

MSP #6 **IMPROPER EARNED INCOME TAX CREDIT PAYMENTS: Measures the IRS Takes to Reduce Improper Earned Income Tax Credit Payments Are Not Sufficiently Proactive and May Unnecessarily Burden Taxpayers**

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TAXPAYER RIGHTS IMPACTED¹

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

When the IRS allows a taxpayer's erroneous claim of the earned income tax credit (EITC), it makes an "improper payment."² The IRS estimates that 25 percent of the claimed EITC credits it allowed in fiscal year (FY) 2018 were improper payments.³ The IRS's attempts to reduce the EITC improper payment rate have met with limited success.⁴ While she recognizes the importance of tracking and minimizing improper payments, the National Taxpayer Advocate is concerned that the focus on "a number" masks both the successes and challenges in improving EITC compliance. Specifically:

- The effect of any statutory measures intended to reduce the EITC improper payment rate are not reflected in the IRS's estimate for years;⁵
- The IRS lost an exemption that allowed it to reduce the improper payment estimate by improper payments it recovered;⁶

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 See Improper Payments Information Act of 2002 (IPIA), Pub. L. No. 107-300 § 2(d)(A), 116 Stat. 2350, 2351 (2002), defining an improper payment as "any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments)."

3 Department of Treasury, Agency Financial Report (AFR) Fiscal Year (FY) 2018 194 (Nov. 2018), estimating an earned income tax credit (EITC) improper payment rate of 25.06 percent.

4 As discussed below, since FY 2010 the improper payment rate has fluctuated but has never been estimated as less than 22.8 percent.

5 See, e.g., Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 201 (a) and (b), 129 Stat. 2242, 3076 (2015) (hereinafter PATH Act), codified at IRC §§ 6071(c) and 6402 (m), discussed below.

6 See Government Accountability Office (GAO), GAO 18-377, *Improper Payments, Actions and Guidance Could Help Address Issues and Inconsistencies in Estimation Processes*, App'x IV, Comments from the Internal Revenue Service (May 2018). When recovered payments are taken into account, the FY 2018 improper payment rate is 23.41 percent rather than 25.06 percent. AFR, FY 2018, 194 n. 4 (Nov. 2018).

- The improper payment rate does not take into account that for every dollar of EITC improper payments, 40 cents of EITC went unclaimed by taxpayers who appear to be eligible for the credit;⁷
- A principal cause of the EITC improper payment rate is the complexity of the rules for claiming EITC, yet the IRS does not provide a dedicated telephone help line available year-round for taxpayers to call with questions about EITC;⁸
- EITC improper payments are a relatively small portion of the tax gap;⁹ and
- The EITC program costs less to administer than other non-tax benefit programs and has higher participation rates.¹⁰

In attempting to address improper payments, the IRS may unnecessarily burden taxpayers.¹¹ The IRS could gain insight from TAS research study results and the proactive approaches other tax administrations have adopted in their interactions with taxpayers.¹²

ANALYSIS OF PROBLEM

Background

The current statutory framework pertaining to improper payments originated in 2002, when Congress required the heads of executive agencies, pursuant to guidance from the Office of Management and Budget (OMB), to identify programs and activities susceptible to significant improper payments and report to Congress the estimated amount of improper payments.¹³

7 Treasury Inspector for Tax Administration (TIGTA), Ref. No. 2018-IE-R004, *The Internal Revenue Service Should Consider Modifying the Form 1040 to Increase Earned Income Tax Credit Participation by Eligible Tax Filers* at 2 (Apr. 2, 2018).

8 The rules for claiming the child tax credit (CTC) are similarly complex. See IRC § 24. The importance of the CTC was magnified by legislation that increased the amount of the credit from \$1,000 to \$2,000, for tax years 2018-2025. See Pub. L. No. 115-97, § 1022(a), 131 Stat. 2054, 2073 (2017). The National Taxpayer Advocate has recommended that Congress consolidate numerous family status provisions into a new Family Credit and require the IRS to establish a dedicated, year-round toll-free help line staffed by IRS personnel to respond to questions about the credit. National Taxpayer Advocate 2016 Annual Report to Congress 329 (Legislative Recommendation: *Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*).

9 As discussed below, EITC misreporting constitutes six percent of the gross tax gap and ten percent of the tax gap attributable to income misreporting by individuals.

10 As discussed below, the cost of administering the EITC program is around one percent of benefits delivered, with a participation rate of 79 percent.

11 See below for a discussion of the IRS's pursuit of extended math error authority and its imposition of two-year bans on claiming EITC.

12 See, e.g., Organisation for Economic Co-operation and Development (OECD), *The Changing Tax Compliance Environment and the Role of Audit* 19, 23-26 (2017), https://www.oecd-ilibrary.org/taxation/the-changing-tax-compliance-environment-and-the-role-of-audit_9789264282186-en (last visited Nov. 26, 2018).

13 IPIA, Pub. L. No. 107-300, 116 Stat. 2350 (2002), as amended. Current Office of Management and Budget (OMB) guidance consists of OMB M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* (2014), as modified by OMB M-18-20 Transmittal of Appendix C to OMB Circular A-123, *Requirements for Payment Integrity Improvement* 25 (June 26, 2018). This guidance implements requirements from the following: (1) IPIA; (2) the Improper Payments Elimination and Recovery Act of 2010 (IPERA), Pub. L. No. 111-204, 116 Stat. 2350 (2010); (3) the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA), Pub. L. No. 112-248, 126 Stat. 2390 (2012); and (4) Executive Order 13520 *Reducing Improper Payments* (Nov. 20, 2009). The 2014 OMB guidance defined "significant improper payments" as gross annual improper payments (*i.e.*, the total amount of overpayments and underpayments) in the program exceeding (1) both 1.5 percent of program outlays and \$10,000,000 of all program or activity payments made during the fiscal year reported or (2) \$100 million (regardless of the improper payment percentage of total program outlays). EITC underpayments are defined as the amount of EITC disallowed by the IRS in processing that should have been allowed, as determined by the National Research Program (NRP) examination. AFR, FY 2013 at 206. Thus, unclaimed EITC amounts are not underpayments and are not included in the calculation of improper payments.

A 2009 Executive Order and 2012 legislation required OMB, among other things, to designate and exercise additional oversight with respect to “high priority” programs.¹⁴ Because EITC has been so designated, the IRS must provide, for inclusion in the Department of the Treasury’s annual Agency Financial Report (AFR), not only the rate and amount of improper EITC payments, but additional information such as the root causes of the improper payments. Pursuant to OMB guidance issued in June 2018, the IRS will be required, among other things, to estimate improper payments attributable to other refundable tax credit programs, such as the Affordable Care Act Premium Tax Credit, the Child Tax Credit, and, potentially, the American Opportunity Tax Credit.¹⁵

In addition to reporting EITC improper payment rates over the years, the IRS has conducted an array of studies relating to erroneous EITC claims, particularly when funds were appropriated for such research.¹⁶ Recent IRS initiatives include studies on the effectiveness of “soft” notices, discussed below.

EITC Improper Payments Estimates, Based on Audits of Tax Years Four Years in the Past, Do Not Reflect the Most Recent Remedial Measures or Take Into Account Unclaimed EITC

As part of its National Research Program (NRP), each year the IRS audits a sample of EITC returns and uses data from the audits to estimate the rate of improper EITC payments for that audit year.¹⁷ The *rate* derived from the NRP data is then used to estimate the *amount* of improper payments for the current year. The most recent year for which NRP data is available is 2014. The total amount of EITC claimed on 2014 returns was divided into the amount which, according to NRP audits, were improper payments to arrive at an improper payment *rate* of 25.06 percent.¹⁸ The FY 2018 EITC improper payment *amount* was estimated by multiplying the NRP *rate* (25.06 percent, based on audits of a tax year four years in the past) times the amount of EITC claimed in 2018 (\$73.6 billion) to arrive at \$18.4 billion.¹⁹ This four-year lag between audit outcomes for the tax year that generated the estimated *rate* and the estimated *amount* of improper payments for a given year is a feature of the improper payment estimating process.

14 Executive Order 13520, *Reducing Improper Payments* § 2 (Nov. 20, 2009); IPERIA, § 3. OMB M-18-20 *Transmittal of Appendix C to OMB Circular A-123, Requirements for Payment Integrity Improvement 25* (June 26, 2018) defines high priority programs as those with more than \$2 billion in improper payments in a given year, an increase from the prior threshold of \$750 million.

15 OMB M-18-20 *Transmittal of Appendix C to OMB Circular A-123, Requirements for Payment Integrity Improvement 25* (June 26, 2018). The guidance institutes this requirement with respect to all programs with outlays in excess of \$5 billion, starting in fiscal year 2020. Thus, programs that meet that threshold will also qualify as “high priority” programs. Affordable Care Act (ACA), Premium Tax Credit, and CTC outlays already exceed that threshold, and the American Opportunity Tax Credit outlays, while currently below the threshold, may grow to the threshold amount in the future. IRS response to TAS information request (Aug. 30, 2018).

16 For example, in 1997, Congress authorized a \$716 million appropriation over five years (from FY 1998 to 2002) “for improved application” of the EITC. Balanced Budget Act of 1997, Pub. L. No. 105–33, § 5702, 111 Stat. 251, 648 (1997). Among the studies the IRS conducted was *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 13 (Feb. 28, 2002), reporting, e.g., that among known errors, the largest *amount of overclaims* was caused by taxpayers claiming children who were not their qualifying children, most commonly because the residency requirement was not met. The most *frequent* known error was income misreporting.

17 IRS, *Improper Payments Estimates for the Earned Income Tax Credit: Methodology for the Fiscal Years 2010-2013 Update 2* (May 2010) (on file with TAS). EITC overclaims, defined as the difference between the amount of EITC claimed by the taxpayer on his or her return and the amount the taxpayer should have claimed, as determined by the NRP audit, are reported in the Treasury’s AFR as “actual monetary loss to the government.” See, e.g., AFR, FY 2017 at 176 (Nov. 2017).

18 See AFR, FY 2017 at 174 (Nov. 2017), for a description of this methodology (which does not appear in the FY 2018 AFR).

19 AFR, FY 2018 at 194 (Nov. 2018).

Thus, the estimated EITC improper payment rate does not reflect the most recent measures taken by Congress and the IRS to reduce EITC improper payments.²⁰

The IRS Lost Its Exemption From a Reporting Requirement That Allowed It to Reduce Improper Payment Estimates by Recovered Amounts

In the past, the IRS estimated the improper payment rate by first estimating the gross amount of improper payments, and reducing that amount by the amount of erroneous EITC payments “prevented or recovered.”²¹

This method of computing the EITC improper payment rate was permitted because the IRS had obtained an exemption from the statutory requirement, introduced in 2012, that agencies “include all identified improper payments in the reported estimate, regardless of whether the improper payment in question has been or is being recovered.”²² The IRS’s temporary exemption was allowed “because the tax system differs from spending programs in that much of the verification and compliance activity for potentially erroneous tax returns takes place after refunds have been issued.”²³ In other words, unlike other benefit programs, EITC does not have a separate application process—the tax return is the application. By design, significant compliance activity occurs after issuance of refunds.

However, the IRS’s exemption was not permanent, and the inconsistency was never resolved by the IRS and OMB.²⁴ In 2018, the IRS acquiesced to the Government Accountability Office’s recommendation that it change its method of computing improper payments to disregard recovered amounts.²⁵

Thus, the improper payment rate used to estimate the amount of improper payments in FY 2018, 25.06 percent, was not reduced by recovered improper payments.²⁶ The change in the calculation does not reflect a change in taxpayer compliance, but yields a higher improper payment estimate. When recovered improper payments are taken into account, the *rate* used to calculate the amount of improper payments for FY 2018 becomes 23.41 percent.²⁷ The estimated *amount* of improper payments would thus be 23.41 percent times the amount of EITC claimed on 2018 returns (\$73.6 billion) to arrive at \$17.2 billion (rather than \$18.4 billion).

20 For example, beginning with 2017, the PATH Act imposed a Jan. 31 due date for filing Forms W-2, *Wage and Tax Statement*, Forms W-3, *Transmittal of Wage and Tax Statements*, and any returns or statements required to report nonemployee compensation (such as Forms 1099-MISC, *Miscellaneous Income*), with the Social Security Administration, and required the IRS to delay payment of any refund that includes the EITC or the refundable portion of the CTC until Feb. 15 of each filing year.

21 “Prevented” EITC improper payments are EITC claims that are determined to be erroneous before a refund is paid (these amounts are sometimes referred to as the amount of revenue protected), while “recovered” improper payments are erroneous EITC claims that are paid but later recuperated.

22 IPERIA § 3(b)(2)(D), implemented with OMB M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* 18 (2014).

23 GAO, GAO 18-377, *Improper Payments, Actions and Guidance Could Help Address Issues and Inconsistencies in Estimation Processes*, App’x IV, Comments from the Internal Revenue Service (May 2018).

24 *Id.*, noting that “[t]he exemption was intended to be temporary until the IRS and OMB could address outstanding questions related to the appropriate representation of EITC and other refundable tax credit overclaims. However, since none of the discussions with OMB have resulted in any decisions to date, the IRS will update its reporting so that recoveries are no longer included in our estimates.”

25 *Id.*

26 The IRS will continue to take into account “prevented” erroneous payments and will also provide a computation of the EITC improper payments that takes into account recovered erroneous payments for comparison purposes. IRS response to TAS information request (Aug. 30, 2018).

27 AFR, FY 2018 at 194 n. 4 (Nov. 2018).

The estimated amount of improper payments also does not take into account that many taxpayers who appear to be eligible do not claim Earned Income Tax Credit (EITC). The Treasury Inspector General for Tax Administration estimated that ... for every dollar of EITC improper payments, there were 40 cents of unclaimed EITC.

For Every Dollar of EITC Improper Payments, There Were 40 Cents of Unclaimed EITC

The estimated amount of improper payments also does not take into account that many taxpayers who appear to be eligible do not claim EITC. The Treasury Inspector General for Tax Administration (TIGTA) estimated that in 2014, when the EITC improper payments were estimated to be \$17.7 billion, \$7.3 billion in EITC refunds went unclaimed.²⁸ In other words, TIGTA estimated that for every dollar of EITC improper payments, there were 40 cents of unclaimed EITC.

Additionally, the improper payment rate does not take into account that EITC, although claimed by the “wrong” taxpayer, may have reached the intended beneficiary, a qualifying child. For example, suppose a taxpayer claims EITC with respect to a qualifying child, A, who is not the taxpayer’s qualifying child. However, the taxpayer’s former spouse could have claimed EITC with respect to A but did not. Thus, allowing EITC claimed by a parent who turns out to be the “wrong” taxpayer could be an improper payment, even though the benefit was only paid once, and was paid with respect to a qualifying child.²⁹

Since 2010, EITC estimated improper payment rates have fluctuated between a low of 22.8 percent in 2012 and a high of 27.2 percent in 2014, as shown in Figure 1.6.1.³⁰

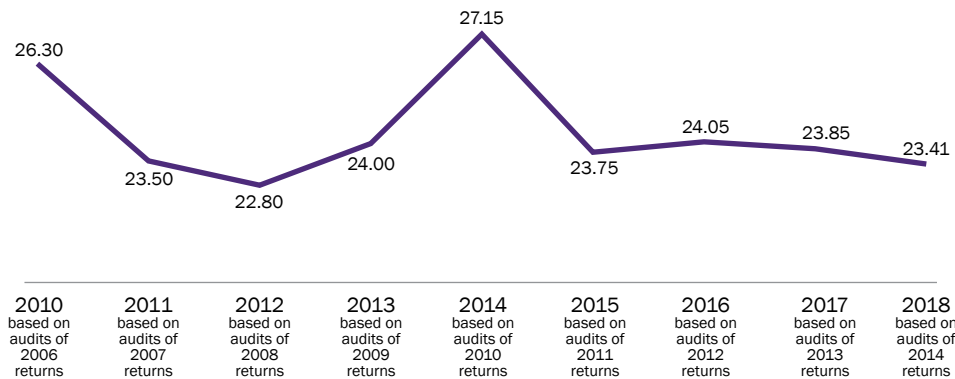
28 AFR, FY 2014 at 201 (Nov. 2014), estimating improper EITC payments of \$17.7 billion; TIGTA, Ref. No. 2018-IE-R004, *The Internal Revenue Service Should Consider Modifying the Form 1040 to Increase Earned Income Tax Credit Participation by Eligible Tax Filers* at 2 (Apr. 2, 2018), estimating that five million potentially eligible taxpayers did not claim approximately \$7.3 billion in EITC refunds on their 2014 returns.

29 The extent to which improper payments occur under these circumstances is not known, but could be developed from NRP data. IRS response to TAS information request (Aug. 31, 2018).

30 See U.S. Dept. of the Treas., AFRs, FYs 2010-2018, <https://home.treasury.gov/about/budget-financial-reporting-planning-and-performance/agency-financial-report>. Until FY 2010, the improper payment rate was expressed as a midpoint between upper and lower bounds. The upper and lower bounds reflected assumptions about whether taxpayers who did not participate in the NRP audits were actually entitled to EITC. Beginning with FY 2010, the rate was expressed as a single rate with confidence intervals, with nonparticipating taxpayers treated as being entitled to EITC at the same rate as those who participated in the NRP audit. However, the AFR continued to report upper and lower bounds through 2014. Figure 1.6.1 depicts the midpoint value for the 2010-2014 and the single point estimate thereafter. For purposes of consistency the FY 2018 value, 23.41 percent, is the one that takes into account recovered amounts.

FIGURE 1.6.1

Estimated EITC Improper Payment Rates, 2010-2018



EITC Improper Payments Arise From Complexity of the Rules and Are Not Usually Due to Fraud

The IRS is required to categorize improper payments using one or more of the following root causes: Program Design or Structural Issues; Inability to Authenticate Eligibility; Failure to Verify; Administrative or Process Errors; Medical Necessity; Insufficient Documentation to Determine; and Other.³¹ According to the IRS, almost all EITC improper payments (94 percent) are caused by Inability to Authenticate Eligibility: Data Needed Does Not Exist.³² This category includes cases in which the taxpayer could not substantiate, and the IRS could not confirm:

- That a claimed “qualifying child” met the requirements for that status (49.5 percent of the payments);³³
- That the taxpayer correctly reported income, mainly self-employment income, not reported to the IRS by third parties (26 percent of the payments);
- That the taxpayer’s return reflected the correct filing status (15 percent of the payments);³⁴ or

31 See OMB M-15-02 Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* 25 (2014). The “inability to authenticate eligibility” root cause is further divided into two sub-categories: (1) inability to access data; and (2) data needed does not exist.

32 AFR, FY 2018 at 196 (Nov. 2017). NRP auditors record the nature of the errors taxpayers made when they erroneously claimed EITC, and the IRS then groups the error according to the “root cause” classification required by OMB. IRS response to TAS information request (Aug. 30, 2018). OMB provides as examples of this type of “root cause:” “the inability to establish that a child lived with a family for a certain amount of time-for the purpose of determining that a family is eligible for a tax credit-because no database exists to do so” and “failing to provide an agency with information on earnings, and the agency does not have access to databases containing the earnings information.” OMB M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* 26-27 (2014).

33 Specifically, they do not exist, or the IRS does not have access to, third-party databases that would confirm, at the time of filing: residency; relationship (when a non-parent claims the qualifying child); age (where the claimed child is a full-time student or is disabled); marital status of children claimed; or whether a valid Social Security number (SSN) is also valid for EITC and not issued solely to receive federal benefits. IRS, *Derivation of Improper Payment Root Cause Percentages* 3 (Aug. 2015).

34 Specifically, the IRS cannot confirm when taxpayers who file as heads of household are actually married. IRS, *Derivation of Improper Payment Root Cause Percentages* 3 (Aug. 2015).

- That the taxpayer met other EITC eligibility requirements (three percent of the payments).³⁵

However, as Treasury and the IRS acknowledge, a central cause of EITC improper payments is the complexity of the rules and the errors, a cause not captured by the OMB categories.³⁶ Experience has shown that simplifying the rules can reduce noncompliance.³⁷

Moreover, TAS studies demonstrate that taxpayers may not be able to document the claim to the examiner's satisfaction, but the taxpayer may actually be entitled to the claimed EITC (*i.e.*, denial of EITC proves only that the IRS did not accept the claim, not necessarily that the taxpayer was not eligible for the EITC).³⁸ In addition, taxpayers may be able to demonstrate eligibility for the credit once they receive adequate explanations of what substantiation the IRS requires.³⁹ To its credit, the IRS has worked with TAS to foster auditors' acceptance of a broader range of substantiating documentation.⁴⁰

As noted above, according to IRS data, when taxpayers erroneously claim EITC with respect to children who were not their qualifying children, the most common error is that the residency requirement was not met.⁴¹ At the urging of the National Taxpayer Advocate, the IRS agreed to allow some audited taxpayers to use affidavits to establish that they met the residency requirement.⁴² Tax Year (TY) 2018 returns will be selected for the initiative in 2019, with the audit results known in 2020.⁴³

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- 35 Specifically, the IRS cannot independently verify when a valid SSN is not valid for EITC and not issued solely to receive federal benefits. IRS, *Derivation of Improper Payment Root Cause Percentages* 3 (Aug. 2015). Additionally, the IRS attributes 0.5 percent of improper payments to cases in which a taxpayer without qualifying children claimed EITC and the taxpayer could have been claimed as the dependent of another taxpayer, or the taxpayer lived outside the U.S. (the IRS cannot verify whether a taxpayer could have been claimed as a dependent by another taxpayer or the length of time a taxpayer lived abroad).
- 36 AFR, FY 2014 at 140, noting that "Treasury and IRS analyses, as well as audits by the GAO and TIGTA, have consistently found that payment errors for EITC and other tax credit programs are largely attributable to the statutory design and complexity of the credits within the tax system, and not rooted in internal control weaknesses, financial management or financial reporting deficiencies." See also Robert Greenstein, John Wancheck, and Chuck Marr, Center on Budget and Policy Priorities, *Reducing Overpayments in the Earned Income Tax Credit*, updated Feb. 20, 2018, noting that "What the Internal Revenue Service (IRS) refers to as the EITC's 'improper payment rate' is not a 'fraud' rate and shouldn't be characterized as such."
- 37 See, e.g., Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. 107-16, § 303, 115 Stat. 38 (2001), modifying and clarifying tiebreaker rules (*i.e.*, rules for determining, when an individual is the qualifying child of more than one taxpayer, which taxpayer is entitled to the credit), and IRS, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 20 (Aug. 2014) comparing the "negligible" incidence of tie-breaker errors, comprising one to two percent of all overclaims, and the 17 percent rate found in the 1999 Compliance Study, and noting "this difference reflects the change in tiebreaker rules that were part of EGTRRA and took effect in 2002."
- 38 See, e.g., National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2 i, *EITC Audit Reconsideration Study*, demonstrating that 43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration.
- 39 See National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2 74, (Research Study: *Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*), discussing a TAS study of a random sample of cases in which the IRS denied a claim for EITC but conceded the issue after the taxpayer petitioned the Tax Court for review. In most cases, taxpayers repeatedly seek information from the IRS before they file their Tax Court petitions. They evidently do not receive from examiners adequate explanations of what documents are needed, but they do receive adequate explanations once they have exited the examination phase of the case.
- 40 See Internal Revenue Manual (IRM) 4.19.14-1, *Examples of Acceptable Documentation for EITC claims (not all-inclusive)* (July 29, 2016) listing various "new" documents for auditors to consider, such as paternity test results, eviction notices, and statements from homeless shelters. However, anecdotal evidence, such as comments from low income taxpayer clinicians, indicates that some auditors still request unreasonable amounts of documents from taxpayers in support of their EITC claims.
- 41 IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 2006-2008 Returns* 22 (2014).
- 42 National Taxpayer Advocate 2017 Annual Report to Congress 141, 149 (Most Serious Problem: *The IRS Continues to Make Progress to Improve Its Administration of the EITC, But It Has Not Adequately Incorporated Research Findings that Show Positive Impacts of Taxpayer Education on Compliance*).
- 43 IRS response to TAS information request (Sept. 26, 2018), noting that the IRS will compare prior audit results to audits of taxpayers who received the affidavits.

EITC Improper Payments Are a Relatively Small Portion of the Tax Gap, While the EITC Program Costs Less to Administer Than Other Non-Tax Benefit Programs and Has Higher Participation Rates

The overall amount of true tax liability that is not paid voluntarily and timely is referred to as the gross tax gap.⁴⁴ The most recent estimate of the gross tax gap, based on data for tax years 2008-2010, is \$458 billion. A portion of the gross tax gap, \$264 billion, or 58 percent, is attributable to income misreporting by individual taxpayers.⁴⁵ The three largest components of this \$264 billion consist of:

- \$125 billion, or 47 percent, attributable to business income misreporting;⁴⁶
- \$64 billion, or 24 percent, attributable to misreporting of non-business income;⁴⁷ and
- \$40 billion, or 15 percent, attributable to misreporting of credits.⁴⁸

Of the \$40 billion in misreported credits, \$26 billion is attributable to EITC misreporting.⁴⁹

Thus, EITC misreporting is a relatively small portion of the tax gap—six percent of the gross tax gap and ten percent of the tax gap attributable to income misreporting by individuals—as shown in Figure 1.6.2.

44 IRS, Research, Analysis & Statistics, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008-2010*, Publication 1415, 1 (May 2016), noting that “the word ‘tax’ in the phrase ‘tax gap’ is used broadly to encompass both tax and refundable and non-refundable tax credits.”

45 *Id.* at 9, reporting annual average estimates for 2008-2010.

46 Business income includes income reported on Schedules C, E, and F, *i.e.*, nonfarm proprietor income (29 percent), flow-through income (from partnerships, S corporations, and estates and trusts) (eight percent), rent and royalty income (eight percent), and farm income (two percent). *Id.* at 19.

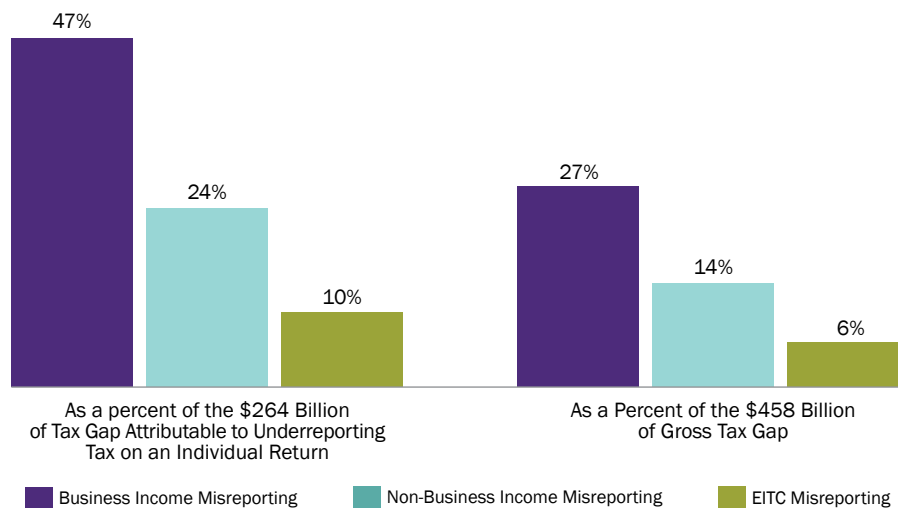
47 Non-business income includes all other individual taxpayer income that is not business income (e.g., wages, salaries, tips, unemployment compensation, pensions and annuities, alimony, interest, dividends, and capital gains). *Id.* at 18.

48 *Id.* at 10.

49 *Id.* at 19, noting that EITC accounts for ten percent of the individual income tax underreporting tax gap; ten percent of \$264 billion is \$26 billion. There are some differences in the methodology for calculating tax gap estimates and calculating improper EITC payments. For example, as noted above, the EITC improper payment rate is expressed as a single rate with confidence intervals, with taxpayers who did not participate in the audit being treated as entitled to EITC at the same rate as those who participated in the NRP audit. For purposes of estimating the tax gap, the EITC audit outcome is used; in most cases, EITC claimed by taxpayers who do not participate in the audit is disallowed. Because of this and other differences in methodology, the amount of estimated EITC misreporting (\$26 billion) for purposes of estimating the tax gap exceeds the estimated improper payment amount (\$18 billion for FY 2013, based on audits of 2010 returns).

FIGURE 1.6.2

Three Largest Components of the Tax Gap, Tax Years 2008-2010



Unlike other anti-poverty programs, taxpayers are not required to meet with caseworkers or submit documentation to establish their eligibility before claiming EITC. Thus, the cost of administering the EITC program (around one percent of benefits delivered) is significantly lower than non-tax payment or benefit programs, and the EITC participation rate (79 percent) is relatively high.⁵⁰ IRS auditors, including NRP auditors, who disallow EITC claimed with respect to a qualifying child are reminded that the taxpayer may still be eligible for the childless worker credit.⁵¹ However, as discussed above, a significant amount of EITC goes unclaimed by taxpayers who appear to be eligible for the credit. IRS notices reminding taxpayers of EITC have not been particularly effective in increasing participation rates.⁵² The IRS could explore the possibility of increasing the EITC participation rate by automatically

50 For a comparison of the costs and benefits of federal payment programs (e.g., Supplemental Nutrition Assistance Program (SNAP), Women, Infants, and Children (WIC), Supplemental Security Income (SSI), Temporary Assistance to Needy Families (TANF), Department of Housing and Urban Development (HUD), Children's Health Insurance Program (CHIP), Medicaid, and school lunch programs), see National Taxpayer Advocate 2016 Annual Report to Congress 341 (Legislative Recommendation: *Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*). See also IRS, *EITC Participation Rate by States*, n.1, <https://www.eitc.irs.gov/eitc-central/participation-rate/eitc-participation-rate-by-states> (last visited Nov. 26, 2018), for tax year 2014.

51 See, e.g., IRM 4.19.14.5.5, *EITC - No Qualifying Children* (Nov. 2, 2017); IRM 4.22.8.6.3.3, *Completing the EIC Eligibility Rules Section of the EIC Lead Sheet Tab* (Jan. 10, 2014).

52 See Office of Evaluation Service, *Tax Filing and EITC Take-up: Reminders promote tax filing compliance and increase EITC payments*, <https://oes.gsa.gov/projects/eitc-filing/> (last visited Nov. 26, 2018), evaluating the effect of sending "combinations of behaviorally informed postcards and brochures, highlighting the recipient's potential eligibility for the EITC" and finding that while the notices increased the number of returns filed, the notices did not increase the rates at which individuals claimed the EITC, although they did increase the amount of EITC dollars paid to treatment individuals by about \$25 on average.

allowing the credit to taxpayers who do not claim EITC but file returns showing they are eligible for it, particularly those eligible for the “childless worker” EITC.⁵³

IRS Measures to Reduce EITC Improper Payments May Unnecessarily Burden Taxpayers

Despite the acknowledged complexity of the rules for claiming EITC as a cause of improper EITC claims, IRS and Treasury legislative proposals to address EITC improper payments have centered on enforcement measures rather than on simplification.⁵⁴ For example, the IRS and Treasury consistently recommend expanding the IRS’s math error authority by conferring “correctible error authority.”⁵⁵ The National Taxpayer Advocate has for many years voiced her concerns about expansions of the IRS’s math error authority and how the IRS exercises that authority and thus does not support this proposal in its current sweeping form.⁵⁶

The IRS also exercises its authority under IRC § 32(k) to impose two-year bans on claiming EITC on taxpayers who claim EITC with “reckless or intentional disregard of rules and regulations.” TAS found that according to IRS data, the IRS improperly imposed the ban 49 percent of the time in 2009, 44 percent of the time in 2010, and 39 percent in 2011.⁵⁷ The IRS imposed 3,442 two-year bans on taxpayers who claimed EITC on their 2017 returns.⁵⁸

53 IRC § 32(c)(1)(A)(ii) defines “eligible individual” to include taxpayers who do not have a “qualifying child.” The maximum amount of EITC for a single worker with no children was \$510 for 2017. IRS, Publication 596, *Earned Income Credit (EIC)* 32 (Jan. 16, 2018). Form 1040 does not capture information about residency, a requirement for claiming childless-worker EITC, but the IRS, through automation and data mining, could use the databases it has access to in order to determine whether the residency requirement was met. See TIGTA, Ref. No. 2018-IE-R004, *The Internal Revenue Service Should Consider Modifying the Form 1040 to Increase Earned Income Tax Credit Participation by Eligible Tax Filers* (Apr. 2, 2018) for a similar recommendation, that the IRS, instead of sending reminder notices, consider revising Form 1040 to capture information about taxpayers’ eligibility for EITC, such as ages of children and duration of residency with the taxpayer, and then automatically refund the EITC to eligible taxpayers even if they did not claim it.

54 In contrast, other tax administrations recognize their responsibility to actively seek tax simplification. See, e.g., Australian Tax Office (ATO), Second Commissioner Andrew Mills, *Tax Administration Continuum - ‘The Law was Made for Man, not Man for the Law’* (2017), <https://www.ato.gov.au/Media-centre/Speeches/Other/Tax-Administration-Continuum---The-Law-was-Made-for-Man,-not-Man-for-the-Law/> (last visited Nov. 26, 2018), noting “[t]he final aspect of the Tax Continuum in the ATO’s role as the tax administrator is legislative change. It is an understatement to say that tax law is extremely complex and labyrinthine...the ATO has a duty to advocate when the law is not operating as intended and when there are unintended consequences for the taxpayer.”

55 See, e.g., *General Explanations of the Administration’s Fiscal Year Revenue Proposals* (Treasury Greenbook) FY 2017 at 225, <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>, proposing to give the Treasury regulatory authority to permit the IRS to “correct errors in cases where (1) the information provided by the taxpayer does not match the information contained in government databases, (2) the taxpayer has exceeded the lifetime limit for claiming a deduction or credit, or (3) the taxpayer has failed to include with his or her return documentation that is required by statute.”

56 See, e.g., National Taxpayer Advocate 2002 Annual Report to Congress 25, 185 (Most Serious Problem: *Math Error Authority*; Key Legislative Recommendation: *Math Error Authority*). See also Most Serious Problem: *Math Error Notices: Although the IRS Has Made Some Improvements, Math Error Notices Continue to be Unclear and Confusing, Thereby Undermining Taxpayer Rights*, *infra*; Most Serious Problem: *The IRS Has Failed to Exercise Self-Restraint in Its Use of Math Error Authority, Thereby Harming Taxpayers*, *infra*.

57 National Taxpayer Advocate 2013 Annual Report to Congress 103, 105 (Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*).

58 The IRS imposed 9,431; 6,445; 6,296; and 6,106 two-year bans claimed on returns for tax year 2013–2016, respectively. IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File, Aug. 2018.

Tax Administrations Benefit From Shifting to Proactive Compliance Activities

As the Organisation for Economic Co-operation and Development (OECD) notes, tax administrations are benefiting from a shift from reactive compliance activities (*e.g.*, audits) to proactive activities (*e.g.*, outreach and education, behavioral nudges) and upstream activities (*e.g.*, early interventions when a potential tax debt arises and pay-as-you-earn systems).⁵⁹

For example, the Australian Taxation Office (ATO) distinguishes between reviews (conducted to assess whether or not there is a risk of noncompliance and to collect information about particular industries and activities) and audits (conducted where there appears to be noncompliance or where a review would be or has been insufficient).⁶⁰ In either situation, the ATO may correct the return and assess additional tax, but this “escalation” approach typically begins with a review, described as “an opportunity to quickly and cooperatively resolve matters in a transparent way” rather than a full-blown audit.⁶¹

ATO also effectively uses behavioral insights by taking measures such as:⁶²

- Sending text message payment reminders to taxpayers who are likely to pay late or not at all. In 2015-2016, sending 540,000 SMS debt prompts resulted in more than \$949 million in debt being paid on time;
- Sending thank-you messages to taxpayers who had paid on time after receiving an SMS reminder in a previous payment quarter;
- Using “nearest neighbor” analysis to advise taxpayers when a claimed deduction is significantly higher than that claimed by their peers, which prompted many to reduce their claimed deductions; and
- Considering sending text messages advising taxpayers of tax benefits they may have overlooked (*e.g.*, taxpayers could be advised that the deductions they had claimed were below the amounts claimed by their peers, and that they should recheck whether they had claimed all the deductions to which they were entitled).

As discussed below, similar proactive approaches to interacting with taxpayers who claim or appear to be eligible to claim EITC may help reduce the EITC improper payment rate.

59 OECD, *The Changing Tax Compliance Environment and the Role of Audit* 19, 23-26 (2017), https://www.oecd-ilibrary.org/taxation/the-changing-tax-compliance-environment-and-the-role-of-audit_9789264282186-en. For a discussion of various pay-as-you-earn (PAYE) systems in other countries and an analysis of the benefits, burdens, and limitations of a broader PAYE system as it might be applied in the U.S., see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, vol. 2, *infra*.

60 ATO, *Taxpayers' charter: If you're subject to review or audit* 3 (2013), <https://www.ato.gov.au/assets/0/104/300/362/2cd37d1a-1184-4568-8dd1-98ecbeb1e503.pdf>.

61 ATO, *Reviews*, <https://www.ato.gov.au/business/privately-owned-and-wealthy-groups/what-you-should-know/tailored-engagement/reviews/> (last visited Nov. 26, 2018).

62 ATO, Second Commissioner Andrew Mills, *Tax Administration Continuum - 'The Law was Made for Man, not Man for the Law'* (2017), <https://www.ato.gov.au/Media-centre/Speeches/Other/Tax-Administration-Continuum---The-Law-was-Made-for-Man,-not-Man-for-the-Law/> (last visited Nov. 26, 2018).

IRS EITC Notices Should Be More Tailored and Include Additional Telephone Support

The IRS issues “soft” notices to taxpayers who appear to have claimed EITC in error, advising them to check their returns to verify that the information is correct.⁶³ However, IRS studies of the effectiveness of the soft notices indicate that receiving a soft notice had minimal effect on taxpayer behavior.⁶⁴

In contrast to the general instructions provided in the soft notices, the National Taxpayer Advocate in 2016 sent *salient* letters to representative samples of taxpayers who appeared to have claimed EITC in error on their 2014 returns.⁶⁵ The letters were mailed at a time when taxpayers were likely to be thinking about taxes, *i.e.*, in the two weeks before the filing season began. Taxpayers were beginning to receive tax documents, such as W-2s, in the mail, and the envelope with the TAS letter bore the notation, in red letters, that it contained “Important Tax Information.” Thus, taxpayers were more likely to open the mail. The message was tailored to identify the specific error the taxpayer appeared to have made, and educated the taxpayer about the requirements for claiming EITC. TAS Research studied the effect of the letters on taxpayer compliance, and on the basis of those findings, the National Taxpayer Advocate revised the letters and sent them to taxpayers in representative samples the following year.⁶⁶

One revision to the 2017 letter that was sent to a separate sample of 967 taxpayers who appeared to not have met the residency requirements on their 2015 returns offered a dedicated “Extra Help” telephone line.⁶⁷ The help line was staffed by TAS employees trained to answer taxpayer questions about the letter and the EITC eligibility rules. Only 35 taxpayers called the additional phone number and spoke with a TAS employee. Nevertheless, according to TAS projections, sending the TAS letter with the extra help telephone line to all taxpayers whose 2015 returns appeared to be erroneous because the residency requirement was not met would have averted over \$44 million in erroneous EITC claims.⁶⁸ TAS will repeat the study in a future filing season, offering the extra help line for all notices. The study will also

63 See IRM 4.19.14.2, *EITC Soft Notices* (Dec. 7, 2017), describing Letter 5621, *Help Us Confirm Your Relationship to the EIC Qualifying Children* and Letter 5621-A, *Confirm Your Schedule C Income Used to Claim Earned Income Tax Credit*. These letters give taxpayers the general instruction to “make sure your children meet the criteria for claiming the Earned Income Tax Credit (EITC)” or “make sure the income and expenses you reported on your Schedule C or Schedule C-EZ are correct.”

64 IRS Wage & Investment, *FY 2016 DDb Soft Notice Phase III: Notice Effectiveness 3* (Jan. 2017), reporting that the soft notices issued in December of 2015 averted only about \$40 per taxpayer in erroneous EITC claims. Additional analysis conducted with respect to 2016 yielded similar results. IRS response to TAS information request (Sept. 25, 2018).

65 National Taxpayer Advocate 2016 Annual Report to Congress vol. 2 32 (Research Study: *Study of Subsequent Filing Behavior of Taxpayers Who Claimed Earned Income Tax Credits (EITC) Apparently in Error and Were Sent an Educational Letter From the National Taxpayer Advocate*), showing that the TAS letter averted noncompliance on tax year (TY) 2015 returns where the TY 2014 return appeared erroneous because the relationship test was not met. Sending the TAS letter to all taxpayers whose TY 2014 returns appeared to be erroneous because the relationship test was not met would have averted about \$47 million of erroneous EITC claims.

66 National Taxpayer Advocate 2017 Annual Report to Congress vol. 2 13 (Research Study: *Study of Subsequent Filing Behavior of Taxpayers Who Claimed Earned Income Tax Credits (EITC) Apparently in Error and Were Not Audited But Were Sent an Educational Letter From the Taxpayer Advocate Service, Part 2: Validation of Prior Findings and the Effect of an Extra Help Phone Number and a Reminder of Childless-Worker EITC Income Tax Credits (EITC) Apparently in Error and Were Sent an Educational Letter From the National Taxpayer Advocate*), showing that sending the TAS letter to all taxpayers whose 2015 returns appeared to be erroneous because the relationship test was not met would have averted over \$53 million in erroneous EITC claims.

67 For a recommendation to Congress that the IRS be required to provide year-round telephone support, see National Taxpayer Advocate 2016 Annual Report to Congress 329 (Legislative Recommendation: *Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*).

68 National Taxpayer Advocate 2017 Annual Report to Congress vol. 2 13 (Research Study: *Study of Subsequent Filing Behavior of Taxpayers Who Claimed Earned Income Tax Credits (EITC) Apparently in Error and Were Not Audited But Were Sent an Educational Letter From the Taxpayer Advocate Service, Part 2: Validation of Prior Findings and the Effect of an Extra Help Phone Number and a Reminder of Childless-Worker EITC Income Tax Credits (EITC) Apparently in Error and Were Sent an Educational Letter From the National Taxpayer Advocate*).

include focus groups to capture qualitative information on the effectiveness of the content and layout of the messages.

The IRS is planning to send soft notices to taxpayers who appear to have claimed EITC in error on their 2017 returns because they misreported the amount of their earned incomes, and to study the effect of the soft notices on taxpayers' 2018 returns.⁶⁹ The National Taxpayer Advocate encourages the IRS to provide specificity in these soft notices and direct taxpayers to a dedicated telephone help line available year-round they can call with questions about EITC.⁷⁰

A principal cause of the Earned Income Tax Credit (EITC) improper payment rate is the complexity of the rules for claiming EITC, yet the IRS does not provide a dedicated telephone help line available year-round for taxpayers to call with questions about EITC.

CONCLUSION

A principal cause of the EITC improper payment rate is the complexity of the rules for claiming EITC, and taxpayers encounter difficulty in documenting their eligibility to claim the credit. At the same time, many taxpayers who appear to be eligible to claim EITC do not claim it, a phenomenon not reflected in the improper payment rate. Automatically allowing EITC in some cases, sending tailored communications to those who appear to have claimed the credit in error, and providing dedicated telephone support available year-round may increase participation rates and avert future erroneous claims.

⁶⁹ IRS response to TAS information request (Sept. 25, 2018).

⁷⁰ See Literature Review: *Improving Notices Using Psychological, Cognitive, and Behavioral Science Insights*, *infra*.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Seek a permanent exemption from the requirement that the IRS include recovered EITC payments in the EITC improper payment estimate.
2. Collaborate with TAS to identify a method of identifying taxpayers who do not claim EITC but are eligible for the childless worker EITC, and automatically award the childless worker credit to those taxpayers.
3. Collaborate with TAS to identify the changes to Form 1040 that would be needed, and the data gathering techniques that could be employed, to award EITC to taxpayers who are eligible for EITC with respect to a qualifying child but do not claim it on their returns.
4. Collaborate with TAS Research in designing and conducting the planned study to compare prior EITC audit results to audit results of taxpayers who used affidavits to establish that they met the residency requirement.
5. Revise soft notices that are sent to taxpayers advising them they may have claimed EITC in error to explain the error the taxpayer appears to have made (*e.g.*, not meeting the residency requirement or the relationship requirement, misreporting income or deductions).
6. Establish a dedicated, year-round toll-free “help line” staffed by IRS personnel trained to respond to EITC and Child Tax Credit questions.
7. In soft notices to taxpayers advising them that they may have claimed EITC in error, include the dedicated telephone “help line.”