

# PROCEDURAL JUSTICE FOR ALL: A TAXPAYER RIGHTS ANALYSIS OF IRS EARNED INCOME CREDIT COMPLIANCE STRATEGY

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## THE TAX SYSTEM AS A VEHICLE FOR DELIVERING BENEFITS TO LOW-INCOME INDIVIDUALS AND FAMILIES

Since its inception, taxation has been used to further social and economic policies through incidence and exemptions, rate levels, and exclusions. In the realm of U.S. individual taxation, tax policy has favored marriage (and sometimes penalized it) and the birth, adoption, care for, and education of children; it has promoted and subsidized retirement savings, home

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ownership, and the purchase of health insurance. Over the last hundred years, as the income tax became more democratized (Scholz, 2003) and evolved from a “class tax” to a “mass tax” (San Juan, 2011), refundable credits have emerged as a favored vehicle for delivering social benefits to individuals, particularly for low-to-middle income taxpayers.

Refundable credits, or negative income tax, are refunded even in excess of tax owed. (Baek & Olson, 2009). In the United States, policymakers find them attractive, because once a refundable credit is enacted and embedded in the Internal Revenue Code, its cost is invisible to the annual appropriations process, unlike direct spending programs, the costs of which are identified and Congress can debate each year (San Juan, 2010; Toder, 2000).

Advocates for low-income populations favor refundable credits because, among other reasons, the application process is relatively easy and private, devoid of the social stigma of receiving welfare or a handout (Zelenak, 2004). Moreover, because so many low-income taxpayers already interact with the tax system annually in order to receive a refund of overwithholding of payroll taxes, the tax return is viewed as an appropriate vehicle to deliver additional benefits. The Internal Revenue Service (IRS) already annually processes nearly 160 million individual and business tax returns and collects and accounts for over \$3 trillion (National Taxpayer Advocate; hereinafter, NTA, 2014a). Since the infrastructure to efficiently handle this activity already exists in the IRS, advocates assume that the IRS can easily process millions of applications for and disbursements of refundable credits.

The conversion of an agency that has historically viewed itself as a law enforcement agency into an agency that determines eligibility and entitlement to social benefits targeted to low-income individuals is not an easy one. It requires a conscious recognition that the very nature of the agency’s mission has changed, requiring different strategies for taxpayer interaction and promoting compliance (NTA, 2010a). To the extent a tax agency ignores the implications of delivering social benefits through the tax system, it will fail in its new mission and impose unnecessary and undue burden on the taxpayers, thereby undermining if not negating all the projected advantages of using the tax system in the first place. Further, if the agency approaches its new mission using its traditional law enforcement tools, it may deny its taxpayers procedural justice, thereby undermining compliance and trust in the agency.

In this paper, I use the IRS’s administration of the earned income tax credit (EITC) as a case study of its ability to administer social programs through the tax code in a manner that promotes procedural justice. I demonstrate how the IRS’s failure to grasp the implications of its

expanded mission undermines taxpayer rights, increases compliance burdens for taxpayers, and impedes voluntary compliance. I first provide an overview of the role of procedural justice and related concepts in tax administration. I then describe the particular characteristics of the low-income taxpayer population that have implications for these taxpayers' ability to effectively interact with the tax system. Next, I set forth the administrative challenges facing the tax agency as it administers refundable tax credits like the EITC and demonstrate how the IRS's current administrative paradigm compromises aspects of fairness and procedural justice. Finally, I make proposals for addressing these challenges in the 21st century, which I believe requires nothing short of a transformation of how the tax agency should view itself.

In the interests of transparency, I must make a disclaimer here. I come at this problem not as an economist, social scientist, or psychologist. My background is one of an advocate, first outside of the IRS and now within the agency. I began my tax career preparing tax returns in 1975, when the EITC was first enacted, and in a sense the two of us have grown up in tax together. Over the years I have prepared thousands of income tax returns, and I represented taxpayers in audits, appeals, litigation, and collection matters. Since becoming the NTA in 2001, I have witnessed firsthand the IRS's and taxpayers' struggles to interact effectively with one another with respect to the EITC and other refundable credits. My personal experience, anecdotal as it is, has convinced me that procedural justice – where the tax agency uses processes that are designed to show respect for the taxpayer by eliciting his or her story, consider the taxpayer's facts and circumstances, and explain the basis for the decision – should be the foundation for tax administration. The IRS's recently adopted Taxpayer Bill of Rights articulates the principles underlying procedural justice ([Internal Revenue Service \[IRS\], 2014c](#)). The IRS can administer the EITC more effectively and fairly by using the TBOR as a roadmap.

## **PROCEDURAL JUSTICE, DUE PROCESS, TAXPAYER RIGHTS, AND TAX ADMINISTRATION**

The holy grail of tax administration is an understanding of why taxpayers comply with tax laws and how we can apply that understanding to promote voluntary compliance. The traditional economic deterrence model, based on a cost-benefit analysis of the risk of detection and level of penalty ([Allingham & Sandmo, 1972](#)), does not fully explain the high degree of

taxpayer compliance in the United States, where the risk of audit (detection) is minimal. Something more is at work here. In recent decades, social scientists and psychologists have demonstrated that procedural justice is one such factor.

Procedural justice includes two issues: fair decision making (voice, neutrality) – i.e. participatory, neutral, transparent, rule based; consistent decision-making – and fair interpersonal treatment (treatment with dignity/respect; trust in authorities) – i.e. treatment involving respect for people; respect for their rights; treatment with dignity and courtesy; care and concern from authorities. Such issues can be considered at the institutional level and/or in terms of the actions of particular individuals. (Citations omitted.) (Tyler, 2009, p. 319)

Procedural justice, as the name implies, refers to how one is treated by the authority that establishes rules. This approach recognizes that an individual's interaction with authority comprises more than just the outcome of the interaction. From an "outcome" perspective, one looks at the neutrality, bias, honesty, quality, and consistency of the results of the authority's actions. The "process" approach, on the other hand, considers whether the authority's interactions were nonjudgmental, polite, and respectful of the individual's rights. This latter approach might be summed up best by the question, "Do you believe you are treated fairly in your interactions with the authority?" That question can be answered affirmatively (or negatively) regardless of the outcome of the interaction.

In the context of U.S. constitutional law, procedural justice is closely associated with the concept of procedural due process, which derives from the recognition that the authority can make mistakes, and therefore persons subject to the authority's power must be given notice and an opportunity to be heard before they are deprived of protected interests (Olson, 2010; see generally Mashaw, 1985; p. 28, noting "[t]here may be winners and losers in bureaucratic politics, but the game should be fair. Access to the seat of power ... should be open to all."). Due process analysis identifies what interests are protected and what process is due. In the field of taxation, courts have reasoned that because "taxes are the lifeblood of government," it is not a violation of constitutional due process if the IRS assesses additional tax or deprives taxpayers of property without first giving the taxpayer an opportunity to protest, so long as a post-assessment or post-deprivation hearing is available (*Bull vs. U.S.*, 259-60; Olson, 2010).

The U.S. Congress, however, has seen fit to provide taxpayers more procedural justice protections than the courts have determined are constitutionally required. Thus, the U.S. Tax Court provides a pre-payment judicial forum for proposed deficiencies of tax (26 USC 6213,

p. 6214), and taxpayers are entitled to a Collection Due Process hearing (and appeal to the Tax Court) before the first proposed levy with respect to a tax liability (26 USC 6330). The hearing is also available immediately after the first filing of a public notice to federal tax lien (26 USC 6320). At Collection Due Process hearings, the authority is required by statute to balance “the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary” (26 USC 6330(c)(3)(C)). This consideration recognizes the taxpayer’s perspective with regard to the intrusiveness of government action, and requires the agency to balance its own (or the aggregate interest of all taxpayers) with the taxpayer’s individual interest.

Perceptions of fairness of agency treatment may drive taxpayers’ behavior, making them more or less likely to comply with the tax law. For example, in one study conducted by the Taxpayer Advocate Service, sole-proprietor taxpayers, who underreported their income, were audited and received an *automatic* penalty (i.e., without first provided an opportunity to show why a penalty was not appropriate), were significantly less compliant five years later than taxpayers who also underreported their income but did not receive a penalty. Other audited and penalized sole-proprietor taxpayers later obtained abatements of their penalties, yet they too were significantly less compliant five years out than taxpayers who had not had their penalties abated (Beers, Wilson, Nestor, Ibbotson, Soldana, & LoPresti, 2013; see also Murphy, 2004, for taxpayer reaction and behavior resulting from a determination by the Australian Tax Office that a scheme they participated in triggered anti-avoidance disallowance and penalties).

Because taxpayers’ perception of procedural justice or fairness is derived from the manner in which the tax authority interacts with its taxpayers, the administrative processes established by the tax agency can either enhance a taxpayer’s perception of the agency’s fairness or erode that perception. For example, a survey of taxpayers who were audited by the Swedish Tax Agency found the most common reason for loss of confidence in the agency post-audit was the “bad attitude” of the tax auditor, which included the subcategories “not listening/cannot have a dialogue”; “has no understanding”; and “is rude/arrogant” (Swedish Tax Agency, 2008).

Procedural fairness can be a challenge to tax agencies that interact with a diverse taxpayer population. Multinational corporations, small- and medium-sized businesses, sole proprietorships, high wealth individuals, and low-income taxpayers all bring different demographics – including education, language, literacy – and attitudes – accepting, distrustful,

intimidated – to the interaction. To achieve procedural justice, the tax agency must have knowledge of the characteristics of the population it is interacting with, and must design its processes to best meet that population’s needs. Absent this approach, taxpayers will not have a successful engagement with the agency or feel they were listened to or respected.

In tax administration, a taxpayer bill of rights (TBOR) embodies procedural justice principles and brings tax administration in line with other areas of administrative and constitutional law. (For a comprehensive discussion of taxpayer rights, see [Bentley, 2007](#).) From a taxpayer perspective, a TBOR is an important procedural justice tool, educating taxpayers through easy-to-understand descriptions of their general rights, reassuring taxpayers that their rights apply to their interactions with the agency, and empowering taxpayers to assert those rights if the agency disregards them. For example, the IRS TBOR provides that taxpayers have “the right to quality service” which includes “the right to receive prompt, courteous, and professional assistance.” The description of taxpayers’ “right to challenge the IRS’s position and be heard” states

Taxpayers have the right to raise objections and provide additional documentation in response to formal IRS actions or proposed actions, to expect that the IRS will consider their timely objections and documentation promptly and fairly, and to receive a response if the IRS does not agree with their position.

The description of taxpayers’ “right to privacy” provides

Taxpayers have the right to expect that any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary and will respect all due process rights, including search and seizure protections, and will provide, where applicable, a collection due process hearing ([IRS, 2014c](#)).

From the tax administrator’s perspective, a TBOR can serve as a roadmap for designing policies and procedures that adhere to those principles. It can also be an excellent training vehicle for its employees, by serving as an organizing principle for the myriad collection of specific statutory rights scattered throughout the tax codes. Moreover, tax agency employees can use the TBOR to reason through new situations not covered in explicit instructions ([NTA, 2013a, 2013b](#)).

Procedural justice is significantly implicated in the context of the EITC, a refundable credit targeted to low-income workers and their families. The EITC is one of the federal government’s largest anti-poverty programs. For Tax Year 2013, almost 28 million tax returns claimed over \$66 billion in EITC. The average adjusted gross income (AGI) for EITC filers was about

\$17,800, and the average EITC was about \$2,384 or over 13 percent of average AGI. The participation rate of eligible beneficiaries was nearly 79 percent (Olson, 2015).

Yet the EITC is not an unqualified success. Since its expansion in the late 1980s and again in the early 1990s, the level of EITC “improper payments” has been the subject of many congressional hearings and reports issued by the Government Accountability Office and the Treasury Inspector General for Tax Administration (Ventry, 2000, 2007). The most recent improper payment estimate of \$17.7 billion accounts for less than eight percent of gross individual income tax noncompliance (U.S. Department of the Treasury, 2014). For comparison, the IRS estimates that business income unreported by individuals accounts for 51.9 percent of gross individual income tax noncompliance (Olson, 2015). But something about the fact that EITC payments are disbursements to taxpayers (as opposed to a failure to report and pay tax) has driven a disproportionate focus on EITC compliance issues (Ventry, 2000).

At the same time, the IRS itself has been under serious funding constraints (NTA, 2014a), and is looking to operate in as efficient manner as possible. These budget constraints drive tax administrators to utilize the least costly approaches to service, education, audit, and collection. In practice, this means that taxpayers’ opportunities for interaction with tax agency employees are reduced, as automated processes replace person-to-person contacts. This narrow definition of “efficiency” has serious implications for low-income taxpayers and for providing them procedural justice in tax administration.

## **UNDERSTANDING THE EITC BENEFICIARY POPULATION: CHARACTERISTICS OF LOW-INCOME TAXPAYERS**

The EITC is a refundable tax credit targeted to the working poor, designed to be an incentive to work. Eligible taxpayers receive the benefit of the EITC regardless of whether they owe any tax. The amount of credit is dependent on the number, if any, of “qualifying children” or “qualifying relatives,” and the taxpayer’s earned income, modified AGI, and investment income. The credit is subject to a phase-in range, a plateau range, and a phase-out range. Fig. 1 shows these ranges per family size and income for Tax Year (TY) 2015.

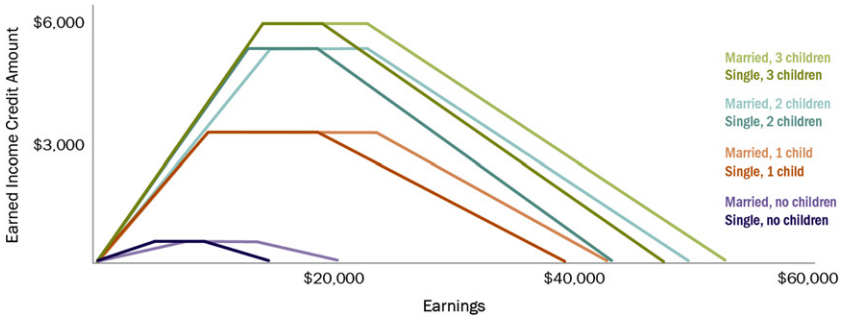


Fig. 1. Household Income and EITC.

To be considered a “qualifying child” for purposes of the EITC, a child must generally be under the age of 19 (24 if attending a full-time educational institution, and there are exceptions for children with disabilities). For the last several years, the EITC has been capped at three “qualifying children” to a household. The two most problematic aspects of EITC eligibility are the relationship and residency tests. Specifically, the child must bear an acceptable familial relationship with the taxpayer (the “relationship” test), and the child must have resided with the taxpayer for more than six months of the TY (the “residency” test). The conditions and permutations of these last eligibility requirements are the source of a great deal of confusion and litigation by taxpayers.

The EITC’s potential beneficiary population comprises low-income workers and their families. Figs. 2 and 3 show the percentage of federal poverty level of the maximum eligible income amount by family size. All family sizes are below 250 percent poverty level, which Congress has defined as “low-income taxpayers” for purposes of receiving free representation from low-income taxpayer clinics (26 USC 7526).

While terms such as “federal poverty level,” “poor,” and “low income” can be interchangeable or encompass slightly different populations, government and other data do paint a consistent picture of the characteristics of taxpayers and families who are potential EITC beneficiaries. Children under age 18 make up approximately 25 percent of the general U.S. population but they make up 42.4 percent of the chronically poor (Edwards, 2014; in this study, “chronically poor” referred to the population that was below poverty for the time period between 2009 and 2011). Likewise, people in female-led households make up 14.9 percent of the general population but are 42.8 percent of the population that was chronically poor. People in “married-couple” families made up 64 percent of the general



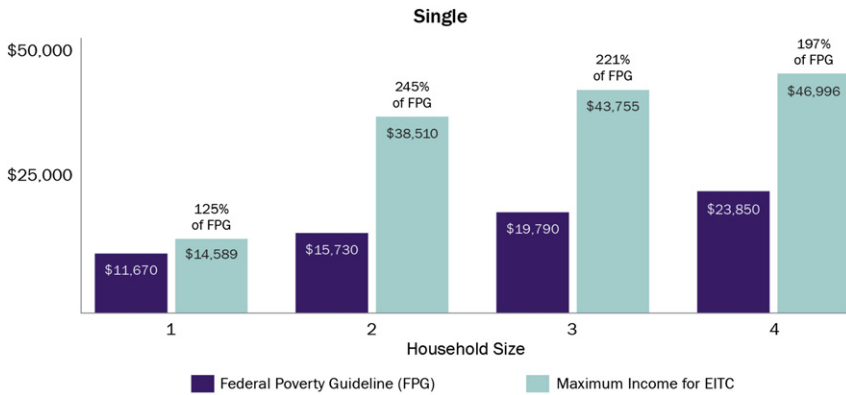


Fig. 2. Single Taxpayers Maximum EITC as Percentage of Federal Poverty Guidelines.

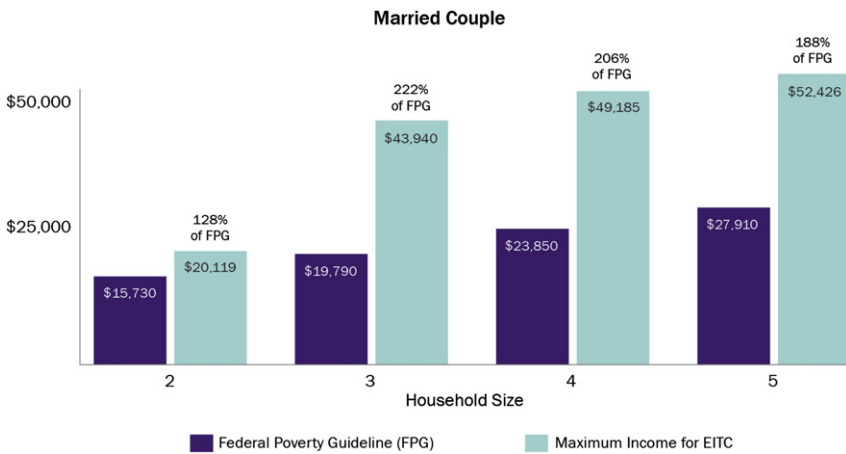


Fig. 3. Married Taxpayers Maximum EITC as Percentage of Federal Poverty Guidelines.

population but only 25.7 percent of the chronically poor. The traditional family structure as contemplated by the EITC’s relationship and residency rules is underrepresented in the chronically poor population.

Generally speaking, low-income taxpayers share a unique set of attributes compared to the average taxpayer. For instance, the low-income taxpayer is more likely to have limited English proficiency, limited computer access, low literacy rates, disabilities, or lower education levels

(NTA, 2009, 2011a). As of 2012, nearly 37 percent of people living at a level less than 125 percent of poverty had less than a high school education. Additionally, over 25 percent of this population was foreign born and nearly 30 percent were disabled (U.S. Census Bureau, 2015).

Low-income households are more likely to be unbanked or underbanked than middle-to-upper-income households. Nearly 82 percent of unbanked households have income below \$30,000 per year (FDIC, 2012; for the purposes of this survey, “unbanked” means that no one in the household had a savings or checking account). Almost 56 percent of the unbanked population has an income less than \$15,000. The absence of a bank account can impact a taxpayer’s ability to substantiate his or her income and expenses, which may impact a taxpayer’s eligibility for the EITC.

The lack of transportation and accessible child care services limits the ability of low-income taxpayers to earn income or limit the types of jobs available to them (Shipler, 2004). Many are often juggling multiple obligations at one time. These taxpayers may not be able to dedicate their time to an EITC audit even if they have a legitimate claim. In addition, low-income taxpayers tend to be more transitory than the general U.S. population. In 2007, 27.5 percent of those below the poverty level changed residences, while only 15 percent of the general population moved during the same time (NTA, 2009). The transiency of this taxpayer population negatively affects their ability to demonstrate that they resided at a particular address at a particular time, much less that their children resided with them. It also hampers their ability respond to IRS correspondence in a timely manner.

In 2013, nearly 133 million people had incomes below 250 percent of the federal poverty level (FPL).<sup>‡</sup> This is an increase of almost 16 million people since 2007, with the percentage of persons below the 250 percent FPL threshold rising from 39.2 to 42.5 percent between 2007 and 2013 (United States Census Bureau [USCB], 2013). For TY 2013, more than 63 million individual tax returns, or about 45 percent of the individual tax returns filed, reported incomes below 250 percent of the FPL (IRS Compliance Data Warehouse, 2013, on file with author).

In 2014, the Taxpayer Advocate Service, as the organization that oversees and administers the Low-Income Taxpayer Clinic program for the IRS, commissioned a survey by Russell Research to better understand the

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<sup>‡</sup>The U.S. Department of Health and Human Services publishes yearly poverty guidelines in the Federal Register each year, which are used to establish the 250 percent FPL thresholds. For the 2015 FPL thresholds, see 80 F.R. 3236 (January 22, 2015).

needs and circumstances of taxpayers eligible to use the clinics (Wilson & Hatch, 2014). LITCs provide free or nominal fee representation to low-income individuals who need help resolving tax problems with the IRS (26 USC 7526). The “LITC-eligibles” survey found that a significant percentage (approximately nine percent) of LITC-eligibles had less than a high school education. Twenty-eight percent of all LITC-eligibles were high school graduates. Almost 30 percent of Spanish-speaking LITC-eligibles had only an elementary school education.

Given the complexity of the law and EITC taxpayer literacy challenges, it is no surprise that these taxpayers disproportionately seek the assistance of commercial preparers, the vast majority of whom are not regulated by the government and are not required to have any special skills, qualifications, or education (Olson, 2013, 2015). The IRS National Research Program (NRP) Compliance Study, discussed below, found 68 percent of returns claiming the EITC showed the involvement of a preparer, compared to 55 percent of individual returns not claiming the EITC (Internal Revenue Service [IRS], 2014a). Unenrolled preparers – who are not attorneys, certified public accountants, or enrolled agents – account for more than three-fourths of EITC returns handled by a paid preparer (Olson, 2015). In the TAS survey, about half of all LITC-eligibles hired a return preparer, as did approximately 75 percent of Spanish-speaking eligibles. The LITC-eligibles reported that a significant percentage of the preparers did not satisfy the very basic statutory requirements established for commercial tax return preparation under the Internal Revenue Code (26 USC 6695(a) and (b), providing for penalties where paid preparers do not provide the taxpayer with a copy of the return or sign the return, respectively). Respondents reported more than 15 percent of the time, for example, the preparer either did not sign the return or did not give the taxpayer a copy. This percentage rose to more than 30 percent of Spanish-speaking eligibles.

Interestingly, the TAS survey found that 15 percent of LITC-eligibles reported receiving notices from the IRS. In response, 55 percent called the IRS, 29 percent replied by letter, 24 percent contacted their preparers, and nearly 20 percent did nothing. (More than one response was allowed in the survey.) This notice rate appears to be disproportionately high for the low-income population, and may reflect their exposure to EITC audits, collection, and math errors.

EITC noncompliance can be almost completely explained by the characteristics of the EITC beneficiary population. As noted above, the most familiar estimate of EITC compliance is the Improper Payment (IP) rate. The IP rate for FY 2012 attributable to EITC is 27.1 percent (or \$17.7 billion)

(United States Department of the Treasury, 2014). This is based on the estimates of dollars ultimately misspent (i.e., the amount of taxpayer overclaims *net* of amounts the IRS prevents or recovers).

While the IP rate provides us with a consistent net measure of improper EITC payments (i.e., IPs actually made), the data on the sources of error for total (gross) EITC overclaims may help us develop targeted strategies to reduce the IP rate. The most recent IRS NRP EITC results are useful in this regard, because they provide a statistically representative sample from which to draw observations of taxpayer behavior and better understand the sources of EITC noncompliance.<sup>§</sup> Specifically, the IRS TY 2006–2008 NRP Compliance Study (IRS, 2014a) data show the impact on compliance of the complex eligibility criteria and the characteristics of the EITC beneficiary population.<sup>\*\*</sup>

While NRP data do not necessarily present a complete picture of the sources of EITC noncompliance because some taxpayers do not participate

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<sup>§</sup>The IRS created the National Research Program (NRP) in 2000 to “develop and monitor strategic measures of taxpayer compliance.” NRP, at [http://www.irs.gov/uac/National-Research-Program-\(NRP\)](http://www.irs.gov/uac/National-Research-Program-(NRP)) (last visited on February 19, 2014). NRP is a comprehensive effort by the IRS to measure payment, filing, and reporting compliance for different types of taxes and various sets of taxpayers and to deliver the data to the Business Operation Divisions to meet a wide range of needs including support for the development of strategic plans and improvements in workload identification. Internal Revenue Manual (IRM) 4.22.1.3 (April 25, 2008).

<sup>\*\*</sup>The NRP Compliance Study estimated the total (gross) dollar overclaim percentage at 28.5 percent or \$14.1 billion (lower bound estimate or LBE). LBEs assume that audit nonparticipants have similar compliance behavior to audit participants with similar characteristics (i.e., in same sampling strata). Upper-bound estimates assume that audit non-participants are noncompliant (i.e., exam conclusion is correct). TAS research studies suggest that the lower bound estimate more accurately reflects the EITC dollar overclaim rate. As discussed later in this paper, a 2004 Taxpayer Advocate Service study of a representative sample of the EITC Audit Reconsideration population found that 43 percent of taxpayers who in the original audit did not respond to IRS contacts, or whose response was received after the IRS deadline and thus was not considered in the audit, had favorable outcomes from the audit reconsideration process (meaning that they received more EITC from the reconsideration than from the initial audit itself). This percentage is about the same as the favorable outcome rate for *all* taxpayers in the audit reconsideration sample. Moreover, the non- and late-responders received about 96 percent of the total EITC claimed on the original return. “This suggests that taxpayers who fail to respond to the audit, or who have a late response, may in fact be eligible for the EITC.” (Emphasis in original.) See NTA (2004, p. 29). Accordingly, we use the LBE rate throughout this discussion.

in the NRP audits for a variety of reasons, NRP audit results are more reliable than typical EITC audits. Unlike the IRS's typical EITC audits, which are conducted via correspondence with a population that has limited literacy and high transiency and thus has a very high no-response rate, 95 percent of NRP EITC audits are conducted in a face-to-face environment in the office or the field. Field and office audits generally have a higher response rate and agreement rate than correspondence audits and thus provide a better opportunity to identify the sources of error (Olson, 2012). On the other hand, the combined no response and undeliverable rate for non-NRP correspondence examinations is 53 percent. An additional 15 percent of taxpayers stopped responding (IRS, TY 2012 Audit Info/Closed Case Database, on file with author). Still, the NRP Compliance Study distinguishes between "known errors" and "unknown errors." It estimates that 30 percent of total possible overclaim returns and 41 percent of total possible overclaim dollars stem from unknown errors (i.e., cases where compliance and errors are unknown mostly because of audit non-participation). Nevertheless, based on audit participants, the IRS believes it can reliably project 8.4 million overclaim returns and \$11.4 billion overclaim dollars to the EITC population (IRS, 2014a).

The NRP Compliance Study found that as a threshold matter, many EITC overclaims are less than \$500 (44 percent lower bound estimate (LBE) of overclaim returns), and relatively few overclaims are above \$3,000 (11 percent LBE). While income misreporting is by far the most common type of error (65 percent of overclaim returns), qualifying child (QC) errors are the most costly (40 percent LBE of total overclaim dollars and 29 percent of overclaim returns). Of the 13 percent of "knowable" QC errors,

- 76 percent were attributable to the residency test;
  - 20 percent were attributable to the relationship test;
  - 7–9 percent were each attributable to the age test, an error corrected in processing, an invalid SSN, and the tiebreaker rules;
  - 1 percent to a married child; and
  - 10 percent to unknown errors (i.e., the taxpayer acknowledged the error but gave no detail, or it was conducted as a non-NRP exam.)
- (Note: More than one reason may apply.)

Of these QC errors, age and SSN errors are very easy for the IRS to detect by matching against other government databases. For children born on or after November 1, 1990, maternal relationship and most paternal relationships are easy for the IRS to confirm because parents are required to apply for a social security number upon birth of the child

(usually before the mother leaves the hospital) and identify the mother and father (where known). This leaves errors relating to the child's primary residence and to relationships other than parental (e.g., grandparents, uncles and aunts, siblings, and foster parents). Historically, information relating to these factors was not readily available from government databases. Given the fluid nature of household living arrangements of low-income taxpayers, the verification of a child's relationship and residence requires the IRS to make fairly intrusive inquiries into the personal living arrangements of taxpayers on a case-by-case basis. Moreover, about one-third of EITC claimants cycle in and out of eligibility each year ([Internal Revenue Service, 2014b](#); [Jeroslow, 2013](#)). Thus, the learning curve for understanding how complex EITC eligibility rules apply to one's (changing) household situation is very steep. Despite these challenges, the NRP Compliance Study found that about 87 percent (LBE) of the qualifying children claimed for EITC are claimed correctly.

This, then, is the portrait of the population that the IRS must interact with when it receives an "application" for the EITC on an individual income tax return. In the next section, I will discuss how these characteristics have presented challenges for the enforcement-oriented IRS and created difficulties for taxpayers navigating the agency to claim and receive the correct amount of EITC, raising questions of procedural justice.

## **ADMINISTRATIVE CHALLENGES WHEN DELIVERING BENEFITS TO LOW-INCOME TAXPAYERS THROUGH THE TAX SYSTEM**

The complexities of the EITC are best demonstrated by real-life stories, and the recent Tax Court case, *Cowan vs. Commissioner* (T.C. Memo., 2015-85) can serve as an example of how statutory complexity and complex family arrangements collide and undermine at least one policy goal of the EITC – promoting economic growth and stability for working families.

Jean Cowan cared for Marquis Woods since he was six weeks old, although he was unrelated to her. She became his legal guardian in 1991 and served as such for 13 years until the guardianship was terminated under state law when Marquis turned 18. Cowan continued to provide a home and care for Marquis after that date, and when Marquis had a child, she also cared and provided a home for that child. In 2011, Cowan claimed the EITC (and other related tax provisions) for Marquis' child, for whom

she had provided the majority of support and with whom she lived for 11 months of the year. However, because Cowan was no longer the legal guardian of Marquis, neither Marquis nor his child were considered to be “eligible foster children” for purposes of the EITC. Therefore, the Tax Court upheld the IRS’s determination to disallow all of the family status benefits, including the EITC, for Marquis’ child. Accordingly, Cowan had an almost \$4,000 deficiency in tax on her 2011 income of \$13,920 (Cowan; Book, 2015).

What is a tax agency to do when faced with the law’s requirements and this set of facts? How does it even ferret out these very personal facts to identify questionable returns? Over the decades, the IRS has developed a set of business rules, the Dependent Database or DDb, whereby it screens tax returns prior to issuing refunds and identifies those presenting “questionable” claims for refund, particularly in the area of the EITC. Congress has granted the IRS extraordinary tools to summarily assess an addition to the reported tax liability, including where the social security number, name, or age of a child do not match government records (26 USC 6213(b), (g)). This extraordinary authority bypasses the normal “deficiency” procedures for assessments of tax, whereby *before* any assessment of additional tax, a taxpayer has an opportunity to provide documentation to the IRS proving his eligibility and can appeal the lower level IRS determination both administratively and judicially (26 USC 6213(a)). With the summary assessment or “math error” authority, the burden is placed on the low-income taxpayer to claim his or her rights to appeal *after* the tax is assessed, rather than being granted these rights from the outset (NTA, 2014e).

The IRS has also developed a system, called the Automated Correspondence Exam (ACE) system, which applies a production line approach to individual audits. The IRS describes today’s ACE as follows:

Automated Correspondence Exam (ACE), formerly Batch Processing (BP), is an IRS-developed, multifunctional software application that fully automates the initiation, Aging and Closing of certain Earned Income Tax Credit (EITC) and non-EITC cases. Using the ACE, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice and closing, tax examiner involvement is eliminated entirely on no-reply cases. Once a taxpayer reply has been considered, the case can be reintroduced into ACE for automated Aging and Closing in most instances. (IRS Internal Revenue Manual 4.19.20.1 (01-01-2015)(01-08-15))

The IRS touts this approach to examinations as highly cost effective, because it limits the amount of direct time any employee spends on an

audit, reserving person-to-person contact for only those individuals who call in and get through to a live examiner. Taxpayers who need to speak to the IRS more than once have an almost zero chance of reaching the same IRS employee, because the system is set up to “efficiently” assign the call to the next available assistor, not the assistor knowledgeable about the taxpayer’s case (NTA, 2014c, 2014d).

As the preceding section makes clear, low-income taxpayers as a population possess characteristics that do not mesh well with such production-line and automated processes. Yet, as a result of congressional interest and other oversight, the IRS audits the EITC taxpayer at a higher rate than any category of individual taxpayers other than those at the highest income levels (Fig. 4).

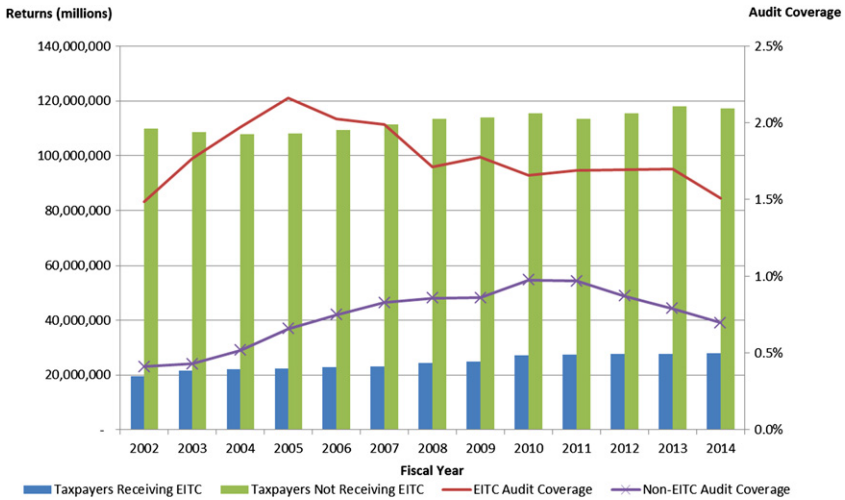


Fig. 4. Returns with and without EITC and Audit Coverage. Sources: FY 2002-FY 2005, Table 10 and FY 2006-FY 2014, Table 9a.

For the last decade, my office, the Taxpayer Advocate Service, has conducted a series of studies that explore the experience of taxpayers as they navigate the IRS EITC audit processes. While these studies do not include taxpayer surveys that capture the taxpayers’ subjective assessment of the fairness of the process or their attitudes toward the agency, they do show the procedural barriers that both impair taxpayers’ ability to engage and communicate with the tax agency and negatively impact outcomes. Taken



as a whole, the studies demonstrate that current IRS EITC processes are stacked against taxpayers as they attempt to interact with the agency and be heard. In short, IRS EITC administration fails to provide procedural justice to its taxpayers. We know from studies in other fields that the absence of procedural justice affects taxpayers' behavioral response and willingness to comply with the law (Kirchler, 2007; Tyler, 2006, 2009).

These studies point the direction for future study – to survey those taxpayers subjected to EITC audits and track their future compliance behavior. The studies also provide a clear roadmap for how to improve compliance activities going forward, so that taxpayers perceive the agency as procedurally just, and trust it to listen to their concerns – their stories.

*2004 Annual Report to Congress: EITC Audit Reconsideration Study*

Our first study explored the effectiveness of EITC audits in reaching the correct answer (NTA, 2004). Specifically, we looked at a representative sample of taxpayers whose EITC was disallowed in whole or in part in IRS audits and who later requested an audit reconsideration of that disallowance. We wondered whether taxpayers received more favorable results the second time around and, if so, why the IRS did not reach that result in the original audit.

In TY 2002, over 21.7 million families and individuals filed tax returns claiming the EITC, comprising 16 percent of all individual returns filed that year. In Fiscal Year (FY) 2002, the IRS closed over 292,000 correspondence examinations of returns claiming the EITC. During the same year, it also completed nearly 67,000 EITC audit reconsideration cases for TYs before 2002, or more than one-fifth the number of EITC correspondence exams closed during 2002. For purposes of our study, the Taxpayer Advocate Service (TAS) analyzed a random sample of 679 EITC audit reconsiderations closed between July 1, 2002 and January 31, 2003. About half of these cases were handled by the IRS audit function alone, and the other half sought the assistance of TAS employees. When a taxpayer seeks assistance from TAS, he or she is assigned a case advocate who handles the case from start to finish and approaches the case holistically by addressing all related issues. TAS taxpayers receive the direct toll-free number to their case advocate's extension and a toll-free fax number for sending documents. In audit cases, the TAS case advocates work with the taxpayer to obtain adequate documentation of his or her position and advocate to the IRS on behalf of the taxpayer to obtain the correct result. For FY 2014, TAS received full

or partial relief for 65.2 percent of its taxpayers with EITC audit issues (TAS Management Information System, on file with author).

Here are some of the study's principal findings:

- Approximately, 45 percent of the taxpayers who went to TAS for assistance received additional EITC as a result of the audit reconsideration, as compared with 40 percent who asked examination for reconsideration.
- As a group, taxpayers working with TAS ultimately recovered about 46 percent of the total EITC dollars they originally claimed on their returns. Taxpayers working solely with examination in aggregate recovered about 38 percent of the EITC dollars they originally claimed. Overall, taxpayers who received EITC as a result of the audit reconsideration received 94 percent of the amount originally claimed.
- 42 percent of the combined sample of TAS and Examination taxpayers either responded late or not at all to the original audit inquiry. About 43 percent of this group had favorable outcomes from the audit reconsideration process, which is about the same as the favorable outcome rate from all taxpayers in the sample. These taxpayers retained about 96 percent of the total amount of EITC they originally claimed on their returns.
- In more than 40 percent of the cases, difficulties with IRS documentation requirements were identified as the reason for EITC audit reconsideration. Communication challenges (taxpayers had not responded or responded late) were the trigger 38 percent of the time.
- TAS initiated on average two outbound contacts per case (telephone and letters – excluding the initial acknowledgment of the case) to request EITC supporting documentation, while the Examination rate of outbound contacts was about one contact for every two cases. Examination employees did not make a third or fourth contact request on any case in the sample.
- An average of \$855 of EITC was received by taxpayers who came to TAS for assistance and who had no telephone contact during the audit reconsideration (these taxpayers received an average of one letter each). In comparison, taxpayers who worked with TAS and made or received at least one phone call received an average of \$1,351 in the audit reconsideration.
- The percentage of taxpayers who received EITC in the audit reconsideration increased in direct proportion to the number of telephone contacts TAS initiated. Overall, only 38 percent of taxpayers who went through the audit reconsideration process but received no phone calls were

awarded EITC. This percentage increased to 67 percent for taxpayers who received three or more calls.

A significant finding of the study is the IRS's longstanding assumption that nonresponse of taxpayers is an indicator or admission of "guilt" is without basis in fact. This finding is hardly surprising, given what we know about the transiency and other challenges characteristic of low-income taxpayers, which would make obtaining satisfactory documentation difficult. Moreover, where taxpayers successfully challenged the IRS's original EITC disallowance through the audit reconsideration process, they received substantially all of the EITC they claimed on the original return. The study demonstrated a connection between making personal contact with low-income taxpayers under audit and allowance of the EITC. All of these findings point to a conclusion that the IRS correspondence audit process is singularly ill-designed for obtaining the correct answer in EITC cases. This conclusion raises profound questions about the quality of procedural justice afforded low-income taxpayers in EITC audits.

*2007 Annual Report to Congress: IRS Earned Income Credit  
Audits – A Challenge to Taxpayers*

The findings of the 2004 EITC Audit Reconsideration Study about the causes of difficulties in the original audit led to our next study, which explored the challenges low-income taxpayers face in attempting to navigate EITC audits and receive a correct result. In the 2007 study, we generated a random sample from the population of TY 2004 EITC tax returns audited and closed between March 2005 and April 2006 (NTA, 2007). Using a multiple wave process, nearly 4,000 surveys were mailed to taxpayers who claimed EITC and were audited by the IRS. The 24 percent response rate generated a margin of error of plus or minus 4 percent at the 95 percent confidence level; thus, the survey results are likely reflective of the EITC population for TY 2004.

We found the following:

- More than one-quarter of taxpayers receiving an EITC audit notice did not understand that the IRS was auditing their return.
- Less than one-third of EITC audited taxpayers thought the IRS audit notification letter was easy to understand, and only about half of the respondents felt that they knew what they needed to do in response to the audit letter.

- Over 90 percent of the EITC audited taxpayers contacted the IRS at some point about their audit.
- Nearly three-quarters of EITC audited taxpayers personally called or visited the IRS in response to the IRS audit notification letter, mostly due to communication issues. For example, 60 percent of those who contacted the IRS were seeking guidance on what documentation to send. More than half of the taxpayers undergoing an EITC audit reported that the IRS took more than 30 days to acknowledge receipt of their documentation or provided no acknowledgment.
- More than half of EITC audited taxpayers reported difficulties obtaining the documents requested by the IRS, and almost half of the taxpayers did not understand why the IRS requested those particular documents.
- More than 70 percent of EITC audited taxpayers stated a preference for an audit by a means other than correspondence.
- More than half of the EITC audited taxpayers who reported supplying all of the documents originally requested by the IRS also received an IRS request for additional documentation.
- More than one-third of the EITC audited taxpayers believed that the IRS did not consider all of their documentation.

From the perspective of taxpayers who were audited for EITC issues, the audit process itself was an obstacle to achieving either a favorable result or an understanding of the error on the return. IRS communications were so unclear that a large number of taxpayers didn't even understand they were under audit. Almost all taxpayers made the effort to contact the IRS to obtain clarification and direction, and yet the IRS did not timely respond, if at all, to submissions of documents and did not explain clearly why such documents were necessary, or why it needed additional documentation. A shockingly high percentage of these taxpayers believed the IRS did not look at the documentation they presented. Taxpayers' perceptions described an unfair procedure – one in which the tax auditor (and agency) failed to listen to the taxpayer and explain what was required to prevail or why it found the taxpayer's documentation unsatisfactory. The arbitrary nature of the audit process, as experienced by these taxpayers, lacks the essential components of procedural justice.

Given that the IRS audit process itself presented significant obstacles to low-income taxpayers, we wondered whether EITC taxpayers who were represented by tax professionals during the audit fared better than unrepresented taxpayers. TAS reviewed 427,807 taxpayers whose TY 2004 returns

were audited for EITC issues (comprising the entire audited population with some anomalies removed). Of that group, only 7,688 (1.8 percent) were represented in the original audit. We compared the audit results of unrepresented taxpayers to represented taxpayers.

Our findings demonstrate that taxpayers who were represented in audits received far more favorable results than unrepresented taxpayers:

- Taxpayers who used representatives during the audit process were nearly twice as likely to be found eligible for the EITC as compared to taxpayers who were not represented during the audit process, and where the EITC was allowed in the audit, represented taxpayers received almost twice as much EITC as unrepresented taxpayers (45 percent EITC allowed vs. 25 percent).
- Over 40 percent of all taxpayers with representatives emerged from their audit with their full EITC intact, whereas less than one in four taxpayers without representation retained their full EITC.
- The taxpayers without representation were more likely to end up owing additional tax than taxpayers with representation (41 percent vs. 23 percent).

While it is possible that taxpayers who sought out and retained representation had the strongest cases for eligibility and thus obtained better results, the cost of professional representation in audits can far outstrip the resources of and be a barrier for even middle class taxpayers. Thus, low-income taxpayers may have no choice but to represent themselves. Further, the TAS LITC-eligible survey indicates that many low-income taxpayers are unaware of the availability of free or nominal cost representation through low-income taxpayer clinics. Only about 10 percent of the LITC-eligible population were aware of the existence of LITCs. Thus, it is far more likely that many low-income taxpayers who have legitimate EITC claims are unable to obtain representation and, left to their own devices, are also unable to successfully navigate the EITC audit process. Access to representation is thus a key component of procedural justice, one that is denied to low-income taxpayers.

*2011 Annual Report to Congress: Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents*

As discussed above, the IRS has the statutory “math error” authority to summarily change and assess certain items on a tax return without first

giving taxpayers the opportunity to prove the entries are correct. Taxpayers who do not agree with the IRS's summary assessment must respond within 60 days and request an abatement of tax; otherwise, the IRS moves forward to collect the balance due, if any.

While some of these entries are simple addition, typing, or copying errors, others are more substantive. Congress has given the IRS authority to use math error assessments when taxpayers do not provide a dependent's correct taxpayer identification number (TIN), which the IRS verifies against other government databases (26 USC 6213(g)(2)(F)). Failure to supply the correct TIN can result not only in summary disallowance of the dependency exemption but also any related credits, including the EITC.

In 2010, the IRS processed 141 million individual TY 2009 tax returns, and issued more than 11.8 million math error notices. In nearly 300,000 of these accounts, the IRS assessed additional tax due to a dependent TIN error. Of the over \$400 million in statutory, additional child, and EITC claimed on TY 2009 returns that were reviewed by the IRS and found to have incorrect TINs, the IRS held back over half of these funds for math error review. The EITC had the highest disallowance rate of the various credits and statutory benefits; the IRS disallowed almost half of the number of EITC claims and nearly 60 percent of the amount claimed. Over \$176 million in EITC was claimed on TY 2009 returns with dependent TIN errors, of which the IRS disallowed \$103 million through math error procedures.

TAS reviewed a statistically valid sample of TY 2009 accounts in which the IRS later reversed its math error adjustments related to dependent TINs (NTA, 2011b). Of the accounts studied, the IRS subsequently reversed at least part of its dependent TIN math errors on 55 percent of the returns with incorrect TINs, after the taxpayer contacted the IRS with correct information. Ultimately about 150,000 taxpayers had their refunds restored to them. On average, the IRS subsequently allowed nearly \$2,000 per return after the initial disallowance, with a delay of nearly three months.

The TAS 2009 Dependent TIN study found that of the cases reviewed, the IRS had internal information sufficient to resolve 56 percent of the dependent TIN math errors and could have avoided making an unnecessary math error adjustment, thereby significantly reducing taxpayer burden. Moreover, the delays associated with these unnecessary math errors cost the public fisc over \$2.3 million in interest paid to taxpayers for these corrected math errors relating to incorrect TY 2009 dependent TINs.

TAS's study also found that a portion of taxpayers who appear to have valid dependent TINs never reply to the IRS math error notice, and are

actually entitled to dependent related exemptions and credits which they never receive. In a sample of cases that had a dependent TIN math error adjustment and never received a refund or abatement, the IRS could have corrected and allowed all of the dependent TINs in 41 percent of those cases based on internal data. It could have corrected at least one of the dependent TINs in another 11 percent of these cases. These sample percentages translate into over 400,000 taxpayers who may not have received refunds they were entitled to, amounting to at least \$44 million related to disallowed dependent TINs, or an average of \$1,274 per taxpayer.

One aspect of procedural justice entails minimizing the compliance burden of taxpayers. For example, the tax agency should not impose unnecessary burden on taxpayers by summarily assessing tax and requiring taxpayers to prove the correct answer where the agency could easily determine that answer for itself from its own internal historical data. Yet IRS current math error processes do not comport with these basic procedural justice principles. The TAS study shows the significant harm taxpayers experience when the tax agency places this avoidable burden on low-income taxpayers, who are least equipped to meet this compliance burden.

*2012 Annual Report to Congress: Study of Tax Court Cases in Which the IRS Conceded the Taxpayer Was Entitled to EITC*

In general, when the IRS determines that additional tax is due at the close of the IRS administrative audit and appeals process, it issues a Statutory Notice of Deficiency (SNOD) which grants the taxpayer an opportunity to petition the U.S. Tax Court for review without first paying the additional tax. Less than 5 percent of Tax Court cases are actually litigated each year; between 70 and 80 percent of all petitions are settled between the parties without litigation.

More than half of all Tax Court cases originate as ACE examinations. Based on our findings about barriers and challenges low-income taxpayers experience in ACE audits, TAS undertook a study of Tax Court cases in which the IRS fully conceded its proposed assessment of EITC (i.e., the government agreed the taxpayer had correctly claimed the EITC on the original return; MacNabb, 2012). Specifically, we looked at the administrative and Tax Court files of a representative sample of 256 fully conceded Tax Court cases to understand why the IRS had failed to

get the correct answer at the earliest point in the dispute process, namely, the ACE examination.

Here are some of our findings:

- The average EITC claimed was \$3,479 and the average AGI was \$17,024; the EITC refunds ultimately allowed represented on average more than a quarter of the taxpayers' AGI. In 39 percent of the cases, taxpayers had to wait 18 months to receive the refunds to which they were entitled to.
- In 63 percent of the cases, taxpayers tried to resolve their problems by calling the IRS before they filed their Tax Court petitions, calling five times on average (in one case, the taxpayer called the IRS 15 times).
- In 78 percent of the cases, taxpayers submitted documentary evidence that the IRS Appeals officer or Chief Counsel attorney accepted as probative of the claim after the Tax Court petition was filed.
- In only 13 percent of the cases did taxpayers wait until after they filed their Tax Court petitions to call the IRS and submit documents.
- In almost a fifth of the cases, taxpayers submitted documentation that the IRS auditor/examiner rejected but an Appeals Officer or Chief Counsel attorney accepted after the Tax Court petition was filed. In most of these cases, the documentation was usually acceptable to audit personnel under IRS internal guidance.

These findings demonstrate that even when low-income taxpayers make substantial efforts to talk with the IRS and resolve their case before they petition the Tax Court, and when they can and do provide acceptable supporting documentation, they are unable to successfully communicate with IRS examiners in an assembly-line environment like ACE audits. Once they engage with an Appeals Officer or Chief Counsel attorney through the interpersonal contact occurring after a Tax Court petition is filed, they fully prevail in their claim.

### *2013 Enhanced Communication Study*

TAS recently conducted another study in collaboration with the IRS Wage and Investment and Small Business/Self Employed divisions' correspondence exam units ([Taxpayer Advocate Service \[TAS\], 2013](#)). In the study, a test group of about 900 taxpayers underwent EITC audits that involved two or more outbound call attempts. A control group of about 2,500 taxpayers underwent traditional correspondence examination (ACE)



processing, which is primarily automated and generally involves no outbound call attempts. When the audit resulted in disallowance of all or part of the EITC claimed on the original returns and the taxpayer did not agree with the audit findings, a TAS case advocate contacted the taxpayer and offered assistance.

Significant findings from the first phase of the study (IRS test and control group audits) include:

- Using internal IRS databases, exam found a contact number associated with the test group taxpayer in 63 percent (564) of the cases. Nevertheless, exam successfully contacted the taxpayer in only 24 percent of the test group cases.
- Overall, taxpayers in the test group participated in the audit (rather than defaulting or “dropping out”) somewhat more frequently than those in the control group. The response rate for these taxpayers was 47 percent compared to 43 percent for the control group. (The results are statistically significant at the 93 percent level.)
- Taxpayers in the test group who were successfully contacted participated in the audit much more frequently than taxpayers in the control group (who received no outbound calls). The response rate for these taxpayers was 61 percent compared to 43 percent for the control group. (This difference is statistically significant at the 95 percent confidence level.)

In the second phase of the study, exam forwarded to TAS 686 cases that had been closed other than as a “no-change” or “agreed” for additional attempts at taxpayer contact and assistance. The significant findings from this phase of the study are:

- To better identify contact telephone numbers, TAS used additional external databases (such as Accurint) and Internet searches that exam did not use, as well as information from the return filed in the TY following the audit. TAS successfully contacted 37 percent (243) of its study cases, including 28 percent (186) of the taxpayers that exam was unable to contact.
- Of the taxpayers TAS successfully contacted, in 44 percent of the cases taxpayers indicated that they were ineligible for the EITC, but only two percent of taxpayers indicated that they understood why they were ineligible for EITC prior to TAS contact.
- TAS successfully advocated for eight taxpayers to receive EITC for one or more children, usually substantiating the claim with conventional documentation.

- TAS assisted an additional 32 taxpayers with receiving the childless-worker EITC. TAS reviewers discovered that exam either was not discussing the childless-worker EITC with taxpayers or did not always process the necessary paperwork to obtain the credit.

“Professional treatment that respects a taxpayer’s rights allows a taxpayer to present evidence, and explains the reasons for audit decisions that lead to positive evaluations, even when audit outcomes were adverse to the taxpayer.” (Scholz, 2003, p. 198). The “Enhanced Communication” study shows that the IRS’s current correspondence exam-based EITC audit strategy squanders an important educational opportunity and in some cases actually misstates the dollar amount of overclaims by not making contact with the taxpayer or by not determining whether the taxpayer is eligible for the childless-worker portion of the EITC. Thus, the ACE process not only impairs EITC taxpayers’ “right to challenge the IRS’s position and be heard,” but also undermines their “right to pay no more than the correct amount of tax.”

## **THE WAY FORWARD: A LEGITIMACY APPROACH TO EITC COMPLIANCE**

The enforcement-dominant approach to tax administration is based on the assumptions underlying the rational actor/economic deterrence model, which describes a taxpayer’s compliance behavior in terms of risk of detection and level of penalties. One problem with this model is that it encourages tax agency employees to view taxpayers as natural cheaters and to believe that the only way to keep these taxpayers in line is to undertake enforcement action. It discounts the role that many other factors might play in the decision whether to comply with the tax laws (Beers, LoPresti, & San Juan, 2012; Beers, Nestor, & San Juan, 2013; Kornhauser, 2007; NTA, 2010b).

The IRS is very fortunate in that its taxpayers by and large report a strong personal sense of integrity and obligation to obey the law. For example, one survey found that 94 percent of U.S. taxpayers agree “it is every American’s civic duty to pay their fair share of taxes” and 86 percent say it is “not at all acceptable to cheat on income taxes” (IRS Oversight Board, 2014). Processes such as I have described above can chip away at those values and convert them into distrust for the tax authority. The same

Oversight Board survey found that only 61 percent of U.S. taxpayers say they “completely or mostly trust the IRS to fairly enforce the tax laws as enacted by Congress and the President.”

What the studies demonstrate is that where the law is complex, as is the EITC, and the taxpayer population is poorly equipped to deal with that complexity, as is the EITC population, one cannot simply assume taxpayers are cheaters and apply traditional law enforcement mechanisms like audit and penalties to that population and hope they will drive compliant behavior. If anything, the studies demonstrate the opposite is true – a disproportionate emphasis on enforcement with the EITC population has not significantly budged the improper or overclaim rate for at least the past five years (United States Department of the Treasury, 2014).

Think about it. If 25 percent of the EITC audit population does not know it is under audit, IRS audit assessments will appear arbitrary and capricious. If almost 40 percent of the audited population does not understand what the IRS is auditing, the IRS action appears unfair, and taxpayers don't have the information necessary to change their behavior going forward. The audit appears punitive without any explanation of what precise act is being punished. If there is a 33 percent chance that the taxpayer's life circumstances will change from one year to the next in such a way that the taxpayer will lose or gain EITC eligibility, how can a taxpayer learn from one year to the next? Eligibility appears to be a toss of the dice. So when someone – say, a preparer – comes along and says, Have I got a deal for you, and that deal seems too good to be true, with a program like EITC that is incomprehensible for the taxpayer to start with, the deal may seem reasonable (Book, 2007). Or at least as reasonable as anything else the taxpayer has learned about the EITC.

Where taxpayers are improperly penalized – either by assessments of tax that are later reversed or abated (as in our audit reconsideration study) or by proposed assessments that are conceded in the Tax Court but only after imposing increased burden on these taxpayers (as in our EITC Tax Court study), how will the taxpayer view (and feel about) the use of enforcement power by the tax agency? What has the taxpayer learned from this experience about the power-wielding IRS?

In other studies, TAS has shown that while audits of unreported income have a positive compliance effect on the taxpayer's income tax return for the year immediately after the audit, that effect significantly erodes over a five-year period (Nestor & Beers, 2014). Enforced compliance, then, “requires the continual presence of a credible threat of punishment” (Tyler, 2009, p. 311). A compliance program that measures its success by reference

to taxpayer education, taxpayer engagement, and improved voluntary compliance behavior going forward may be far less costly and more enduring than traditional enforced compliance.

This shift requires taxpayers to accept IRS decisions and defer to them going forward. To feel comfortable accepting an outcome, taxpayers need to engage with the IRS and tell their stories – the particular facts and circumstances of their situation. But for taxpayers to be able to effectively engage with the IRS, the agency must design processes that foster that engagement, that value education of taxpayers over punishment and deterrence, and that respect and understand the causes of noncompliance and propose solutions that address those causes.

The typology of noncompliance suggests that different types of noncompliance require different responses (Book, 2003). Where there is a mismatch between cause and response, noncompliance can be transformed from a more benign type to a more confirmed resistant strain (Murphy, 2004). Poorly designed compliance programs can thus convert taxpayers into recidivist noncompliant taxpayers, causing the tax agency to go after them with ever more audits.

How do we break this cycle? At the heart of all law abiding behavior is the acceptance of the legitimacy of the rule giver.

Legitimacy, therefore, is a quality possessed by an authority, a law, or an institution that leads others to feel obligated to obey its decisions and directives. This feeling of responsibility reflects a willingness to suspend personal considerations of self-interest, because a person thinks that an authority or a rule is entitled to determine appropriate behavior within a given situation or situations (Tyler, 2009, pp. 313–314).

If most taxpayers believe that the tax agency exercises its power legitimately, they will be comfortable cooperating and engaging with the agency and more likely to defer to its directions and decisions (Gangl, Hofmann, & Kirchler, 2015; Kirchler, Kogler, & Muehlbacher, 2014). The authority will be able to concentrate its enforcement resources on those who flat-out refuse to cooperate, as opposed to those who simply make mistakes for whatever reason.

Voluntary acceptance by taxpayers, as Tyler notes, goes beyond mere compliance with the rules just because you were told to do so. It means accepting internally that the rule-maker is itself legitimate and that its decisions were made legitimately and therefore are entitled to respect and deference. This is a personal calculation, made at an individual level, based on the person's observations of the authority's actions, with respect to one's self or to others.

It is possible to design such a system. Legislative reform is one approach to enhancing legitimacy, by ensuring that the law has the flexibility to recognize taxpayers' facts and circumstances. For example, in the United Kingdom, a taxpayer is eligible for family credits if he or she is the "main carer" of the child (Hood & Oakley, 2014). This approach accommodates the fluid nature of household relationships in the low-income population and eliminates the sense of the taxpayer's being judged on her life circumstances, so evident in the *Cowan vs. Commissioner* cited earlier. Another example of legislative reform is Congress' modification of the EITC "tiebreaker" rule in 2001, where more than one eligible person (e.g., a parent and a grandparent, or two separated parents) claim a QC (see Economic Growth and Tax Relief Act of 2001, Public Law 107-16, § 303). Before the legislative change, tiebreaker errors accounted for 17 percent or more of overclaim dollars (U.S. Department of the Treasury, 2002). After the legislative change, tiebreaker errors are now trivial (IRS, 2014a). Just as a tax law change in 2001 redefined what constituted EITC noncompliance, so could we bring potentially millions of taxpayers into compliance overnight by adopting a "main carer" or similar standard.

Regulation of tax return preparers who are not attorneys, certified public accountants, or enrolled agents (persons who complete a rigorous testing and continuing education regime and are authorized to practice before the IRS) would go a long way to improving the quality of EITC returns prepared by these preparers. The IRS needs the statutory authority to establish minimum competency standards and a testing and continuing education for this program (Book, 2007, 2008; NTA, 2013c; Olson, 2013). But taxpayers will only use these qualified preparers if they (1) want to comply with the tax laws and (2) have the information to distinguish between qualified and unqualified preparers. Thus, we come back to taxpayers' trust in the IRS and the need for the IRS to educate taxpayers.

Making compliance easier will certainly impact taxpayer's willingness and ability to comply with the tax law (Swedish Tax Agency, 2005). For example, since 65 percent of EITC overclaims are attributable to misreported income, if the IRS receives third-party income reports (e.g., wage statements) early in the filing season, taxpayers (or their regulated preparers) would be able to access this information and download it into tax software (Baek, 2013). The IRS can check returns against this data at time of filing, and alert the taxpayer in a nonconfrontational manner about any discrepancies.

Part of the problem (and the solution) rests in the IRS's failure to recognize, decades ago, that the EITC was not a traditional tax administration

program and therefore required a different response and different skillsets from ordinary tax administration duties including auditing and collection (Baek & Olson, 2009). Specifically, for a program whose participants present the language, literacy, economic, and other challenges that the low-income taxpayer population possess, the IRS should hire and train employees who possess good social and communication skills. Employees with more of a social worker mindset would be better suited to conduct the type of person-to-person audits that EITC taxpayers say they need, and would be more flexible in the kinds of evidence necessary for demonstrating EITC eligibility. Employees with this skill set would ensure IRS written communications are comprehensible. This approach would transform the “audit” into an educational experience – less focused on the amount of dollars assessed than on educating the taxpayer about the reasons for ineligibility and the EITC rules going forward (particularly important given the “churning” of the EITC population in and out of the program from one year to the next).

Because EITC eligibility is very fact specific and there is so much misinformation about the EITC circulating in the public domain, the IRS should establish a dedicated EITC help line during the filing season. Staffed by the new type of assistors with excellent interviewing and listening skills, taxpayers could explain their circumstances and receive guidance on how the law applies to those circumstances. They could even double-check what their preparers have told them before they sign and file their returns. Framing this phone line as a “help line” removes the stigma of enforcement, builds trust with the taxpayer, and enables the taxpayer to view the IRS as a legitimate and helpful source of knowledge.

I have discussed elsewhere other recommendations for improving EITC compliance (Olson, 2015). Central to all of them is the requirement that the IRS attempt to understand the EITC taxpayer population’s needs and how they view and feel about the agency when their needs are not met. For example, how does a low-income taxpayer feel when the IRS audits him but not the preparer whom the taxpayer paid to prepare the return? Would the taxpayer feel more open toward the agency if that agency held the preparer accountable for his own errors, and did not penalize the taxpayer for someone else’s negligence or error? What if the government didn’t assess additional tax but just sent the taxpayer a letter advising that it had noticed an error on the return, noticed the taxpayer used a preparer, explained (in plain language) the source of the error, and suggested the taxpayer be extra careful with next year’s return? Would the taxpayer voluntarily correct the error the following year? Would the taxpayer change preparers, or keep with the same

one, and persist in the error? Would the taxpayer think the IRS was a toothless tiger because no assessment was made, just a gentle tap? We don't know the answers to these questions. But these are the types of things we need to know in order to understand how to establish legitimacy in the eyes of taxpayers and derive the benefits of voluntary cooperation with the tax laws.

## **SOME FINAL REFLECTIONS**

The problems of legitimacy of the tax authority are not unique to the EITC. I have elsewhere discussed the punitive impact of the IRS's one-size-fits-all approach to offshore voluntary disclosure initiatives (NTA, 2014b). But the EITC affords a compelling example of how the traditional deterrence approach just has not worked, with EITC noncompliance remaining fairly constant over the years despite significant enforcement activity. Thus, the EITC is ripe for a different approach. But as long as the IRS and its overseers look to the number of audits conducted, or levies issued, or tax liens filed as a measure of tax compliance, the IRS will never change its approach.

It is odd, to me, that for an agency that deals daily with human beings presenting "life in all its fullness" (Welch vs. Helvering, 1933), the IRS is singularly incurious about what makes taxpayers tick. This is not just of intellectual importance. Such an understanding is at the core of being a wise and effective administrator. Failure to gain a better understanding dooms the agency to continuing, expensive, one-off compliance efforts. It is highly inefficient.

In closing, I will tell one last story. In late June of this year, my office (located in the IRS headquarters in Washington, DC) received a number of overnight express envelopes, each one containing a bank account deposit slip for an amount over \$5,000. Nothing else was in the envelopes. By contacting the taxpayers listed on the envelopes' return addresses, we learned that someone posing as an IRS employee had called them, told them they had been audited, that they owed over \$5,000, and that they had to deposit that amount within the hour or the sheriff would arrest them and put them in jail. To prove the legitimacy of the calls, the taxpayers were instructed to send the deposit slip, via overnight delivery, to the nonexistent employee at IRS headquarters in Washington, DC. The taxpayers told us that the fake IRS employee was very convincing; one taxpayer said it was the worst day of his life.

Now, scams have been operating throughout human history. The most successful (if that is the right word) play on some fear or belief of the victims that lends credibility to the scammer's claims or demands. In this instance, each of these taxpayers believed that the IRS was capable of auditing them and assessing tax without their knowledge, calling them up out of the blue and demanding immediate payment, and threatening immediate arrest and imprisonment if payment was not made within the hour. The fact that these taxpayers found those demands not only possible but plausible should give every tax administrator pause and cause for reflection upon what they can do to make that belief no longer even a remote possibility.

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