INTRODUCTION: The IRS Can Do More to Improve Its Administration of the Earned Income Tax Credit and Increase Future Compliance Without Unduly Burdening Taxpayers and Undermining Taxpayer Rights

The Earned Income Tax Credit (EITC), enacted as a work incentive in the Tax Reduction Act of 1975, has become one of the government's largest means-tested anti-poverty programs.[1] Unlike traditional anti-poverty and welfare programs, the EITC was designed to have an easy "application" process by allowing an individual to claim the benefit on his or her tax return. This approach dramatically lowered administrative costs, since it did not require an infrastructure of case workers and local agencies. For instance, the EITC has less than one percent in administrative costs.[2] This is compared to administrative costs of 41.8 percent for the Women, Infants, and Children (WIC) program.[3]

To effectively administer the EITC, the IRS must understand the characteristics of EITC taxpayers. Generally speaking, low income taxpayers share a unique set of attributes compared to the average U.S. taxpayer. For instance, the low income taxpayer is more likely to be less educated. Of all able-bodied adults between the ages of 25 and 55 living in the bottom third of income distribution, 23 percent had less than a high school education, compared to five percent of the comparable group living in the top two-thirds of the income distribution.[4] Nearly two-thirds of working-age adults who experience consistent income poverty have one or more disabilities.[5] Low income families experience lower literacy rates.[6] Twenty-four percent of working-age adults with limited English proficiency live below the poverty line, whereas 13 percent of the comparable group of English speakers live below the poverty line.[7]

Low income households are more likely to be unbanked than middle to upper-income households. In fact, approximately 39 percent of households with income below $30,000 per year do not have a bank account.[8] Approximately 28 percent of households with an income below $15,000 do not have a bank account.[9] The absence of a bank account can impact a taxpayer's ability to substantiate their income and expenses for an EITC claim.

Lack of transportation and accessible child care services limit the ability of low income taxpayers to earn income.[10] Many low income taxpayers are often juggling competing obligations at one time, such

1 Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975).

2 General Accounting Office (GAO), *Tax Administration Earned Income Noncompliance* 6 (May 8, 1997).

3 *WIC Program: Nutrition Service and Administrative Costs* (Mar. 6, 2015).

4 Isabel Sawhill and Quentin Karpilow, The Social Genome Project at Brookings, *Strategies for Assisting Low-Income Families* 4-5 (June 28, 2013).

5 Shawn Fremstad, Center for Economic and Policy Research, *Half in Ten: Why Taking Disability into Account Is Essential to Reducing Income Poverty and Expanding Economic Inclusion* 2 (Sept. 2009). Consistent income poverty is measured as more than 36 months of income poverty during a 48-month period. *Id*.

6 The Urban Child Institute, *Poverty Can Jeopardize the Development of Literacy and Early Reading Habits* (Aug. 30, 2012), *available at* http://www.urbanchildinstitute.org/articles/research-to-policy/policy/poverty-can-jeopardize-the-development-of-literacy-and-early.

7 Brookings Institute, *Investing in English Skills: The Limited English Proficient Workforce in U.S. Metropolitan Areas* (Sept. 24, 2014), *available at* http://www.brookings.edu/research/reports2/2014/09/english-skills#/M10580.

8 Federal Deposit Insurance Corporation (FDIC), *2013 FDIC National Survey of Unbanked and Underbanked Households* 17 (Oct. 2014). For the purposes of this survey, "unbanked" means that no one in the household had a savings or checking account. *Id*. at 4.

9 *Id*.

10 David K. Shipler, *The Working Poor, Invisible in America* 45, 52 (Alfred A. Knopf, 2004).

as multiple jobs, child care, health problems, and financial strains. These taxpayers may not be able to dedicate their time to an audit of their EITC claim even if they have a legitimate claim. In addition, low income taxpayers tend to be more transitory. Between 2012 and 2013, 20.5 percent of those below 100 percent poverty changed residences, while only 11.7 percent of the general population moved during the same time.[11] The transiency of this taxpayer population negatively affects their ability to respond to IRS correspondence in a timely manner. The "Characteristics of Taxpayers Claiming the Earned Income Tax Credit" infographic illustrates the general characteristics of taxpayers claiming the EITC.

11 U.S. Census Bureau, *Current Population Survey, 2013 Annual Social and Economic Supplement* (Nov. 2013).

Characteristics of Taxpayers Claiming the

EARNED INCOME TAX CREDIT

Low income taxpayers are more likely to have:

- Limited English proficiency
- Limited computer access
- Lower education levels
- Lower literacy rates
- Higher level of disabilities

Low income taxpayers living under 125% of poverty levels

37% have less than high school education

25% are foreign born

30% are disabled

Comparison of the general and chronically poor populations

Children under 18 make up

25% of general population

42% of chronically poor population

People in female-led households make up

15% of general population

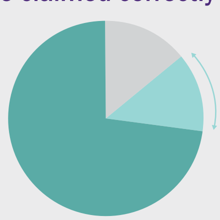
43% of chronically poor population

People in married-couple families make up

64% of general population

26% of chronically poor population

73-87% of qualifying children claimed for EITC are claimed correctly



Low income taxpayers are more likely to face specific limitations

Absence of a bank account hinders ability to verify income and expenses

About 39% of households with income below $30,000 per year do not have a bank account.

About 28% of households with income below $15,000 per year do not have a bank account.

Changing residences hinders ability to respond timely to IRS correspondence

From 2012 to 2013, over 20% of taxpayers below poverty level moved compared to less than 12% in the general population.

A 2004 TAS study found 43% of taxpayers had valid or partially valid EITC claims but couldn't successfully complete the correspondence exam process

The poor spend a higher percent of their income on transportation costs

Individuals below poverty spend over four times as much of their wage income on transportation as those who are above poverty level.

Low income families spend a considerably higher portion of their income on child care

On average, families with employed mothers spent about 7.2% of their income on child care; however, families with income less than $1,500 per month spent 39.6% of their family income on child care.

Limited English proficiency: www.brookings.edu/research/reports2/2014/09/english-skills#/M10580. Limited computer access: Forrester, North American Consumer Technographics Online Benchmark Survey (Part 2), 2014. Lower education levels: Isabel Sawhill and Quentin Karpilow, The Social Genome Project at Brookings, *Strategies for Assisting Low-Income Families* 4-5 (June 28, 2013). Lower literacy rates: www.urbanchildinstitute.org/articles/research-to-policy/policy/poverty-can-jeopardize-the-development-of-literacy-and-early. Higher levels of disability: http://talkpoverty.org/2014/09/19/disability-cause-consequence-poverty/. Comparisons of the general and chronically poor populations: Edwards, A. N. (Jan. 2014), *Dynamics of Economic Well-Being: Poverty 2009-2011,* United States Census Bureau. Children claimed for EITC: IRS, Research, Analysis and Statistics, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008* Returns 5 (Aug. 2014). Low income taxpayers living under 125% of poverty levels: (U.S. Census Bureau, 2015). Absence of a bank account: Federal Deposit Insurance Corporation (FDIC), 2013 FDIC National Survey of Unbanked and Underbanked Households 17 (Oct. 2014); Households moving: U.S. Census general mobility 2012-2013; At least partially valid EITC claims: National Taxpayer Advocate 2004 Annual Report to Congress vol. 2. Lack of transportation: www.urban.org/research/publication/impact-rising-gas-prices-below-poverty-commuters. Child care: www.pewresearch.org/fact-tank/2014/04/08/rising-cost-of-child-care-may-help-explain-increase-in-stay-at-home-moms/.

The EITC is a sizable credit, with approximately 26.7 million people receiving over $65 billion in EITC for tax year (TY) 2014.[12] Taxpayers use the credit to supplement their wages to pay for basic living expenses such as food, housing, and transportation costs. In 2013, the EITC lifted about 6.2 million people out of poverty.[13]

The EITC is associated with a high improper payment rate.[14] The IRS currently estimates that the EITC improper payment rate is 27 percent (which accounts for an estimated $17.7 billion in improper payments).[15] Despite much attention to this issue, the current improper payment rate has increased slightly from the improper rate measured in 2004, when it was 25 percent.[16] However, for context, EITC overclaims account for just seven percent of gross individual income tax noncompliance, while business income underreported by individuals accounts for 51.9 percent.[17] Improper EITC payments nonetheless continue to present a problem that cannot be ignored.

As Professor Leslie Book points out, EITC noncompliance is actually "a series of problems reflecting very different types and degrees of noncompliance."[18] As a result, proposals and programs to address EITC noncompliance must avoid a one-size-fits-all approach and instead "properly reflect the true dimensions of noncompliance within the EITC program, including ever-changing substantive rules, a fairly complex enforcement process, and the characteristics and circumstances of the appropriate taxpaying community."[19] Professor Book defines eight types of noncompliance, which he argues should serve as the basis for the IRS's action.[20]

Three types of noncompliance that are particularly pertinent to EITC compliance include: procedural noncompliance, unknowing noncompliance, and brokered noncompliance.[21] Procedural noncompliance occurs when the taxpayer cannot follow the EITC rules. In terms of an EITC claim, you may see procedural noncompliance when the IRS requests substantiating documentation from the taxpayer during an audit and the taxpayer responds with incorrect paperwork. Unknowing noncompliance occurs when an error is attributable to the complex and changing EITC rules. This error could occur when a taxpayer who was previously eligible for the EITC is no longer eligible because of a change in circumstances that he or she does not realize makes the taxpayer currently ineligible. Last, brokered noncompliance occurs

12 IRS, *About EITC*, *available at* https://www.eitc.irs.gov/EITC-Central/abouteitc (last visited Dec. 9, 2015).

13 Center on Budget Policy and Priorities, *New Research: EITC Boosts Employment; Lifts Many More Out of Poverty Than Previously Thought*, *available at* http://www.cbpp.org/blog/new-research-eitc-boosts-employment-lifts-many-more-out-of-poverty-than-previously-thought (last visited Sept. 23, 2015).

14 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).

15 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).

16 *Id*. The lowest improper payment measurement since 2004 was 23 percent, which occurred in 2012. *Id*.

17 IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012). The IRS estimates $235 billion in individual income tax underreporting for tax year (TY) 2006 with $122 billion of this amount attributable to business income underreported by individuals as sole proprietors on Schedule C (Profit or Loss from Business) or as farmers on Schedule F (Profit or Loss from Farming). Department of the Treasury, *Fiscal Year 2014 Agency Financial Report* 197 (Nov. 17, 2014). The IRS provided a lower bound estimate of $16.2 billion in EITC overclaims for TY 2014 ($16.2 billion / $235 billion is about seven percent).

18 Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145, 1147 (2003).

19 *Id*. at 1147-48.

20 *Id*. at 1166. Mr. Book relies on the work of sociologists Robert Kidder and Craig McEwen in this analysis.

21 *Id*. at 1167-73.

when the taxpayer receives inaccurate advice or assistance from a tax professional. In our Most Serious Problems below, we discuss each of these types of noncompliance.

The Office of Management and Budget (OMB) recently requested that the Department of Treasury (Treasury) analyze the problem of EITC improper payments. The OMB encouraged Treasury to "continue to explore new and innovative ways to address the problem and to continue to attack this challenge with every tool at our disposal."[22] OMB requested an action plan from Treasury to meet improper payment reduction targets. One pertinent issue OMB wanted addressed included the question: What are the one or two actions you are not already engaged in (but could realistically engage in) that would lead to a significant decrease in improper payments in the EITC program?[23] In the material below, the National Taxpayer Advocate will recommend several actions that can be realistically adopted to improve EITC compliance and reduce improper payments.

Improvement to the EITC audit program is also an important step to meeting Congress's expectations to "engage in the first top to bottom review since 1996 of how federal policies can better support work, strengthen families, and move America forward."[24] Based on this expectation, the National Taxpayer Advocate provides her concerns and recommendations for improving EITC compliance in the Most Serious Problems described below:

- *The IRS Does Not Do Enough Taxpayer Education in the Pre-Filing Environment to Improve EITC Compliance and Should Establish a Telephone Helpline Dedicated to Answering Pre-filing Questions From Low Income Taxpayers About Their EITC Eligibility;*
- *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;* and
- *The IRS's EITC Return Preparer Strategy Does Not Adequately Address the Role of Preparers in EITC Noncompliance*

We believe that if the IRS and Congress adopt the recommendations set forth in these discusisons, we will achieve improved EITC voluntary compliance. Some of our proposals call for innovation, improved training, person-to-person contact, and staffing the program with employees that have a different set of skills. In order to improve the future compliance and protect the taxpayer rights of low income individuals, these resources are a necessary investment.

22 Shaun Donovan, Director, OMB, *Letter to Honorable Jacob J. Lew, Secretary of the Treasury* (Feb. 26, 2015).

23 *Id.*

24 *Challenges Facing Low-Income Individuals and Families in Today's Economy: Hearing Before the Subcomm. on Human Resources of the H. Comm. on Ways and Means*, 114th Cong. (2015) (statement of Subcommittee Chairman Charles Boustany).