRC § 32(k). Consolidated Appropriations Act, 2016, Pub. L. No. 114-113 § 208 (2015).

21 LITCs represent low income individuals in disputes with the IRS, including audits, appeals, collection matters, and federal tax litigation. See IRS Publication 4134, *Low Income Taxpayer Clinic List* (Jan. 2015).

22 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 86.

23 *Id.*

24 IRS Compliance Data Warehouse (CDW), Audit Information Management System through July 2015. This data represents information provided by the IRS. The amount of Appeals dispositions may not be accurately tracked by the IRS Audit Information Management System.

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...An additional percentage of the audits that are closed as undeliverable, meaning the taxpayers never had an opportunity to engage in the audit process because the audit notices could not be delivered to the taxpayer... These numbers indicate that the IRS may not be having sufficient communication with taxpayers to make full use of the audit process, which includes educating taxpayers.

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For instance, each year saw over half of all assessments closed with a default assessment (meaning that the credit was denied because the taxpayer did not respond or stopped responding), making default assessments the primary type of audit closure. The number of default assessments was largest in FY 2010, with 63.7 percent of audits closed as a default assessment and smallest in FY 2014, with 58.6 percent closed as a default assessment.<sup>25</sup> Audits closed with a taxpayer in agreement with the outcome also stayed relatively consistent over the five years. The highest number of cases closed with taxpayer agreement occurred in FY 2010 and FY 2013, with 14.7 percent of cases closed in agreement. The lowest measurement for cases closed in agreement occurred in FY 2011, when there were 13.3 percent of the cases closed in agreement.<sup>26</sup> Audits closed with a no change status (meaning that following a review of documentation submitted by the taxpayer, the IRS agreed with the taxpayer's return) peaked in FY 2014 with 12.9 percent and the lowest measurement occurred in FY 2011 with 9.5 percent of the audits closed with no change.<sup>27</sup>

Each fiscal year there is an additional percentage of the audits that are closed as undeliverable, meaning the taxpayers never had an opportunity to engage in the audit process because the audit notices could not be delivered to the taxpayer. For the five fiscal years, an average of 11 percent of the cases were closed as undeliverable.<sup>28</sup> Overall, these numbers indicate that the IRS may not be having sufficient communication with taxpayers to make full use of the audit process, which includes educating taxpayers.

Figure 1.23.2 shows the outcome of closed audits for FY 2013. While a majority (65.2 percent) are full paid, approximately one-quarter remain open with a balance due remaining. Of those listed as currently not collectible (CNC), 23.4 percent were CNC hardship.<sup>29</sup> CNC hardship is a status that is used when the IRS determines that collection of the liability would leave the taxpayer unable to pay their basic living expenses.<sup>30</sup> Taxpayers in this category will still have their refunds offset unless they can request their refund prior to offset. This means that taxpayers whom the IRS has determined are unable to pay their outstanding liabilities may still full pay the liability because of offsets. Liabilities are more likely to be

25 In 2010 there were 474,024 audits and 301,818 resulted in a default assessment. In 2014, there were 435,639 audits and 255,286 resulted in a default assessment. IRS CDW, Audit Information Management System Closed Case Database.

26 In 2010, there were 474,024 audits and 68,185 were closed with taxpayer agreement. In 2011, there were 483,820 audits and 64,275 were closed with the taxpayer in agreement. *Id.*

27 In 2014, there were 435,639 audits and 56,193 were closed with no change. In 2011, there were 483,820 audits and 45,780 closed with no change. IRS CDW, Audit Information Management System Closed Case Database. Appeals closed 212 non-docketed EITC cases in FY 2012. This number totaled 196 in FY 2013, 174 in 2014, and 148 in FY 2015. Appeals did not track this information during FY 2010 or FY 2011. IRS response to TAS information request (Dec. 9, 2015). The IRS noted in its fact check response dated Dec. 16, 2015 that it considers no change cases with adjustment and certain other closures as agreed cases. Accordingly the IRS computation of its agreed cases is some percentage points higher and its computation of its no change rate is correspondingly some percentage points lower. By the IRS classification of disposal codes, FY 2014 has the highest percent of cases agreed at 21.5 percent.

28 FY 2010 had an undeliverable measurement of approximately nine percent, FY 2011 had approximately 12 percent, FY 2012 had a measurement of approximately 13 percent, FY 2013 had a measurement of approximately 12 percent, and FY 2014 had a measurement of approximately ten percent.

29 Individual Master File (IMF) as of cycle 201530, AIMS data, cases closed in FY 2013.

30 Internal Revenue Manual (IRM) 5.16.1.2, *Currently Not Collectible Procedures* (Jan. 1, 2015).

paid by refund offset than by other subsequent payments. In FY 2013, the IRS received approximately \$93 million in subsequent payments but approximately \$333 million from refund offsets.<sup>31</sup>

**FIGURE 1.23.2, Status of EITC Audited Accounts, FY 2013 Audit Closures<sup>32</sup>**

| Category                  | Count          | Percent       |
|---------------------------|----------------|---------------|
| Full Paid                 | 314,720        | 65.2%         |
| Balance Due Remaining     | 120,941        | 25.0%         |
| Installment Agreement     | 18,543         | 3.8%          |
| Currently Not Collectible | 28,709         | 5.9%          |
| <b>Total</b>              | <b>482,913</b> | <b>100.0%</b> |

### *Internal Guidance That Encourages Acceptance of Alternative Documentation to Substantiate EITC Claims Will Help Taxpayers Eligible for the Credit*

One practice that could benefit low income taxpayers is the acceptance of alternative documentation. The IRS has guidance for analyzing documentation submitted by taxpayers in EITC cases. In particular, IRM 4.19.14.5.4 provides IRS employees with a chart for analyzing EITC cases involving qualifying children.<sup>33</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. The current internal guidance also lacks specific instruction for tax examiners to consider alternative documentation.<sup>34</sup> In 2013, the National Taxpayer Advocate issued internal guidance to TAS employees related to EITC issues.<sup>35</sup> This guidance included a list of 50 alternative documents that could be used to substantiate an EITC claim.<sup>36</sup> While not exhaustive, it created a more flexible approach to analyzing documents in EITC cases.<sup>37</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.

In 2005, the IRS studied the use of affidavits as part of the EITC Qualifying Child Residency Certification Study.<sup>38</sup> 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 (TY), but for whom the IRS could not establish qualifying child residency through available data. The documents sent to the taxpayer explained the certification requirements, Form 8836, *Qualifying Child Residency Statement*, an affidavit form, and educational publications.<sup>39</sup> To certify his or her 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,

31 IMF as of cycle 201526.

32 IMF as of cycle 201530. We could not determine the current status of approximately 175 cases.

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

34 TAS, *Memorandum for 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).

35 *Id.*

36 *Id.*

37 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, 10 EITC TAOs were issued and the IRS complied with nine. Data obtained from the Taxpayer Advocate Management Information System (TAMIS) (Oct. 1, 2014; Oct. 1, 2015).

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

39 *Id.*



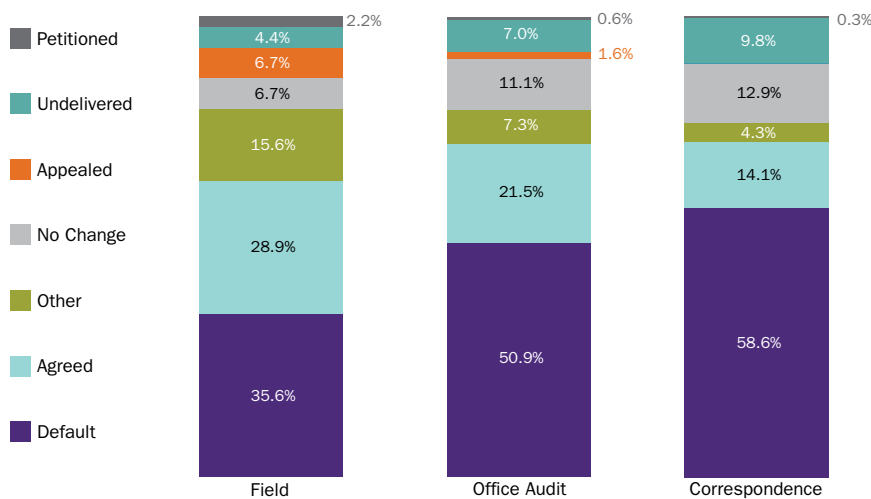
etc.) or the affidavit. The study found that affidavits had the highest rate of acceptance at 82 percent, compared to an overall acceptance rate of 64 percent for all document types.<sup>40</sup> The study concluded that this outcome was reasonable because affidavits had dedicated lines for all of the information, explaining “as long as the affidavit was filled out completely, it would contain all the required information to be accepted.”<sup>41</sup>

**The EITC Audit Program Has a No-Response Rate of Over 40 Percent, Raising Questions About the Accuracy of Some Default Assessments and of the Audit’s Effectiveness As an Educational Tool for Future Compliance**

The EITC audit process has a fairly large non-response rate of over 40 percent.<sup>42</sup> Audits are not just about correcting a specific year’s tax liability. Every audit provides an opportunity for the IRS to educate the taxpayer about errors on the return, so he or she becomes and remains compliant going forward. 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.<sup>43</sup> By meeting the needs of low income taxpayers during the audit process, the IRS may improve the response rate and thus increase future compliance by educating more taxpayers.

**FIGURE 1.23.3**<sup>44</sup>

**FY 2014 EITC Audit Dispositions by Type of IRS Examiner**



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

41 *Id.*

42 For FY 2014, the exact no response rate is 45.6 percent. This calculation includes 255,286 default assessments minus 99,067 default assessments that involved some taxpayer contact, bringing the total of default assessments with no taxpayer contact to 156,219. In addition, 42,490 cases involving undeliverable mail were then added, for a total of 198,709 cases with either a default assessment and no contact or undeliverable notices. That number divided by the total of 435,639 equals 45.6 percent and represents the portion of taxpayers who did not respond to the EITC audit. Audit Information Management System (AIMS) Closed Case Database.

43 National Taxpayer Advocate 2013 Annual Report to Congress 110.

44 AIMS Closed Case Database. Percentages may not total to 100 percent due to rounding. The examiner type is based on the AIMS employee code. It should be noted that field audits and office audits account for less than 400 of the EITC audits closed in FY 2014. We cannot determine if the selection of EITC cases for audit by different types of employees affects the disposition of the audit.

The audit outcome for a taxpayer appears to improve depending on the audit method and which type of IRS examiner handles the audit. Field audits, in which a revenue agent is assigned to the taxpayer's case, have the lowest default and undeliverable numbers. Field audits had a default closing in 35.6 percent of the cases and the audit was closed as undeliverable in 4.4 percent of the cases.<sup>45</sup> When compared to the average undeliverable rate for all audits above, field audits that result in an undeliverable status are approximately half as frequent. Cases worked in correspondence, which do not have an assigned employee, had a default rate of 58.6 percent and an undeliverable measurement of 9.8 percent.<sup>46</sup> These numbers may indicate that audit outcomes are improved when an assigned employee is working the case and it is not only based on a correspondence examination.<sup>47</sup>

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**Audits are not just about correcting a specific year's tax liability. Every audit provides an opportunity for the IRS to educate the taxpayer about errors on the return, so he or she becomes and remains compliant going forward.**

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The correspondence examination process is based on an exchange of documentation and not personal interaction. Under this system, even if the IRS does receive correspondence from the taxpayer, there will be missed educational opportunities. For example, if the taxpayer receives a request for substantiating documentation and does not understand the notice, he or she may send in incomplete or irrelevant documentation. Without an employee to speak with, the taxpayer will not learn what specifically is at issue and what specific documentation is needed. Thus, an otherwise legitimate claim may be denied or reduced in amount simply because the taxpayer needed an explanation of what is at issue and what is required, in terms he or she can understand.

The IRS National Research Program (NRP) recently conducted EITC audits in order to gather information about the nature of errors taxpayers made when claiming the EITC in TYs 2006 through 2008.<sup>48</sup> Focused taxpayer education is one component of the NRP audit that is not present in a correspondence exam.<sup>49</sup> NRP audits are worked by examiners "trained to make every accommodation to meet with taxpayers, to educate them about the necessary documentation for substantiating EITC eligibility, and to give them sufficient opportunity to obtain and supply the necessary information."<sup>50</sup> Nearly 95 percent of the NRP audits require a face-to-face meeting with an IRS examiner.<sup>51</sup> On the other hand, in the correspondence examination process, education of the taxpayer is not a focus.<sup>52</sup> As part of a study on enhanced taxpayer communication in 2013, TAS called taxpayers who had been assessed an

45 AIMS Closed Case Database through August 2015. It should be noted that field audits and office audits account for less than 400 of the EITC audits closed in FY 2014. We cannot determine if the selection of EITC cases for audit by different types of employees affects the disposition of the audit.

46 AIMS Closed Case Database through August 2015.

47 It should be noted that field audits and office audits account for less than 400 of the EITC audits closed in FY 2014. We cannot determine if the selection of EITC cases for audit by different types of employees affects the disposition of the audit.

48 IRS, Research, Analysis & Statistics (RAS), *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (Aug. 2014). The NRP "seeks to increase public confidence in the fairness of our tax system by helping the IRS identify where compliance problems occur, so that the IRS can efficiently utilize its resources to address those problems." IRM 4.22.1.3(1) (Apr. 25, 2008).

49 For a general discussion of how the lack of an assigned employee in correspondence exam harms taxpayers, see National Taxpayer Advocate 2014 Annual Report to Congress 134-44.

50 IRS, RAS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 8 (Aug. 2014).

51 *Id.* at 5.

52 Since correspondence exam does not assign cases to one employee, the focus in correspondence exam is to have taxpayer contact go to the next available employee instead of the employee working the case. This creates a system where the IRS employee answering the taxpayer's question may not be familiar with the taxpayer's issue or documentation. National Taxpayer Advocate 2014 Annual Report to Congress 139-40.



EITC liability in a correspondence examination and found that less than one-quarter learned that they were ineligible during the audit compared to almost one half after contacting TAS.<sup>53</sup>

If the IRS wants to reach the correct conclusion in *all* of its EITC audits and simultaneously promote future voluntary compliance, it should tailor its correspondence exam process to include interaction with the taxpayer and taxpayer education. Such an approach will increase EITC compliance and instill a sense of procedural justice into the audit process. One way the IRS can accomplish this is by assigning EITC correspondence exam cases to a single employee when the taxpayer responds with some information. That way, the employee can be charged with the same responsibility for educating the taxpayer as NRP auditors are.<sup>54</sup> This approach may reduce the number of EITC audits (which are already a disproportionately high percentage of all individual audits), however, the effectiveness of the audit in terms of ongoing compliance may even increase the indirect effectiveness of the audit.<sup>55</sup> Another approach involves the use of virtual face-to-face audits, whereby the taxpayer can make an appointment and meet with the auditor virtually. This technique captures the cost savings of a centralized audit group and the benefits of face-to-face communication, which enables the auditor to establish trust with the taxpayer and to identify when the taxpayer does not understand directions or is otherwise confused.

### The IRS May Not Be Auditing the Group of EITC Returns Having the Most Non-Compliance, Thereby Diminishing the Effectiveness of IRS Efforts to Improve Future Compliance and Creating a Burden for Taxpayers

TAS analysis reveals the following issues with the way in which the IRS selects EITC cases for audit:

- The IRS relies on the Dependent Database (DDb) and does not build a workload selection model based on NRP data;
- Most NRP audits did not trip DDb rules, meaning the existing DDb rules may not be capable of capturing a complete sample of cases to audit; and
- The IRS is currently focusing on cases where the DDb rules for both residency and relationship are broken, and generally focusing only on the relationship component in these audits because it is the easiest basis for denial. Because residency is the eligibility requirement associated with three-quarters of the qualifying child errors, the IRS should consider more cases where the DDb rule for residency is the only rule broken, and also educate the taxpayer about the residency requirements when both rules are broken.

### *The IRS Relies on the DDb and Does Not Build a Workload Selection Model Based on NRP Data*

Data from the NRP show how attributes of the EITC population and the complex eligibility rules impact compliance.<sup>56</sup> The NRP Individual Income Tax study is based on a multi-year random sample of federal individual income tax returns. As noted earlier, the NRP audit approach is better suited than the cor-

53 Unpublished results from *Enhanced Communication Study*, results on file with the National Taxpayer Advocate.

54 See National Taxpayer Advocate 2014 Annual Report to Congress 134-144 (Most Serious Problem: *Correspondence Examination: The IRS Has Overlooked the Congressional Mandate to Assign a Specific Employee to Correspondence Examination Cases, Thereby Harming Taxpayers*).

55 IRS FY 2014 Data Book Table 9a. The audit coverage rate for all individual returns is about 0.9 percent, while the coverage rate is about 1.6 percent for EITC returns. See also *supra* note 9 regarding the number of EITC audits.

56 IRS, RAS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (Aug. 2014). Unlike the IRS's typical EITC audits, NRP EITC audits have a response rate of about 85 percent when a qualifying child is involved. The response rate for operational EITC audits is under 60 percent. For more information on this topic, see National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress 123-28.

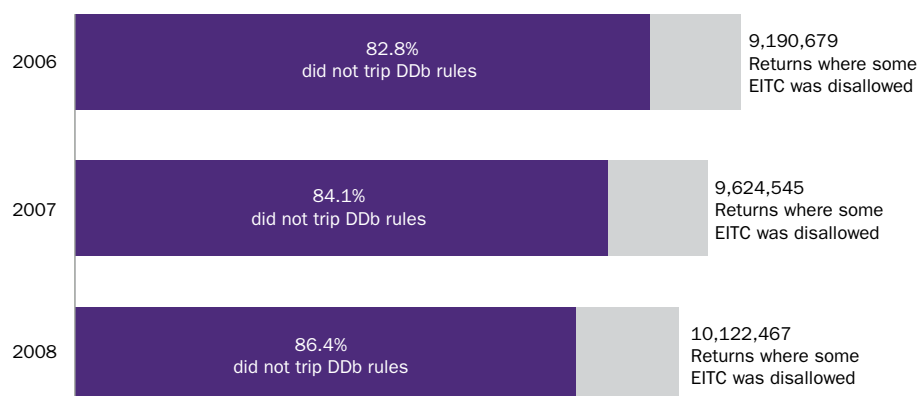
respondence audit to accurately determine the audit results of the low income population by generally providing for in-person (instead of correspondence) audits. NRP data should be driving how the IRS selects EITC cases for audit, since it provides information about the sources of EITC noncompliance. Currently, however, Examination receives most of its EITC cases from the DDb.<sup>57</sup> In this program, returns are scored by comparing the return information against various business rules established by the IRS, with the highest-scoring returns selected for audits.

### *Most NRP Audits Do Not Trip DDb Rules*

TAS analyzed NRP audits that broke DDb rules and found that in TY 2008, approximately 86 percent of the NRP cases with adjustments *did not* trip a DDb rule.<sup>58</sup> As mentioned above, the quality of the NRP data is quite high. The IRS should use this information to reevaluate its method of selecting cases for audit and improve on its ability to identify areas of noncompliance. The following figure shows the results from 2006 through 2008 NRP audits.

**FIGURE 1.23.4**<sup>59</sup>

#### NRP Audits Disallowing Some EITC That Broke DDb Rules



<sup>57</sup> IRM 4.19.14.1(2) (Jan. 1, 2015).

<sup>58</sup> The DDb data comes from a Business Object interface with the DDb. The NRP and closed audit information comes from the database of NRP data stored on the IRS CDW and from the AIMS also on the IRS CDW. The NRP data is a weighted sample. TAS used a weighting scheme which did not generally assign a weight to no response cases and cases selected for audit based on the DDb score. If the weights are recomputed to include these cases, about 80 percent of the returns where EITC was disallowed did not trip DDb rules. This percentage has also dropped in subsequent years, but is still about 70 percent. IRS fact check response (Dec. 16, 2015).

<sup>59</sup> *Id.*

In other words, the IRS is concentrating its Earned Income Tax Credit (EITC) audit resources on taxpayers with a noncompliance issue that is relatively minor, compared to an issue associated with 75 percent of all EITC qualifying child errors. If the point of an audit is not just to score audit adjustments and create good statistics, but rather to educate taxpayers so they understand the rules and voluntarily comply in the future, then IRS EITC audit strategy is ineffective.

### *The IRS Should Consider More Cases Where the DDb Rule for Residency Is the Only Rule Broken*

NRP data shows that approximately 75 percent of children claimed in error failed the residency test and only about 20 percent failed the relationship test.<sup>60</sup> TAS further analyzed DDb audits for TY 2012, and preliminary data show that approximately 70 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 23 percent of all returns that broke an EITC DDb rule.<sup>61</sup> TAS also found that only 11 percent of the audited returns broke the DDb rules for residency but not relationship for all children claimed, even though these returns represent about 31 percent of the returns that failed or partially failed a DDb test.<sup>62</sup> The data suggest that the IRS should focus some 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. In other words, the IRS is concentrating its EITC audit resources on taxpayers with a noncompliance issue that is relatively minor, compared to an issue associated with 75 percent of all EITC qualifying child errors. If the point of an audit is not just to score audit adjustments and create good statistics, but rather to educate taxpayers so they understand the rules and voluntarily comply in the future, then the IRS EITC audit strategy is ineffective.

### *Analysis of DDb Data Shows It Is Not Detecting Most Noncompliant Taxpayers*

TAS 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. The NRP EITC study indicates that qualifying child errors are the most expensive, and account for at least 42 percent of the overclaims.<sup>63</sup> The NRP study involved a random sample of returns weighted to reflect the taxpayer population.<sup>64</sup> On the other hand, the IRS EITC audit population includes EITC returns that tripped the DDb rules. Of all returns in the NRP EITC study (which includes data from TYs 2006 through 2008) 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.

60 IRS, RAS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 22-23 (Aug. 2014).

61 The DDb data comes from a Business Object interface with the DDb. The NRP and closed audit information comes from the database of NRP data stored on the IRS CDW and from the AIMS also on the IRS CDW. 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.

62 The DDb data comes from a Business Object interface with the DDb. The NRP and closed audit information comes from the database of NRP data stored on the IRS CDW and from the AIMS also on the IRS CDW.

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

64 *Id.* at 5.

According to this NRP analysis, most returns failing EITC residency and relationship requirements are not being detected by the DDb rules. As noted above, the NRP study indicates that qualifying child errors are the most expensive EITC errors. NRP data also show that nearly three-quarters of the qualifying child errors stem from failing the residency requirements, while less than 25 percent result from relationship requirements.<sup>65</sup> However, the IRS does not have significant audit coverage of those who only fail EITC residency rules. By not selecting the most appropriate cases for audit, the IRS is missing many opportunities that could truly impact compliance, overlooks educational opportunities, and continues to allow erroneous claims to be filed.

## CONCLUSION

A poorly designed EITC audit program results in lost opportunities to educate taxpayers and thus improve voluntary compliance, thereby reducing the improper payment rate. Under the present correspondence exam program, taxpayers whose EITC is correctly disallowed in one year do not learn about EITC eligibility rules and, as a result, may not claim the EITC in a future year in which they are eligible. Given that many low income taxpayers are not equipped to deal with the complexity of the EITC, the IRS should redesign its audit strategy to take into consideration how best to reach these taxpayers, how they respond to various types of outreach and education, how they prefer to receive service from the IRS, and how well they can comply with the EITC requirements and instructions.<sup>66</sup> The approach should foster engagement, valuing education and future compliance over assessed dollars.

The IRS should also consider how it selects EITC cases for audit so that the cases with the largest impact are being reviewed. Examination receives most of its EITC cases from the DDb. However, TAS research indicates that this approach alone may not identify the most appropriate cases for audit, which impacts EITC noncompliance.

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65 IRS, RAS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns v* (Aug. 2014); *supra* note 60.

66 See National Taxpayer Advocate 2009 Annual Report to Congress 117.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Conduct an EITC pilot with three different treatments: a regular correspondence examination, an office audit, and a correspondence examination with one auditor assigned. The pilot should measure the following: direct time on case, no response/drop-out rate, agreed to rate, audit reconsideration rate, and future compliance rate.
2. When an EITC taxpayer calls the IRS with information in response to an audit, one employee should be assigned to the taxpayer's case until it is resolved. If the taxpayer calls back, he or she could have the option to speak to the next available employee or wait for the assigned employee to call back. The IRS should hire employees with a social work background or train existing auditors to conduct the audits.
3. Use NRP data to design a formula for workload selection in addition to (or incorporated into) the DDb that will reach the audits with the most impact for taxpayer education and improvement to future compliance. This would include qualifying child errors that involve the residency test.
4. Revise the IRM with the list of additional documentation listed in the TAS IGM, as well as IRM updates about accepting alternative EITC substantiating documentation.
5. Publish and accept Form 8836, *Third Party Affidavit*, for purposes of substantiating the residency requirement for a qualifying child.
6. Collaborate with TAS to draft IRM guidance requiring correspondence examiners to adjust accounts for the childless worker credit when the taxpayer is ineligible for the EITC with children. This should be done automatically without requiring the taxpayer to request the credit.