# Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

# Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)[1]



[1] The principal author of this study is Jill MacNabb, Attorney-Advisor to the National Taxpayer Advocate.

## EXECUTIVE SUMMARY

When the IRS takes a "second look" at denied EITC claims, taxpayers often recover part or all of the credit. In the meantime, however, they are burdened by uncertainty, the cost of contesting the IRS's position, and refund delays. The IRS in turn is burdened by the cost of handling contested cases through increasingly higher paid employees and interest charges on delayed refunds. The Taxpayer Advocate Service (TAS) undertook a study to examine a random sample of cases in which the taxpayer petitioned the Tax Court for review of IRS disallowance of the EITC and the IRS conceded the EITC issue in full without trial. The objective of the study is to identify impediments that prevent the IRS from conceding cases before the taxpayer filed the Tax Court petition.

The study found that taxpayers often had to wait almost a year and a half to receive the EITC refunds to which they were entitled. The average EITC claimed was $3,479 and taxpayers' average adjusted gross income was $17,024. For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes. The government paid interest on delayed refunds in more than a third of the cases, amounting to about $200 per return.

In most cases, taxpayers try to resolve their cases by repeatedly calling the IRS before they file their Tax Court petitions. They also submit documentation, but usually after petitioning Tax Court. However, taxpayers who submit their documents after petitioning the Tax Court have usually spoken with an IRS examiner beforehand, five times on average. Evidently, taxpayers do not receive from examiners adequate explanations of what documents are needed, but they do receive adequate explanations once they have exited the examination phase of the case. Only infrequently do taxpayers not speak to the IRS or submit any documentation until after they file their Tax Court petitions.

Even when taxpayers submit documentation before petitioning Tax Court, the case may be unnecessarily prolonged. In about a fifth of the cases, taxpayers submit documentation before filing a Tax Court petition that the examiner rejects but an Appeals Officer or Chief Counsel attorney later accepts. The documentation is usually listed in the Internal Revenue Manual (IRM) as acceptable substantiation of the claim. Moreover, examiners sometimes deny EITC because they misapply the law— this happened five percent of the time.

Appeals Officers and Chief Counsel attorneys do not often accept testimony as a substitute for documents, and the cases are rarely conceded due to the hazards of litigation.[2] The findings suggest that taxpayers are willing to talk with the IRS before they petition the Tax Court and are able to provide acceptable supporting documentation, but do not obtain the information about how to substantiate their claims from their conversations with examiners. Moreover, it appears that Appeals Officers and Chief Counsel employees are more

2 As discussed below, "hazards of litigation" refers to the uncertainty of the outcome if the case were litigated.

adept at evaluating the documents taxpayers provide or more willing to elicit additional documentation as necessary, or both.

## INTRODUCTION

The Earned Income Tax Credit (EITC) is an anti-poverty program consisting of a refundable tax credit available to certain low income working taxpayers and their families.[3] Each year, the IRS audits the returns of approximately half a million taxpayers who claimed the EITC; EITC audits comprise about a third of all individual taxpayer audits.[4] The statutory provisions are complex, and the IRS's automated process for evaluating EITC claims sometimes leads it to deny taxpayers the credit Congress intended them to have. When the IRS takes a "second look" at denied EITC claims, the taxpayer often recovers part or all of the credit.[5] In the meantime, however, taxpayers are burdened by uncertainty, the cost of contesting the IRS's position, and refund delays. The IRS is burdened by the cost of handling contested cases through increasingly higher-paid employees and interest charges on delayed refunds.[6] Thus, the National Taxpayer Advocate and the IRS have an interest in identifying obstacles that prevent early resolution of EITC cases.

Some taxpayers can overcome these hurdles and take their cases to court. The "family status" provisions in the Internal Revenue Code (IRC), including EITC, were among the top ten sources of court decisions each year from 2001 to 2010, resulting in their inclusion as Most Litigated Issues in the National Taxpayer Advocate's Annual Reports to Congress.[7] Yet a discussion of litigated issues does not cover cases settled without litigation. In fact, only a small percentage of Tax Court cases (fewer than five percent for each of the past ten years) are closed as a result of a trial and decision. As Figure 1 shows, the largest category of closed cases, from 70 percent in fiscal year (FY) 2002 to 80 percent in FY 2011, consists of settlements.

3 Internal Revenue Code (IRC) § 32.

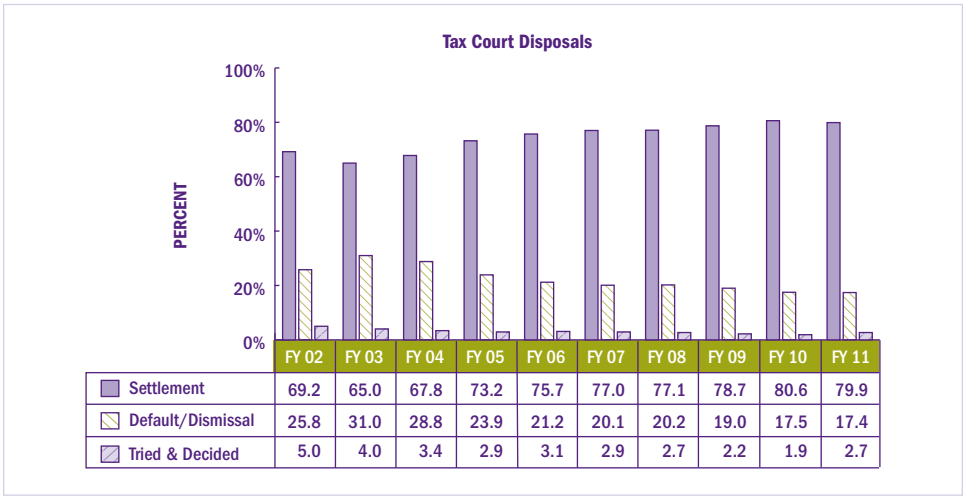
4 *See* National Taxpayer Advocate 2011 Annual Report to Congress 296, 300 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*), reporting that the IRS increased the number of EITC audits from 483,825 in fiscal year (FY) 2009 to 585,202 in FY 2010, or from approximately 34 to 37 percent, respectively, of *all* individual taxpayer audits.

5 In the 2004 EITC Audit Reconsideration study, TAS Research found that when enhanced communication techniques are employed in audit reconsiderations, 40 percent of EITC claimants working with IRS Exam employees, and 45 percent of those working with TAS, recovered EITC payments. The 2010 TAS *EITC No Relief, No Response Review* showed that on average, TAS obtains full or partial relief in approximately 48 percent of EITC cases. *See* TAS Business Performance Review, 2nd Qtr. 2011, 15 (Mar. 2011).

6 As discussed below, the first IRS employee assigned to an EITC audit is likely to be a Tax Examiner. A Tax Examiner may begin his or her IRS career as a Grade 5 employee. *See* National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 76 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*). The 2012 base salary for a Grade 5 employee is $17,803. U.S. Office of Personnel Management, 2012 General Schedule (Base), *available at* http://www.opm.gov/oca/12tables/pdf/gs.pdf. Once the taxpayer files a Tax Court petition, the case is handled by a Chief Counsel attorney. Newly-appointed Chief Counsel attorneys may begin their IRS careers as Grade 11, step 8 employees. *See* IRS Publ'n. 4063 (Rev. Apr. 2011). The 2012 base salary for a Grade 11 step 8 employee is $62,019.

7 IRC § 7803(c)(2)(B)(ii)(x) requires the National Taxpayer Advocate to identify in her Annual Report to Congress the ten tax issues most litigated in federal courts. *See* Most Litigated Issues, *supra*. The "family status" provisions include IRC § 2, *Definitions and Special Rules*; IRC § 21, *Expenses for Household and Dependent Care Services Necessary for Gainful Employment*; IRC § 24, *Child Tax Credit*; IRC § 32, *Earned Income*; and IRC § 151, *Allowance of Deductions for Personal Exemptions*.

**FIGURE 1, Tax Court Disposals, FY 2002–2011[8]**




| | FY 02 | FY 03 | FY 04 | FY 05 | FY 06 | FY 07 | FY 08 | FY 09 | FY 10 | FY 11 |
|---|---|---|---|---|---|---|---|---|---|---|
| Settlement | 69.2 | 65.0 | 67.8 | 73.2 | 75.7 | 77.0 | 77.1 | 78.7 | 80.6 | 79.9 |
| Default/Dismissal | 25.8 | 31.0 | 28.8 | 23.9 | 21.2 | 20.1 | 20.2 | 19.0 | 17.5 | 17.4 |
| Tried & Decided | 5.0 | 4.0 | 3.4 | 2.9 | 3.1 | 2.9 | 2.7 | 2.2 | 1.9 | 2.7 |

Thus, restricting an analysis of EITC cases to those that are litigated overlooks a great deal of activity and significant information.

More than half of all Tax Court cases (EITC and non-EITC) originate as campus correspondence exams, a highly automated type of audit that involves little or no person-to-person interaction with taxpayers.[9] As the National Taxpayer Advocate has repeatedly pointed out, this efficiency effort is particularly ill-suited to the needs of low income taxpayers, who may face verbal and functional literacy challenges and are often transient.[10] Members of this vulnerable population may lose EITC simply because they do not effectively navigate the audit process.

This study examines a sample of 256 Tax Court cases in which:

- The taxpayer claimed EITC that the IRS disallowed;
- The taxpayer petitioned the Tax Court for review of the disallowance; and
- The IRS conceded the EITC issue in full without trial.[11]

8 The numbers do not include declaratory judgments (*i.e.*, review of certain IRS administrative determinations as provided by statute. For example, the Tax Court has jurisdiction under IRC § 7436 to review the IRS's determination of an individual's worker classification). Source: Counsel Automated Tracking System, TL-711, prepared by: CC:FM:PMD:MA.

9 For FY 2011, 17,800 out of 29,700 Tax Court cases (60 percent) came from a campus (or "Service Center"). Counsel Automated Tracking System, TL 708B, discussed *infra*.

10 National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*); National Taxpayer Advocate 2008 Annual Report to Congress 227-42 (Most Serious Problem: *Suitability of the Examination Process*).

11 As discussed below, the 256 cases are a representative sample from a population of 734 fully-conceded Tax Court cases in which EITC was an issue. The sample, statistically valid at the 95 percent confidence level with a margin of error no greater than +/- 5 percent, allows study findings to be projected to the population.

The objective of the study is to identify impediments that prevented the IRS from conceding the cases before the taxpayer filed the Tax Court petition. The significant findings from this study are:

- For most taxpayers, EITC refunds ultimately allowed represent on average more than a quarter of their adjusted gross incomes;
- The average EITC claimed was $3,479 and the average adjusted gross income was $17,024;
- In many cases (99 out of 256 or almost 39 percent), taxpayers must wait an average of *almost a year and a half* to get the refunds they are entitled to;
- The IRS pays interest on delayed refunds in more than a third of the cases (90 out of 256), amounting to almost $200 per affected return;
- In most cases (162 out of 256, or 63 percent), taxpayers try to resolve their problems by calling the IRS before they file their Tax Court petitions, calling five times on average;
- In most cases (201 out of 256, or 78 percent), taxpayers submit documentary evidence that the Appeals Officer or Chief Counsel attorney accepts as probative of the claim;
- Taxpayers who submit documents often do so (in 136 of 201 cases) only after petitioning the Tax Court, but these taxpayers have usually (in 83 out of the 136 cases) spoken with an IRS examiner beforehand;
- Only infrequently (33 out of 256 cases, or 13 percent) do taxpayers wait until after they file their Tax Court petitions to call the IRS and submit documents;
- In almost a fifth of all cases, (50 out of 256), taxpayers submit documentation, usually approved by the IRM, that the examiner rejects but an Appeals Officer or Chief Counsel attorney accepts; and
- Cases are rarely (13 out of 256 cases) settled based on hazards of litigation.[12]

The findings suggest that taxpayers are willing to talk with the IRS before they petition the Tax Court and can provide acceptable supporting documentation, but do not obtain the information necessary to enable them to substantiate their claims from their conversations with examiners. It appears that Appeals Officers and Chief Counsel attorneys are more adept at evaluating the documents taxpayers provide, or are more willing to elicit additional documentation as necessary, or both. Moreover, in five percent of the cases, the examiner denied EITC by misapplying the law. Not only did the IRS deny EITC to 13 taxpayers in our sample of 256 due to legal error, and we expect that the same is true for 37 taxpayers out of our population of 734, but this finding raises worrisome questions about legal errors in EITC audits generally.

12 As discussed below, "hazards of litigation" refers to the uncertainty of the outcome if the case were litigated.

## BACKGROUND

### Most EITC Audits are Correspondence Exams, Highly Automated Audits that Generate Most Tax Court Cases.

Almost all (94 percent) of the cases we reviewed were campus correspondence exams.[13] These audits commence when an IRS computer at a centralized processing center automatically generates an initial contact letter to the taxpayer informing him or her of the audit and requesting substantiation for claimed EITC.[14] The initial contact letter may also advise the taxpayer that the IRS is holding the EITC portion of a refund pending the outcome of the audit.[15] The letter does not provide the name of a specific employee with responsibility for handling the taxpayer's case, a matter of significant concern to the National Taxpayer Advocate.[16]

If the taxpayer telephones the IRS to discuss the examination, the call will be routed to the next available examiner (not necessarily the same examiner the taxpayer may already have spoken with or the one who will make a determination in the case). Taxpayers' reaction to call routing has been to "rightfully complain that they are frustrated about talking to tax examiners who do not have their files, having to resubmit paperwork, not having documentation acknowledged, having to repeat conversations, not receiving return calls, and not being able to get their cases resolved while on the phone."[17] If the taxpayer does not respond to the initial contact letter, the IRS disallows the claimed EITC, and the same automated system that produced the initial contact letter ultimately generates a statutory notice of deficiency.[18] As Figure 2 shows, most Tax Court cases (EITC and non-EITC) originate as campus (or "Service Center") correspondence exams.[19]

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13 Of the 256 cases in our sample, 242 were correspondence exams.

14 See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*), describing correspondence examination procedures and reporting that during FY 2010, 86 percent of the examinations of individuals were performed by correspondence.

15 Notice CP-75 *Exam Initial Contact Letter – EIC – Refund Frozen*, shown in the Appendix; IRM 21.3.1.4.48 (Oct. 1, 2009).

16 Only IRS correspondence that responds to correspondence from the taxpayer will identify a specific IRS employee to whom future inquiries may be directed. IRM 4.19.10.1.6(6) (Feb. 24, 2011). As a practical matter, not even this IRS correspondence will necessarily identify a specific employee as a point of contact. This is because the IRS, after reviewing the taxpayer's correspondence, may use Letter 565, *Acknowledgement and Request for Additional Information* or similar communication to request additional information. Letter 565, issued through an automated system, does not include any information identifying the employee who issued it. The National Taxpayer Advocate has significant concerns about this procedure because not only does it burden taxpayers, but it may also violate the requirement under § 3705(b) of the IRS Restructuring and Reform Act of 1998 that the IRS include in all manually-generated correspondence the name, telephone number, and unique identifying number of the employee the taxpayer may contact regarding correspondence. *See* Pub. L. No. 105-206, 112 Stat. 685, 777 (1998); National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 78, (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*); National Taxpayer Advocate Blog, *Are IRS Correspondence Audits Really Less Burdensome For Taxpayers?,* http://www.taxpayeradvocate.irs.gov/Blog/are-irs-correspondence-audits-really-less-burdensome-for-taxpayers (last visited Dec. 9, 2012).

17 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 79 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

18 For a detailed discussion of Automated Correspondence Examination (ACE), the software application that fully automates the initiation, aging, and closing of certain cases, see National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*); IRM 4.19.20.1.6.1 (Apr. 16, 2008). As discussed below, the statutory notice of deficiency triggers the taxpayer's right to obtain Tax Court review of the IRS's determination.

19 When the Tax Court receives a petition, it assigns it a docket number. Rule 35, Tax Court Rules of Practice and Procedure. The case is then sometimes referred to as a docketed Tax Court case.

**FIGURE 2, Source of Petitioned Cases**[20]


| | FY 02 | FY 03 | FY 04 | FY 05 | FY 06 | FY 07 | FY 08 | FY 09 | FY 10 | FY 11 |
|---|---|---|---|---|---|---|---|---|---|---|
| Appeals | 1.9 | 1.8 | 2.1 | 2.0 | 2.1 | 2.3 | 2.4 | 2.8 | 3.0 | 3.2 |
| Exam | 2.2 | 3.2 | 2.9 | 3.6 | 4.5 | 5.9 | 6.8 | 7.8 | 7.7 | 8.3 |
| Service Center | 8.7 | 12.8 | 15.0 | 14.9 | 16.6 | 19.3 | 22.3 | 19.6 | 18.4 | 17.8 |
| Unreported | 5.1 | 3.7 | 4.1 | 4.1 | 2.9 | 1.5 | 0.7 | 0.6 | 0.4 | 0.4 |
| Total | 17.9 | 21.5 | 24.1 | 24.6 | 26.1 | 29.0 | 32.2 | 30.8 | 29.5 | 29.7 |

### Eligibility for EITC is Especially Difficult for Transient Taxpayers to Substantiate.

For eligible taxpayers whose incomes do not exceed certain amounts, IRC § 32 provides for a refundable credit, calculated as a function of the number of the taxpayer's "qualifying children."[21] A "qualifying child" is a person who among other things meets age requirements, bears a specified relationship to the taxpayer, and has the same principal residence as the taxpayer for more than half the year.[22] The last two components of EITC eligibility — relationship and residency — can be particularly difficult to substantiate.[23]

### The IRS Applies the EITC Rules with Unnecessary Rigidity in Correspondence Exams.

The IRS does not require Tax Examiners, the employees who handle correspondence exams, to possess more than a high school education (or GED certificate) or have a background in tax or accounting.[24] IRS publications, rather than primary sources of law, serve as the basis of Tax Examiners' training, and their conclusions as to whether the EITC is allowable may be based on narrow "If - Then" reasoning, without a broader understanding

20 The numbers include declaratory judgments. The unreported category includes cases where no statutory notice was attached to the petition. Source: Counsel Automated Tracking System, TL-708B, prepared by: CC:FM:PMD:MA.

21 IRC § 32(c)(1) sets out the definition of "eligible individual" and IRC § 32(b) contains the calculation of the amount of allowable credit. The credit is also available to taxpayers who do not have qualifying children. IRC § 32(b)(1)(A).

22 IRC §§ 32(c)(3); 152(c) (providing that a qualifying child is an individual who is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (*e.g.*, a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them).

23 National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*).

24 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 76 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

of what the law actually says or what it intends to accomplish.[25] The applicable IRM provisions contain a link to Publication 501, *Exemptions, Standard Deduction, and Filing Information*, and a table in which one column identifies an EITC condition and another column displays the related "Acceptable Documentation."

For example, "Acceptable Documentation" for the qualifying relationship condition is "Birth certificates or other official documents of birth; Marriage certificates that verify your relationship to the child; Letter from an authorized adoption agency; Letter from the authorized placement agency or applicable court document."[26] "Acceptable Documentation" for the residency condition is "Photocopies of school (no report cards), medical, childcare provider (provider can't be a relative), or social service records; A letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of child's parent or guardian, child's address and the dates that they lived with taxpayer."[27]

Lists of "acceptable documentation" in IRM provisions never include "other credible evidence" or allow for consideration of alternative records.[28] Tax Examiners generally do not accept the taxpayer's own testimony to substantiate the relationship or residency components of the claim.

Recognizing the difficulties taxpayers face in substantiating their EITC claims in correspondence exams, in February 2012 the National Taxpayer Advocate issued interim guidance to TAS employees describing how to improve advocacy on EITC issues through:

- Better understanding of the legal requirements to qualify for the EITC;
- Greater consideration of the challenges eligible taxpayers may face trying to understand and navigate IRS requirements and correspondence;
- Research of information available through IRS systems;
- Awareness and pursuit of alternative documents to substantiate income or prove relationship and residency; and
- Increased efforts to contact taxpayers by phone to establish dialogue and rapport.

25 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 77 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*), giving as an example of "If - Then" reasoning: "'If' a taxpayer has a birth certificate and full-year school record for their child, 'Then' the child meets the relationship and residency requirements for the Earned Income Tax Credit (EITC). 'If' a taxpayer has a birth certificate where the paternal information is blank and the child is too young to be in school or have a personal relationship with a pastor who could attest to residency, 'Then' the taxpayer is simply out of luck. Alternative sources of documentation are neither offered nor considered."

26 IRM 4.19.14.5.6(3) (Nov. 25, 2011).

27 *Id*.

28 As part of a three-year study that began in 2003, the IRS investigated the effectiveness of a pre-certification program that required EITC claimants either to pre-certify their eligibility or to submit documentation of eligibility with their tax returns. The IRS ultimately concluded that pre-certification should not be pursued because the "results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers." IRS, *Earned Income Tax Credit Initiative: Final Report to Congress* (Oct. 2005). *See also* IRM 4.19.14.7.3 (Nov. 25, 2011); *EITC Affidavit Study, supra/infra*.

The guidance includes a list of traditional and alternative documents that can substantiate entitlement to EITC.[29]

### Most Taxpayers Do Not Dispute the Audit Results, and Those Who Do Almost Always Settle Their Cases Without Trial.

If the IRS proposes to disallow claimed EITC, it issues a Notice of Proposed Adjustments, also known as a 30-day letter, which advises the taxpayer of the right to seek administrative review of the disallowance by IRS Appeals.[30] Taxpayers in correspondence exams almost never seek this administrative review in response to a 30-day letter, but as described below, they may nevertheless encounter an Appeals Officer later in Tax Court proceedings.[31]

IRS Appeals is the unit whose mission is to settle cases.[32] Unlike Tax Examiners, Appeals Officers are authorized to consider "hazards of litigation" in evaluating how best to proceed.[33] A "hazards" settlement may result when there is "substantial uncertainty in the event of litigation as to: how the courts would interpret and apply the law; what facts the courts would find; or the admissibility of or weight that would be given to a specific item of evidence."[34] Hazards include "whether the taxpayer will testify, what he or she will say, and what force and effect the court will give to the testimony."[35] If the hazards of litigation are strongly in favor of the taxpayer, IRS Appeals may settle the case with a full concession.[36]

Appeals Officers close a case by completing an Appeals Case Memorandum.[37] Form 5402, *Appeals Transmittal and Case Memo,* is part of every Appeals Case Memorandum and is sometimes all that is needed.[38] For more complex cases, the memorandum may also include a schedule of adjustments with a brief or more developed narrative.[39]

29 *Interim Guidance on Advocating for Taxpayers Claiming Earned Income Tax Credit (EITC) with Respect to a Qualifying Child*, Control No: TAS-13-0212-006 (Feb. 9, 2012), *available at* http://www.irs.gov/pub/foia/ig/tas/tas-13-0212-006.pdf.

30 Treas. Reg. § 601.105(d)(1)(iv) authorizes the 30-day letter, which explains the proposed changes and advises the taxpayer of the liability and of the right to file a protest within 30 days to be considered by IRS Appeals. The IRS sometimes uses combination or "combo" letters which merge the initial contact letter with the 30-day letter. Because combo letters can confuse taxpayers, the National Taxpayer Advocate has consistently expressed concern about their use. *See, e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 85 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

31 National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

32 IRM 8.1.1.1 (Feb. 10, 2012) provides "The Appeals Mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." This mission is accomplished by "considering protested cases, holding conferences, and negotiating settlements."

33 Treas. Reg. §601.106(f)(2) provides that "Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in light of the hazards which would exist if the case were litigated;" *Hazards of Litigation-Settlement Practice*, Student Guide 3, IRS Training 22924-002 (May 2007).

34 *Hazards of Litigation-Settlement Practice*, Student Guide 16, IRS Training 22924-002 (May 2007).

35 *Id*. at 17.

36 *Id*. at 27.

37 IRM 8.6.2.1.2 (Mar. 21, 2012).

38 IRM 8.6.2.1.2(1)(a) (Mar. 21, 2012).

39 IRM 8.6.2.1.2(1)(b), (c) (Mar. 21, 2012).

Independently of the format, Appeals employees are required to indicate on the Appeals Case Memorandum whenever they settle a case on the basis of hazards of litigation.[40]

In FY 2012, Appeals resolved over 67 percent of its non-docketed cases (*i.e.*, EITC and non-EITC cases in which the taxpayer requested Appeals review in response to the 30-day letter).[41] If the case is not settled, then Appeals issues the statutory notice of deficiency authorized by IRC § 6212, which informs the taxpayer of the additional amount of tax the IRS believes he or she owes and advises of the right to petition the Tax Court for review of that determination. If the taxpayer did not seek Appeals review in response to the 30-day letter (and, as noted earlier, most do not), the IRS Examination function issues the statutory notice of deficiency.

IRC § 6213 provides that a taxpayer has 90 days after the IRS mails the statutory notice of deficiency (150 days, if the notice was addressed to a taxpayer outside the U.S.) to file a Tax Court petition. Taxpayers rarely petition the Tax Court, however.[42] While the IRS Examination function issued more than 350,000 statutory notices of deficiency in FY 2012, for only half a percent of them did taxpayers file Tax Court petitions.[43] The $60 Tax Court filing fee may be waived by the court "if the petitioner establishes to the satisfaction of the Court by an affidavit or a declaration containing specific financial information the inability to make such payment," but taxpayers may not be aware of this possibility, particularly those not represented by counsel.[44] In any event, the most likely outcome in a correspondence exam in which the IRS proposes adjustments to the taxpayer's account is that the taxpayer will not contest it.[45] The IRS then assesses the additional tax against the taxpayer by default.[46]

For the relatively few taxpayers who petition the Tax Court, settlement opportunities continue; the cases we reviewed were all resolved at this stage. Tax Court cases not previously considered in Appeals are referred to Appeals for consideration of settlement.[47] In FY 2012, Appeals resolved over 54 percent of its docketed cases, but if the case remains

40 IRM 8.6.2.1.1 (Mar. 21, 2012), *Four Major Sections of an Appeals Case Memo (ACM)* provides: "(1) Summary and Recommendation: The Summary and Recommendation is the first section of your narrative and is required in all ACMs. It briefly summarizes the issue and the recommendation. This section should contain enough information to cover all the most important matters, yet still be concise enough that the reader doesn't feel bogged down in details. If the issue is simple, this section may be all that is needed. Include a summary and brief analysis of what the taxpayer and examiner did or said. Briefly state the rationale for the recommendation. *Include the litigating hazards facing the government and how these hazards affect the settlement.*" (emphasis added).

41 Response from IRS Appeals dated Dec. 3, 2012, on file with TAS.

42 National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

43 In FY 2012, the IRS issued 352,043 statutory notices of deficiency. Taxpayers filed Tax Court petitions with respect to only 1,409 of these, about .04 percent. TAS Research, Exam Statutory Notices of Deficiency by Disposal Code, FY 2012 (Dec. 7, 2012).

44 Rule 20(d), Tax Court Rules of Practice and Procedure, as amended effective July 6, 2012. Prior to amendment, the reference to "a declaration" was not part of the rule. The Tax Court provides a form, *Application for Waiver of Filing Fee and Affidavit*, that may be used to request waiver of the filing fee.

45 National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

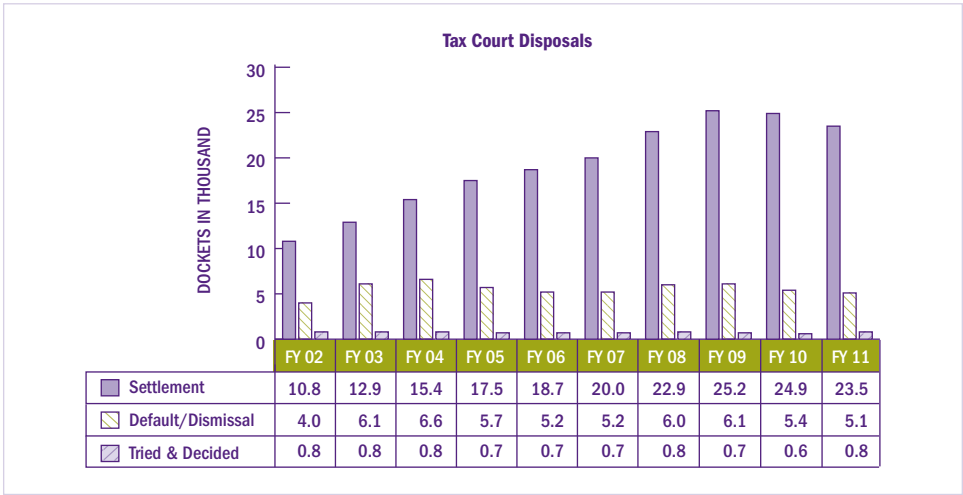
46 IRC § 6213(c) provides that if a taxpayer does not timely petition the Tax Court for review of a notice of deficiency, the IRS must assess the additional tax.

47 National Taxpayer Advocate 2009 Annual Report to Congress (Most Serious Problem: *Appeals' Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence in Appeals*).

unresolved or was considered in Appeals before the Tax Court petition was filed, it is next considered by an attorney in the IRS Office of Chief Counsel (Counsel), who then decides whether to settle or proceed to trial.[48]

Counsel's goals include settling cases "at the earliest possible date prior to the cases being calendared for trial."[49] Like an Appeals Officer, a Counsel attorney considers the hazards of litigation and in general "regards all cases as susceptible of settlement except those which involve negligible litigation hazards and cases designated for litigation."[50] The Counsel attorney prepares a Counsel Settlement Memorandum that explains the basis for the settlement, including any hazards of litigation.[51] As Figure 3 shows, the majority of Tax Court cases (EITC and non-EITC) are settled.

**FIGURE 3, Tax Court Disposals of Cases**[52]




| | FY 02 | FY 03 | FY 04 | FY 05 | FY 06 | FY 07 | FY 08 | FY 09 | FY 10 | FY 11 |
|---|---|---|---|---|---|---|---|---|---|---|
| Settlement | 10.8 | 12.9 | 15.4 | 17.5 | 18.7 | 20.0 | 22.9 | 25.2 | 24.9 | 23.5 |
| Default/Dismissal | 4.0 | 6.1 | 6.6 | 5.7 | 5.2 | 5.2 | 6.0 | 6.1 | 5.4 | 5.1 |
| Tried & Decided | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.8 | 0.7 | 0.6 | 0.8 |

When the case settlement results in an overpayment of tax by the taxpayer, the IRS refunds to the taxpayer any amounts still due, with interest as required by law.[53]

48 Response from IRS Appeals dated Dec. 3, 2012, on file with TAS. Rev. Proc. 87-24, 1987-1 C.B. 720, sets out the procedures for referring docketed Tax Court cases to Appeals and returning them to Counsel. Generally, deficiency cases of $10,000 or less will be returned to Counsel after six months or by the month prior to the calendar call of the case (15 days, for small tax cases).

49 Chief Counsel Directives Manual (C.C.D.M.) 35.5.1.3 (Aug. 11, 2004).

50 C.C.D.M. 35.5.2.2 (Aug. 11, 2004). Cases that present recurring, significant legal issues affecting large numbers of taxpayers may be designated for litigation "in the interest of sound tax administration to establish judicial precedent, conserve resources, or reduce litigation costs for the Service and taxpayers." A case designated for litigation will not be resolved without a full concession by the taxpayer. C.C.D.M. 33.3.6 (Aug. 11, 2004). EITC is not an issue that was designated for litigation in the years involved in our sample.

51 C.C.D.M. 35.5.2.14(2) (Aug. 11, 2004) provides "The memorandum must justify the action taken in the case...*If an essential factor in the settlement is litigation hazards, such hazards should be set forth and explained*" (emphasis added).

52 These numbers do not include declaratory judgments. Source: Counsel Automated Tracking System, TL-711, prepared by: CC:FM:PMD:MA.

53 *See* IRC § 6611, generally providing for interest on overpayments.

## RESEARCH QUESTIONS

Our current study examines the EITC cases conceded in FY 2010. In the past, the National Taxpayer Advocate has studied the manner, in other settings and proceedings, in which the IRS processes and evaluates claims for EITC. For example, in 2004 TAS investigated the outcomes of audit reconsiderations for EITC claimants and found that about 45 percent of the taxpayers who received TAS assistance, and 40 percent who worked only with IRS examiners, received additional EITC as a result of the audit reconsideration.[54] In 2007, TAS studied the effect of representation in EITC audits in examinations and found that represented taxpayers are more likely to retain claimed EITC.[55] In 2011, TAS studied the IRS examination strategy and found, among other things, that greater emphasis on communication with taxpayers would protect taxpayers' rights, enhance compliance, and preserve IRS credibility.[56] This year's study extends the analysis beyond cases worked within the IRS and considers cases in which the taxpayer requested judicial review of the IRS's denial of claimed EITC, and the IRS conceded the case.

For the 256 conceded EITC Tax Court cases studied, we examined:

### General characteristics of the cases:

- The amount of claimed EITC in relation to income, whether a refund was claimed, and the time that elapsed between return filing and refund dates;
- Whether the return was prepared by a paid preparer, and how frequently the taxpayer was represented during the audit or in Tax Court;
- Whether another taxpayer claimed the same person as a qualifying child; and
- The amount of time that elapsed between audit commencement and case closure.[57]

### How taxpayers communicated with the IRS before and after they filed their Tax Court petitions:

- How often, on average, taxpayers spoke with IRS employees by telephone or in person;
- Who usually initiated communications (the taxpayer or the IRS), and at what point in the process, and how many times on average they spoke;
- How often the taxpayer did not respond at all to the IRS; and
- How often taxpayers "dropped out" of the exam (*i.e.*, began to cooperate or correspond and then did not respond further to requests for information).

54 National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, 9 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

55 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 94 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*). The National Taxpayer Advocate also sponsored a study by a Carnegie Mellon University research team which found that the behavior of taxpayers claiming EITC could be simulated, which would allow better understanding of the impact of IRS activity on this population. National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 118 (*Simulating EITC Filing Behaviors: The 2004 Hartford Case Study*).

56 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

57 We adopted a convention in which there are 360 days in the year and each month has 30 days.

**How the IRS evaluated third-party written statements or other documentary substantiation of the claim before and after the taxpayer filed the Tax Court petition:**

- Whether documents were received in time for the IRS to associate them with the file and consider them before issuing the notice of deficiency;
- Whether the substantiation later accepted by an Appeals Officer or Chief Counsel attorney was considered but deemed inadequate by an examiner, and if so, what the substantiation consisted of;
- Whether an Appeals Officer or Chief Counsel attorney accepted testimony as a substitute for documents;
- Whether an Appeals Officer or Chief Counsel attorney settled cases on the basis of hazards of litigation; and
- Whether an examiner misapplied the law in denying the taxpayer's claimed EITC.

## METHODOLOGY

The IRS Office of Chief Counsel provided TAS Research a list of Tax Court cases in which EITC was an issue and that the IRS fully conceded in FY 2010. From a population of 734 cases, TAS Research selected a random sample of 256 cases in which the IRS conceded the case in full. The sample is statistically valid at the 95 percent confidence level with a margin of error no greater than +/-5 percent, which allows study findings to be projected to the population. The project lead, a TAS Attorney Advisor, ordered hardcopy IRS Examination or Chief Counsel case files from IRS storage facilities for each case in the sample and distributed the case files among three experienced TAS employees. The employees, all Internal Revenue Agent Technical Advisors, reviewed the case files containing a record of the examination process from the beginning of the audit until the case was closed.[58]

## DATA COLLECTION

The project team, with assistance from TAS Research, developed a scannable data collection instrument (DCI), which appears in Appendix A, to capture information about the original tax return, the original examination, and the IRS case actions. The reviewers completed the data collection instrument for each case file, augmenting information found in the hardcopy file with information from IRS databases as necessary. To minimize bias, case reviewers were thoroughly and consistently briefed on the purpose of the data collection and provided guidelines on proper completion of the DCI. The project lead reviewed ten cases from each team member for accuracy, and the team discussed ten additional cases as a group. TAS Research developed a database to compile the information collected on the DCIs and performed quality checks on the data after input. TAS Research collected additional data from return and examination databases, such as income level and the

58 Internal Revenue Agent Technical Advisors in TAS provide expert advice on tax examination issues, research technical issues and apply tax law to facts, and access and analyze taxpayer returns and related documents, among other things. *See* IRS Standard Position Description No. 92548.

frequency and amount of refund claims, tax adjustments, notices, and examinations. TAS also reviewed information from Tax Court docket records.

In October 2012, TAS shared some preliminary results of the study with representatives of the IRS Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) operating divisions, who in collaboration with TAS are studying correspondence exam procedures.[59] The operating division representatives raised the issue of whether the cases in this study were settled based on hazards of litigation. Because the original data collection instrument did not capture this information, the team extracted additional information from the case files: the type of document that recorded the case closure (*e.g.*, Appeals Case Memorandum, Chief Counsel Settlement Memorandum), and whether the document indicated that hazards of litigation had been considered. The supplemental questions appear in Appendix B.

## FINDINGS

### Taxpayers Often Must Wait for Over a Year to Receive EITC Refunds Which Usually Represent More than a Quarter of Their Income, and Most Incur Litigation Costs in the Meantime.

Paid preparers prepared most returns in the cases we reviewed (180 out of 256, about 70 percent), but other than paid preparers shown on the returns, in 162 out of the 256 cases (63 percent), there was no indication of representation during the audit or in Tax Court. The average amount of EITC claimed on the return (and ultimately conceded by the IRS) was $3,479 and taxpayers' average adjusted gross income was $17,024. For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes. All but three of the returns were claims for refunds, with an average refund claim of $3,880.

In 99 cases (or almost 39 percent), the taxpayers did not receive the claimed refunds until after the audits ended. From the time they filed their returns, these taxpayers had to wait on average *513 days, or 17 months*, to get their refunds. The IRS paid $17,400 in interest on delayed refunds in 90 cases (an average of slightly less than $200 per return). For all 256 cases, from the April 15 due date of the returns, it took about a year (366 days) on average for the IRS to audit the returns, the taxpayers to commence litigation, and the IRS to concede the cases and close them on its databases.[60] Most taxpayers (189 out of 256, or 74 percent) paid the $60 Tax Court filing fee. In two thirds of these cases (127 of 189, or 67 percent) the taxpayer did not have representation at any point in the proceedings (other than having a paid preparer prepare the return, if that). In the 67 cases in which the filing fee was waived, the taxpayers were without representation only about half the time (34 of the 67 cases, or 51 percent).

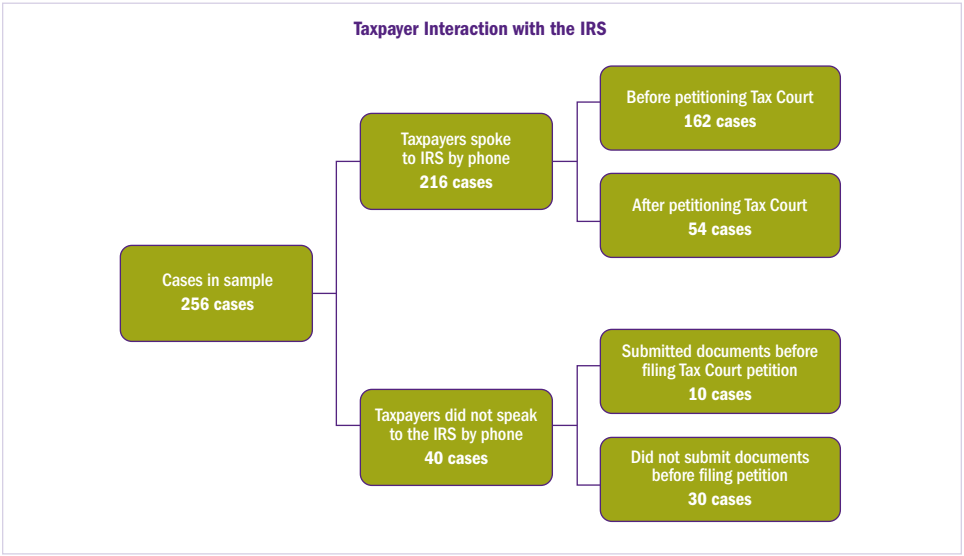
59 The IRS Correspondence Examination Assessment Project (CEAP) includes representatives from TAS, W&I, and SB/SE. The project consists of internal reviews to evaluate how to continue, revise, or otherwise improve the IRS's Correspondence Examination program. CEAP Interim Report 1 (Sept. 28, 2012).

60 We were unable to identify the disposal dates for seven of the cases.

### Taxpayers Call the IRS Repeatedly While There is Still Time to Resolve the Case Without Going to Tax Court.

Once the audit began, taxpayers or their representatives spoke to an IRS employee by telephone in 216 of the 256 cases, or 84 percent of the time.[61] Even when they did not speak to employees on the phone, they submitted documents to substantiate their claims. Figure 4 shows how taxpayers interacted with the IRS at various points during the audit process.

**FIGURE 4, Taxpayer Interaction with the IRS**

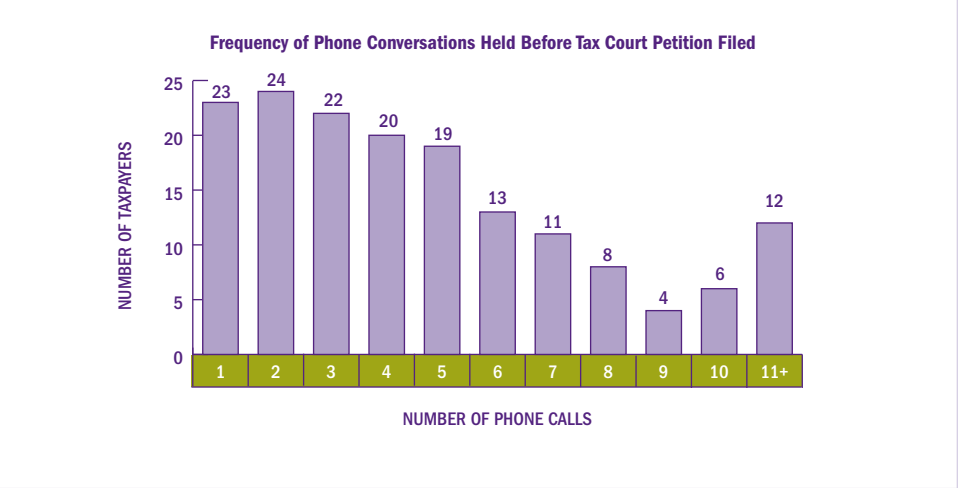



Taxpayers spoke to the IRS before filing their Tax Court petitions in 162 of the 256 cases, or 63 percent of the time. These 162 taxpayers continued to communicate, speaking to the IRS about five times on average. They called up to 21 times, with 61 calling between five and ten times.[62] Figure 5 shows the frequency of the phone conversations for the 162 taxpayers who spoke to the IRS before they petitioned the Tax Court.

61 Of the 216 cases, the IRS initiated the first phone call in 46 cases, usually when the taxpayer had already filed the Tax Court petition. In 14 cases, the IRS made the first call before the Tax Court petition was filed. These 14 taxpayers spoke with the IRS three times on average. Taxpayers did not often meet with the IRS in person. In the 19 cases in which they did meet face-to-face, it was usually (in 12 cases) after the Tax Court petition was filed; in only three cases did more than one in-person meeting take place.

62 Only 23 of the 162 taxpayers spoke to the IRS only once: 66 of them called between two and four times, and 127 of them called between two and ten times.

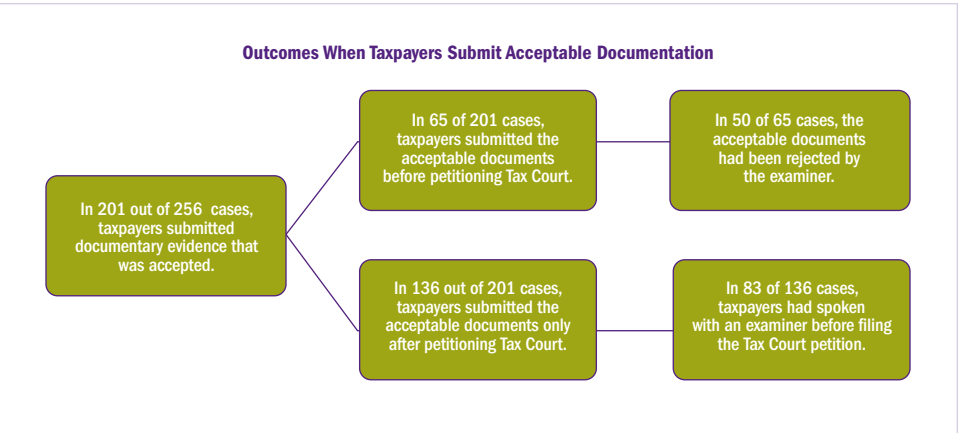
**FIGURE 5, Frequency of Taxpayer Phone Conversations with the IRS**




## Taxpayers Can Substantiate their Claims, But Have Difficulty Doing So While Working With Examiners.

In 201 of the 256 cases, or 78 percent of the time, taxpayers submitted documentary evidence that the Appeals Officer or Chief Counsel attorney accepted as probative of the claim. However, in 136 of the 201 cases, they submitted these documents only after petitioning the Tax Court.[63] The various outcomes when taxpayers submitted documents later accepted in support of their claims are shown in Figure 6 below.

**FIGURE 6, Outcomes When Taxpayers Submit Acceptable Substantiation**




63 In 28 of these 136 cases, the documentation was insufficient and the IRS accepted testimony as a substitute. As discussed below, 65 taxpayers submitted valid documentation before filing their Tax Court petitions. The examiner rejected the substantiation in 50 of these cases.

Of the 136 taxpayers who submitted documents only after petitioning Tax Court, 83 (61 percent) had spoken to the IRS before filing their Tax Court petition.[64] These 83 taxpayers called up to 21 times, five times on average. This shows that taxpayers who contact the IRS early in the process can provide valid documentation to support their claims, but often do not do so until they have exited the examination phase of the case. The most likely explanation for this behavior may be that when taxpayers call and speak to an examiner, they do not receive adequate explanations of what documents are needed, but do receive adequate explanations thereafter. We found only 33 cases in which the taxpayer called and submitted acceptable documentation only after filing the Tax Court petition.

### Appeals Officers or Chief Counsel Attorneys Accept Documents Rejected by IRS Examiners in One-Fifth of the Cases.

As shown in Figure 6, above, in 50 cases in the sample (about 20 percent of the time), an Appeals Officer or Chief Counsel attorney accepted documents the examiner had considered but rejected.[65] In these 50 cases, the documentation that was unacceptable to the examiner but was later accepted by the Appeals Officer or Chief Counsel attorney most often included a birth certificate (in 28 cases), school records (in 24 cases), or statements by a health care provider (in 20 cases).[66] Other documents that the examiner and Appeals Officer or Chief Counsel attorney evaluated differently were Social Security cards (in 12 cases), a statement by a property owner or landlord (in 11 cases), and other third-party statements, such as those by a neighbor (in 12 cases). The taxpayers submitted these documents to establish relationship and residency, the components of EITC that present the most difficult proof problems for taxpayers.

Even if the documents submitted to the examiner were incomplete, the Appeals Officer or Chief Counsel attorney accepted testimony as a substitute for documents in only six of these 50 cases (12 percent of the time), meaning that taxpayers were almost always able to produce additional documents if necessary.[67] Only one of these 50 cases was settled on the basis of hazards of litigation.

64 The IRS made the first phone call (calling before the petition was filed) in five of these cases.

65 We found only three cases in which the taxpayer submitted documents that were not associated with the file in time for the examiner to consider them. We also found 15 cases in which the taxpayer "dropped out" of the examination process by initially responding to requests for information but then becoming nonresponsive. In eight of these 15 cases, the taxpayer submitted documents that the examiner rejected.

66 Twelve cases involved all three of these documents.

67 Testimony was accepted as a substitute for documents more frequently in the sample as a whole, occurring in 44 of the 256 cases (17 percent of the time).

### The Documents Examiners Reject Are Usually Listed in the IRM as Acceptable Substantiation, and Sometimes Examiners Deny EITC Because they Misapply the Law.

In about 40 percent of the cases (18 out of 50) in which an examiner rejected a document that was later accepted, the document was not among those specified in the IRM.[68] Given the rigidity with which Tax Examiners are trained to evaluate EITC claims, it is perhaps unsurprising that a document not specifically mentioned as acceptable substantiation would be rejected. For the remaining 32 cases, however, the acceptable documents rejected by the examiner were listed in the IRM as acceptable. None of these 32 cases were settled on the basis of hazards of litigation, and in only three cases was testimony accepted as a substitute for documents. Therefore, it appears that examiners do not resolve cases on the basis of IRM-sanctioned documents that Appeals Officers and Chief Counsel attorneys later find sufficient.

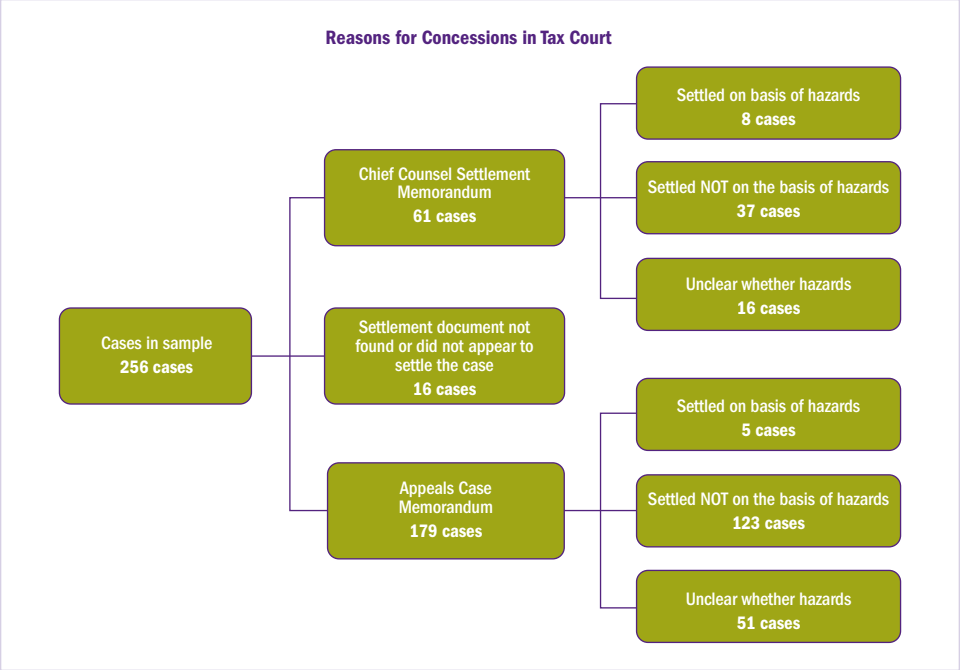
Appeals Officers or Chief Counsel attorneys found that the examiner had misapplied the law in 13 cases, or about five percent of the total number of cases in the sample. All but one of these taxpayers spoke to the IRS before petitioning the Tax Court and in nine of these 13 cases submitted documents that the examiner rejected but the Appeals Officer or Chief Counsel attorney accepted. Projecting this error rate to our population of 734 taxpayers, we expect that 37 taxpayers were denied EITC, amounting to almost a quarter of their incomes, because the IRS examiner misapplied the law. The implications for EITC exams generally are worrisome.

### Hazards of Litigation Is Rarely the Reason the IRS Concedes the Cases.

Both IRS Appeals and Chief Counsel pursue the mission of settling cases whenever possible, and their authority to consider the hazards of litigation furthers that mission. As previously noted, an Appeals Officer who settles a case due to the hazards of litigation is expected to so indicate on the Appeals Case Memorandum. Of the 179 cases with an Appeals Settlement Memorandum explaining the disposal of the case, in only five was hazards of litigation given as a reason for conceding the case. Counsel attorneys are expected to indicate when they settle cases on the basis of hazards of litigation; of the 61 cases with a Counsel Settlement Memorandum, in only eight cases was hazards of litigation given as a reason for conceding. As Figure 7 shows, hazards of litigation does not explain the concessions.

[68] In 12 of these 18 cases, the additional document consisted of a third-party statement, in ten cases the additional document was another type of document not mentioned in the IRM, and four cases included documents in both categories.

**FIGURE 7, Reasons for Concessions in Tax Court**




It is clear in 160 cases (123 with Appeals Case Memoranda and 37 with Counsel Settlement Memoranda) that hazards of litigation was not the reason the case was conceded.[69]

### Almost One-Fifth of the Cases Involved Duplicate EITC Claims for a Qualifying Child, and These Taxpayers May Need More Time to Provide Documents.

We further examined the 47 cases in the sample in which another taxpayer claimed the same qualifying child, to test the hypothesis that it might be particularly difficult for taxpayers in these cases to obtain documentation early. For example, a disruptive event such as divorce or identity theft may have led to the duplicate claim and caused delay in obtaining acceptable documents. Taxpayers in the duplicate claim category exhibited the call-early-submit-documents-late behavior more frequently than taxpayers in the sample generally, so duplicate claims could explain that behavior, at least in part.[70]

69 The narrative in 160 cases makes clear that the case was not being conceded on the basis of hazards (*e.g.*, because the taxpayer produced a document that had not previously been submitted which was sufficient to establish the validity of the claim). The narrative in the remaining cases was more general. For example, a narrative that often appeared on Form 5402 was "TP provided new facts and arguments and without involving exam, Appeals made a determination." In ten cases in the sample, the closing document could not be found or did not appear to dispose of the case.

70 We found 18 duplicate claim cases in which the taxpayer called the IRS before filing the Tax Court petition but did not submit documents until afterward (18 out of 47 is 38 percent, compared to the 33 percent rate at which taxpayers in the sample overall exhibited this behavior).

## CONCLUSION

This study adds to the National Taxpayer Advocate's body of research on EITC audits by considering post-audit events: the filing of a Tax Court petition followed by the IRS's full concession of the case. The correspondence audits in the study were initiated by a computer. Documents taxpayers submitted during the audit were considered by Tax Examiners trained to elicit and accept only certain types of substantiation without regard to whether other reliable evidence would demonstrate equally well that the statutory requirements had been met. Most taxpayers in the study responded to the IRS early in the audit process, but despite calling repeatedly, they were often able to substantiate their claims only after the IRS completed the audit.

Once their claims were considered by a specific Appeals Officer or Chief Counsel attorney, with more training and greater flexibility to judge the adequacy of their documentation and elicit additional information as necessary, taxpayers were able to satisfy the IRS that they were entitled to EITC. While Appeals employees and Chief Counsel attorneys are authorized to settle cases on the basis of the hazards of litigation, they rarely did so. Rather, they were able to elicit documents that the taxpayers had not previously submitted, or they accepted documents (often documents listed in the IRM as acceptable) the examiner had previously rejected. In about five percent of the cases, they corrected errors of law made at the audit stage. In the meantime, before the IRS conceded the case, almost 40 percent of the taxpayers were deprived of refunds to which they were entitled, usually amounting to about a quarter of their incomes, for almost a year and a half. This delay cost the government almost $200 per affected return in interest payments.

Taxpayers attempt to understand what they must do to substantiate their EITC claims. If employees were trained on flexible approaches to evaluating whether taxpayers meet the statutory requirements for claiming the credit, they would be more likely to have meaningful conversations with taxpayers. If the IRS engaged taxpayers in meaningful conversations earlier in the process, more cases could be resolved earlier in the process. Fewer taxpayers with meritorious claims would be forced to resort to Tax Court to prove their claims, and the government would less often be required to pay interest on delayed refunds.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS revise the IRM, incorporate rules similar to the interim guidance issued to TAS employees, and train Tax Examiners accordingly. Specifically, the IRS should train Tax Examiners to clearly explain to taxpayers why the IRS needs documents, to determine the type of records the taxpayer possesses that could corroborate the claim, and to consider whether alternative documentation might suffice when traditional records are not available. In cases in which two taxpayers claim the same qualifying child, the IRS should train examiners to consider allowing taxpayers more time to submit documents before issuing the statutory notice of deficiency.

Most importantly, the National Taxpayer Advocate calls upon the IRS to recognize that the EITC is a very complex statute, such that its employees must be trained in the *law*, not just "if-then" scenarios. Therefore, she recommends that the IRS use higher-graded employees with higher education requirements to handle these cases. As this study demonstrates, the minimal additional upfront costs of these recommendations will be more than offset by savings from the elimination of work downstream in the tax controversy process.

## APPENDIX A, DATA COLLECTION INSTRUMENT

18072

Docket # ☐☐☐☐☐ - ☐☐

| | |
|---|---|
| 1. Does a paid preparer appear on the return? | O Yes O No |
| 2. Other than the return, does a POA appear for the taxpayer anywhere on any document, indicating that the taxpayer was represented at some point? | O Yes O No |
| 3. Was the case settled within two months after the petition was filed? | O Yes O No |
| 4. How many weeks elapsed from the date of initial contact letter until date of notice of deficiency (any part of a week equals a week). | ☐☐ |
| 5. Did the first telephone conversation take place before the notice of deficiency was issued? | O Yes O No |
| 6. Did the first telephone conversation take place after the notice of deficiency was issued but before the petition was filed? | O Yes O No |
| 7. Did the first telephone conversation take place only after the petition was filed? | O Yes O No |
| 8. Did the taxpayer (or the POA) initiate the first telephone conversation? | O Yes O No |
| 9. Did the taxpayer (or the POA) speak with the IRS on the phone more than once? | O Yes O No |
| 10. How many times did the taxpayer or the POA speak to the IRS on the telephone? | ☐☐ |
| 11. Did you find evidence of the conversation(s) in the paper file? | O Yes O No |
| 12. Did you find evidence of the conversation(s) in AMS? | O Yes O No |
| 13. Did you find evidence of the conversation(s) in CEAS? | O Yes O No |

**In -Person Contact with IRS - complete this section only if the taxpayer or the POA spoke to the IRS in person.**

| | |
|---|---|
| 14. Did the in person conversation take place before the notice of deficiency was issued? | O Yes O No |
| 15. Did the first in person conversation take place after the notice of deficiency was issued but before the petition was filed? | O Yes O No |
| 16. Did the first in person conversation take place only after the petition was filed? | O Yes O No |
| 17. Did the taxpayer (or the POA) initiate the first in person conversation? | O Yes O No |
| 18. Did the taxpayer (or the POA) speak with the IRS in person more than once? | O Yes O No |
| 19. How many in person conversations did the taxpayer (or the POA) have with the IRS? | ☐☐ |

18072

**Case Characteristics**

20. Did Counsel or Appeals explicitly accept testimony as a substitute for documents? (If not explicit, answer N) O Yes O No

21. Did the IRS state that another taxpayer had claimed the same person as a qualifying child? O Yes O No

22. Did Counsel or Appeals clearly state that the examiner misapplied the law in denying the taxpayer's claimed EITC? O Yes O No

23. Is there a no-change letter in the file? O Yes O No

Written third-party statements or other documents or receipts: Complete this section only if the taxpayer submitted at least one third-party statement or document in support of his or her position, which was clearly accepted by Counsel or Appeals (as shown in the Appeals Case Memorandum or Counsel Settlement Memorandum) as substantiation of the claim.

24. Was the written third-party statement or document or receipt stamped "received" by the IRS, or date stamped on a fax to the IRS, more than 15 days before the notice of deficiency was issued? If no, skip to question 25. O Yes O No

24a. Was the same written third-party statement or document or receipt clearly not associated with the file in time for Examiner to consider it? (Y or N) (examiner has a case until there's a notation in the case activity record that the exam is closed, submitted to manager, etc.) O Yes O No

24b. Was the same wtitten third party statement or document or receipt clearly considered inadequate by Exam? O Yes O No

O Birth Cert. O Employer O Signed 3rd Party Statement
O Marriage License O Soc. or Gov't agency O Sch. C Bus. Records
O SSN Card O Court Order
O Divorce Decree O Health Care Provider
O School Records O Utility Bills
O Prop. Mgr./Landlord O Indian Tribal Council
O Clergy O Other

24c. Was the same written third part statement or document or receipt associated with the file but clearly not considered by Exam? O Yes O No

25. Was the written third-party statement or document or receipt received by the IRS after the statutory notice of deficiency was issued but before the petition was filed? O Yes O No

26. Was the written third party statement or document or receipt received by the IRS only after the petition was filed? O Yes O No

**Taxpayer interaction with Exam**

27. Did the taxpayer ever respond to any IRS notices? O Yes O No

28. Did the taxpayer "drop out" of the examination? i.e, did the taxpayer begin to cooperate/correspond and then give up by not responding further to requests for information O Yes O No

## APPENDIX B: ADDITIONAL QUESTIONS PERTAINING TO HAZARDS OF LITIGATION

**29. What document did you consult for the explanation of why the case was conceded?**

1. Appeals Settlement Memorandum with narrative
2. Form 5402 only
3. Another document (other than Appeals Settlement Memorandum or Form 5402) or no document is found
4. Counsel Settlement Memorandum

**30. Does the document identified in the previous question state that hazards of litigation were considered?**

1. Yes. Hazards of litigation is given as the reason for the concession (a statement that the taxpayer is credible, or that testimony is being accepted as a substitute for documents, is not sufficient).
2. No. Hazards of litigation is not given as the reason for the concession, and the explanation in the closing document makes clear that the case was *not* settled on the basis of hazards of litigation (*e.g.*, the taxpayer provided documents for the first time and they were sufficient.).
3. Hazards of litigation is not mentioned, and the explanation is general (*e.g.*, "TP provided new facts and arguments and without involving exam, Appeals made a determination").

## APPENDIX C: NOTICE CP-75 EXAM INITIAL CONTACT LETTER – EIC – REFUND FROZEN

B248939 60625 IRS USE ONLY SB E 0 0 09 201041 CP: 75

Department of the Treasury
**Internal Revenue Service**
Examination Operations
5333 Getwell Rd Stop 822
Memphis, TN 37501-0001

For assistance, call:
1-866-899-9085
**Your Caller ID:** 742026

**Notice Number:** CP75
**Date:** October 25, 2010

**Taxpayer Identification Number:**

**Tax Form:** 1040
**Tax Year:** December 31, 2009

001654

### We're Auditing Your Tax Return And Delaying Part of Your Refund

**Why We're Auditing Your Tax Return**

We're auditing your tax return. This audit is why we've delayed sending you the earned income credit (EIC) part of your refund. The information below explains why we're auditing your return and the information you need to send us so we can make the right decision about your taxes.

**Earned Income Credit** - Your child must meet three tests to be your qualifying child for EIC. The enclosed *Form 886-H-EIC, Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children,* explains the tests. It also explains the information you can send to us to show you've met the tests.

**Dependents** - You must meet five tests to claim a dependent. The enclosed *Form 886-H-DEP, Supporting Documents for Dependency Exemptions,* explains the tests. It also explains the information you can send to us to show you've met the tests.

**Filing Status** - If you claimed a Head of Household filing status on your tax return, you must meet three qualifying tests. The enclosed *Form 886-H-HOH, Supporting Documents To Prove Head of Household Filing Status* explains the qualifying tests. It also explains the information you can send to us to show you've met the tests.

**Schedule C** - You must have earned income to claim the EIC. Please complete and send us the enclosed *Form 11652, Questionnaire and Supporting Documentation, Form 1040 Schedule C (Profit or Loss from Business)* to help us determine if you have the right amount of earned income.

**What You Need To Do Now**

To get the EIC you deserve, please send us the above information **within 30 days** from this letter's date.

You can send us the information by mail, in the enclosed envelope, or by fax to 1-901-395-1600 (not toll-free).

Fill in and send us the stub on the last page of this letter. We'll use the stub to make sure your information gets to the right person and to make sure we can call you if we have any questions.

**If you can't get all your information to us in time, call us at the above number to discuss what you can do.**

Page 1

**What We'll Do Once We Hear from You**

We'll review the information you send us. If your information shows your return was correct, we won't make any changes to your tax return and we'll send you the EIC part of your refund. You won't need to do anything else.

If your information doesn't show your return was correct, we'll send you a report of changes we plan to make to your tax return and explain the tax you will owe. We'll also explain your right to appeal if you disagree.

Please allow us at least 30 days to review your information. After our review, we'll let you know by letter what we're going to do and explain your appeal rights, if we propose changes.

Any EIC refund you claimed will be delayed while we review your information.

**What Happens If You Don't Reply**

If we don't hear from you **within 30 days** you will not receive the EIC part of your refund. We'll send you a letter and a report disallowing the tax return items we've questioned. We'll explain how you can appeal if you disagree.

**How to Get Help**

You can only receive your EIC by mailing or faxing us the information we've requested.

However, we've enclosed *Publication 3498-A, The Examination Process,* to help you understand this audit and your appeal rights. It will explain your right to have someone help or represent you. Please visit our website at www.irs.gov/eitc to learn more about the examination process.

You can also call our toll-free number, 1-866-899-9085, with any questions you may have about this letter or the information we need.

Your local IRS office can provide free help. You can find your nearest IRS office listed in your local phone book or at www.irs.gov/localcontacts/index.html If you have a significant hardship, you can contact the Taxpayer Advocate Service at 1-877-777-4778 (toll-free).

A Low Income Taxpayer Clinic may be able to offer you free help. The enclosed *Publication 4134, Low Income Taxpayer Clinic List,* lists the clinics' locations and their eligibility guidelines.

| Follow These Steps |
|---|
| 1. Read the enclosed forms and publications and call us if you have questions or need help. |
| 2. Gather the information explained on the first page of this letter. |
| 3. Make clear, readable copies of the information and **keep the originals** for your records. |
| 4. Fill in your telephone numbers and the best time to call on the stub. (You can find the stub on the last page of this letter.) |
| 5. You can send us your information in the enclosed envelope or you can use your own envelope. **Be sure to enclose the stub.** Send all information to us at the address on this letter. |
| 6. You also can fax the stub with your documents to fax number 1-901-395-1600 (not toll-free). |

B248939 CP: 75

Memphis Service Center Tax Period: December 31, 2009

**Remember: If you can't get all your information to us within the 30 days, call us at our toll-free number, 1-866-899-9085, to discuss what you need to do.**

Enclosures:
*Form 886-H-DEP, Supporting Documents for Dependency Exemptions*
*Form 886-H-HOH, Supporting Documents To Prove Head of Household Filing Status*
*Form 886-H-EIC, Supporting Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children*
*Publication 3498-A, The Examination Process*
*Publication 4134, Low Income Taxpayer Clinic List*
*Form 11652, Questionnaire and Supporting Documents, Form 1040 Schedule C (Profit or Loss from Business)*
Return Envelope

001654

CUT HERE

Return this voucher with your payment or correspondence.

Your Telephone Number: ( )_____-_____ Best Time to Call: _____AM_____PM

☐ **Correspondence enclosed:**
- Write your Taxpayer Identification Number, tax period and tax form number on your inquiry or correspondence

0623

SB 201041

75 Internal Revenue Service
Examination Operations
5333 Getwell Rd Stop 822
Memphis, TN 37501-0001

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## APPENDIX D: FORM 886-H-EIC. *DOCUMENTS YOU NEED TO PROVE YOU CAN CLAIM AN EARNED INCOME CREDIT ON THE BASIS OF A QUALIFYING CHILD*; FORM 866-H-DEP, *SUPPORTING DOCUMENTS FOR DEPENDENCY EXEMPTIONS*; FORM 866-H-HOH, *SUPPORTING DOCUMENTS TO PROVE HEAD OF HOUSEHOLD FILING STATUS*

**Form 886-H-EIC-2011**
(January 2012)

### Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children

*Usted puede conseguir una versión de esta forma en español llamando el número de teléfono en la primera página de la carta adjunta*. You can get a Spanish version of this form, by calling the telephone number in the first page of the enclosed letter.
Your child must meet **relationship, age, and residency** requirements to qualify you for an Earned Income Credit (EIC). However, you may not need to claim a dependent child to qualify for a reduced EIC (see the reverse side of this form).

| | If the Child Is | Then |
|---|---|---|
| **Relationship Test** | Your son or daughter (including an adopted child) | **GO TO THE AGE and RESIDENCY TESTS.** IRS will confirm the relationship; however, we may ask you later for additional information. |
| | Your grandchild or great grandchild, stepson, stepdaughter, step-grandchild or step-great grandchild, child pending adoption, brother, sister, stepbrother or stepsister or a descendant of any of them (such as a niece or nephew), eligible foster child (placed with you by an authorized placement agency) | Send us photocopies of documents that show evidence of the relationship, such as:<br>• **Birth certificates or other official documents of birth that verify your relationship**<br>• **Marriage certificates that verify your relationship to the child**<br>• **Letter from an authorized adoption agency**<br>• **Letter from the authorized placement agency or applicable court document** |
| **Age Test** | Under age 19 at the end of 2011 | **GO TO THE RESIDENCY TEST**. IRS will confirm the age; however, we may ask you later for additional information. |
| | Under age 24 at the end of 2011 and a full-time student for at least five months of the year | Send us photocopies of official school records showing the child was a full-time student for at least five months of the tax year. The school records should show the dates of attendance. The months of attendance don't have to be consecutive. |
| | Any age and permanently and totally disabled at any time during 2011 | Send us a letter from the child's doctor, other healthcare provider, or any social service program or agency verifying the child is permanently and totally disabled. |
| **Residency Test** | Related to you and lived with you in the United States for **more than half** of 2011 | Send us photocopies of school (no report cards), medical, childcare provider (provider can't be a relative) or social service records<br>**or**<br>Send us a letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of your child's parent or guardian, your child's address and the dates that they lived with you.<br>**You may need to send more than one document** to prove your child lived with you for more than half of the year |
| | Any documents you submitted must reflect your actual street address. If you filed your tax return using a P.O. Box please submit a copy of the completed Form 1093 - P.O. Box Application - stamped by the post office. | |

Form **886-H-EIC-2011** (1-2012) Cat No. 58202G www.irs.gov Department of the Treasury-**Internal Revenue Service**

**Earned Income Credit for Taxpayers without a Qualifying Child**

**Stop here if you meet the test to claim an Earned Income Credit on the basis of a qualifying child or children as outlined on the other side. You do not need to complete this section.**

You may qualify for a reduced earned income credit (EIC). The EITC Assistant link (found at irs.gov) can help you determine your eligibility and estimate the EIC amount that you may receive. Take the test below to see if you can qualify for a reduced EIC. (Note -- Your earned and adjusted gross income each must be less than $13,660 ($18,740 if married filing jointly).

| TEST | YES | NO |
|---|---|---|
| You (or your spouse, if you filed a joint return) were at least age 25, but under age 65, on December 31, 2011 | ☐ | ☐ |
| You (and your spouse, if you filed a joint return) cannot be claimed as a dependent on another person's return. | ☐ | ☐ |
| You (and your spouse, if you filed a joint return) lived in the United States for more than half of 2011. | ☐ | ☐ |

If you checked **any of the "No" boxes**, you do **not** qualify for an EIC. You will receive a report, *Form 4549* or *Form 4549-EZ*, *Income Tax Examination Changes*, reflecting our proposed adjustment.

If you checked **all of the "Yes" boxes**, you qualify for an EIC without a qualifying child. Please sign, date, and return this page in the enclosed envelope. **If you filed a joint return both you and your spouse must sign this form.** You will receive a report, *Form 4549* or *Form 4549-EZ*, *Income Tax Examination Changes*, showing the amount of EIC you qualify for without a qualifying child.

*Under penalties of perjury, I declare that I have examined this claim, and, to the best of my knowledge and belief, it is true, correct, and complete.*

Print Name _____ Social Security Number _____

Signature _____ Date _____

Signature (For joint filed returns) _____ Date _____

Form **886-H-EIC-2011** (1-2012) Cat No. 58202G www.irs.gov Department of the Treasury-**Internal Revenue Service**

## Supporting Documents for Dependency Exemptions

| If You Are: | And: | Then please send photocopies of the following documents: |
|---|---|---|
| Divorced, legally separated, or living apart from the other parent of the child claimed on your return. | Both parents (together) provided more than half of the child's **total support** for the tax year.<br>**and**<br>One or both parents have custody. | Entire divorce decree, separation agreement, decree of separate maintenance. If you are living apart from the child's other parent, but you are not divorced or legally separated, send proof that you did not live with the child's other parent for the last six months of the year.<br>Current custody order, completed *Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents* or a similar statement as applicable for 2011. You may need to send more than one document. |
| **If the Person Is:** | **And:** | **Then please send photocopies of the following documents:** |
| Your qualifying child | The child is: your son, daughter, adopted child, a child lawfully placed with you for legal adoption, stepson, stepdaughter, brother, sister, stepbrother, stepsister, foster child placed with you by an authorized placement agency or by court order, or a descendant of any such person (for example, a grandchild, a niece, or a nephew),<br>**and**<br>The child lived with you for more than half of 2011; (temporary absences away from home, such as the child going away to school, count as time lived at home),<br>**and**<br>The child did not provide half of his or her own support for 2011,<br>**and**<br>At the end of 2011, the child is under age 19, or a full time student under the age of 24, or permanently and totally disabled regardless of age. | Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child).<br>To show both you and your child lived together at the same address or addresses for more than half of 2011, send either:<br>● School, medical, daycare, or social service records.<br>● A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.)<br>**You may need to send more than one document** to show that the child lived with you for more than half of the year. |
| **If the Person Is:** | **And:** | **Then please send photocopies of the following documents:** |
| Your qualifying relative | Your relative is any of the relatives listed in the box above or any of the following: father or mother and their ancestors, step-father or step-mother, aunt or uncle, brother- in-law or sister in-law,<br>**and**<br>You provided over half of his or her support in 2011, (except for children of divorced or separated parents),<br>**and**<br>Can not be claimed as a qualifying child by any other person in 2011. | Birth and marriage certificates that verify your relationship to the qualifying relative.<br>If you claim a non-blood related person as a qualifying relative, send proof the person has lived in your home for the entire 12 months of the year. To show both of you lived together at the same address or addresses for all of 2011, send either:<br>● School, medical, daycare, or social service records.<br>● A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.) |

Form **886-H-DEP-2011** (1-2012) Cat No. 58203R www.irs.gov Department of the Treasury-**Internal Revenue Service**

***** Note - Send Us Copies of the Following Documents as Proof You Provided More Than Half of Your Dependent's Total Support: *****

- A statement of account from a child support agency.
- A statement from any government agency verifying the amount and type of benefits you and/or your dependent received for the year.
- Rental agreements or a statement showing the fair rental value of your residence (proof of lodging cost).
- Utility and repair bills (proof of household expenses) with canceled checks or receipts.
- Daycare, school, medical records or bills (proof of child's support) with canceled checks or receipts.
- Clothing bills (proof of child's support) with canceled checks or receipts.

Form **886-H-DEP-2011** (1-2012) Cat No. 58203R www.irs.gov Department of the Treasury-**Internal Revenue Service**

## Supporting Documents To Prove Head of Household Filing Status

You may qualify for Head of Household filing status if you meet the following three tests:
**Marriage Test, Qualifying Person Test, and Cost of Keeping up a Home Test.**

| | | | |
|---|---|---|---|
| **Marriage Test** | **If You Are:** | | **Then send photocopies of the following documents for tax year 2011** |
| | Single | | Go to the Qualifying Person Test and Cost of Keeping up a Home Test. |
| | Divorced or legally separated | | Entire divorce decree, separate maintenance decree, or separation agreement. |
| | Married, but your spouse did not live with you during the last 6 months of tax year 2011 | | Documents verifying your spouse did not live with you during the last 6 months of the year, such as a lease agreement, utility bills, a letter from a clergy member, or a letter from social services. |
| **Qualifying Person Test** (If your relationship with the child is not in this listing, please see Publication 501, Exemptions, Standard Deduction, and Filing Information for more information). | **If the Person Is:** | **And** | **Then send photocopies of the following documents for tax year 2011** |
| | Your child (including an adopted child, or a pending adoption), Your brother or sister, stepbrother or stepsister, or any of their descendants (for (example, grandchild, niece, or nephew), Your eligible foster child (a child placed in your home by an authorized placement agency or by a court order). | You can claim a dependency exemption for the child. The child lived in your home for more than half of 2011 (temporary absences away from home, such as time spent at school, count as time lived at home). Note-- A married child must be your dependent. | Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child). To show both you and your child lived together for more than half of 2011, send: ● School, medical, daycare, or social service records ● A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter.) **Send as many** documents as necessary to show that the child lived with you for more than half of the year. |
| **Cost of Keeping up a Home Test** | **If:** | **And** | **Then send photocopies of the following documents for tax year 2011** |
| | You pass both the marriage test and the qualifying person test, | You paid more than half the cost of keeping up your home for 2011. | Rent receipts, utility bills, grocery receipts, property tax bills, mortgage interest statement, upkeep and repair bills, property insurance statement, and other household bills. |

Form **886-H-HOH-2011** (1-2012) Cat No. 58204C www.irs.gov Department of the Treasury-**Internal Revenue Service**