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# Beyond polemics: Poverty, taxes, and noncompliance

Michelle Lyon Drumbl<sup>1</sup>

## **Abstract**

The earned income tax credit (EITC) is perhaps the most significant refundable credit in the U.S. tax system. Designed as an anti-poverty program, it is a social benefit administered by the Internal Revenue Service (IRS). Studies show it has a positive impact upon the children whose families receive it. Despite its many positives, however, the EITC is a program that for years has been plagued by taxpayer noncompliance. Though it is believed that the majority of EITC noncompliance may be unintentional, public reports of misconduct and fraud hurt the program's image and fuel political rhetoric.

This article unpacks the rhetoric. It describes why the term 'improper payments' is not synonymous with fraud. It places EITC noncompliance within the broader context of the US 'tax gap,' explores motivations for intentional EITC noncompliance, and examines the role of inadvertent error in the overpayment rate.

Building upon theories of taxpayer noncompliance, the article concludes that increasing the amount of information required from all taxpayers (whether self-prepared or using a preparer) at the time of filing will reduce both intentional and unintentional EITC errors. Increasing these requirements, coupled with slowing down the refund process generally, is a reasonable way to improve administration of the EITC program without unduly burdening low-income taxpayers.

Keywords: earned income tax credit, tax compliance, poverty law, tax policy

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## 1. INTRODUCTION

The earned income tax credit (EITC) suffers an image problem. Introduced in 1975, today the EITC reaches more than 27 million households annually and is the most significant earnings-based refundable credit in the Internal Revenue Code.<sup>2</sup> While the EITC has long enjoyed bipartisan support and is lauded as a successful anti-poverty program, it is also criticised for its complexity and its difficulty to administer and enforce.<sup>3</sup> Despite the high audit selection rate for EITC returns<sup>4</sup> and a myriad of approaches aimed at improving accuracy and educating taxpayers, the Internal Revenue Service (IRS or ‘Service’) has been unsuccessful at reducing the rate of EITC overclaims in the last decade.<sup>5</sup> Since 2003, the estimated rate of improper payments on EITC claims has exceeded 20% and ranged as high as 30%.<sup>6</sup> The annual dollar amounts of improper EITC payments have ranged between an estimated minimum of \$8.6 billion (in 2004) to an estimated maximum of \$18.4 billion (in 2010). These figures long have drawn the attention of the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO).<sup>7</sup> These overpayment figures add fuel to the political rhetoric about a tax system in which nearly half of Americans pay no federal income tax.<sup>8</sup>

<sup>2</sup> Refundable Tax Credits, Cong Budget Off Rep No 43767, at 10 (Feb 2013). The Premium Tax Credit, also refundable, is projected to surpass the earned income credit in size. In contrast to the earned income credit, the Premium Tax Credit is an expenditure based, rather than earnings based, credit.

<sup>3</sup> For an overview of the political history of the EITC, including examples of both bipartisan support and criticisms, see Jason Furman, ‘Poverty and the Tax Code’ (2014) 32 *Democracy* 8.

<sup>4</sup> EITC returns are twice as likely to be audited as the average individual income tax return. National Taxpayer Advocate, *2011 Annual Report to Congress* (2011) 300; US Government Accountability Office, GAO-16-92T, *Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government’s Fiscal Position* 14–15 (Oct 1, 2015) (Statement of Gene L Dodaro also noting that ‘about 45 percent of correspondence audits (audits done by mail) that closed in fiscal year 2013 focused on EITC issues.’)

<sup>5</sup> See generally ‘Compliance Estimates for the Earned Income Tax Credit Claimed on 2006–2008 Returns’, IRS Pub 5162 (Aug 2014). This report updates a similar compliance study released in 1999 that had been considered to be ‘the authoritative source on the nature of EITC compliance’: at 1.

<sup>6</sup> Treas Inspector Gen Tax Admin, ‘The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act’ 2014-40-027 (Mar 31, 2014), figure 2, 5. Section 2, below, defines ‘improper payment’ and explains why this measure is controversial.

<sup>7</sup> See, eg, Treas Inspector Gen Tax Admin, ‘Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments’ 2014-40-093 (Sept 29, 2014); GAO-16-92T, ‘Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government’s Fiscal Position’ 15 (Oct 1, 2015).

<sup>8</sup> According to Tax Policy Center estimates published in 2013, 50% of all households paid no federal income tax in 2009. ‘Tax Units with Zero or Negative Income Tax Liability Under Current Law, 2004–2024’ Tax Policy Center, <<http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0228.pdf>>, accessed 21 October 2016. This percentage was estimated to decline over time, but not by more than a few percentage points; See ‘Table T15-0138: Tax Units with Zero or Negative Income Tax Under Current Law, 2011–2025’ Tax Policy Center, <<http://www.taxpolicycenter.org/numbers/Content/PDF/T15-0138.pdf>> accessed 21 October 2016. For a detailed consideration of why EITC noncompliance attracts so much political attention, see Lawrence Zelenak, ‘Tax or Welfare? The Administration of the Earned Income Tax Credit’ (2005) 52 *University of California Los Angeles Law Review* 1867 (in which Zelenak attempts to answer his own question: ‘Why does tolerance for errors that leave individuals with too much money and the government with too little vary according to the tax, transfer, or hybrid nature of the program in which the errors occur?’)

Certainly, the rate of improper payments is troubling; the IRS must continue in its efforts to reduce overpayments. It is important, however, to frame these figures within a larger context of taxpayer noncompliance in the United States. As dollar amounts, the EITC overclaim figures pale in comparison to the estimated annual \$122 billion underreporting tax gap attributable to business income on individual returns,<sup>9</sup> or to the \$40 to \$70 billion dollars that are estimated to be lost annually to evasion through the use of offshore tax havens and tax shelter abuses.<sup>10</sup> As a percentage of the gross tax gap, improper EITC claims comprise perhaps only 3.5% of the total.<sup>11</sup>

This article explores the nature and nuances of EITC noncompliance, identifies ways in which it is both different than and similar to other types of taxpayer noncompliance, critiques certain of the Service's EITC enforcement efforts, and discusses ways in which the IRS might improve upon its EITC audit selection and enforcement mechanisms in the future. It concludes by proposing a program that would allow first-time EITC claimants the option to submit substantiating documentation with the return in order to receive an expedited refund.

## 2. WHAT WE KNOW (AND DON'T) ABOUT THE EXTENT OF TAXPAYER NONCOMPLIANCE

This section provides a general overview of taxpayer noncompliance, the US tax gap, and the nature of EITC noncompliance. It is believed that the majority of EITC errors are inadvertent, and this is an important consideration to bear in mind when crafting policy solutions.<sup>12</sup> That said, a significant portion of improper EITC claims are

<sup>9</sup> The most recent tax gap figures show that, as of the 2006 data, 56% of business income that should have been reported on individual tax returns went unreported. Robert Greenstein, John Wancheck and Chuck Marr, 'Reducing Overpayments in the Earned Income Tax Credit' at 5 (Dec 1, 2015). The \$122 billion in estimated underreported business income is 'about ten times the estimated EITC overpayments that year.' See also IRS, *Tax Gap for Tax Year 2006*, IRS Pub 2012-4, <[http://www.irs.gov/pub/newsroom/overview\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf)> accessed 21 October 2016.

<sup>10</sup> The 2006 Tax Gap study doesn't pull this out separately in its data, and TIGTA has criticised the IRS for that. See *How Much Tax Cheating is Really Going On?*, FORBES.COM (Sept 16, 2013 at 3:23 pm). The TIGTA report mentions the \$40 to \$70 billion figure and cites to Jane G Gravelle, Cong Research Serv, *Tax Havens: International Tax Avoidance and Evasion* (July 9 2009). See also Dave Rifkin, 'An Overview of the "Tax Gap"' (2008) Scholarship @ Georgetown Law at <[http://scholarship.law.georgetown.edu/fwps\\_papers/77](http://scholarship.law.georgetown.edu/fwps_papers/77)> accessed 21 October 2016. This article, which used the 2001 data available at the time: 'An estimated \$50 to \$100 billion (15 to 30 percent) of the \$345 billion tax gap is due to offshore tax haven and tax shelter abuses.' The IRS's most recent net tax gap estimate (defined by the IRS as 'the amount of true tax liability that is not paid on time' less 'account receipts from enforcement activities and late payments'), provided using 2006 data, is \$385 billion. See 'IRS Releases 2006 Tax Gap Estimates', FS-2012-6, Jan 2012. Of the \$385 billion, \$28 billion is attributable to credits on individual income tax returns, while \$122 billion is attributable to underreporting of business income on individual income tax returns. IRS, *Tax Gap 'Map' Tax Year 2006*, see <[http://www.irs.gov/pub/newsroom/tax\\_gap\\_map\\_2006.pdf](http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf)> accessed 21 October 2016.

<sup>11</sup> Rifkin (above n 10) notes later 'The IRS estimates that approximately \$32 billion [ie, approximately 10%] of the tax gap is due to errors in claiming tax credits and deductions.' This overstates the portion attributable to the EITC in that includes all credits and deductions (again, this is 2001 data). My figure of 3.5% is based on the most recent EITC improper payment estimates (using the 'maximum' figure of 15.6 billion) as compared to the most recent gross tax gap estimate of \$450 billion.

<sup>12</sup> Robert Greenstein, John Wancheck and Chuck Marr, 'Reducing Overpayments in the Earned Income Tax Credit', Center on Budget and Policy Priorities (CBPP), (Apr 7, 2014) (citing two older studies on this point: Janet Holtzblatt & Janet McCubbin, 'Issues Affecting Low-Income Filers' in Henry Aaron & Joel Slemrod (eds), *The Crisis in Tax Administration* (Brookings Institution Press, 2004); and Jeffrey Liebman, *Noncompliance and the EITC: Taxpayer Error or Taxpayer Fraud* (Harvard University, 1995). See also Leslie Book, 'The Poor and Tax Compliance: One Size Does Not Fit All' (2003) 51

intentional and/or fraudulent, just as taxpayers intentionally underreport or hide income in other contexts.<sup>13</sup> Notably, it is important to understand and appreciate this distinction, because the two ends of the spectrum present different enforcement challenges and should be addressed by different policy prescriptions.

## 2.1 Estimating taxpayer noncompliance: The ‘tax gap’

The US revenue collection system is largely dependent on voluntary compliance. The voluntary nature of the compliance is bolstered by such mechanisms as withholdings, third-party reporting, and the deterrent effect of selective audit procedures. As a means of evaluating the effectiveness of the system, the Service has developed statistical methods to periodically estimate the ‘voluntary compliance rate’ (VCR) and specific types of noncompliance.<sup>14</sup> These estimates, known as the ‘tax gap’, are compiled and released every several years. There is a significant time-lag between the statistics and the reporting. The most recent tax gap report was issued in 2012 (using data from tax year 2006) as an update to the estimates released in 2006 (using data from tax year 2001).

The Service provides estimated figures for the ‘gross tax gap’ and the ‘net tax gap.’ The former is defined as ‘the amount of true tax liability faced by taxpayers that is not paid on time’, while the latter is the amount of tax liability that is not paid or subsequently collected through Service enforcement.<sup>15</sup> The estimated VCR for tax year 2006, calculated on the gross tax gap, was 83.1%; the IRS concluded this to be ‘statistically unchanged’ from the 2001 estimates.<sup>16</sup>

In its 2006 estimate, the IRS reported a gross tax gap of \$420 billion and a net tax gap of \$365 billion—representing a noncompliance rate of 14.5 percent.<sup>17</sup> Commentators

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*Kansas Law Review* 1145, 1165. (‘Somewhat surprisingly, there is little data relating to how much EITC noncompliance is intentional, although there is strong anecdotal evidence that a significant amount of EITC noncompliance is caused by taxpayer ignorance or mistake.’) In his July 17, 2003 testimony to Congress, Leonard Burman framed EITC noncompliance within the context of all taxpayer noncompliance: ‘while the noncompliance among EITC recipients is troubling, there is no reason to think that it is any worse than exists among the taxpaying public generally, and is probably lower than the noncompliance rate for certain classes of individuals and businesses.’ ‘Waste, Fraud, and Abuse: Hearing Before the Comm On Ways and Means’ 108<sup>th</sup> Cong, 1 (2003) (statement of Leonard Burman).

<sup>13</sup> See generally Michelle L Drumb, ‘Those Who Know, Those Who Don’t, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns’ (2013) 11 *Pittsburgh Tax Review* 113.

<sup>14</sup> See generally Internal Revenue Serv, Off of Research, *Overview of the Tax Gap for Tax Year 2006* (Jan 6, 2012), <[http://www.irs.gov/pub/newsroom/overview\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf)> accessed 9 September 2014) (hereinafter ‘IRS Overview 2006’); Treas Inspector Gen for Tax Admin, ‘The Internal Revenue Service Needs to Improve the Comprehensiveness, Accuracy, Reliability, and Timeliness of the Tax Gap Estimate’ 2013-IE-R008 (Aug 21, 2013) (hereinafter TIGTA, ‘Tax Gap’).

<sup>15</sup> IRS Overview 2006, above n 14, at 1.

<sup>16</sup> Ibid. Notably, an 83.1% compliance rate is high compared to many European nations. See, eg, JD Tuccille, ‘Globally Speaking, American Taxpayers Are Pushovers’, *reason.com*, Apr 17, 2012 12:33 pm (reporting rates from a number of countries, including: the United Kingdom (77.97%); Switzerland (77.70%); France (75.38%); Austria (74.80%); Netherlands (72.84%); Belgium (70.15%); Portugal (68.09%); Germany (67.72%); and Italy (62.49%)).

<sup>17</sup> Billy Hamilton, ‘How Big a Problem Is the Underground Economy?’ (2014) 73 *State Tax Notes* 847, 848. (‘no one knows precisely how large the underground economy is.’)

note, however, that the IRS figure is ‘at best a sophisticated guess’, in part because no one knows the extent of the underground economy.<sup>18</sup>

The Service divides the tax gap into three categories: (1) the non-filing gap; (2) the underreporting gap; and (3) the underpayment gap.<sup>19</sup> The underreporting gap is by far the largest of these three categories, accounting for \$376 billion of the tax gap, while non-filing and underpayment account for \$28 billion and \$46 billion, respectively.<sup>20</sup> The individual income tax accounts for the largest segment of the gross tax gap (an estimated \$296 billion) as compared to corporate income taxes, employment taxes, estate taxes, and excise taxes.<sup>21</sup> EITC noncompliance is categorised as underreporting of individual income tax, specifically, an overstated offset of tax due.<sup>22</sup>

Unsurprisingly, the Service finds that ‘compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding’.<sup>23</sup> Thus, noncompliance is more prevalent with regard to amounts subject to little or no information reporting, such as sole proprietor income and rents. For example, the Service estimates that \$179 billion (comprising nearly 40% of the gross tax gap) is lost due to misreporting of individual business income and related self-employment taxes.<sup>24</sup>

The Service estimates that the portion of the underreporting gap attributable to credits is \$28 billion, which is 6% of the overall gross tax gap.<sup>25</sup> This figure includes all credits, not just EITC. Combining the tax gap estimates with other available data on EITC overclaims, I estimate that EITC overclaims account for approximately 3.5% of the gross tax gap.<sup>26</sup>

As discussed in the next section, the Service is required to collect and report detailed information annually on EITC overclaims as part of the federal government’s program to reduce improper payments. A primary source of this EITC data is the IRS’s National Research Program (NRP).<sup>27</sup> NRP estimates are based upon audit data, including audits in which the taxpayer did not participate or in which the taxpayer

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<sup>18</sup> Ibid. Hamilton cites two academic studies, one estimating the underground economy may be as much as \$2 trillion annually, and the other estimating a \$1 trillion shadow economy. The former study also estimated the federal tax gap is higher than what the IRS estimates: somewhere between \$450 and \$500 billion, with noncompliance rates of 18 to 19 percent.

<sup>19</sup> IRS Overview 2006, above n 14, at 1. The underpayment gap is based on actual amounts, while the other categories are estimated amounts.

<sup>20</sup> Ibid table 1.

<sup>21</sup> Ibid.

<sup>22</sup> TIGTA, ‘Tax Gap’ above n 14 at n 9. On the ‘Tax Gap Map’, EITC noncompliance presumably is reflected in the subcategory of ‘credits’. See IRS, above n 10.

<sup>23</sup> IRS Overview 2006, above n 13 at 1. The IRS reports that amounts subject to substantial information reporting and withholding, such as wages reported on W2s, are accurately reported by taxpayers on individual returns nearly 99% of the time; US Govt Accountability Office, GAO 12-651T, Tax Gap: Sources of Noncompliance and Strategies to Reduce It (2012), 5.

<sup>24</sup> US Govt Accountability Office, GAO 12-651T, Tax Gap: Sources of Noncompliance and Strategies to Reduce It (2012). See also IRS, above n 10.

<sup>25</sup> IRS, above n 10.

<sup>26</sup> My figure of 3.5% is based on the most recent EITC improper payment estimates (using the ‘maximum’ figure of 15.6 billion) as compared to the most recent gross tax gap estimate of \$450 billion.

<sup>27</sup> Treas Inspector Gen for Tax Admin, ‘The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments’ 2013-40-084 (Aug 28, 2013), 8-9 (hereinafter TIGTA, ‘Not in Compliance’.)

prevailed after the initial audit had been closed.<sup>28</sup> These studies furthermore present imperfect information insofar as they do not capture cases of undetected EITC overclaims (those that were not detected by audit). Despite these shortcomings, the NRP study nonetheless provides concrete data as to the types of errors that the IRS discovers and identifies. While this is helpful in comprehending the types of overclaims, unfortunately the reports do not shed light on whether these overclaims are intentional or unintentional.

## 2.2 Improper payments and EITC noncompliance

The Improper Payments Information Act of 2002 (IPIA) requires federal agencies to annually review and identify those programs that are ‘susceptible to significant improper payments.’<sup>29</sup> The US Office of Management and Budget has declared the EITC to be a ‘high-risk’ program. As a result of this designation, the Service is required to undertake detailed studies to identify and reduce the level of erroneous EITC payments and has been doing so since fiscal year 2003.

Two important caveats must be noted regarding the improper payment rate calculations. First, ‘improper payment’ estimates are not intended to be estimates of fraud.<sup>30</sup> The estimates encompass both intentional and unintentional overclaims. However, this nuance is sometimes overlooked or misunderstood by critics who conflate improper payments with fraud.<sup>31</sup> Second, improper payment rate estimates

<sup>28</sup> [National Taxpayer Advocate] Nina Olson has reported that in over 40% of the cases where the IRS examiners classified an EITC claim as invalid but the filer later received assistance from the Taxpayer Advocate Service (a component of the IRS that the National Taxpayer Advocate oversees) in appealing the ruling, the ruling was reversed.’ Greenstein, Wancheck, and Marr, above n 12 at 4. See also Book, ‘One Size Does Not Fit All’, above n 12, 1170, noting that taxpayer non-response to IRS examination requests make it hard to determine the extent of overclaims and EITC noncompliance.

<sup>29</sup> Improper Payments Information Act of 2002 (IPIA), Pub L No 107-300, 116 Stat 2350. IPIA has been amended and expanded by two subsequent acts of legislation and a recent executive order: Improper Payments Elimination and Recovery Act of 2010 (IPERA), Pub L No 111-204, 124 Stat 2224; Improper Payments Elimination and Recovery Act of 2012, Pub L No 112-248, 126 Stat 2390; and Reducing Improper Payments and Eliminating Waste in Federal Programs, Executive Order 13520 (November 20, 2009).

<sup>30</sup> US Govt Accountability Office, ‘Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges’, GAO-11-575T (2011), 5: ‘Fraud consists of intentional acts of deception with knowledge that the action or representation could result in an inappropriate gain.’ <<http://www.gao.gov/new.items/d11575t.pdf>> accessed 21 October 2016.

<sup>31</sup> As one example, US Senator Ron Johnson of Wisconsin was quoted as saying in a January 2014 speech: ‘Do you realize the average rate of fraud, whether it’s in the Earned Income Tax Credit or Medicare or Medicaid, across the board, food stamps — the average rate of fraud in those programs is 20 to 25 percent?’ When the *Milwaukee Journal Sentinel* asked for numbers to substantiate the claim, his policy advisor clarified that the senator ‘meant error rates in the various programs, not actual fraud.’ Senator Johnson then followed with a statement to the newspaper that ‘when he made his claim, he was ‘primarily referencing fraud’ in the Earned Income Tax Credit program.’ His statement continued: ‘I made too broad a generalization to other mandatory spending programs based on reports in the press and from colleagues that are not supported by other inspector general reports. I strive hard to convey accurate information that is fully supportable, and I was mistaken in making this overly broad generalization.’ Tom Kertscher, ‘PolitiFact: Testing Ron Johnson claim of 20% to 25% fraud in public assistance programs’, *Milwaukee Journal Sentinel Online*, Jan 20, 2014 at 5 am, <<http://www.politifact.com/wisconsin/statements/2014/jan/20/ron-johnson/fraud-claims-20-25-cents-every-1-spent-four-govern/>> accessed 21 October 2016. More recently, Rand Paul conflated ‘improper payment’ with fraud and also overstated the dollar amounts: ‘When you look at the earned income tax credit, it has about a 25 percent fraud rate. We’re looking at \$20 billion to \$30 billion.’ Steve Contorno, ‘Rand Paul says Earned Income Tax Credit has 25 percent fraud rate that costs up to \$30 billion’, 30 January, 2015 at 1:27 pm, <<http://www.politifact.com/truth-o->

are intended to include not only overpayments, but also underpayments and payments that were not adequately documented.<sup>32</sup> Thus in the EITC context, the improper payment rate should include figures for taxpayers who are eligible for EITC but fail to claim it, or claim less than they are entitled to claim. However, TIGTA has reported that the IRS has not provided estimates of EITC underpayments<sup>33</sup> as required by Executive Order 13520.

The EITC occupies a somewhat unique function in that it is housed in the Internal Revenue Code but serves as a social program to provide anti-poverty payments to low-income working individuals. Lawrence Zelenak has described the EITC as ‘a welfare program that happens to be administered through the tax system,’ and has contrasted the taxpayer’s self-declaration for eligibility for EITC through tax filing with the process for applying for government benefits through other agencies, which generally requires a claimant to establish eligibility to the agency prior to the receipt of any benefits.<sup>34</sup> With that function in mind, the high improper payment rate must also be viewed relative to the EITC program’s very low administrative costs, which approximate 1% of the total program benefits. Contrast this to other social welfare spending programs in the US that have far more direct contact with their recipients, resulting in lower overpayment rates but far higher administrative costs: the Supplemental Nutrition Assistance Program (SNAP), for example, is cited as having a typical overpayment rate of less than 5%, with an administrative cost that is more than 9% of the program’s benefits.<sup>35</sup>

The Treasury Department has identified several factors that serve as barriers to reducing EITC noncompliance, with no single of these ‘considered the primary driver of program error.’<sup>36</sup> These factors include: the complexity of the tax law; structure of the EITC; confusion among eligible claimants; high turnover of eligible claimants; unscrupulous tax return preparers; and fraud.<sup>37</sup> Note that these factors include barriers to reducing both intentional and unintentional noncompliance. As to unintentional noncompliance, in January 2014, IRS Commissioner John Koskinen addressed the complexity of EITC provisions for taxpayers with children and went on to state: ‘Our biggest problem isn’t that people are stealing the money who have no right to it at all.

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meter/statements/2015/jan/30/rand-paul/rand-paul-says-earned-income-tax-credit-has-25-per/> accessed 25 September 2015>.

<sup>32</sup> GAO-11-575T, above n 30, 5.

<sup>33</sup> TIGTA, ‘Not in Compliance’ above n 27, 3, 9. The IRS report responding to the TIGTA report ‘indicated that it intends to incorporate underpayments into its estimates beginning with the Fiscal Year 2013 estimate’: at 9.

<sup>34</sup> Zelenak, above n 8, 1903.

<sup>35</sup> See Congressional Budget Office, *Refundable Tax Credits* (2013), <[http://www.cbo.gov/sites/default/files/cbofiles/attachments/RefundableTaxCredits\\_One-Col.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/RefundableTaxCredits_One-Col.pdf)> at 21, stating that ‘federal and state governments together spend approximately \$7 billion annually to administer the program (which paid out approximately \$75 billion in benefits in fiscal year 2011)’. Hereinafter ‘CBO Report’, access 21 October 2016.

<sup>36</sup> US Dept of Treasury, *Fiscal Year 2013, Agency Financial Report*, (Dec 16, 2013), 214. See <<https://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/2013%20Department%20of%20the%20Treasury%20AFR%20Report%20v2.pdf>> accessed 21 October 2016

<sup>37</sup> Ibid.

It is that the program is so complicated that people are inadvertently having difficulty figuring out where they fit and where they don't.<sup>38</sup>

The most recent NRP study, published in August 2014, provides compliance estimates for EITC claimed on returns in tax years 2006–2008 and found ‘no discernible change in the overall tendency for noncompliance between 1999 and 2006–2008’.<sup>39</sup> It reported that the majority of taxpayers (an estimated 79–85%) who overclaim the EITC are in fact altogether ineligible for the credit, as opposed to overstating the amount of money for which they are eligible.<sup>40</sup> Among ‘known errors’, the NRP study identifies the most common error as income misreporting (appearing in 67% of returns with known errors, and cited as the only error in 51% of identified overclaims), particularly self-employment income misreporting. It is followed by qualifying child errors (occurring in 30% of known overclaim returns, 15% of the time as the only error), most commonly errors relating to the residency requirement. Lastly, the third-most common type of error is incorrect filing status. While qualifying child errors are less common than income misreporting errors, the former constitutes a higher percentage of overclaims by dollar amount.

While the dollar amounts of EITC overclaims are staggering in the aggregate, it is important to keep perspective as to the individual noncompliance amounts. The NRP study reports that ‘[a] large fraction’ (between 38% and 44%) of the taxpayers that overclaim the EITC ‘do so by less than \$500’.<sup>41</sup>

The NRP study also provides noncompliance estimates according to who prepares EITC returns. Significantly, the study finds ‘no statistical difference between self-prepared and paid-preparer returns in either the frequency of overclaims or the dollar overclaim percentage.’<sup>42</sup> Among those who do use a preparer, the study notes that ‘EITC claimants are more likely to use an unenrolled return preparer (43 percent) or a preparer from a national tax return preparation firm (35 percent) than non-claimants (28 percent and 14 percent, respectively).’<sup>43</sup> Among those taxpayers who use a preparer, the report highlights its estimate that returns prepared by IRS programs including Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) have ‘much lower overclaim percentages’ than other types of preparers, with unenrolled return preparers representing ‘the highest frequency and percentage of EITC overclaims.’<sup>44</sup> The report cautions, however, that it cannot account for the *reasons* for these differences, and suggests this might reflect selection bias arising from the taxpayer’s choice of preparer and does not imply that certain types of preparers ‘are either less capable or more unscrupulous.’<sup>45</sup>

To be sure, EITC overclaims are a significant issue, even if the improper payments caveats described herein suggest that the magnitude of the issue is overstated. The

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<sup>38</sup> William Hoffman, ‘Koskinen Kicks off Filing Season with Spotlight on EITC’ (2014) 142 *Tax Notes* 617.

<sup>39</sup> ‘Compliance Estimates for the Earned Income Tax Credit’, above n 5, iii.

<sup>40</sup> *Ibid* iv.

<sup>41</sup> *Ibid*.

<sup>42</sup> *Ibid* 24.

<sup>43</sup> *Ibid*.

<sup>44</sup> *Ibid*.

<sup>45</sup> *Ibid*.

next section considers intentional taxpayer noncompliance generally and how intentional EITC noncompliance may and may not be different.

### 3. IS INTENTIONAL EITC NONCOMPLIANCE SIMILAR TO OTHER TYPES OF INTENTIONAL TAXPAYER NONCOMPLIANCE?

This section compares two types of intentional noncompliance: EITC noncompliance and sole proprietor noncompliance. It provides a brief overview of selected theories of noncompliance. In doing so, the article hopes to highlight that EITC misconduct is not fundamentally different than other types of tax misconduct.

Theories and models of tax compliance include: deterrence, tax morale,<sup>46</sup> norms (including group identity and also attitudes toward government),<sup>47</sup> complexity of the Code, the role of tax return preparers,<sup>48</sup> and opportunities.<sup>49</sup> Certain theories or models are more applicable to studies of specific types or contexts of taxpayer noncompliance. Thus, not all theories necessarily fit well to all types of noncompliance.

Though not intended as a comprehensive review of the research on this subject, this section examines some of what the IRS and academic researchers have studied and written about the motivation behind intentional taxpayer noncompliance in the specific context of sole proprietors. In doing so, it seeks to draw upon some connections specific to intentional EITC noncompliance.

At first blush, it may seem odd to compare sole proprietors and EITC claimants — one group earns cash and fails to report it accurately, while the other claims a social benefit and fails to determine eligibility accurately. Intentionally noncompliant sole proprietors deprive the fisc of revenue by underreporting, while intentionally noncompliant EITC claimants contribute to the tax gap by overstating or claiming credits to which the taxpayer knows he or she is not entitled.

This article posits that intentional EITC noncompliance in fact shares much in common with intentional sole proprietor noncompliance. With both sets of taxpayers, there is a lack of information reporting available to the government, which provides opportunities to cheat and perhaps evade detection. With both sets of taxpayers, there is evidence to suggest that community norms and/or a sense of systemic fairness or unfairness may drive decisions about intentional noncompliance, and evidence to suggest the limitations of deterrence-based IRS initiatives.

<sup>46</sup> For a literature review of ‘tax morale,’ see Marjorie Kornhauser, ‘Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers’ *2007 Annual Report to Congress* (2007) 138. Kornhauser emphasises that ‘tax morale refers to taxpayer attitudes and beliefs—not behaviors’: at 142.

<sup>47</sup> Susan Morse, Stewart Karlinsky and Joseph Bankman, ‘Cash Businesses and Tax Evasion’ (2009) 20 *Stanford Law & Policy Review* 37, 40–41.

<sup>48</sup> Sagit Leviner, ‘The Role Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation with Policy Implications’ (2012) 60 *Buffalo Law Review* 1079; Book, ‘One Size Does Not Fit All’, above n 12, 1145.

<sup>49</sup> Kent Smith and Karyl Kinsey, ‘Understanding Taxpayer Behavior: A Conceptual Framework with Implications for Research’ (1987) 21 *Law & Society Review* 639, 642; Robert Kidder and Craig McEwen, ‘Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance’ in Jeffrey A Roth and John T Scholz (eds), *Taxpayer Compliance: Social Science Perspectives, Volume 2* (University of Pennsylvania Press, 1989) 47.

At least with respect to the concern of *intentional* noncompliance, studies of sole proprietor noncompliance may provide useful insights and analogies as to intentional EITC noncompliance.

### 3.1 Sole proprietor noncompliance

‘The problem [of the underground economy] is as old as the US tax system, and probably as old as taxation generally.’<sup>50</sup>

The tax gap data discussed in section 2 above indicates a correlation between taxpayer compliance and information reporting, finding high levels of noncompliance among sole proprietors.<sup>51</sup> Having identified this as the largest portion of the tax gap, the Taxpayer Advocate Service (TAS) conducted both a national survey and a community survey of sole proprietors, and it linked the results of these surveys to IRS estimates of the survey respondent’s actual tax compliance.<sup>52</sup> This national survey sought to understand why those sole proprietors who pay their taxes voluntarily comply with the law, because prior research led TAS to conclude that increasing voluntary compliance is ‘the only practical way to reduce the tax gap’.<sup>53</sup> Accordingly, the national survey was designed to investigate six specific factors identified in previous research as ‘potentially driving voluntary compliance’:<sup>54</sup>

1) deterrence (the perceived likelihood of getting caught outweighs the economic gain from cheating); 2) norms (taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying); 3) tax morale (those who trust the government and feel the tax laws and procedure are fair and fairly enforced may be more likely to feel a moral obligation to comply, even if the outcome of those procedures is unfavourable); 4) trust (taxpayers may use unfair rules or procedures, unreasonable penalties, bad experiences with the IRS, or a lack of faith in government or the IRS to justify either reducing efforts to comply or active noncompliance); 5) complexity and convenience (taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance); and 6) preparers and other third parties (tax preparers may have a significant effect on tax compliance).

From the survey results, TAS concluded that the primary types of noncompliance among sole proprietors are: 1) social noncompliance (taxpayers acting ‘in accordance with social norms and peer behaviour’) and 2) symbolic noncompliance (taxpayers ‘perceived the law or the IRS as unfair’).<sup>55</sup> With respect to both types of

<sup>50</sup> Hamilton, above n 17.

<sup>51</sup> See text accompanying notes 23–24, above.

<sup>52</sup> National Taxpayer Advocate, ‘Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results’, *2012 Annual Report to Congress* (2012) (hereinafter ‘Factors Influencing Compliance’). In its executive summary of the survey, TAS describes the survey as significant in that: ‘a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent’s actual tax compliance...provid[ing] an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates’: at 4.

<sup>53</sup> National Taxpayer Advocate, ‘Researching the Causes of Noncompliance: An Overview of Upcoming Studies’, *2010 Annual Report to Congress* (2010) 75 (hereinafter ‘Researching the Causes’).

<sup>54</sup> ‘Factors Influencing Compliance,’ above n 52, 7–8, citing ‘Researching the Causes’, above n 53, 71–88.

<sup>55</sup> *Ibid* 7, 38.

noncompliance, the survey associated taxpayers with a distrust of government.<sup>56</sup> From these results, TAS recommended proposals that would promote trust in government and the IRS, including tax simplification and taxpayer education that is normative rather than technical.<sup>57</sup> TAS also concluded that ‘[t]raditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behaviour (ie, behaviour that may be addressed by increasing deterrence) is prevalent.’<sup>58</sup>

In a similar vein, an earlier qualitative study of noncompliance among cash business taxpayers in the US conducted by Susan Clearly Morse, Stewart Karlinsky and Joseph Bankman noted the same connection between information reporting and compliance (‘[b]y far the most important determinant of tax compliance is income source’) and connected this relationship to opportunity as a causal factor:

The strong relationship between evasion and income source suggests that the primary causal factor that explains evasion is opportunity. Employees whose employers comply with wage reporting rules cannot cheat successfully and so such employees do not cheat. Individual business owners can cheat successfully ... and, in the aggregate, individual business owners do cheat.<sup>59</sup>

Morse, Karlinsky and Bankman additionally cite peer influence, social norms, and tax preparer influence—not complexity, morality, or opposition to government policy—as the predominate drivers of cash business noncompliance.<sup>60</sup> Their qualitative study concluded that ‘tax cheating follows opportunity, not complexity or immorality, and it is shaped by peer influence’.<sup>61</sup> The authors note that ‘opportunity’ includes ‘the low-perceived likelihood of detection and penalty’ and further conclude that ‘[t]he perceived equity of the tax system has less importance, and the complexity of the tax law does not appear to play a significant role’.<sup>62</sup> The taxpayers they interviewed reported that they learned tax evasion tactics from family and friends, and that tactics are ‘shared wisdom among cash business owners’.<sup>63</sup> Interviewees noted a readiness to advise other business owners, with one stating: ‘I tell people everything, like never, ever deposit the cash.’<sup>64</sup>

Other interviewees involved in cash business rationalised intentional noncompliance as a form of rough justice: ‘roughly equivalent to a sensible government subsidy for

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<sup>56</sup> Ibid 38.

<sup>57</sup> Ibid 39.

<sup>58</sup> Ibid. The previous research on noncompliance, published in 2010, was similarly sceptical about traditional enforcement measures: ‘Deterrence may be least effective among taxpayers operating in the cash economy — the largest component of the tax gap — precisely because the IRS cannot reliably detect unreported income that is not subject to information reporting. Deterrence will also be ineffective with respect to taxpayers whose noncompliance is unintentional.’ ‘Researching the Causes’, above n 53, 76.

<sup>59</sup> Morse, Karlinsky and Bankman, above n 47, 38.

<sup>60</sup> Ibid 65.

<sup>61</sup> Ibid 67.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid 65.

<sup>64</sup> Ibid.

small businesses’<sup>65</sup> or analogous to ‘direct subsidies to farmers or bail-outs to various international businesses’.<sup>66</sup>

The characterisations described in these two studies of sole proprietors bear important similarities to observations about intentional EITC noncompliance. The next section outlines selected studies and scholarship on EITC noncompliance, with an emphasis on intentional noncompliance in particular.

### 3.2 Intentional EITC noncompliance

Intentional EITC noncompliance presents challenges similar to what the Service faces with sole proprietor noncompliance: in both cases, the lack of information reporting creates a knowledge asymmetry between IRS and taxpayer. Just as the IRS cannot readily verify how much cash is received in a small business, it also cannot easily verify the fact-intensive elements of EITC eligibility.<sup>67</sup>

Among those taxpayers who knowingly claim refundable credits (including EITC) to which they know they are not entitled, it is reasonable to believe the same general factors drive noncompliance as those identified in the TAS research:<sup>68</sup> 1) the likelihood of getting caught; 2) norms; 3) tax morale; 4) trust; 5) complexity and convenience; and 6) preparers and other third parties.

In his scholarship, Book has proposed a typology of low income and EITC noncompliance<sup>69</sup> and identified specific structural incentives for certain types of intentional EITC noncompliance.<sup>70</sup> Book’s work provides a useful tool from which one can draw comparisons between sole proprietors and EITC claimants and also frame policy prescriptions.

Among other categories in his typology, Book identified two categories of EITC noncompliance that were also named by TAS as the primary types of noncompliance among sole proprietors:<sup>71</sup> (1) social noncompliance and (2) symbolic noncompliance.

Of social noncompliance, Book writes: ‘if taxpayers believe that others are not complying, then taxpayers will resent complying and be more inclined to cheat.’<sup>72</sup> Conversely, ‘to the extent that taxpayers believe others are complying, then taxpayers will not take advantage of the tax system.’<sup>73</sup> Thus, it follows that the very fact that

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<sup>65</sup> Ibid.

<sup>66</sup> Ibid 67.

<sup>67</sup> Written Testimony of John Koskinen, Commissioner Internal Revenue Service, before the House Ways and Means Committee Subcommittee on Oversight on the 2014 Filing Season and Improper Payments, May 7, 2014 at 12 (noting ‘the significant degree of difficulty in enforcing compliance with the EITC, which derives in large part from its eligibility requirements. EITC eligibility depends on items that the IRS cannot readily verify through third-party information reporting, including marital status and the relationship and residency of children.’)

<sup>68</sup> ‘Factors Influencing Compliance,’ above n 51, 7-8, citing ‘Researching the Causes’, above n 53, 71–88.

<sup>69</sup> Book, ‘One Size Does Not Fit All,’ above n 12, 1167–1177. In this article, Book builds upon the work of sociologists Robert Kidder and Craig McEwen by developing their typology of taxpayer noncompliance into a ‘typology of EITC noncompliance’.

<sup>70</sup> Leslie Book, ‘Freakonomics and the Tax Gap: An Applied Perspective’ (2007) 56 *American University Law Review* 1163.

<sup>71</sup> ‘Factors Influencing Compliance,’ above n 52, 39.

<sup>72</sup> Book, ‘One Size Does Not Fits All’, above n 12, 1176, citing Dan Kahan’s reciprocity theory.

<sup>73</sup> Ibid.

EITC overclaims have become a political issue will itself lead to future taxpayers making intentional overclaims. As taxpayers read headlines highlighting EITC fraud, it undermines their faith in the system and creates a feeling that they are losing out by being an honest taxpayer.

A quick Google search will provide one insight into the culture of intentional EITC noncompliance, as well as the public perception of this noncompliance. As but one example, a website called Twitchy compiled a list of 22 tweets in January 2013 of 'taxpayers looking to borrow children for tax credit', commenting with a hint of disdain: 'Gotta love American ingenuity. Yeesh.'<sup>74</sup> Upon closer examination, however, not all of the tweets linked were examples of noncompliance. The tweets did include several solicitations ('Can I claim ur kid on my taxes ill give u 1500'; 'Anybody have an extra kid I can claim on my taxes? I'll split the cash'; and 'Does someone have a kid I can use on my taxes this year? Thanks ahead of time.'), but also tweets more in the nature of wishful thinking ('I need to find a single mom soon...so I can claim her kid on my taxes asap') or laments ('I take her kid to school off and on. The least she can do is let me claim her kid on my taxes' and 'the only reason why i would want a kid right now is to get more money on my taxes lol'.)<sup>75</sup>

The concept of claiming someone else's child on one's taxes stems from the possibility that the parents who reside with and support the child, and thus would be statutorily entitled to claim the child, will not benefit from doing so. The inability to benefit from a credit that other people benefit from, coupled with the perception that it is common for other people to wrongly benefit from claiming children that they are not entitled to claim, can foster the climate of intentional noncompliance. Note that this is very similar to the sole proprietor context, in which taxpayers who were interviewed admitted that they cheated on their taxes and justified it by pointing out that other people also cheat.

Book identified two common instances in which taxpayers fail to meet eligibility requirements and are left feeling frustrated, leading them to engage in symbolic noncompliance. He described these as 'structural incentives within the EITC' that create the motivation to cheat.<sup>76</sup> His first example is the taxpayer who has more than the maximum number of qualifying children.<sup>77</sup> Because the statute limits the benefit to a maximum number of children, Book noted that taxpayers who have additional children feel frustrated and are 'tempted to 'share' the benefits with related parties who may have earned income, but fewer than two qualifying children on their own.'<sup>78</sup> His second example is the non-custodial parent who is connected to the children but fails to meet the residency requirement.<sup>79</sup> While a non-custodial parent might be eligible to claim his children as dependents and claim them for the child tax credit, he cannot claim his children for the more valuable earned income credit, and he cannot

<sup>74</sup> <<http://twitchy.com/2013/01/04/rent-a-kid-taxpayers-looking-to-borrow-children-for-tax-credit>> accessed 11 March, 2015). Some of the tweet links were still active, while others had been removed. Tweets on file with the author.

<sup>75</sup> Ibid.

<sup>76</sup> Book, 'Freakonomics', above n 70, 1176–1177.

<sup>77</sup> For tax years beginning after 2008, the maximum number of qualifying children for EITC is three. IRC §32(b)(1). From 1993 until 2007, the maximum number of qualifying children was two.

<sup>78</sup> Book, 'Freakonomics', above n 70, 1177.

<sup>79</sup> Ibid 1176–1177.

file using head of household status based upon his children.<sup>80</sup> This is true despite the fact that the non-custodial parent may be required to pay child support for his children. As Book noted, Taxpayer Advocate Nina Olson made a legislative recommendation many years ago to allow the non-custodial parent a credit in this situation,<sup>81</sup> but Congress has not followed her recommendation, so the structural incentive remains.

In my work directing a low-income taxpayer clinic, I have seen or heard of instances of both of these types of symbolic noncompliance. But I am even more familiar with a third scenario, in which the taxpayer who would be entitled to claim the children has little or no earned income, but no one else is legally entitled to claim the children. In some cases this is because the taxpayer receives social security disability payments, which are not earned income as defined in section 32(c)(2). It may also be because the taxpayer is a mother who is out of the workforce for a period of years because she cares for her young children. In these cases, there may be a boyfriend in the household who does have earned income and plays a significant role in supporting his girlfriend's children. If he is not the father of the children and the couple is not married, he is not statutorily entitled to claim the children for EITC.<sup>82</sup> As with Book's other examples, a couple in this situation may be frustrated by the perceived inequity of the system and thereby motivated to engage in intentional symbolic noncompliance. After all, if other people are using Twitter to find strangers' children to claim, why should a hard-working taxpayer not benefit from his girlfriend's children whom he actually lives with and supports?

### 3.3 Combating social and symbolic noncompliance

If we accept that EITC claimants and sole proprietors share similar motivations in their intentional noncompliance, it follows, then, that proposals to reduce intentional EITC noncompliance should be crafted in a similar fashion as the TAS recommendations to address sole proprietor noncompliance. Recall that these recommendations include 'promoting trust in government and the IRS, including tax simplification and taxpayer education that is normative rather than technical.'<sup>83</sup> I am sceptical of TAS's recommendations, which I view as well-intended but unrealistic: regardless of the type of taxpayer or the type of noncompliance, it is not easy to affect cultural change regarding trust in government. As I discuss in section 6, the better way to combat noncompliance is to increase information sharing between the taxpayer and the government.

The next two sections of the article describe the different challenges that arise depending on whether the taxpayer uses a return preparer or chooses to self-prepare. The proposal in section 6 below attempts to bridge these two universes.

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<sup>80</sup> IRC §§152(e); 32(c)(3)(A); 2(b)(1)(A)(i).

<sup>81</sup> National Taxpayer Advocate, 'Tax Reform for Families: A Common Sense Approach' *2005 Annual Report to Congress* (2005) 397, 398.

<sup>82</sup> In this example, he may be entitled to claim the children as dependents. IRC §152(d)(2)(H). Unless he is within the relationship described in §152(c)(2), he cannot claim the children for EITC or the child tax credit, and he cannot file using the Head of Household status. See IRC §2(b)(3)(B)(i).

<sup>83</sup> 'Factors Influencing Compliance,' above n 52, 38.

#### 4. RETURN PREPARERS AND EITC NONCOMPLIANCE

This section will discuss EITC noncompliance in the return preparer context, including ways in which return preparers enable or instigate noncompliance. It will evaluate some of the IRS initiatives in place to detect and deter noncompliance. This is especially timely in light of the Service's recent efforts to regulate the tax return preparer industry. For years the Service has pointed to the return preparer industry as one reason for the high rate of EITC noncompliance, and this was part of the rationale for it developing the mandatory tax return preparer regulation scheme that was struck down in February 2014 by the DC Court of Appeals.<sup>84</sup> In the wake of that defeat, the IRS introduced a voluntary program for uncredentialed return preparers for the next filing season (known as the 'Annual Filing Season Program'), again with the hope of increasing competency and protecting taxpayers from unscrupulous preparers. The program was criticised as an end run around the court's decision,<sup>85</sup> but the IRS is likely to continue its efforts at some form of regulation in light of its latest EITC compliance study, which concludes that 'unenrolled preparers ... as a group have the highest overclaim percentages among known preparer types.'<sup>86</sup>

A majority of EITC claimants rely on a paid preparer to file their income tax return. The most recent NRP study, based upon tax years 2006–2008, found that approximately 68% of EITC claimants used a paid preparer.<sup>87</sup> The study notes, however, that the rate at which EITC claimants use paid preparers has declined measurably in the years since.<sup>88</sup> In May 2014, IRS Commissioner John Koskinen noted that approximately 57 percent of the returns claiming the EITC are prepared by tax return preparers.<sup>89</sup>

As noted in the previous section, IRS estimates show 'no statistical difference in either the frequency of [EITC] overclaims or the dollar overclaim percentage' between paid preparers and self-prepared returns.<sup>90</sup>

However, within the data group of paid preparers, the IRS estimates show the error rate — and the dollar overclaim percentage — to be significantly higher within the subset of paid preparers who are not subject to regulation under Treasury Department

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<sup>84</sup> See *Loving v IRS*, 2014 WL 519224 (CA DC), *aff'g Loving v IRS*, 917 F Supp 2d 67 (D DC 2013).

<sup>85</sup> In July 2014, the American Institute of Certified Public Accountants (AICPA) sued the IRS to block the voluntary program, calling it 'impermissible end run around *Loving v. IRS*' Complaint at 2, *Am Inst of Certified Pub Accountants v IRS*, No 14-1190 (D DC filed July 15, 2014). The IRS filed a motion to dismiss for lack of standing, and the district court dismissed the case on those grounds. More recently, the US Court of Appeals for the DC Circuit reversed on appeal, holding that the AICPA does have standing to pursue the challenge, so this issue remains unresolved. *Am Inst of Certified Pub Accountants v IRS*, No 14-5309 (DC Cir Oct 30, 2015).

<sup>86</sup> 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 27.

<sup>87</sup> *Ibid v.*

<sup>88</sup> *Ibid [v]* n 4.

<sup>89</sup> Koskinen testimony, above n 67, 13. See also Written Statement of Nina Olson, National Taxpayer Advocate, Hearing on the National Taxpayer Advocate's *2014 Annual Report to Congress* Before the Subcommittee on Government Operations Committee on Oversight and Government Reform, US House of Representatives, Apr 15, 2015, 28 (with data showing that 55% of EITC returns in tax year 2013 were paid preparer returns).

<sup>90</sup> 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 24.

Circular 230 regulations governing practice before the IRS and are not affiliated with a nationally known tax preparation firm.<sup>91</sup>

The IRS's ill-fated attempt to regulate all return preparers was the culmination of years of concern about this phenomenon based on studies and reports of problems with the industry's accuracy, lack of due diligence, lack of professionalism, and unscrupulous behaviour.<sup>92</sup>

The Taxpayer Advocate and others mention EITC returns as a particular concern due to the size and refundable nature of the credit.<sup>93</sup> A number of limited sample 'mystery-shopper' compliance studies, both government and private, have revealed disturbing levels of inaccuracy in EITC claims. Moreover, certain studies reveal evidence of intentional overclaims by paid preparers.<sup>94</sup>

The role of return preparers in EITC noncompliance has been examined for nearly two decades, dating back to the findings of an IRS compliance study of tax year 1994.<sup>95</sup> Then as now, unscrupulous (and unregulated) return preparers have seized upon the event of a taxpayer receiving a large refundable credit as an opportunity to sell various products to the taxpayer.<sup>96</sup> This dynamic is inherently problematic, as it incents the return preparer to inflate the refund so the taxpayer has more money to spend.<sup>97</sup>

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<sup>91</sup> Ibid v, 24; the study cautions that 'due to the problem of selection bias, one cannot conclude anything about the relative ability or integrity of unenrolled preparers without further study.' When stated as a dollar overclaim percentage by preparer type, the higher end estimates very close as between this subset of preparers and self-prepared returns.

<sup>92</sup> See, eg, National Taxpayer Advocate, 'Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined From Continuing its Efforts to Effectively Regulate Unenrolled Preparers', *2013 Annual Report to Congress* (2013) 67.

<sup>93</sup> See, eg, Nina Olson, 'More Than A Mere Preparer: Loving and Return Preparation' (2013) 139 *Tax Notes* 767. 'Taxpayers who are the beneficiaries of these credits are often the least educated and least financially sophisticated in the United States today. Thus, they become easy targets for marketing schemes of unregulated and unqualified so-called return preparers whose real interest in the tax return process is to push high-interest loans (formerly refund anticipation loans, and now in the form of 'pay-stub' loans) and charge high fees': at 769–770.

<sup>94</sup> For a compilation and summary of several of these studies, see Chi Chi Wu, 'How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do' (2013) *National Consumer Law Center Report*; see also Brief for Amici Curiae, National Consumer Law Center and National Community Tax Coalition in Support of Defendants-Appellants, *Loving v Internal Revenue Service*, No 13-5061 (DC Cir 2014). It is important to note that the inaccuracies described are far from limited to EITC overclaims. Other inaccuracies involved: intentional omission of income; falsifying information to make the taxpayer eligible for various deductions such as charitable deductions, job-related expenses, and Schedule C business expenses; inability to properly deal with education-related credits and income; misclassifying filing status; and data entry errors resulting in incorrect refunds. 'Errors and Fraud', 5–6.

<sup>95</sup> US Gen Accounting Office, *Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance*, GAO/GGD-98-150 (1998) (finding the EITC overclaim rate on returns prepared by unregulated preparers was 31%, while the overclaim rate on returns prepared by attorneys, CPAs, national tax preparation companies, and enrolled agents was 20%).

<sup>96</sup> For a detailed analysis of this phenomenon, see Danshera Cords, 'Paid Tax Preparers, Used Car Dealers, Refund Anticipation Loans, and the Earned Income Tax Credit: The Need to Regulate Tax Return Preparers and Provide More Free Alternatives' [2009] 59 *Case Western Reserve Law Review* 351, 374. While refund anticipation loans are no longer the product du jour, each filing season brings new products to the attention of consumer rights agencies.

<sup>97</sup> Cords, above n 96, 385; see also Leslie Book, 'Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor through the Tax System' [2006] *Wisconsin Law Review* 1103, 1116–1118.

As part of his work that builds on the Kidder and McEwen typology, Book categorises this type of intentional noncompliance as ‘brokered noncompliance’, meaning the overclaim occurred on the advice of a tax professional.<sup>98</sup> Book notes: ‘[t]here is a wide range in the honesty of preparers, and there were reports of illicit preparers generating business through their guaranteeing the windfall of government EITC dollars.’<sup>99</sup>

Brokered noncompliance is of course not unique to EITC overclaims. It occurs in many contexts, including the sole proprietor context discussed above in section 3. Morse, Karlinsky and Bankman address this in their study and note that it includes a continuum of behaviour on the part of the preparer: ‘Many preparers in [the cash sector] adopt a “don’t ask, don’t tell” attitude toward their clients reported receipts. A small minority of preparers, however, actively aid in their clients’ evasion’.<sup>100</sup>

Brokered EITC noncompliance should be viewed in that larger context, as it poses part of a larger challenge the IRS faces. As revealed in the IRS’s most recent EITC compliance study, there is significant overlap between EITC noncompliance and sole proprietor noncompliance: recall that the study identifies the most common (and 51% of time, the only) EITC overclaim error as income misreporting, in particular self-employment income misreporting.<sup>101</sup> Income misreporting can result either at the suggestion of the return preparer or at the taxpayer’s initiative coupled with a ‘don’t ask, don’t tell’ attitude.

If approximately one-half of EITC overclaims are due to income misreporting, then this is part of a broader noncompliance phenomenon, and one that has proven very difficult for the IRS to enforce. Unfortunately, because it drives the improper payment rate, it in turn fuels the EITC’s image problem.

The IRS has honed in on paid preparers as part of the problem and is working to turn paid preparers instead into part of the solution. So far, it has been unsuccessful in its attempts to regulate preparers. It remains to be seen whether Congress will provide the IRS the authority to regulate preparers as there have been several bills introduced that would do so.<sup>102</sup> Even if Congress does so, many (including this author) are sceptical that regulation will provide a magic panacea that will correct the problems with EITC noncompliance.<sup>103</sup>

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<sup>98</sup> Book, ‘One Size Does Not Fit All’, above n 12, 1173.

<sup>99</sup> Ibid.

<sup>100</sup> Morse, Karlinsky and Bankman, above n 47, 67.

<sup>101</sup> See text accompanying notes 40 and 41 above. The 51% figure is not broken down as between paid preparers and self-prepared returns. It is not known how much of this is brokered noncompliance, but in either case it contributes to the sole proprietor tax gap.

<sup>102</sup> See, eg, Tax Return Preparer Competency Act, HR 4141, 114<sup>th</sup> Congress (2015); Taxpayer Protection and Preparer Proficiency Act of 2015, S 137, 114<sup>th</sup> Congress (2015); Taxpayer Rights Act of 2015, HR 4128, 114<sup>th</sup> Congress (2015); Identity Theft and Tax Fraud Prevention Act of 2015, HR 3981, 114<sup>th</sup> Congress (2015).

<sup>103</sup> See Michelle Lyon Drumbl, ‘When Helpers Hurt’ (2014) 145 *Tax Notes* 1365; Justin Gelfand and Dan Alban, ‘Licensing Tax Preparers Won’t Help Taxpayers’, *wsj.com*, March 12, 2015 8:08 pm ET, <<http://www.wsj.com/articles/justin-gelfand-and-dan-alban-licensing-tax-preparers-wont-help-taxpayers-1426204063>> accessed 9 Dec, 2015.

The next sections provide an overview of some of the ways in which the IRS is addressing the problem of noncompliant return preparers short of industry-wide regulation.

#### 4.1 Enforcing the due diligence requirement

One point of recent emphasis has been the requirement for paid preparers to exercise due diligence in determining a taxpayer's eligibility for the EITC.

This requirement was first enacted as part of the Taxpayer Relief Act of 1997,<sup>104</sup> and was in part intended to address concerns arising from the EITC compliance study of tax year 1994.<sup>105</sup> As originally enacted, the penalty was \$100 per failure. This was increased to the current penalty of \$500 in 2011.<sup>106</sup> The regulations promulgated under section 6695(g) in 2000 required the return preparer to complete a due diligence checklist (IRS Form 8867 or alternative), compute the credit using certain prescribed methods, and maintain the form in their records for three years.<sup>107</sup> In 2011, the Treasury Department amended the regulations to provide that Form 8867 must be submitted with the return or to the taxpayer for filing with the return.<sup>108</sup>

The Treasury Regulations provide the following example of EITC due diligence:<sup>109</sup>

Taxpayer asks Preparer D to prepare her tax return and tells D that she has a Schedule C business, that she has two qualifying children and that she wants to claim the EIC. Taxpayer indicates that she earned \$10,000 from her Schedule C business, but that she has no expenses. This information appears incomplete because it is very unlikely that someone who is self-employed has no business expenses. D must make additional reasonable inquiries regarding taxpayer's business to determine whether the information regarding both income and expenses is correct.

Form 8867 is a four page form, in which the first three pages consist of a series of 24 yes or no questions for the return preparer to answer, though not all questions apply to a given taxpayer. The questions are relatively straight-forward and can be used as the basis for a client interview. On the fourth page is a checklist on which the preparer must indicate the types of documents the taxpayer provided the preparer in connection with the return. The documents pertain to residency of any qualifying children claimed, disability of qualifying children (if applicable), and information used to complete Schedule C (if applicable). Notably, the preparer is not required to rely on any documents and can indicate such on the form.

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<sup>104</sup> Taxpayer Relief Act of 1997, Pub L No 105-34, §1085(a)(2), 111 Stat 788, 956.

<sup>105</sup> Cords, above n 96, 374; HR REP 105-148, 105TH Cong, 1ST Sess 1997, 1997 WL 353016, 1997 USCCAN 678 (Leg Hist) at 695 ('the bill provides three compliance measures to address the EIC compliance problem').

<sup>106</sup> United States-Korea Free Trade Agreement Implementation Act of 2011, Pub L No 112-41, Title V, §501(a), 125 Stat 428, 459.

<sup>107</sup> TD 8905, 65 FR 61269, Oct 17, 2000. Additionally, the regulation imposed a knowledge and constructive element as to eligibility: 'The preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete.' Treas Reg §1.6695-2(b)(3).

<sup>108</sup> TD 9570, 76 FR 78819, Dec 20, 2011; effective for tax years beginning after December 31, 2011.

<sup>109</sup> Treas Reg §1.6695-2(b)(3)(ii) Example 4.

The IRS makes efforts to educate return preparers about the due diligence requirements and Form 8867. Paid preparers who filed ten or more EITC returns without Form 8867 in filing season 2013 received a warning letter, and the IRS issued penalty letters to 225 of these preparers when they again filed ten or more EITC claims without the required form in the 2014 filing season.<sup>110</sup> TIGTA reports that these 225 tax return preparers prepared 5,729 tax returns claiming more than \$18.7 million in EITC<sup>111</sup> — in other words, these preparers on average filed 25 EITC returns claiming an average EITC of \$3,264. The IRS proposed the section 6695(g) penalty against these 225 preparers for each claim, meaning the proposed penalties total nearly \$2.9 million.<sup>112</sup> The preparers are given 30 calendar days to respond to the proposed penalty and can request an appeals hearing. As of the release of the TIGTA report, only \$151,500 in penalties had been assessed against these 225 preparers.<sup>113</sup>

The Treasury Inspector General reports that its analysis of EITC claims filed during the 2012 through 2015 filing seasons shows that returns that include Form 8867 are more accurate than those that do not: ‘as of May 7, 2105, the IRS identified processing errors on 6.8 percent of EITC claims that were filed by a preparer without a Form 8867 compared to only 0.2 percent of EITC claims filed with a Form 8867’.<sup>114</sup> However, ‘processing error’ is defined as ‘eg, mathematical errors, invalid EITC qualifying child Social Security Number (SSN), etc)’. This is not the same as evidence of a reduction in intentional EITC overclaims. As TIGTA has pointed out elsewhere:<sup>115</sup>

the majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has math error authority. For example, the IRS identified approximately 6.5 million potentially erroneous EITC claims totaling approximately \$21.9 billion in Tax Year 2012 for which it does not have math error authority. In Tax Year 2012, the IRS used math error authority to identify and systemically correct only 241,975 (.009 or less than 1 percent) of approximately 27.3 million EITC claims. The 241,975 returns claimed EITCs totaling \$299 million.

Still, it is evidence that the form increases accuracy to some degree.

One advantage of the EITC due diligence requirement is that it increases communication between the taxpayer and the return preparer. An ethical return preparer has every incentive to complete the form correctly and submit it. As to filling it out correctly, the preparer will not wish to be associated with a significant number of returns that examinations later reveal to be overclaims, because the IRS may turn its attention to the preparer. As to submitting the form, the IRS can impose the penalty

<sup>110</sup> Treas Inspector Gen Tax Admin, ‘Results of the 2015 Filing Season’ 2015-40-080 (Aug 31, 2015) 6 (hereinafter TIGTA, ‘Results’).

<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

<sup>113</sup> Ibid. TIGTA had criticised the IRS in prior years for not issuing section 6695 penalties. See Leslie Book, ‘IRS Leaves Hundreds of Millions of Dollars in Preparer Penalties on the Table’ on Leslie Book, *Procedurally Taxing* (January 7 2014), <<http://www.procedurallytaxing.com/irs-leaves-hundreds-of-millions-of-dollars-in-preparer-penalties-on-the-table>> accessed 21 October 2016.

<sup>114</sup> TIGTA, ‘Results’, above n 110, 6.

<sup>115</sup> Treas Inspector Gen Tax Admin, ‘Assessment of Internal Revenue Service Compliance with the Improper Payment Reporting Requirements in Fiscal Year 2014’ 2015-40-044 (Apr 27, 2015) 9-10 (hereinafter TIGTA, ‘Assessment’).

even if the underlying EITC claims are correct, so relying on different due diligence practices while ignoring the regulation's specific requirements will not protect even the most honest preparer.<sup>116</sup>

Applying due diligence standards to the qualifying child requirements makes good sense. While qualifying child errors are the second most frequent error, this type of error represents 38% of overclaim dollars.<sup>117</sup> The preparer's use of Form 8867 alerts the taxpayer to the requirements and the types of documentation that the IRS would request if the return were audited. It moves the question from 'how are you related to the child?' to 'do you have documentation showing how you are related to the child?' If the answer is no, the preparer can rely on the taxpayer's word, but the taxpayer is on notice that documentation may be required post-filing. In this regard, it surely reduces the chance of unintentional noncompliance due to a miscommunication or an incomplete interview process. At the same time, this due diligence requirement serves a gatekeeper role in that it informs the IRS whether a preparer (who at least in some cases is a professional subject to Circular 230) has seen documentation confirming EITC eligibility. For the IRS, this is beneficial — it places the preparer in the role of a de facto pre-refund auditor at no cost to the IRS. Presumably the IRS stratifies risk according to the type of preparer and the type of documentation recorded on Form 8867: a return prepared by an attorney or CPA who certifies that they have relied upon and retained school records verifying residence must surely be at less risk of audit than an unenrolled preparer who certifies that they 'did not rely on any documents'.

It is less clear how the EITC due diligence requirement will help reduce income misreporting, which is the most commonly made error and appears on an estimated two-thirds of EITC overclaim returns.<sup>118</sup> Further, if due diligence could cure income misreporting, shouldn't it be explicitly required as a separate questionnaire on *all* sole proprietor returns? For instance, a preparer who relies on taxpayer records of gross receipts and expenses on an EITC return is required by the regulations to retain copies those records; however, on non-EITC returns, the preparer is not required to retain the taxpayer's records. Why not? In light of statistics and studies about cash business noncompliance, why not apply the same standards to all sole proprietor returns? This double standard highlights one way in which EITC noncompliance is stigmatised relative to other forms of noncompliance.

Finally, the due diligence requirement will not necessarily cure intentional noncompliance (or what Book calls 'brokered noncompliance'<sup>119</sup>). An unscrupulous return preparer who is determined to claim a bogus EITC can provide false information of Form 8867, fail to file the form, or fail to sign the return (making the return appear as if it were self-prepared, in which case the form is not required).

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<sup>116</sup> IRC §6695(g). See also Leslie Book, 'The Intersection of Preparer Penalty and Taxpayer Examinations' on Leslie Book, *Procedurally Taxing* (June 26 2014), <<http://www.procedurallytaxing.com/the-intersection-of-preparer-penalty-and-taxpayer-examinations/>> accessed 21 October 2016.

<sup>117</sup> 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 17. ('Where the only error is a qualifying child error, the average estimated overclaim is \$2,327.')

<sup>118</sup> *Ibid.* The report notes, however, 'Overclaim dollars associated with income misreporting (only) are disproportionately much lower, at 25 percent. The average overclaim associated with income misreporting alone is estimated to be \$673.'

<sup>119</sup> Book, 'One Size Does Not Fit All', above n 12, 1173.

## 4.2 Targeted return preparer education

Though resource intensive, the IRS believes that targeted preparer education is an effective tool to combat EITC noncompliance. These include data-driven compliance and warning notices, preparer audits by field examiners, and ‘knock-and-talk’ visits from IRS Criminal Investigator agents.<sup>120</sup> The degree to which these efforts are effective in reducing noncompliance must surely be hard to measure, but the Commissioner reported that an expanded pilot program in 2013 ‘protected an additional \$590 million in revenue from being paid out improperly.’<sup>121</sup> Of course, \$590 million is but a fraction of the estimated 17.7 billion in improper EITC payments made in fiscal year 2014.<sup>122</sup>

## 4.3 Pursuing injunctions and permanent bars against the most egregious preparers

As the US District Court for the District of Columbia emphasised in its *Loving* opinion, ‘Congress has already enacted a relatively rigid penalty scheme to punish misdeeds by tax-return preparers.’<sup>123</sup> In addition to various monetary penalties, the Code permits the government to bring civil action to enjoin tax return preparers from engaging in certain conduct. The IRS and the Department of Justice Tax (DOJ) Division work together under this statutory authority to pursue injunctions and permanent bars against the most egregious offenders, including those who engage in intentional EITC noncompliance.<sup>124</sup> These injunctions and bars are publicised with press releases and website news items by both the IRS and the DOJ.<sup>125</sup>

Certainly these actions are a resource and time intensive response to return preparer noncompliance. However, the expressive value of these injunctions and bars (and in some cases criminal prosecutions) may influence taxpayer perceptions of fairness, which is important in a voluntary reporting system.<sup>126</sup>

## 4.4 Query: Are these initiatives driving some taxpayers to do-it-yourself noncompliance?

Preparers certainly play a significant role in the EITC noncompliance problem. Laws regulating the return preparer industry was the IRS’s favoured solution to address incompetence and unscrupulous behaviour, but absent Congressional action authorising such regulation, the IRS must focus its energy on other tactics.

There are reasons to suspect that noncompliance by return preparers is more intentional than not, and that the behaviour trends more unscrupulous than incompetent. The IRS should continue working with the DOJ to identify and pursue those preparers as they have been doing. The IRS’s efforts to crack down on paid preparer noncompliance are important and have both practical and symbolic value.

With that said, the added burdens on preparers, whether in the form of regulation or increased due diligence, do come with a financial cost that is likely passed on to the client. The IRS estimates that the average time needed to complete Form 8867 is 1

<sup>120</sup> Koskinen testimony, above n 67, 13.

<sup>121</sup> Ibid.

<sup>122</sup> TIGTA, ‘Assessment’, above n 115.

<sup>123</sup> *Loving v IRS*, 917 F Supp 2d 67, 75 (D DC 2013).

<sup>124</sup> See Drumbl, above n 103.

<sup>125</sup> See, eg, <<http://www.justice.gov/tax/program-shut-down-schemes-and-scams>>.

<sup>126</sup> See discussion of social noncompliance in section 3, above.

hour, 49 minutes.<sup>127</sup> As EITC returns inevitably become even more expensive for low-income taxpayers, the increased cost may drive the number of self-prepared returns higher. Taxpayers trying to ‘go it alone’ to save money run the risk of unintentional errors due to complexity.

Other taxpayers may ill-advisedly rely on a friend or family member who is willing to prepare the return on the cheap (or for free) but who plays fast and loose with the eligibility requirements in order to ‘help’ the taxpayer. Such returns appear to the IRS as self-prepared, and the amateur preparer is not subject to any risk of penalty — it is the taxpayer who is left vulnerable if the IRS questions the return.

At least one CEO of a national tax return preparation firm, William Cobb of H&R Block, thinks that another factor may drive taxpayers to ‘do-it-yourself’.<sup>128</sup>

The implementation of inconsistent EITC eligibility standards and documentation requirements has resulted in a movement of this issue out of the assisted tax space and into the self-prepared channel (DIY), contributing to a material change in EITC taxpayer behaviors. ... The movement to DIY and the billion dollar increases in the improper payment rate have gone hand-in-hand.

In other words, there is concern that greater enforcement efforts directed at return preparers will drive taxpayers who know they are EITC ineligible to do their own false return on home software rather than face the stricter compliance standards imposed upon them by a regulated tax return preparer. Cobb likens this to the analogy of squeezing a balloon — if one part is squeezed, the air rushes to another.<sup>129</sup>

With this concern in mind, and recalling that only 57% of EITC returns are prepared by tax return preparers,<sup>130</sup> the next section considers noncompliance on self-prepared returns.

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<sup>127</sup> Instructions to IRS Form 8876, 3 (2014).

<sup>128</sup> Letter from H&R Block CEO William Cobb to the Senate Finance Committee, and House Committee on Ways and Means, Mar 10, 2015, on file with author and available at <[newsroom.hrblock.com/download/126469/hrb-ceo-to-sfc.pdf](https://newsroom.hrblock.com/download/126469/hrb-ceo-to-sfc.pdf)>.

<sup>129</sup> Intuit chief tax officer David Williams used the balloon analogy first, but in the context of industry combating tax return fraud on a company by company basis: ‘If any one company ... decided to take a whole bunch of actions that would 100 percent determine that every single one of their customers was exactly who they said they were, that would not stop fraud in the industry. It would just push the fraud around. It would squeeze the balloon.’ Jonnelle Marte and Craig Timberg, ‘Who’s to blame when fraudsters use TurboTax to steal refunds?’ *Washington Post*, March 4, 2015. H&R Block CEO William Cobb built upon this analogy in a letter asking Congress to extend the EITC due diligence requirements to self-prepared returns. Of Williams’ balloon concern, Cobb wrote, ‘We could not agree more! In fact, we have been saying exactly this with respect to the EITC. Here, a fraud and improper payment filter (a series of questions) is being applied only to taxpayers who use paid preparers and the same fraud and improper payment filter is NOT being applied to DIY taxpayers.’ Letter from William C Cobb to Senators Orrin Hatch and Ron Wyden and Congressmen Paul Ryan and Sander Levin, March 15, 2015, on file with author and available online at <<https://presspage-production-content.s3.amazonaws.com/uploads/1475/hrb-ceo-to-sfc.pdf>> accessed 17 November, 2015).

<sup>130</sup> Koskinen testimony, above n 67, 13.

## 5. SELF-PREPARED RETURNS AND TAXPAYER ERROR

The IRS reports that in recent years the rate of EITC self-preparation has increased while the rate of paid preparation has declined.<sup>131</sup> This section examines EITC noncompliance issues unique to self-prepared returns. These range from lack of taxpayer sophistication to lack of industry oversight, making it especially challenging (yet increasingly important) for the Service to respond effectively and correctly to this type of noncompliance. This section also describes the recent calls from industry and members of Congress to impose greater burdens on taxpayers who self-prepare in order to match the increased burdens that have been placed on return preparers.<sup>132</sup>

It is unknown what percentage of self-prepared noncompliance is intentional as opposed to unintentional. Due to the complexity of the EITC, there is reason to believe that unintentional noncompliance is more common in this context than in the return preparer context.<sup>133</sup> This section will explain statutory complexity as the root cause of *unintentional* noncompliance and will also discuss how requiring more from taxpayers who self-prepare might drive down the rate of unintentional noncompliance.

Requiring more from taxpayers who self-prepare might also drive down the rate of *intentional* noncompliance, but for this to be effective, it must be coupled with more meaningful sanctions for wrongdoing. Section 3 above discussed several theories of intentional noncompliance that extend to self-prepared returns, such as social and symbolic noncompliance. This section will consider how requiring more information from taxpayers may affect these types of noncompliance, and how designing more meaningful sanctions for ‘do-it-yourself’ fraud may help combat this type of noncompliance.

### 5.1 Complexity: Why unintentional noncompliance may occur more often when taxpayers self-prepare

The EITC requirements are complex, and this is surely a challenge for taxpayers who self-prepare their returns. In her annual reports to Congress, Taxpayer Advocate Nina Olson has repeatedly recommended simplifying the credits.<sup>134</sup> While I agree that simplification would likely reduce taxpayer error, the statute is complex in part because Congress intended to make the credit available to workers in non-traditional family structures. It would be easier to administer a credit that is available only to parents (including stepparents) who live with their children year-round. However, that would be ignoring the demographic reality that children live in households headed by grandparents, aunts or uncles, and sometimes even older siblings. Further, children don’t necessarily live in the same household year-round. The Code sections governing filing status, dependency exemptions, and family-based refundable credits are complex because they attempt to capture certain of these demographic realities.

<sup>131</sup> ‘Compliance Estimates for the Earned Income Tax Credit’ above n 5, [24] n 51.

<sup>132</sup> See below section 5.

<sup>133</sup> If one accepts the estimate that the majority of all EITC noncompliance is unintentional, it is also reasonable to believe that unintentional noncompliance is higher among self-prepared returns than among those completed by paid preparers.

<sup>134</sup> See National Taxpayer Advocate, ‘Legislative Recommendation: Simplify the National Status and Related Requirements for Qualifying Children’, *2012 Annual Report to Congress* (2012) 507–511; National Taxpayer Advocate, ‘Research Study: Running Social Programs through the Tax System’, *2009 Annual Report to Congress* (2009) 75, 90; National Taxpayer Advocate, ‘Legislative Recommendation: Simplify the Family Status Provisions’, *2008 Annual Report to Congress* (2008) 363.

Congress should be applauded for the inclusiveness of these provisions, even if the downside is complexity (and a corresponding higher error rate).

The complexity used to be even worse than it is now. Congress moved to a uniform definition of qualifying child in 2004.<sup>135</sup> These changes were an improvement, but still today the Code's benefits for families do not perfectly align. For example, for a taxpayer to claim a qualifying child as a dependent, the qualifying child must not have provided more than half of their own support for the tax year.<sup>136</sup> A taxpayer claiming a 'qualifying child' for EITC has no support requirement at all, while a taxpayer claiming the head of household filing status must pay more than half the cost of 'maintaining the household' in a tax year.<sup>137</sup> If the child doesn't meet the 'qualifying child' test, the taxpayer might still be able to claim the individual as a dependent if they meet the 'qualifying relative' test, but only if (among other requirements) the taxpayer provided more than half of the person's total support for the year.<sup>138</sup> While a 'qualifying relative' can be claimed as a dependent, this individual cannot be claimed for EITC or child tax credit.<sup>139</sup> These subtle differences make it difficult for taxpayers to keep track of how to file properly. It is possible for the same taxpayer to be entitled to EITC but not head of household filing status; to be eligible for the EITC but not the child tax credit; or to be eligible to claim an individual as a dependent but for no other purpose.

Section 32, authorising the EITC, contains over 2,400 words. It contains cross-references to more than 20 other sections or subsections of the Code, including international tax provisions, passive loss rules, and capital gain definitions.<sup>140</sup> It references half a dozen federal statutes outside of the Code.<sup>141</sup> It is no wonder that taxpayers — and even preparers — make unintentional errors in determining eligibility.

The Service attempts to translate these statutory requirements to plain English, using simplified forms, flowcharts and illustrations in its publications.<sup>142</sup> Some of these resources are terrific, presuming the taxpayer can find them and/or has the patience and sophistication to study them. But the most logical place to provide the requirements is on Form 1040 itself — Form 1040 does capture the most essential information. Taxpayers claiming a qualifying child are required to fill out Schedule EIC to provide the child's name, social security number, year of birth, relationship to taxpayer, and number of months the child lived with the taxpayer during the tax year.

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<sup>135</sup> Working Families Tax Relief Act of 2004, Pub L No 108-311, 118 Stat 1166, Sections 2001–2008; see John Buckley, 'Uniform Definition of a Child: Large Unintended Consequences' (Mar 20, 2006) 110 *Tax Notes* 1345 for background on the uniform definition and a discussion of how the uniform definition 'lacks uniform application.'

<sup>136</sup> IRC §152(c)(1)(D).

<sup>137</sup> IRC §2(b)(1).

<sup>138</sup> IRC §152(d)(1)(C).

<sup>139</sup> IRC §§32 and 24, respectively, refer to 'qualifying child' and do not extend to 'qualifying relative'.

<sup>140</sup> See §32(i).

<sup>141</sup> See §32(l) and (m).

<sup>142</sup> See, eg, IRS Publication 596 (2014). Though at 37 pages it may overwhelm a first-time claimant, the publication provides flowcharts, examples and sample worksheets. The publication helpfully informs taxpayers of the availability of free tax preparation services at Volunteer Income Tax Assistance (VITA) sites, but this information is located on p 26 rather than in the introduction where it might be more helpful to taxpayers.

Schedule EIC is written clearly and captures the most relevant information concerning the EITC requirements for a qualifying child on one page, but it doesn't fully capture the complexity, alert the taxpayer to certain pitfalls, or highlight the differences between the EITC, head of household filing status and the child tax credit. The next section of this article discusses why taxpayer intent matters, and how ascertaining intent is key to developing appropriate and effective sanctions. Section 6 will suggest an even more comprehensive approach to involving the taxpayer in information gathering.

## **5.2 Intentional noncompliance on self-prepared returns: How increasing due diligence can help the IRS ascertain taxpayer intent, and why that matters**

Certainly some percentage of self-prepared return noncompliance is intentional. One problem the IRS currently faces is that its examination and enforcement mechanisms are reactive and not equipped to ascertain whether a taxpayer's overclaim was intentional or not. Increasing required due diligence, coupled with imposing more meaningful sanctions for intentional noncompliance, could serve to better deter social and symbolic noncompliance.

When the IRS detects a suspicious EITC return, a correspondence examination results. Once money is paid, it is difficult to recover. Therefore, more often than not, the IRS 'freezes' the credit pending the outcome of the examination, meaning the taxpayer does not receive the refund unless they prove to the satisfaction of the IRS (or, failing that, the US Tax Court) that they were entitled to it.

In a significant percentage of cases, the taxpayer never responds to the correspondence examination notices. One might infer one of two reasons for the silence: 1) the taxpayer did not receive the notice, did not understand its significance, or did not know how to meaningfully respond; or 2) the taxpayer knew they were not entitled to the credit, and therefore consciously chose not to respond, recognising that they had been 'caught'.

In either case, the silence is problematic because the Service cannot ascertain whether the noncompliance was intentional or unintentional. The former case denotes a taxpayer who may be disenfranchised, unsophisticated, unable to access legal representation, and/or may not even speak English. In some percentage of these situations, it is possible that the taxpayer is entitled to the EITC but is incapable of pursuing the matter further. This is the worst case scenario for the tax system, and the Service should work to reduce the number of these cases by making examination notices as simple as possible and informing taxpayers of the possibility of free legal representation through Low-Income Taxpayer Clinics. Of course in a percentage of these cases, the lack of sophistication or English literacy may have contributed to an unintentional error, and so the 'correct' outcome is achieved. I do not advocate for these taxpayers to be penalised for their error.

In the latter scenario, the taxpayer committed reckless or fraudulent behaviour and was caught. But because the taxpayer ignored the examination notices, the IRS likely does not have enough evidence to bring forth a civil fraud penalty case or other punishment. Thus, the intentional wrong-doer taxpayer is not penalised any differently than the unintentional or mistaken taxpayer. The lack of a meaningful sanction may serve to fuel social and symbolic noncompliance.

### 5.2.1 Accuracy related penalties apply to all overpayment claims

Taxpayers who erroneously claim the EITC are subject to the section 6662 20% accuracy penalty, regardless of whether the error was unintentional and intentional.<sup>143</sup> In November 2013, in a decision that was viewed as quite favourable to low-income taxpayers, the US Tax Court held that this accuracy related penalty could not apply to the *refundable* portion of a credit (commonly referred to as the negative income tax): that is, the amount refunded to the taxpayer in excess the amount of tax shown on the return.<sup>144</sup> However, the Tax Court was legislatively overruled two years later when Congress amended the definition of underpayment to explicitly include refundable credits in the calculation of the accuracy related penalty.<sup>145</sup>

I have argued elsewhere that the IRS is overly punitive in its application of section 6662 because it does not attempt to distinguish between intentional and unintentional EITC noncompliance.<sup>146</sup> As a result, unsophisticated taxpayers face penalties of \$1,000 or higher even if their mistake was a wholly innocent one. To be clear, I do not wish to see the Service penalise inadvertent error. But as I will explain in section 6 below, increasing information with return filing may put the IRS in a better position to determine when the taxpayer is knowingly engaging in fraud.

### 5.2.2 Section 32(k) — taking away a right that one never rightfully had isn't a meaningful deterrent

In cases where there is evidence of reckless or fraudulent noncompliance, the IRS can impose (respectively) a two-year or ten-year EITC ban on the taxpayer.<sup>147</sup> Schedule EIC puts taxpayers on notice of this possibility: 'If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years.'<sup>148</sup>

This ban sounds meaningful, but is of questionable deterrent effect: the possibility of a two-year or even a ten-year ban is likely meaningless for a taxpayer who is not eligible for EITC to begin with.<sup>149</sup> In other words, a dishonest taxpayer can intentionally claim an EITC to which they know they are not entitled, and not much is at stake: if the IRS is suspicious, it will freeze the refund and issue a correspondence examination notice. The taxpayer can simply ignore the notice, having given it a try and failed. Meanwhile, if the refund was frozen, there is no financial penalty, no interest to repay, and if the taxpayer was ineligible to begin with, the Code's

<sup>143</sup> For many years, the accuracy related penalty applied to EITC overclaims even if the refund had been frozen and never received by the taxpayer. See IRS Chief Couns Mem 200113028 (Mar 30, 2001). In 2012, Chief Counsel reconsidered this policy and issued guidance advising the Service not to impose the penalty on frozen refunds. IRS Program Manager Tech Adv Mem 2012-16 (May 30, 2012). Presumably this guidance stands following the legislative overruling of *Rand*.

<sup>144</sup> *Rand v Commissioner*, 141 TC 12 (November 18, 2013).

<sup>145</sup> Consolidated Appropriations Act, 2016, Pub L No 114-113, Section 209(a).

<sup>146</sup> See generally Drumbl, above n 13.

<sup>147</sup> IRC §32(k)(1).

<sup>148</sup> IRS Form 1040, Schedule EIC.

<sup>149</sup> Judge Morrison made this point in his dissent in *Rand v Commissioner*: 'Many taxpayers who falsely claim the earned income credit for one year will not qualify for the credit for the subsequent two years anyway. ... For such taxpayers...section 32(k), even if applicable, deprives them of nothing to which they would otherwise be entitled.'

recertification requirement<sup>150</sup> and/or bans are meaningless. In other words, one loses nothing for trying.

The Service must find ways to require more information from the taxpayer on the return itself, and it must create better deterrents to noncompliance.

### 5.2.3 *How increasing due diligence requirements can help drive down intentional noncompliance, if coupled with more meaningful sanctions*

As discussed in section 4 above, return preparers who commit fraud face civil and criminal penalties, and the Justice Department and IRS publicise these cases as a measure of general deterrence for the return preparer community. However, as the preceding sections describe, there is no analogous deterrent for taxpayers who wish to engage in ‘do-it-yourself’ EITC fraud.

This is a significant problem. If we believe that taxpayers who commit social noncompliance do so because others are not complying, or because others are getting away with it,<sup>151</sup> then there should exist a meaningful punishment for those who are caught — in the absence of that, anyone who tries ‘gets away with it’: even if the IRS doesn’t issue the refund, the taxpayer has lost nothing for trying.

While individual taxpayers are subject to criminal sanctions for wilfully making false statements on tax returns,<sup>152</sup> it is rare for the IRS to bring criminal charges against a taxpayer in the context of the EITC fraud on their individual return.<sup>153</sup> At a minimum, the IRS should add a warning on Schedule EIC reminding a taxpayer that a false statement on a tax return is a criminal offense. Preferably, Congress should enact a provision providing specific criminal sanctions for EITC fraud. Individuals who commit fraud in other social benefit programs are subject to criminal penalties. For example, it is a felony offense for individuals to commit certain violations such as trafficking (the knowing and improper use, transfer, acquisition, or alternation) of benefits in the federal SNAP.<sup>154</sup> The punishment for SNAP trafficking is a maximum fine of \$250,000 or 20-year imprisonment. There is no reason to treat EITC fraud differently,<sup>155</sup> or not to at least have that option on the books.

One difficulty in imposing criminal sanctions is the high burden of proof required of the government. By way of example, the Internal Revenue Manual provides that imposition of the ten-year EITC ban requires a final determination that the taxpayer engaged in ‘affirmative acts of fraud’.<sup>156</sup> The manual includes the following as examples of indicators of fraud: ‘Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as

<sup>150</sup> IRC §32(k)(2).

<sup>151</sup> See generally Book, ‘One Size Does Not Fit All’, above n 12.

<sup>152</sup> IRC §7206.

<sup>153</sup> For one notable and recent example of the government pursuing criminal charges against an individual for filing false income tax returns claiming EITC, see <<https://www.justice.gov/usao-wdmo/pr/ozark-man-pleads-guilty-false-tax-claim-advertised-craigslist-dependents>> accessed 6 April, 2016.

<sup>154</sup> 7 USC §2024(b).

<sup>155</sup> Though I am by no means suggesting 20 years’ imprisonment is an appropriate punishment for individual EITC fraud.

<sup>156</sup> IRM 25.1.14.5(1) (06-19-2013), 10-Year Earned Income Tax Credit (EITC) Ban Consideration.

birth certificates, lease documents, school/medical records, for the purpose of claiming ... EITC, or other refundable credits.’<sup>157</sup>

An evidentiary problem arises: currently, a taxpayer is not required to provide with the return any documents supporting an EITC claim. Thus, if audited, the taxpayer can respond with silence, effectively preventing the IRS from pursuing a fraud case, because it will never see the false documents.

This is why requiring more due diligence on self-prepared returns, or at least more affirmative statements on the Schedule EIC, can combat intentional noncompliance. If more due diligence were required, including affirmative statements about relationship, the circumstances of residency, and the types of documentation that can be provided upon request, the IRS would have some basis to pursue criminal charges against taxpayers who knowingly make false statements. The IRS needs the power to do so in the most egregious cases, just as it has the power to pursue a permanent injunction against the most egregious tax return preparers.

Realistically, the IRS does not have the resources to pursue a significant number of time-intensive cases with a high evidentiary requirement against individual taxpayers. Again by way of analogy, the IRS imposes the ten-year ban infrequently: based on data provided by the Taxpayer Advocate, it imposed it only 13 times, 27 times, and 17 times in 2009, 2010, and 2011 respectively.<sup>158</sup> But if it could hold itself out on the tax forms as having the authority to pursue criminal charges (rather than just a ban that is effectively meaningless) for EITC fraud, perhaps more taxpayers would think twice before making a false statement.

The mere threat of criminal sanction would serve as a general deterrence, and perhaps even create an expressive notion of integrity in the tax system among all taxpayers.

### **5.3 Combating unintentional error by increasing due diligence requirements: Easing the statutory complexity without a legislative fix**

William Cobb, CEO of H&R Block, wrote to the IRS Commissioner and Treasury Assistant Secretary for Tax Policy and advocated for the IRS to modify Schedule EIC ‘to require all taxpayers — regardless of how they file — to answer the same eligibility questions and to submit those responses to the IRS’.<sup>159</sup> According to his letter, this proposal has been discussed since 2012 by an IRS-EITC Software Developers Working Group.<sup>160</sup> Cobb characterises this proposal as ‘a simple, common sense first-step to reduce improper payments among both self-preparers and paid preparers.’<sup>161</sup>

<sup>157</sup> IRM 25.1.2.3(2) (06-09-2015), Indicators of Fraud

<sup>158</sup> National Taxpayer Advocate, ‘Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC’, *2013 Annual Report to Congress* (2013) 104, n 12. It imposes the two-year ban far more frequently: 5,438 times in 2011; but in a significant percentage of cases, it does so inappropriately, because 39% of the time it does so without receiving any response from the taxpayer. This practice is contrary to published IRS Chief Counsel guidance, which provides that ‘a taxpayer’s failure to participate in an EITC audit does not justify imposing the ban’: at 103.

<sup>159</sup> Cobb letter, published in *Tax Notes Today*, Nov 11, 2014.

<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

Cobb believes that if this proposal were adopted, ‘the IRS would have better information more quickly on the sources and causes of improper payments, and it will likely see a reduction in the improper payment rate.’<sup>162</sup>

Cobb notes that the IRS can implement this change without statutory authority.<sup>163</sup> Cobb’s proposal makes far more sense than waiting for Congress to simplify the EITC provisions (assuming one even thinks that simplification is desirable).

Book describes Cobb’s proposed changes as likely to be ‘good for the tax system’ because ‘changes that enhance visibility and accountability are the most effective and cost-efficient ways of decreasing errors.’<sup>164</sup> I agree with Cobb and Book, and describe in section 6 how the IRS can go even further in partnering with taxpayers for increased information.

Some members of Congress also agreed with Cobb’s proposal. A Senate appropriations bill for fiscal year 2016 directed the Department of Treasury to ‘ensure that the same eligibility questions are being asked of taxpayers whether they are preparing their returns with a paid tax preparer or via do-it-yourself methods such as paper forms, preparation software, or online preparation tools.’<sup>165</sup> The Senate Appropriations committee noted that this measure is intended to reduce the improper payment rate on EITC:<sup>166</sup>

Implementing uniform eligibility questions for refundable credit filers is a common sense step that will help alleviate confusion over eligibility and better establish qualification for these credits. The Department of the Treasury shall ensure that all EITC eligibility questions included on Form 8867, such as questions 1 through 19 and the eligibility questions used to meet the requirements of question 24, will be included on the Schedule EIC. The Department of Treasury shall implement this for tax returns filed after January 1, 2016.

David Williams, chief tax officer of Intuit and formerly the Director of the Earned Income Tax Credit office at the IRS, disagrees with this premise. Williams states that ‘making self-preparation harder will likely increase EITC error, not reduce it’ and further states that increased information ‘is also a very bad idea because it puts the burden of tax compliance squarely on lower-income working taxpayers.’<sup>167</sup>

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<sup>162</sup> Ibid.

<sup>163</sup> Ibid.

<sup>164</sup> Leslie Book, ‘H&R Block CEO Asks IRS to Make it Harder to Self-Prepare Tax Returns and Why That’s a Good Idea’, on Leslie Book, *Procedurally Taxing* (December 3 2014) <<http://www.procedurallytaxing.com/hr-block-ceo-asks-irs-to-make-it-harder-to-self-prepare-tax-returns-and-why-that-is-good-for-the-tax-system/>> accessed 21 October 2016.

<sup>165</sup> Senate Report 114-97, 37, ‘Financial Services and General Government Appropriations Bill, 2016.

<sup>166</sup> Ibid.

<sup>167</sup> ‘Intuit Chief Tax Officer Says Reducing EITC Errors Should Not Come on Backs of Poor,’ Leslie Book, *Forbes*, Mar 6, 2015 at 7:16 am, <<http://www.forbes.com/sites/procedurallytaxing/2015/03/06/intuit-chief-tax-officer-says-reducing-eitc-error-shouldnt-come-on-backs-of-low-income-taxpayers/#66e474ff4bfd>> accessed 21 October 2016.

So how to strike an appropriate balance? If too much is required of return preparers, taxpayers may prefer to self-prepare. If too much is required of self-preparing taxpayers, it may discourage eligible recipients from applying.

While I am not in favour of burdening a vulnerable population, I will address in section 6 why I believe requiring this information (and incenting additional documentation) is not more burdensome than what is asked in other tax and non-tax benefit contexts, and why it is ultimately the best solution for all EITC-eligible recipients.

## **6. KNOWLEDGE IS POWER: A TWO-STEP (COMMON SENSE) PROPOSAL TO REDUCE IMPROPER PAYMENTS AND COMBAT ALL FOUR TYPES OF EITC NONCOMPLIANCE**

This section supports the calls for increased due diligence requirements on all returns, whether completed by a paid preparer or self-prepared, and builds upon theories of noncompliance to suggest that increased due diligence may help reduce both intentional and unintentional EITC errors.

The quote ‘knowledge is power’ is commonly attributed to Francis Bacon. A more modern variant is attributed to Ethel Watts Mumford: ‘Knowledge is power, if you know it about the right person’.<sup>168</sup>

Research on noncompliance and the tax gap confirms the common sense suspicion that taxpayer compliance correlates with information reporting. In the case of the EITC, this means having knowledge about not just income but also a taxpayer’s personal situation. If the IRS had more knowledge before processing the return — if it could readily and easily ascertain information about residency, relationships, and income (ie, have better knowledge) on EITC claims — it could more effectively reduce the improper payment rate.

Building on what (we think) we know about noncompliance, this section will outline in two steps why requiring taxpayers to provide an increased amount of information with the return, coupled with slowing down the refund process generally, is a reasonable way to improve administration of the EITC program.

### **6.1 Step one: Increase information required on every return, with an additional statement required of taxpayers claiming children they didn’t claim last year and an expedited refund for those who can attach documentation to the return**

Increasing due diligence requirements on all returns, including self-prepared returns, is an appropriate start. All taxpayers — regardless of whether they self-prepare or rely on a preparer, and regardless of whether they are claiming EITC for the first time or the twentieth time, should have to provide basic information on an IRS schedule indicating: the relationship; the number of months the qualifying child lived in their home; and a box indicating the type of documentation they can provide to the IRS upon request to substantiate their claim.

Currently, taxpayers are required to provide the first two items on Schedule EIC. The third requirement is a proposed twist on Form 8867: whereas the form asks the

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<sup>168</sup> See, eg, Gyles Brandreth, *Oxford Dictionary of Humorous Quotations*, 5th edition (Oxford University Press, 2013) 252.

preparer to indicate which documents, if any, the preparer was provided by the taxpayer and relied upon in completing the return (and imposes a duty for the preparer to retain copies of those documents), the form should ask the question of the taxpayer and not just the preparer.

Why require this? Because it puts all taxpayers on notice that they may be required to substantiate their claim. Currently, self-preparing taxpayers are not required to consider such specifics about substantiation. Even taxpayers who rely on preparers can have a return prepared simply by answering questions and without providing or even describing the types of documents they have at home to substantiate the claim upon request.

Schedule EIC or a revised due diligence form for all taxpayers should require an affirmative statement from the taxpayer indicating that they can provide, upon request, some type of evidence to verify the EITC claim. It is crucial that the form present taxpayers with a wide array of options to indicate how they might substantiate the claim. I know firsthand from representing low-income taxpayers that not all claimants can provide the type of rigid documentation the IRS asks for upon examination, which includes school records, medical records and utility bills spanning at least a six-month period.<sup>169</sup> Not all children are school-aged, not all see the doctor regularly, and not all taxpayers have bills in their name. Some taxpayers are transient, but move as a family; some don't keep paperwork when they move from residence to residence. There are many legitimate obstacles that explain why low-income taxpayers may have trouble providing official documentation showing at least six months of shared residency with their qualifying children.

For this reason, it is imperative that taxpayers be allowed the option to indicate that they can (upon request) provide an affidavit from any third party (including, but not limited to, a spouse or relative) regarding the child's residency.<sup>170</sup> A taxpayer affirmatively indicating that they can provide a third-party affidavit upon request should by no means be an automatic trigger for examination. EITC controversies that go to trial in US Tax Court sometimes turn on the veracity of taxpayer testimony and witnesses rather than the rigid documentation preferred by the IRS.<sup>171</sup>

I propose that there should be a streamlined process for a taxpayer who claims the same children in the following tax year. Parents claiming the same children year after year should be provided an option to indicate on the form that their living situation is the same as the last year.

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<sup>169</sup> For examples of why some taxpayers cannot provide such documentation, see 2002 GAO report 15–20. These descriptions are consistent with the various challenges I have seen in my representations.

<sup>170</sup> I have previously criticised both the automated nature of EITC correspondence examinations and the rigidity with which documentation is accepted. See Drumbl, above n 13, at 132–139. A Taxpayer Advocate Service study of 256 Tax Court cases in which the Service conceded that the taxpayer was entitled to the EITC (though had been denied such at the audit level) discovered that in 20% of the study's cases an Appeals Officer or Chief Counsel attorney accepted documents that the Tax Examiner had rejected. National Taxpayer Advocate, *2012 Annual Report to Congress* (2012) 89–90. In 5% of the cases studied, the Service conceded after concluding that the Tax Examiner misapplied the law.

<sup>171</sup> See, eg, *Coats v Commissioner*, TC Memo. 2003-78 ('We find petitioner's testimony credible. We find convincing petitioner's explanation for the discrepancy between the school records and his testimony regarding where [his daughter] lived during 1998. Under these circumstances, we afford more weight to his testimony than to the school records.')

Those taxpayers claiming qualifying child(ren) for the first time present a different situation. The IRS should (and likely already does) primarily focus its enforcement (and education/outreach) efforts on these first-time claimants. Up to one-third of EITC claimants, each year, are ‘intermittent or first-time claimants,’<sup>172</sup> and these taxpayers may be less likely to understand or appreciate the EITC requirements. Thus it is crucially important for the tax form itself to clearly communicate the requirements and also put taxpayers on notice as to the gravity of self-declaring eligibility and the potential post-filing consequences.

As part of increased due diligence, I propose that first-time claimants of qualifying children should have to add a statement to Form EIC indicating what changed (ie, why the children were not claimed last year). If this entry is left blank on the return, the IRS should follow up with a simple letter to the taxpayer explaining that they must provide a statement or the credit will not be processed.

Weighing the burden against the benefit, I do not think requiring a one or two sentence explanation for first-time claimants will adversely impact the take-up rate of eligible claimants. There are many easily-explained reasons a taxpayer may be claiming children for the first time: children are born; people get married and gain stepchildren; custody arrangements change; children move in with uncles or grandparents for a variety of economic and/or relationship reasons; or the financial support structure within a multi-generational household shifts.

Asking taxpayers to provide this information does not seem unreasonable given the amount of the credit at stake. Having to affirmatively provide this explanation will impress upon the taxpayer the significance of claiming entitlement for the first time. Providing even a brief one-sentence explanation demonstrates good faith. In the event the IRS decides to further scrutinise the return, the affirmative statement becomes the starting point for the examiner.

An even more proactive way to strengthen due diligence would be to invite these first-time claimants to optionally partner with the IRS in information sharing.

#### 6.1.1 *‘EITC Fast-Track’ — A voluntary path for taxpayers to partner with the IRS in exchange for expedited refund consideration*

This proposal is inspired by a government agency that plays an entirely different role for the federal government: the Transportation Security Administration (TSA).<sup>173</sup> Think of the TSA line at the airport: every traveller who wishes to board the airplane must go through the security line. But some travellers decide it is worth it to go through the extra rigor of qualifying for the optional ‘TSA Precheck’ program: they fill out extra forms, provide documentation of citizenship or immigration status, provide fingerprints, and voluntarily subject themselves to a behind-the-scenes screening process. In exchange (assuming they are cleared), they receive a known

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<sup>172</sup> TIGTA, ‘Not in Compliance,’ above n 27, 2.

<sup>173</sup> The taxpaying public may not be so enthused about a proposal that borrows an idea from the TSA; past polls measuring opinions of government agencies have found both agencies equally unlikable. Eileen Sullivan, ‘Poll: Travelers Dislike TSA as Much as IRS’, Associated Press, USA Today.com, 12/20/2007 5:32 PM. However, in more recent years, the IRS has taken an even bigger popularity dip relative to the TSA. Joe Davidson, ‘Survey says Uncle Sam flunks government’, *Washington Post*, Nov 24, 2015.

traveller number and the privilege of expedited clearance every time they travel thereafter. The program is purely optional: not every traveller does this, though all travellers who clear security eventually arrive at the same destination. Some, however, clear more quickly because they have voluntarily provided a government agency with additional information. They have partnered with the government by sharing knowledge about themselves.

I envision a similar program that would serve as an EITC Fast-Track for first-time claimants. Imagine an example: Joe Taxpayer is claiming EITC for the first time this tax year because he married Jane Taxpayer and now has three stepchildren who are qualifying dependents. Assume that Jane does not have a filing obligation because her only income was from social security disability; thus, no taxpayer claimed the children last year. Presumably as a married couple they will now file a joint income tax return. Like all taxpayers, they will be required to provide the standard information indicating relationship, number of months the children resided in the household, and the type of documentation they can provide upon request to substantiate the claim. Like all first-time EITC claimants, Joe and Jane will have to make an affirmative one or two sentence statement explaining this straightforward change in circumstance if they wish to receive the EITC.

Beyond that, they have two options: 1) they can enclose substantiating documentation, which might include the marriage certificate and a letter from a relative or neighbour attesting that all five individuals lived together for at least six months of the year; 2) alternatively, they can choose not to submit any documentation. If they choose option one, the IRS will process the refund on a 'fast-track' basis. If they choose option two, they will still receive the refund, but it may take several weeks longer to process because the IRS would have to verify eligibility through its regular internal procedures (and as I propose in the next section, the IRS should slow down all refunds subject to these verification procedures). Depending on how those internal procedures turn out, Joe Taxpayer may be asked to provide the marriage certificate at a later time. Just as all compliant passengers eventually get on the airplane, all eligible taxpayers would get their EITC — but some would get it faster than others.

Consider these proposals for increased due diligence in the context of symbolic noncompliance. As discussed in section 3 above, one common type of noncompliance is when a boyfriend claims his girlfriend's children (and he is not the father). Under the current procedures, this may be likely to trigger an examination because the IRS will know he has never claimed the children before. If his return is audited and the refund frozen, he simply can ignore the notice and he is not penalised in any way for trying. There is also a chance that his claim would slip through undetected and that he would receive the improper payment without examination.

But imagine if this proposal were implemented and that the boyfriend (a first-time claimant of these children) was required to include a statement explaining the change in circumstance on Schedule EIC. Would he be so bold to write that he married the mother and these are now his stepchildren; particularly if Schedule EIC included a warning that a false statement is a criminal offense?

On the other hand, if the taxpayer indeed had married the mother last year, and he is making first-time claim to which he is entitled, he would simply include an affirmative statement to that effect, and he could even choose to submit documentation under the 'EITC Fast-Track' option.

This approach would incent a population of first-time claimants to affirmatively show they are entitled to the benefit. Of course not all taxpayers have the resources, means, or sophistication to provide the appropriate affirmative documentation with the return for a ‘fast track’ EITC refund. Again: this should not create a barrier to the EITC; in these cases the IRS should allow self-declared eligibility as it always has, but the refund will not be processed on an expedited basis.

Long-time observers of the EITC might find this proposal reminiscent of a controversial pilot program that the IRS once proposed and abandoned — EITC pre-certification. I rebut that comparison and distinguish my proposal in the section that follows.

### 6.1.2 *Pre-certification: Why it failed, and how this proposal is different*

To some, the ‘fast-track’ proposal may be reminiscent of a previous IRS pilot program that required pre-certification for a test sample of taxpayers for tax years 2003 and 2004.<sup>174</sup> The pre-certification pilot program proved to be quite controversial, and the Service ultimately abandoned the pilot program after two tax years. While policy makers and scholars noted that the program the program might improve compliance, common concerns included that it ‘also could significantly reduce participation, and might not save the government much money.’<sup>175</sup> Some criticised it as unfairly targeting poor taxpayers,<sup>176</sup> and for requiring something of EITC claimants that is not required of other taxpayers:<sup>177</sup>

There are also real issues in subjecting EITC recipients to a pre-certification process that does not apply to any other tax filers. People do not need to pre-certify before taking a charitable deduction for a used car or clothing, even though there is ample evidence that these deductions are overstated. Sole proprietorships do not need to pre-certify that they are not hiding cash from the tax authority before claiming deductions for inventories, rent, and equipment, even though they are notoriously noncompliant. And so on.

The optional nature of the fast track EITC proposal draws in part on lessons learned from the IRS’s ill-fated pre-certification pilot program. That program selected a small population (45,000 taxpayers) and imposed an additional burden on them — one that was not imposed upon other EITC claimants or any other type of taxpayer. The mandatory nature of the pre-certification was, in my view, its greatest shortcoming. It burdened taxpayers who lacked the sophistication, means, language skills, or time to comply with its requirements.

I share the concerns about limiting participation and burdening a vulnerable population. For this reason, the fast-track program should be strictly optional, and taxpayers who do not opt in should be disadvantaged only as to timing of the refund. For those who do not opt in, the agency will have to take a more active role in verifying the claim. Hence, the longer processing time (which in the next section I

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<sup>174</sup> See IRS Announcement 2003-40, 2003-26 IRB 1132, 2003-1 CB 1132, 2003 WL 21362731.

<sup>175</sup> Leonard E Burman, statement before The Committee on Ways and Means, United States House of Representatives, Subcommittee On Waste, Fraud, and Abuse, 11 (July 17, 2003): ‘The fear among those who care about the EITC is that the pre-certification strategy is tantamount to a 100 percent audit rate (in advance) for certain people who claim the EITC’: at 9.

<sup>176</sup> For a collection of such criticisms, see Zelenak, above n 8, 1870–1871.

<sup>177</sup> Burman, above n 175, 12.

suggest is appropriate for most taxpayers in any event). Taxpayers who do not opt in would not face a presumption of noncompliance; as with the current system, they would make a claim of eligibility and the IRS would use its filters to assess the risk of paying the credit without requesting documentation of eligibility through examination.

Some segment of the EITC population, however, is able to comply with additional information reporting, and may be willing to do so if it means receiving the refund on an expedited basis. The IRS should allow this population to self-select for a number of reasons. First, it is highly unlikely that a taxpayer who voluntarily submits documentation would engage in deliberate noncompliance. Morse, Karlinsky and Bankman conclude that intentional noncompliance is driven by opportunity and ‘a low-perceived likelihood of detection and penalty’.<sup>178</sup> The fast-track procedure would invite increased scrutiny, which is the opposite of what an intentionally dishonest taxpayer would want to attract. In a similar vein, Book writes of symbolic noncompliance: ‘to the extent that taxpayers believe others are complying, then taxpayers will not take advantage of the tax system’.<sup>179</sup> If a significant percentage of taxpayers were to elect to offer more documentation than is required in order to receive their EITC more quickly, it will demonstrate that this population is complying beyond the minimum requirement. Presumably, those who know that they do not meet eligibility requirements would not affirmatively draw attention to themselves by attempting a fast-track refund. In these regards, a fast-track option could advance the sort of cultural change and trust in government that underpinned the Taxpayer Advocate Service recommendations to address sole proprietor noncompliance.

Fast-track taxpayers would effectively remove themselves from the pool of claimants who would otherwise be scrutinised for eligibility with third-party information reporting. This in turn would allow the IRS to direct its limited resources to a relatively smaller population of claimants.

Would a ‘fast-track’ option unfairly target poor taxpayers? By definition, any form of increased due diligence requirement directed at EITC taxpayers is directed at lower income taxpayers. It is true that we do not subject sole proprietors, taxpayers claiming itemised deductions, or taxpayers claiming education credits to tougher due diligence requirements at the time of filing. Arguably, we should. But in any event, the EITC is somewhat special — as Zelenak notes, it is a hybrid provision that is housed in the tax system but functions as a social benefit.<sup>180</sup> And even with increased due diligence standards and an optional ‘fast-track’ program, claiming the EITC is far less burdensome than applying for more traditional welfare benefits such as SNAP or Temporary Assistance for Needy Families (TANF).<sup>181</sup>

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<sup>178</sup> Morse, Karlinsky and Bankman, above n 47, 67.

<sup>179</sup> Book, ‘One Size Does Not Fit All’, above n 12, 1176.

<sup>180</sup> Zelenak, above n 8, critiques the pre-certification pilot program and analyses the hybrid characteristic. Though some of the details of the assistance programs that Zelenak describes in his article have changed over time, the current iterations of these programs require similar front-end determinations of eligibility by the agency before benefits are administered. Concluding that ‘overall EITC enforcement efforts remain much more similar to ordinary tax enforcement than to welfare-type enforcement’, Zelenak cautions that ‘[i]t may not be wise, then, for EITC proponents to object to every respect in which EITC enforcement may be more rigorous than income tax enforcement generally’: at 1915–1916.

<sup>181</sup> *Ibid.* Consider also that states have the option to impose drug testing on welfare recipients. See Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub L No 104–193, 110 Stat 2105, Section 902. For an overview of this controversial practice, see Maggie McCarty, Gene Falk,

Even within the tax code, there are examples of increased reporting or due diligence requirements in other taxpayer realms, including ones that typically involve moderate- or high-income taxpayers. Consider the burdensome reporting regime imposed upon US citizens holding foreign accounts. At certain income thresholds, these taxpayers are subject to two separate and potentially overlapping reporting regimes: foreign bank and financial account reporting (FBAR) and the Foreign Account Tax Compliance Act (FATCA). Taxpayers who run afoul of these reporting requirements, even non-wilfully, can face significant civil penalties, and criminal penalties may also apply. The penalty structure is far more serious than anything faced by EITC claimants. While there are many legitimate reasons to hold an offshore account, all taxpayers are swept up in the reporting regime because the government has made this type of tax evasion an enforcement priority.

As discussed, the two biggest causes for EITC overclaims are income misreporting and the residency requirement. Of the two causes, income misreporting is the trickier one for which to require substantiation. Not all taxpayer income is reported on a Form W2 or 1099. But to the extent that income is subject to third-party reporting, the IRS would benefit by either 1) speeding up the matching process, or 2) slowing down the refund process. The next section describes why slowing down can reduce improper payments.

## 6.2 Step two: Slowing it down—the agency verifies the claim, maximizing information available to it

I am hardly the first person to suggest that the IRS should not issue a refund until it has had time to verify the claim. The IRS struggles with a difficult balance: the EITC is meant to lift people out of poverty, and delaying refunds hurts people who rely on the credit to pay bills. Yet rushing a refund creates different problems, including not just improper payments to people claiming the credit incorrectly, but also identity theft that diverts the refund from the taxpayer who is entitled to receive it.<sup>182</sup>

Much of the information the IRS would like to have to verify EITC claims is available, but not always at the time of filing. While the ideal solution is for the IRS to modernise its technology so it could speed up verification, for the time being the more realistic solution is to slow down the refund to check it against the systems it has.

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Randy Alison Aussenberg and David H Carpenter, 'Drug Testing and Crime-Related Restrictions in TANF, SNAP, and Housing Assistance', CRS Report R42394, 18 November 2015. Compared to such invasive monitoring and punitive administration, increased due diligence and a 'fast-track' proposal for EITC seem like fairly mild measures.

<sup>182</sup> Book notes that 'dummying up tax returns with phony withholding amounts that take advantage of the IRS's lack of early access to information returns is the main tool of the identity theft fraudster.' Leslie Book, 'Warren Buffet Calls for Expanding EITC: Tax Administration Impact Highlights There is No Free Lunch' on Leslie Book, *Procedurally Taxing* (May 27 2015) <<http://www.procedurallytaxing.com/warren-buffet-calls-for-expanding-eitc-tax-administration-impact-highlights-there-is-no-free-lunch/>> accessed 21 October 2016. The Senate Finance Committee introduced a Bill to address this concern; the Bill would require employers to submit Forms W2 and 1099-MISC to the IRS by mid-February in most cases. Joint Committee on Taxation, 'Description of the Chairman's Mark of a Bill to Prevent Identity Theft and Tax Refund Fraud' (JCX-108-15), September 11, 2015.

As to income reporting, the IRS depends on third-party verification to verify accuracy. Under the current approach, the EITC refund is typically issued before the IRS has received and processed all third-party information including Forms W2 and 1099. Thus, if the taxpayer has made a mistake in calculating income, or has underreported income (whether inadvertently or intentionally), the IRS is left playing catch-up after the return has been processed. To the extent that the IRS cannot independently verify income, we must accept any accompanying EITC overclaim as an inevitable form of taxpayer noncompliance, just as we accept that cash business noncompliance is relatively high.

Moreover, information reporting as to residency is not as simple. The IRS needs to modernise; it needs to invest in upgrading its technology and database sharing, particularly with other social benefit programs administered by states. Along these lines, the Urban Institute undertook a recent case study using data from Florida ‘to explore whether SNAP data could be used to improve EITC enforcement and whether SNAP data can provide information that would help the IRS identify EITC-eligible workers who have not claimed the tax credit.’<sup>183</sup> There is far from perfect overlap between SNAP recipients and EITC eligible claimants: SNAP includes an asset test, whereas EITC does not. Approximately one-half of SNAP recipients have children, and approximately one-half of those who have children have earned income.<sup>184</sup> Of the Florida data set showing overlap between SNAP recipients and EITC claimants, the SNAP data verified the EITC relationship test in 99% of cases.<sup>185</sup> However, the available SNAP data was ‘insufficient’ to verify the EITC residency test in 20% of the cases.<sup>186</sup> The study concluded that ‘the information that applicants report to SNAP is not detailed enough to conclusively verify eligibility, but the data could help the IRS spot potential overclaims worthy of further examination as part of the audit process.’ Slowing down EITC refunds would aid the Service in maximizing these verification opportunities.

## 7. CONCLUSIONS

The EITC is overly complex, is not administered effectively, and has a high improper payment rate. The EITC process will never be perfect. It can’t be: it is impossible to design a benefits program with a 100% take up rate and a 0% noncompliance rate. The politicians and taxpaying population must accept that reality, especially as one of the ‘costs’ of administering a benefits program on the cheap.

Competing pressures are at play. If enforcement is too low, noncompliance may increase. But enforcement costs money, and one of the most attractive features of the EITC is its low administrative overhead relative to program size.

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<sup>183</sup> Elaine Maag, Michael Pergamit, Devlin Hanson, Caroline Ratcliffe, Sara Edelstein and Sarah Minton, ‘Using Supplemental Nutrition Assistance Program Data in Earned Income Tax Credit Administration: A Case Study of Florida SNAP Data Linked to IRS Tax Return Data’, Urban Institute (Sept 2015) <<http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000438-using-snap-data-in-eitc-administration.pdf>> accessed 21 October 2016.

<sup>184</sup> Ibid 6.

<sup>185</sup> Ibid 10.

<sup>186</sup> Ibid. The SNAP data is considered ‘insufficient’ in cases in which ‘the tax filer(s) and the child receive benefits in the same case but the benefit receipt does not cover a six-month period or there are more than 10 months between benefit receipts.’ This illustrates one of the evidentiary challenges of the residency test.

Increasing due diligence requirements on all types of filers would increase the burden on low-income taxpayers. But the additional layers of due diligence recommended in this article would protect taxpayers, both from themselves and from their preparers. Given the amount of money at stake, it is not unreasonable to increase the burden, especially on those who are claiming qualifying children for the first time.

The IRS must continue to develop initiatives to improve the administration of the EITC; doing so may be key to the continued political viability of what is a very important anti-poverty program. Those who benefit from this program deserve this protection. Time and again, the program has been shown to improve the lives of children. The US cannot afford to lose those benefits because of the political fallout from inept administration of this program.