

Unequal Burdens in EITC Compliance

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Lower income means harsher treatment from the government for taxpayers who claim the Earned Income Tax Credit (EITC). EITC claimants are audited more often than any taxpayers other than the very wealthy. More concerning, however, is that the IRS audits EITC claimants by correspondence examination in a manner that unduly burdens access to this refundable tax credit: a credit that often keeps lower income workers out of poverty.

Improper payment law brings increased scrutiny to federal programs that issue erroneous payments. Because the EITC is alleged to have substantial improper payments, it is subject to federal improper payment law, which adds administrative burdens in hopes of diminishing erroneous payments. While other scholars have noted the relationship between improper payment law and the EITC, this Article takes the unique view that improper payment law, instead of burdening EITC administration, can provide relief to the Service's onerous EITC compliance methods.

Introduction

For the last three decades, income disparity within the U.S. has been widening.¹ After the Occupy Wall Street protests, the nation is undoubtedly conscious of this growing disparity.² It is unlikely, however, that the nation is conscious of the compliance burden disparity experienced by low and moderate income taxpayers. For taxpayers claiming the EITC, lower income brings

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1. See David J. Lynch, *Growing Income Gap May Leave US Vulnerable*, BLOOMBERG (Oct. 13, 2011 11:37 AM), <http://www.bloomberg.com/news/2011-10-13/growing-income-divide-may-increase-u-s-vulnerability-to-financial-crises.html> (referencing Census Bureau Data that indicates "[s]ince 1980 about five percent of annual national income has shifted from the middle class to the nation's richest households").

2. *Id.*

with it harsher treatment by the government.³

In chasing increased efficiency while broadening audit coverage, the Internal Revenue Service (Service) has dramatically increased its use of correspondence examinations, nearly tripling their usage since FY 2000.⁴ While sophisticated taxpayers with representation can navigate correspondence examinations with minimal difficulty,⁵ in EOTC examinations, ninety-eight percent of taxpayers are unrepresented.⁶ Moreover, successful application for EITC is often complex and can require atypical documentation for nontraditional family living arrangements.⁷ This would make EITC compliance ill-suited for the correspondence examination process and results in the Service's declarations of ineligibility for eligible EITC claimants.⁸ The Service has struggled to

3. See Francine J. Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 WIS. L. REV. 461, 461 (2003).

4. Compare IRS, IRS DATA BOOK 2000 42 (2000), with IRS, IRS DATA BOOK 2010 tbl. 9a (2010) (comparing FY 2000 vs. FY 2010 correspondence activity); see also Mike Landsmann, Campus Correspondence Audit Process & Resolution, slide 4 (Jul. 14, 2010) (graphing the rise in correspondence examinations) (on file with author).

5. See Leslie Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net*, 81 OR. L. REV. 351, 390 (2002) [hereinafter *Compliance Regime*] ("[W]hile the Service's middle-income constituency would be able to tackle these tasks, it provides a formidable obstacle for low-income taxpayers.").

6. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, VOLUME TWO, at 102 (2007) ("The findings are based on a dataset containing 427,807 taxpayers. Of these returns only 7,688 (1.8%) were represented in the original audit.").

7. See Book, *Compliance Regime*, *supra* note 5, at 369–72, 390–406 (noting complexity as a reason for EITC errors and discussing special circumstances of the working poor and specific barriers to effective EITC compliance action); see also *Taxpayer Advocate Report and Low-Income Taxpayer Clinic Program: Hearing Before the Subcomm. on Oversight of the Comm. on Ways & Means*, 107th Cong. 4–5 (2001) (written statement of Janet Spragens, Professor of Law and Director, Federal Tax Clinic, Washington College of Law, American University) (examining documentation challenges that EITC taxpayers face).

8. See NAT'L TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS, VOLUME TWO, at i:

[T]his study confirms what many low income taxpayer advocates have maintained for many years – that the manner in which the IRS conducts its audits of low income taxpayers impacts the audit outcomes. One can infer from the study that in many cases – 43 percent of 67,000 FY 2002 audit reconsiderations, or over 28,000 cases – taxpayers were entitled to virtually all of the EITC they claimed. That is, their original audit results did not accurately reflect their eligibility for the EITC. Rather, the audits merely show that the taxpayer flunked the IRS audit process.

Id.

successfully administer EITC for thirty years;⁹ however, seeking EITC compliance under the correspondence examination procedures is not a good answer. Administering the EITC in this manner burdens benefit distribution to low-income taxpayers.¹⁰

This is particularly true when the Service fails to offer basic support services for EITC correspondence exams. For example, the Service only answers approximately seventy percent of taxpayer phone calls it receives.¹¹ Callers to the EITC phone line may find a phone line that is not staffed, and for those who leave a voicemail message, anecdotal evidence suggests that they may not receive a return phone call.¹² While this is frustrating and undoubtedly makes navigating the credit more difficult, perhaps it is fortuitous that taxpayer needs are not adequately addressed by phone; correspondence examination cases are only assigned to an examiner after correspondence is received from a taxpayer.¹³ Accordingly, the taxpayer must correspond in writing with the Service to extricate himself or herself from an otherwise wholly automated system.¹⁴ Unfortunately, even if an EITC taxpayer writes the Service, the correspondence may be lost, incorrectly matched, or experience significant delay before it is logged into the Service's system, which could trigger the automated system to send inaccurate correspondence in response.¹⁵ An EITC taxpayer facing examination may experience some or all of these barriers before even attempting to provide the required document-intensive proof to verify his or her entitlement to the credit.¹⁶

Adding another layer of challenge to EITC administration is that EITC has been branded as a social benefit riddled with fraud.¹⁷ The Service reports,¹⁸ between twenty-three and twenty-

9. See Gene Steuerle, *Economic Perspective: Research Required for the EITC Precertification Process*, 100 TAX NOTES 259, 259 (2003) (articulating that, even though the Service has administered the EITC since 1975, it still lacks knowledge about, and research to substantiate, its successes and failures).

10. See *infra* pp. 55–61.

11. See IRS OVERSIGHT BOARD, FISCAL YEAR 2012 INTERNAL REVENUE SERV. BUDGET RECOMMENDATION SPECIAL REPORT 4 (2011).

12. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, VOLUME TWO, at 102 (2007).

13. See Landsmann, *supra* note 4, at slide 13 (depicting that cases with no response are worked completely through an automated system).

14. See *id.*

15. See Joe B. Marchbein, *Managing an IRS Correspondence Audit*, J. ACCT., Aug. 2011, <http://www.journalofaccountancy.com/Issues/2011/Aug/20114142.htm>.

16. IRS, INTERNAL REVENUE MANUAL 4.19.14.5.5, 4.19.14.5.7 (last visited Oct. 27, 2012).

17. See Anne Alstott, *Tax Policy and Feminism: Competing Goals and Institutional Choices*, 96 COLUM. L. REV. 2001, 2080 (1996) ("[I]n recent years the

eight percent of EITC payments are improperly made.¹⁹ This report is likely inaccurate,²⁰ but it forms the basis of subjecting EITC to heightened scrutiny under federal improper payment laws.²¹ While other commentators have noted the effect of improper payment laws on aspects of the EITC,²² this Article takes the unique view that improper payment law, instead of burdening EITC administration, could provide relief to the Service's onerous EITC compliance methods.

EITC has been widely criticized as a program 'rife with fraud.'" (citing Anne L. Alstott, *Comments on Samansky, Tax Policy and the Obligation to Support Children*, 57 OHIO ST. L. J. 381, 390-91 (1996))); James Bovard, *Clinton's Biggest Welfare Fraud*, WALL ST. J., May 10, 1994, at A18; Lisa Schiffren, *America's Best-Kept Welfare Secret*, AM. SPECTATOR, Apr. 1995, at 24)); see also Dorothy Brown, *The Tax Treatment of Children: Separate but Unequal*, 54 EMORY L. J. 755, 779-80, n.111, n.112 (2005) [hereinafter *Separate but Unequal*] ("[T]he assumption has often been made that errors on EITC returns are the result of fraud" (citing Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, 99 TAX NOTES 1821, 1823 (2003) ("[A]t the center of the debate on the Initiative is the belief that the EITC is riddled with taxpayer cheating."))).

18. See U.S. DEP'T OF TREASURY, 2010 PERFORMANCE AND ACCOUNTABILITY REPORT 281 app. B (2010).

19. See *Recent Efforts to Address Improper Payments and Remaining Challenges: Hearing Before the Subcomm. on Gov't Org., Efficiency, and Finan. Mgmt. of the H. Comm. on Oversight and Gov't Reform*, 112th Cong. 7 (2011) (written statement of Kay L. Daly, Director, Financial Management & Assurance, GAO) [hereinafter *Daly Statement*].

An improper payment is defined as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payment for services not received, and any payment that does not account for credit for applicable discounts. Office of Management and Budget (OMB) guidance also instructs agencies to report payments for which insufficient or no documentation was found as improper payments.

Id.

20. See *infra* text pp. 70-71.

21. Improper payment laws, discussed in *infra* Part I, are designed to limit the federal government from wrongly paying third parties.

22. See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1896-98 (2005) (articulating that the EITC is the only Service program identified as susceptible to improper payments and for which OMB has requested improper payment information and that improper refunds of withholding and estimated payments should be similarly subject to IPRA requirements); Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 AM. U. L. REV. 1163, 1170 (2007) [hereinafter *Freakonomics*] (noting the EITC's error rate in comparison with the error rates of other benefits programs and citing to the IPRA); Dorothy Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. LAW REV. 790, 806 (2007) [hereinafter *Race and Class*] (highlighting that "[t]he EITC is the only tax provision about which the OMB has requested improper payment information").

Executive Order 13520 contributes to the landscape of federal improper payment law, but it could provide relief to EITC and its claimants. Executive Order 13520 requires federal agencies with programs representing the highest improper payments to submit plans to reduce these improper payments, but the plans may not “unduly [burden] program access and participation by eligible beneficiaries.”²³ Correspondence examinations, and more specifically the manner in which they are conducted, unduly burden access to EITC, and this contravenes the Executive Order 13520 requirement to refrain from an undue burden for program access. This Article is divided into six Parts to address the collision of EITC and the correspondence examination process with Executive Order 13520 and its kindred improper payment laws. In Part I, this Article discusses improper payment laws, including Executive Order 13520. Part II identifies the alleged EITC overpayment rate and comments on the trigger of improper payment program requirements. Part II also highlights the fact that EITC is the only Department of Treasury or Service program subject to such scrutiny, even though EITC comprises only five percent of the tax gap.²⁴ Part III discusses how the Service executes its compliance mission and function via the correspondence examination process, and Part IV offers evidence that the correspondence examination process often impedes legitimate claimant access to EITC. Part V concludes that the Service’s use of correspondence examinations unduly burdens access to EITC in contravention of Executive Order 13520. Finally, in Part VI, the Article examines possible solutions, including previous and current Service Pilot projects.

I. Accountability Via Improper Payment Law

The U.S. faces burgeoning spending, debt levels, and lower revenue receipts due, at least in part, to the recent recession and sluggish national growth.²⁵ In addition, there is heightened

23. See Exec. Order No. 13520, 74 Fed. Reg. 62,201–05 (Nov. 20, 2009).

24. The tax gap is the difference between projected revenue and the amount collected. See JAMES M. BICKLEY, CONG. RES. SERV., R42739, TAX GAP, TAX ENFORCEMENT, AND TAX COMPLIANCE PROPOSALS IN THE 112TH CONGRESS 3–5 (2012).

25. See Catherine Rampell, *Sure Cure for the Debt Problem: Economic Growth*, N. Y. TIMES, July 30, 2011, at BU1 (“We face the largest budget deficit the nation has ever known: \$1.6 trillion, the equivalent of about 11 percent of our economy. And, whatever Washington does, many economists say the situation will grow only worse, particularly as Americans age and Medicare costs spiral higher.”); see also Harry Bradford, *U.S. Economy Surpasses Pre-Recession Level After 45 Months*, HUFFINGTON POST (Oct. 28, 2011, 6:11 PM), <http://www.huffingtonpost.com/>

political rhetoric calling, in many cases, for smaller government and, at the very least, more efficient government.²⁶ One way to control spending and to reform governmental administration is to closely monitor and control governmental payments to third parties.

It is not difficult to find political support for limiting and monitoring improper payments by the federal government.²⁷ When couched in terms of merely requiring the federal government to properly execute its duties and refrain from abetting activities that sound like fraud, improper payment legislation garners near unanimous support.²⁸ Congress passed and the president signed improper payment legislation in 2002 and 2010.²⁹ President Obama added more processes to the minimization of improper payments with Executive Order 13520 in 2009 and two presidential memoranda in 2010.³⁰ This legislation and manifestation of executive administrative power creates a more systematic framework for improper payment identification, measurement, planning, and reporting. What follows is a brief overview of the legislative and presidential contributions to improper payment law. While each offers contribution to the improper payment landscape, it is Executive Order 13520 that provides the possible opportunity for change in EITC compliance.

2011/10/28/us-gdp-growth-us-economy-surpasses-pre-recession-level-45-months_n_1064016.html (reporting on recession and U.S. economic growth levels).

26. See Brent Cebul, *Government, Big or Small*, L.A. TIMES, Jan. 23, 2012, <http://articles.latimes.com/2012/jan/23/opinion/la-oe-cebul-smaller-govt-20120123> (noting President Obama's rhetoric promising smaller, more efficient government); see also Mitt Romney, Address at the Detroit Economic Club (Feb. 21, 2012), DETROIT FREE PRESS, Feb. 24, 2012, available at <http://www.freep.com/article/20120224/NEWS15/120224034/Text-of-Mitt-Romney-s-speech-to-the-Detroit-Economic-Club> ("By making bold cuts in spending and commonsense entitlement reforms, we will make our government simpler, smaller, and smarter Together, let's put America on the path toward more jobs, less debt, and smaller government.").

27. See GARRETT HATCH & VIRGINIA A. MCMURTRY, CONG. RESEARCH SERV., RL34164, IMPROPER PAYMENTS INFORMATION ACT OF 2002: BACKGROUND, IMPLEMENTATION AND ASSESSMENT 25 (2010).

28. *Id.*

29. See Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (2002); Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204, 124 Stat. 2224 (2010).

30. See Presidential Memorandum, *Finding and Recapturing Improper Payments*, 75 Fed. Reg. 12,119-29 (2010) [hereinafter *Finding and Recapturing*]; Presidential Memorandum, *Enhancing Payment Accuracy Through a 'Do Not Pay List'*, 75 Fed. Reg. 35,953 (2010) [hereinafter *Enhancing Payment Accuracy*].

A. *Improper Payments Act of 2002*

Prior to the passage of the Improper Payments Act of 2002 (IPIA), there was no universal federal agency requirement to report or analyze wrongly made payments by the federal government.³¹ The IPIA began the process by requiring executive branch agencies “to review annually all programs and activities they administer and identify those which may be susceptible to significant erroneous payments.”³² A program is at “significant” risk with \$10 million of improper payments.³³ If an agency has improper payments greater than the \$10 million trigger IPIA requires the agency to estimate annual improper payments and report on its actions for reducing these improper payment estimates.³⁴

To comply with IPIA, federal agencies typically report their findings in their agency performance and accountability reports (PARs), annual financial reports (AFRs), or annual reports.³⁵ The IPIA’s process and reporting demands have, at the very least, allowed the federal government to have an increasingly comprehensive picture of the universe of improper payments.³⁶ It appears that the IPIA’s effect has not been short lived. Every year since IPIA was implemented in 2004, federal agencies have consistently identified new programs or activities as risk-susceptible and reported estimated improper payment amounts.³⁷

IPIA and its implementation were not without their critics. After its passage, the Office of Management and Budget (OMB) issued guidance for agencies implementing the IPIA.³⁸ In its guidance, the OMB augmented the IPIA’s statutory requirements. The guidance departed from the express IPIA provisions in two

31. See HATCH & MCMURTRY, *supra* note 27, at 1.

32. See MITCHELL E. DANIELS, OFF. MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, IMPROPER PAYMENTS INFORMATION ACT OF 2002 P.L. 107-300, at 2 (2003).

33. *Id.*

34. U.S. GOV’T ACCOUNTABILITY OFFICE, STATUS OF FISCAL YEAR 2010 FEDERAL IMPROPER PAYMENTS REPORTING 2 (2011).

35. See JACOB LEW, OFF. MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ISSUANCE OF REVISED PARTS I AND II TO APPENDIX C OF OMB CIRCULAR A-123, at 3 (2011).

36. See PAYMENT ACCURACY, <http://paymentaccuracy.gov/about-improper-payments> (last visited Nov. 9, 2012) (commenting on the progress on improper payments); see also HIGH-ERROR PROGRAMS, <http://paymentaccuracy.gov/high-priority-programs> (last visited Nov. 9, 2012) (containing a list of the federal programs with the highest error rates.).

37. See HIGH-ERROR PROGRAMS, *supra* note 36.

38. See DANIELS, *supra* note 32, at 13. Additional IPIA guidance was revised and incorporated into OMB Circular A-123, Appendix C. *Id.* at 14.

ways: dollar amount trigger and timing of reporting.³⁹ Whereas IPIA requires reporting programs with improper payments exceeding \$10 million, OMB guidance states that reporting is only required for programs meeting the \$10 million threshold and improper payments amounting to at least 2.5% of total program payments.⁴⁰ Critics noted that the addition of the 2.5% threshold exempted a number of programs from IPIA requirements that would have met the statutory trigger.⁴¹ OMB guidance also faced criticism because it enabled programs with substantial improper payments, so long as they were under the technical thresholds to avoid risk assessment planning with regard to improper payments, which, of course, defeated the purpose of the legislation.⁴²

In other words, critics suggested that there was too little process when an agency's improper payments were less than \$10 million and 2.5%. OMB guidance went even further by augmenting the IPIA reporting time periods. IPIA required annual reporting; however, OMB guidance allowed for reporting every three years for "low risk" programs.⁴³ While OMB's guidance drew criticism, OMB was somewhat vindicated when the Improper Payments Elimination and Recovery Act of 2010 (IPERA) codified OMB guidance.⁴⁴

B. Executive Order 13520 & Subsequent Presidential Memoranda

While the IPIA served to highlight the problem of agency improper payments to federal agencies and the public, the law itself, as well as OMB's guidance, failed to capture significant improper payments in the processes and provided only a very basic framework for agency consideration of these payments. In late 2009, President Obama signed Executive Order 13520 to extend the IPIA by providing more processes for reporting on improper payments.⁴⁵ Specifically, Executive Order 13520 requires:

- OMB to identify federal programs with the *highest* improper payments;
- OMB to set reduction targets for those programs, and

39. *Id.*

40. See HATCH & MCMURTRY, *supra* note 27, at 3.

41. *Id.*

42. See *id.* at 4.

43. See *id.* at 14.

44. *Id.* at 25.

45. Exec. Order No. 13520, *supra* note 23, at §§1, 3 (emphasis added).

Agencies to designate an official accountable for meeting the OMB reduction targets ***“without unduly burdening program access and participation by eligible beneficiaries,”***;

- Agencies to report to their inspector generals regarding measuring improper payments and the agency’s plan to meet the reduction targets ***without unduly burdening program access.***⁴⁶

It should be noted that Executive Order 13520 has a different trigger than the IPIA. Under Executive Order 13520, an agency’s “highest” improper payments trigger the process, as opposed to the IPIA’s dollar and percentage triggers. Because Executive Order 13520 does not change the IPIA and only adds another layer of process, its trigger subjects more agencies and programs to improper payment law.

Most significant for the purposes of this Article, however, is Executive Order 13520’s recognition that an agency should not minimize improper payments in manners that unduly burden beneficiary access to, and participation in, federal programs. This requirement was missing from both the IPIA and also the later IPERA.

In addition to Executive Order 13520, President Obama also issued two presidential memoranda aimed at reducing improper payments. On March 10, 2010, the President issued *Memorandum on Finding and Recapturing Improper Payments*, which expanded the use of payment recapture audits.⁴⁷ On June 18, 2010, President Obama issued *Memorandum on Enhancing Payment Accuracy Through a “Do Not Pay List,”* which required federal agency cross-checking before making payments.⁴⁸

C. Improper Payments Elimination & Recovery Act of 2010

The Improper Payments Elimination and Recovery Act of 2010 (IPERA)⁴⁹ codified some of OMB’s extra-statutory IPIA guidance.⁵⁰ IPERA also increased process requirements for identifying, estimating, and reporting improper agency payments, and added a recovery audit piece as well as consequences for agency noncompliance.⁵¹ Most significantly, IPERA requires the

46. See *id.* at 62201–02 (emphasis added).

47. See *Finding and Recapturing Improper Payments*, *supra* note 30, at 12,119.

48. See *Enhancing Payment Accuracy*, *supra* note 30, at 35,953.

49. Pub. L. No. 111-204, 124 Stat. 2224 (2010).

50. See HATCH & MCMURTRY, *supra* note 27, at 14.

51. See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 34, at 8.

head of each Federal agency to review all the agency's programs and identify activities that may be susceptible to significant improper payments (\$10 million and 2.5% or \$100 million), at least once every three years.⁵² This is the same trigger that OMB guidance suggested under IPIA.⁵³ Because IPERA's provisions became effective in fiscal year 2011, results for measuring its effectiveness are not yet available.⁵⁴

D. Applying Improper Payment Law

As explained above, federal improper payment law is drawn from two federal statutes, an executive order, and two presidential memoranda, but to what end? Currently, OMB uses these to require a formal process for decreasing unnecessary and wasteful expenditures.⁵⁵ These procedures certainly create additional work for federal agencies by requiring new processes as well as monitoring and reporting. This is new bureaucracy, but it appears to be working. According to OMB, agencies payout \$2-3 trillion annually to third parties.⁵⁶ From fiscal year 2009 to 2010, there was a drop in the improper payment rate from 5.65% to 5.49%, although the 2010 rate was still above the targeted 5.3%.⁵⁷ These rates do not include the provisions of IPERA, which becomes effective in fiscal year 2011.

Despite only modest improvements in improper payment

52. See Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204, §2(a)(1) (2010).

53. See DANIELS, *supra* note 32, at 4–5.

54. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 34, at 2.

55. See HATCH & MCMURTRY, *supra* note 27, at 1.

56. See OFF. FED. FINAN. MGMT. IMPROPER PAYMENTS, http://www.whitehouse.gov/omb/financial_fia_improper/ (last visited Nov. 11, 2012).

57. See PAYMENT ACCURACY, *supra* note 36. The website states:

Improper payments' occur when: funds go to the wrong recipient; the right recipient receives the incorrect amount of funds (including overpayments and underpayments). Documentation is not available to support a payment; or the recipient uses funds in an improper manner. For 2010, federal agencies reported a government-wide improper payment rate of 5.49%, a decrease from the 5.65% improper payment rate that was reported in 2009, but more than the original target of 5.33% established last year. Despite the lower improper payment rate, due to higher outlays associated with the economic downturn, improper payments totaled approximately \$125 billion in 2010 - an increase of \$15 billion from 2009. For example, the Supplemental Nutrition Assistance Program (formerly known as food stamps), reported that outlays grew from \$34.6 billion in 2009 to \$50.4 billion in 2010.

Id.

rates, a review of agency annual reports and agency inspector general reports illustrates that most agencies appear to be publicly reporting (and perhaps by extension, paying more attention) to the level of improper payments.⁵⁸ With implementation of IPERA in progress, the addition of more specific and mandatory processes should decrease improper payments. It is possible, however, that these processes could initially have the opposite effect by flagging previously unknown improper payments. This could, at least temporarily, increase the number of known improper payments and give the impression that this improper payment regime is not successful.⁵⁹

II. EITC & Improper Payments

While Part I offered an overview of improper payment law, Part II will briefly examine the EITC to lay a foundation for identifying and explaining the alleged level of EITC overpayments. Significant scholarship examining the EITC is available from a number of sources.⁶⁰ Accordingly, this Article only provides enough EITC information to advance an understanding of the EITC's intersection with improper payment law.

A. *What is the EITC?*

The EITC provides a refundable tax credit to low-income taxpayers.⁶¹ A refundable credit is one that not only offsets a taxpayer's tax liability but can also result in a cash payment in excess of tax liability.⁶² EITC increases with the amount of earned income a taxpayer reports, thereby functioning as an incentive to work.⁶³ Its design, as part direct payment and part tax offset, is

58. The Postal Service and the Department of Transportation failed to report program risk assessments to comply with the provisions of the IPRA for fiscal year 2010. See *Daily Statement*, *supra* note 19, at 7.

59. See *id.*

60. See Zelenak, *supra* note 22; Leslie Book, *Preventing The Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 WIS. L. REV. 1103 (2006); Book, *Compliance Regime*, *supra* note 5; Book, *EITC Noncompliance*, *supra* note 17; Brown, *Separate but Unequal*, *supra* note 17; Brown, *Race and Class*, *supra* note 22; Stephen Holt, *Keeping it in Context: Earned Income Tax Credit Compliance and Treatment of the Working Poor*, 6 CONN. PUB. INTEREST L. J. 183 (2007); Lipman, *supra* note 3.

61. See I.R.C. § 32(a)(1).

62. IRS, PUBLICATION 596: EARNED INCOME TAX CREDIT, <http://www.irs.gov/publications/p596/ar01.html> (last visited Nov. 9, 2012).

63. *Hearing on Improper Payments in the Administration of Refundable Tax Credits, Before the Subcomm. on Oversight of H. Comm. on Ways and Means*, 112th Cong. (2011) (written statement of Nina Olson, National Taxpayer Advocate) [hereinafter Olson, *Ways and Means*] (citing Stacy Dickert et al., *The Earned*

consistent with its dual purpose as part social assistance payment and part work incentive.⁶⁴ An attempt to make the EITC serve dual masters is at least partially responsible for its complex rules and administration.⁶⁵

Most EITC claimants must prove, among other things, three primary items: earned income, relationship of qualifying children, and minimum residency of qualifying children.⁶⁶ EITC is available to claimants without children but increases dramatically when a qualifying child resides with a claimant for more than half of the tax year.⁶⁷ EITC further increases with the number of “qualifying children” who reside with the claimant.⁶⁸ Prior to 2009, EITC payments plateaued for claimants with two qualifying children.⁶⁹ In other words, a claimant did not receive any additional EITC for three (or more) children than for two children. Pursuant to the Tax Relief Act of 2010, EITC increased for claimants with three children.⁷⁰ The third-child expansion is temporary for two years, which is in addition to the original two-year expansion under the American Recovery and Reinvestment Act of 2009.⁷¹ There has been discussion opining that the previous two-child maximum created an incentive for larger families to improperly allow others to claim their other children.⁷²

Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation, in TAX POLICY AND THE ECONOMY, VOL. 9 (James M. Poterba ed., 1995)).

64. See Zelenak, *supra* note 22, at 1873–75 (depicting EITC as a hybrid tax-transfer program).

65. See Book, *Compliance Regime*, *supra* note 5, at 352 (“The EITC is excessively complicated in its application. . .”).

66. See I.R.C. § 32(b) (listing the percentages for qualifying children); I.R.C. § 32(c)(2) (defining earned income); I.R.C. § 32(c)(3) (defining qualifying child). For example, in 2010 a single mother with \$24,000 of earned income would be entitled to an EITC of \$3,440 for two qualifying children but only \$1,830 with one qualifying child. EITC plateaus at three children; there is no additional credit for a fourth qualifying child.

67. See I.R.C. § 32(b)(1)-(2).

68. *Id.*

69. *Id.*

70. The American Recovery and Reinvestment Act of 2009 (ARRA) created the third child additional amount for tax years 2009 and 2010. See Pub. L. No. 111-5, 123 Stat. 115 (2009). The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the additional amount for two more years. See Pub. L. No. 111-312, 124 Stat. 3296 (2010).

71. For 2011, EITC phases out at \$49,078 of income for a married couple with at least three qualifying children. See IRS, PUBLICATION 596, *supra* note 62.

72. See Book, *Freakonomics*, *supra* note 22, at 1177:

Poverty is more prevalent among larger families, and the EITC's effectiveness is ‘poorly designed to address this pattern of child poverty.’ To address this inequity, low wage workers with more than two children are tempted to ‘share’ the benefits with related parties who may have

B. Consequences for Improperly Claiming the EITC

Like many social assistance programs, the EITC contains severe penalties for claims made fraudulently, recklessly, or with intentional disregard.⁷³ Taxpayers who are found to have fraudulently claimed the EITC may not receive it for ten years, even if they are otherwise eligible.⁷⁴ EITC claims that are made recklessly, or with intentional disregard of the rules, render a taxpayer unable to claim EITC for two years, even if they are otherwise eligible.⁷⁵ Penalties for fraudulent, reckless, or intentionally improper EITC claims are more severe than penalties for fraud in other social assistance programs.⁷⁶ Benefits under Temporary Assistance for Needy Families (TANF) may be denied for an entire family for a month due to noncompliance, and repeated noncompliance may result in denial for up to six months.⁷⁷ Food stamp programs have similar sanctions.⁷⁸ In these other benefits programs, repeated abuse only garners sanctions for months, whereas comparable actions garner sanctions lasting years under EITC.

There are, of course, civil penalties for non-EITC reckless or fraudulent violations of the Internal Revenue Code.⁷⁹ Non-EITC penalties, however, pale in comparison to the EITC civil penalties, and they do not bar future use of any code section for which a taxpayer is otherwise eligible.⁸⁰ Indeed, with respect to EITC sanctions, "[t]here are no analogous sanctions applicable to other improper positions taken on federal income tax returns."⁸¹ Penalties for EITC abuse, criminal or civil, are significantly harsher than sanctions for other tax violations or other social benefit abuse. These heavier penalties are consistent with the

earned income, but fewer than two qualifying children of their own.

Id. (citing JASON FURMAN, CTR. ON BUDGET & POLICY PRIORITIES, TAX REFORM AND POVERTY 4 (2006)); *see also* Brown, *Separate but Unequal*, *supra* note 17, at 789 (2005).

73. *See* I.R.C. § 32(k) (disallowing EITC for taxpayers making fraudulent and reckless EITC claims for ten years and two years respectively).

74. I.R.C. § 32(k)(1)(B)(i).

75. I.R.C. § 32(k)(1)(B)(ii).

76. *See* Zelenak, *supra* note 22, at 1893–85 (comparing EITC sanctions with those under TANF and food stamps and concluding that “[a]rguably, the EITC sanctions are even more severe . . .”).

77. *Id.*

78. *Id.*

79. *See* I.R.C. § 6662-63 (listing accuracy-related and fraud penalties).

80. *See* Zelenak, *supra* note 22, at 1894.

81. *Id.*

impression that EITC is riddled with fraud.⁸²

C. Improper EITC Payment Rates

There certainly exists an impression of significant EITC fraud, and many interpret the government's improper payment numbers to support this theory.⁸³ The Treasury Department estimates total EITC program payments for FY 2010 as \$64 billion,⁸⁴ and EITC overpayment rates of twenty-three to twenty-eight percent or \$15–18 billion.⁸⁵ The estimated EITC overpayment rate has remained constant at twenty-three to twenty-eight percent for several years and is not expected to change through 2013.⁸⁶ The Service has argued that impending preparer regulation will shrink the future EITC overpayment rate,⁸⁷ but in examining the Service's expectation, the Treasury Inspector General for Tax Administration (TIGTA) found no evidence to expect a positive impact on the rate.⁸⁸

The annual EITC overpayment estimate ranks it fourth in relative size of programs with improper payment estimates.⁸⁹ When programs administered by state and local agencies with federal funds are removed and only federally administered programs are examined, EITC overpayments are the second

82. See *supra* note 17.

83. See, e.g., David Nolte, *IRS is Paying Tens of Billions of Fraudulent Refundable Tax Credits*, BETWEEN THE NUMBERS BLOG (May 31, 2011), <http://betweenthenumbers.net/2011/05/irs-is-paying-tens-of-billions-of-fraudulent-refundable-tax-credits/> (assuming erroneously that improper payments are all due to fraud); Ernest Istook, *Congress Will Send Billions To Tax Cheaters*, HERITAGE FOUND. (Feb. 5, 2008), <http://www.heritage.org/research/commentary/2008/02/congress-will-send-billions-to-tax-cheaters> (attributing all EITC improper payments to "fraud" by "cheaters" filing "phony" returns).

84. See U.S. DEP'T OF TREASURY, 2010 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 18, at 278 app. B.

85. See *id.*; see also TREASURY INSPECTOR GEN. FOR TAX ADMIN., REDUCTION TARGETS AND STRATEGIES HAVE NOT BEEN ESTABLISHED TO REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME TAX CREDIT PAYMENTS EACH YEAR 3 (2011) [hereinafter REDUCTION TARGETS].

86. See U.S. DEP'T OF TREASURY, 2010 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 18, at 278 app. B. While Treasury expects EITC outlays to remain flat for FY 2011, Treasury expects total outlays to shrink to \$58 billion for FY 2012 and FY 2013. *Id.*

87. Other scholars have noted the possibility of reduced improper payment rates with preparer regulation. See Brown, *Separate but Unequal*, *supra* note 17, at 781 n.120 ("One study suggests that regulating certain tax preparers could decrease the EITC error rate from 30% to 18%." (citing Lipman, *supra* note 3, at 494)).

88. See REDUCTION TARGETS., *supra* note 85, at 335–37 app. D.

89. See *Daily Statement*, *supra* note 19, at 4.

highest federal program overpayments.⁹⁰ EITC's ranking as one of the "highest dollar value" of government-wide improper payments triggers the application of Executive Order 13520's required reduction targets and planning. IPIA and IPERA designation as a "susceptible program" is triggered, not by the EITC overpayment relative ranking against other federal program overpayments, but by passing the established thresholds of \$10 million of improper payments and 2.5% of program outlays, or at least \$100 million in improper payments.⁹¹ Designation under IPERA obligates an agency to perform risk assessments and report on plans to meet "measurable milestones."⁹²

The Department of the Treasury's FY 2010 Performance and Accountability Report found EITC to be the only high-risk susceptible program under IPIA.⁹³ That same report identified EITC as the only high priority program under Executive Order 13520.⁹⁴ This is strange, particularly considering that EITC overpayments are estimated to be only five percent of the tax gap.⁹⁵ In contrast, twenty percent of the tax gap (four times the EITC overpayment amount) is attributable to underreported self-employment income.⁹⁶ Between ten and fifteen times the EITC overpayment amount is attributable to misreported business income.⁹⁷ Commentators have also identified other tax credits that likely meet IPERA designation, including alternative fuel credits,⁹⁸ and research credits.⁹⁹ Others have argued that "improper refunds of withholding and estimated tax payments" are subject to IPIA as well.¹⁰⁰ TIGTA estimates that the improper First Time Home Buyer Credits paid in 2009 and 2010 were hundreds of millions of

90. See TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 85, at 1.

91. See Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204, 124 Stat. 2224 (2010).

92. *Id.*

93. U.S. DEPT OF TREASURY, 2010 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 18, at 45.

94. *Id.*

95. See Holt, *supra* note 60, at 188 (estimating EITC tax gap).

96. *Id.* (comparing EITC tax gap with underreported self-employment tax gap); see also Brown, *Separate but Unequal*, *supra* note 18, at 776 (noting the tax gap difference between EITC overpayments and underreported self-employment income).

97. JOHN WANCHECK & ROBERT GREENSTEIN, CENTER ON BUDGET & POLY PRIORITIES, EARNED INCOME TAX CREDIT OVERPAYMENT AND ERROR ISSUES 4 (2011), available at <http://www.cbpp.org/files/4-5-11tax.pdf>.

98. See NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2012 OBJECTIVES REPORT TO CONGRESS 9 (2012).

99. *Id.*

100. See Zelenak, *supra* note 22, at 1897.

dollars.¹⁰¹ Improper payments at these levels should be subject to IPERA, at the very least. Other tax payments and preference items, including tax expenditures, should also be subject to improper payment law; however, this is beyond the purview of this Article.¹⁰²

D. The Service's Actions to Combat Improper EITC Payments

In compliance with IPIA, and with TIGTA's mission as the Inspector General of the Service,¹⁰³ TIGTA regularly audits the Service's functions, including the administration of EITC and overpayments.¹⁰⁴ In its February 2011 report, TIGTA identified some of the Service's EITC administrative efforts and shortcomings.¹⁰⁵ TIGTA noted that the Service had failed to establish reduction targets and strategies for reducing EITC overpayments.¹⁰⁶ In response, the Service defended itself with the actions it takes to reduce improper payments.¹⁰⁷ The Service's defense relied almost exclusively on its return preparer initiative and identified it as its most promising avenue.¹⁰⁸ TIGTA did note, however, that the Service has undertaken a variety of education and public relations activities to assist participation by eligible

101. TREASURY INSPECTOR GEN. FOR TAX ADMIN., *THE INTERNAL REVENUE SERVICE FACES SIGNIFICANT CHALLENGES IN VERIFYING ELIGIBILITY FOR THE FIRST-TIME HOMEBUYER 4* (2009); *see also* TREASURY INSPECTOR GEN. FOR TAX ADMIN., *ADMINISTRATION OF THE FIRST-TIME HOMEBUYER CREDIT INDICATES A NEED FOR IMPROVED CONTROLS OVER REFUNDABLE CREDITS 26* (2011) [hereinafter *NEED FOR IMPROVED CONTROLS*].

102. *See* Zelenak, *supra* note 22, at 1896–98 (asserting that the EITC is the sole Service program identified under the IPIA and noting that, for the purposes of improper payment law, EITC is treated like TANF and food stamp overpayments and unlike income tax overpayments); *see also* Brown *Race and Class*, *supra* note 22, at 806–07 (acknowledging that EITC is the “only tax provision about which the OMB has requested improper payment information,” and speculating that “[t]he belief that EITC errors are the result of fraud and not complexity is a function of the mental connection between EITC recipients and welfare recipients”).

103. TREASURY INSPECTOR GEN. FOR TAX ADMIN., *STRATEGIC PLAN FISCAL YEARS 2009–2014*, at 1 (2009), *available at* http://www.treasury.gov/tigta/about/tigta_strategic_plan.pdf (last visited Oct. 28, 2012).

104. *See* *REDUCTION TARGETS*, *supra* note 85; TREASURY INSPECTOR GEN. FOR TAX ADMIN., *ACTIONS CAN BE TAKEN TO IMPROVE THE IDENTIFICATION OF TAX RETURN PREPARERS WHO SUBMIT IMPROPER EARNED INCOME TAX CREDIT CLAIMS* (2010) [hereinafter *ACTIONS CAN BE TAKEN*]; TREASURY INSPECTOR GEN. FOR TAX ADMIN., *THE EARNED INCOME TAX CREDIT PROGRAM HAS MADE ADVANCES; HOWEVER, ALTERNATIVES TO TRADITIONAL COMPLIANCE METHODS ARE NEEDED TO STOP BILLIONS OF DOLLARS IN ERRONEOUS PAYMENTS* (2008) [hereinafter *PROGRAM HAS MADE ADVANCES*].

105. *See* *REDUCTION TARGETS*, *supra* note 85, at 1.

106. *Id.* at 10.

107. *Id.*

108. *Id.*

individuals.¹⁰⁹ The responses of both TIGTA and the Service fail to acknowledge the power and process the Service undertakes to administer and police EITC. Their responses belie the Service's toolbox, which includes the use of correspondence exams, math error authority, and civiland preparer penalties.

III. Managing EITC with Correspondence Examinations

In Part II, this Article identified the alleged level of EITC overpayments. Part III attempts to explain the process that identifies the alleged improper payments: the correspondence examination process. This Part will explain how returns are selected for examination, as well as how often and why the Service utilizes correspondence examinations to audit EITC taxpayers.

A. Return Selection for Correspondence Examination

The Service executes its taxpayer compliance function with the examination process.¹¹⁰ Typically, the Service utilizes a correspondence examination, office examination, or a field examination,¹¹¹ which involve escalating degrees of Service personnel involvement. With a limited budget and personnel, "the Service uses sophisticated computer technology and the accumulated experience of its personnel in the classification and selection of returns" with the greatest potential for tax change and revenue yield for examination.¹¹² Returns are chosen for audit by computer analysis that "numerically scores tax returns according to a mathematically determined probability of error."¹¹³

The Service has recently placed an emphasis on honing EITC audit selection, "spen[ding] millions of dollars developing probability filters to improve its selection of cases for audit using information contained in the Dependent Database."¹¹⁴ The Service

109. *Id.*

110. See MICHAEL SALTZMAN, IRS PRACTICE AND PROCEDURE 8-5 (2d ed. 2002).

111. See Book, *Compliance Regime*, *supra* note 5, at 375 ("The most common types of examinations are those conducted at a taxpayer's place of business, at an IRS office, or by correspondence.").

112. See SALTZMAN, *supra* note 110, at 8-4.

113. *Id.*

114. See TREASURY INSPECTOR GEN. FOR TAX ADMIN., REDUCTION TARGETS AND STRATEGIES HAVE NOT BEEN ESTABLISHED TO REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME TAX CREDIT PAYMENTS EACH YEAR 4 (2011) ("Probability filters are characteristics of noncompliance the IRS has developed using historical data and are used to determine the likelihood that an EITC claim is erroneous. The Dependent Database is a risk-based audit selection tool used by the IRS to identify EITC tax returns for audit.").

also uses prior audit information to inform its audit selection.¹¹⁵ Recently, the Service has increasingly used third-party information from non-Service sources, including the Federal Case Registry, which is a database of custody orders for children receiving public assistance and custody orders from some private divorce cases, as well as information from the Social Security Administration databases to validate social security numbers and parents' names for qualifying children.¹¹⁶ TIGTA believes that the Service is leveraging this technology to identify EITC improper payments.¹¹⁷ Even with all of these investments into EITC error detectors, the Service has made virtually no progress in limiting the EITC improper payments.¹¹⁸ As previously stated, overpayment rates are alleged to have hovered between twenty-three percent and thirty percent for years and are predicted to remain at the same level for several more years.¹¹⁹ Other than some educational public relations activities and the impending regulation of preparers, the Service has not committed to any new plans for reducing the EITC improper payment rate.¹²⁰ It appears that the Service intends to continue using correspondence examinations as the primary compliance tool for EITC administration.

B. Why Use Correspondence Examinations?

No doubt a primary driver for the Service's choice of correspondence examinations to manage EITC claims is the low cost. Correspondence exams are less expensive because they are more automated, requiring less personnel labor than office or field examinations.¹²¹ The Service estimates that its administration of EITC costs less than one percent of benefits distributed.¹²² The

115. See Landsmann, *supra* note 4, at slides 10, 11 (on file with the author).

116. *Id.*

117. PROGRAM HAS MADE ADVANCES, *supra* note 104, at 22.

118. *Id.*

119. See U.S. DEP'T OF TREASURY, 2010 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 18, at 281 app. B.

120. See REDUCTION TARGETS, *supra* note 85, at 14–15.

121. TREASURY INSPECTOR GEN. FOR TAX ADMIN., Ref. No. 2011-30-016, PROGRESS HAS BEEN MADE TO REENGINEER THE EXAMINATION PROGRAM, BUT ADDITIONAL IMPROVEMENTS ARE NEEDED TO REDUCE TAXPAYER BURDEN 1 (2011) ("In contrast to the more labor-intensive, face-to-face examination, the correspondence examination process is . . . more automated," and "correspondence examinations also enable the IRS to reach more taxpayers at a lower cost . . .") [hereinafter PROGRESS HAS BEEN MADE].

122. IRS, IRS EARNED INCOME TAX CREDIT INITIATIVES, ADDENDUM TO THE REPORT ON QUALIFYING CHILD RESIDENCY CERTIFICATION, FILING STATUS, AND AUTOMATED UNDERREPORTED TESTS, IMPLEMENTATION OF ALTERNATIVE

Service contrasts its EITC costs with the cost estimate of other social assistance program, which are nearly twenty percent of benefits distributed.¹²³ Ironically, the alleged overpayments of twenty-three to twenty-eight percent are strikingly similar to the twenty percent administrative cost of benefits, making the real cost of administration of EITC comparable to other social assistance programs targeting the poor.¹²⁴

EITC administration is kept at this low one percent cost by burdening the beneficiaries with administration costs.¹²⁵ The EITC process leaves beneficiaries on their own to determine eligibility via the self-assessment process.¹²⁶ Scholars and practitioners have noted that the complexity of claiming the EITC is overwhelming.¹²⁷ Indeed, completing a return with an EITC claim is “more challenging than completing a Form 1040 with itemized deductions.”¹²⁸

Although some Service tools are available to help EITC claimants, most are underutilized. The Service has an Internet

APPROACHES TO IMPROVING THE ADMINISTRATION OF THE EITC 2 (2008) [hereinafter EARNED INCOME TAX CREDIT INITIATIVES].

123. *Id.*

124. See Olson *Ways and Means*, *supra* note 63, at 9.

Current administration costs are less than 1% of benefits delivered. This is quite different from other non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures. For TY 2009, the IRS reports that it paid \$55 billion in EITC claims. If this amount had been paid by another agency that spent 20 percent of program expenditures verifying eligibility, the administration costs to the government would have been \$11 billion – nearly 100 percent of the amount of improper payments that the IRS estimates were made.

Id.

125. See Lipman, *supra* note 3, at 465 (commenting that EITC claimants manage the “inconceivable complexity” of the credit by hiring paid tax practitioners to assist them).

126. The Service offers an online EITC Assistant. IRS, *Earned Income Tax Credit (EITC)—Use the EITC Assistant to Find Out if You Should Claim It*, IRS.GOV, (last updated Aug. 2, 2012), <http://www.irs.gov/Individuals/Earned-Income-Tax-Credit-%28EITC%29-%E2%80%93-Use-the-EITC-Assistant-to-Find-Out-if-You-Should-Claim-it>.

127. George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 294 (1994) (“Both the program's eligibility rules and the paperwork necessary to file a claim are complex, particularly for the typical taxpayer eligible for the EITC benefit.”); see also Brown, *Race and Class*, *supra* note 22, at 829 (“Numerous scholars have described the EITC as complex.”); Leslie Book, *The Poor and Tax Compliance*, 51 U. Kan. L. Rev. 1145, 1155 (2003).

128. See Lipman, *supra* note 3, at 464.

guide to EITC,¹²⁹ and the Service funds free EITC return preparation through its Volunteer Income Tax Assistance (VITA) program.¹³⁰ Very few EITC claimants utilize the free preparation options. Fewer than two percent of EITC returns are prepared by VITA sites.¹³¹

For most taxpayers, successfully claiming EITC requires professional assistance.¹³² For tax year 2009, 57.3% of all individual returns were prepared by preparers.¹³³ Seventy percent of EITC claimants use preparers.¹³⁴ It is evident that many of the costs of tax administration are transferred to taxpayers by virtue of self-assessment and code complexity, which, in many cases, requires professional assistance. This is certainly true for EITC administration, and the transfer of the cost for EITC administration is borne by those least able to afford it.

Experience does not seem to help alleviate the complexity and professional assistance problem. Recent studies indicate that changes to the EITC population may contribute to the long-term ineffectiveness of EITC education and public relations activities that the Service has undertaken.¹³⁵ Sixty-one percent of EITC claimants from 1989 to 2006 claimed EITC for only one or two years at a time.¹³⁶ The study indicated that only twenty percent of EITC claimants used EITC for more than five consecutive years.¹³⁷ Accordingly, efforts to educate an ever-changing population are likely ineffective. Any experience or knowledge which might be helpful for claiming EITC is likely only useful to a small number of

129. See EITC Assistant, *supra* note 126.

130. IRS, *Free Tax Return Preparation for You by Volunteers*, IRS.GOV (last updated Oct. 30, 2012), <http://www.irs.gov/individuals/article/0,,id=107626,00.html>.

131. See ALAN BERUBE, THE BROOKINGS INSTITUTION, *THE NEW SAFETY NET: HOW THE TAX CODE HELPED LOW-INCOME WORKING FAMILIES DURING THE EARLY 2000S* 1 (2006).

132. See Lipman, *supra* note 3, at 463 (“Congress has created an extensive anti-poverty program, which is almost impossible for the targeted families to obtain without professional assistance because it is too complicated to comprehend and claim.”).

133. IRS, *SOI Tax Stats—Tax Stats at a Glance*, IRS.GOV (last updated Aug. 22, 2012), <http://www.irs.gov/uac/SOI-Tax-Stats---Tax-Stats-at-a-Glance>.

134. IRS, *Earned Income Credit Preparer Due Diligence at IRS Nationwide 2008 National Tax Forum* at slide 5 (2008), available at http://www.irs.gov/pub/irs-utl/eitc_due_diligence_requirements.pdf.

135. See Indivar Dutta-Gupta, *New Research Highlights Importance of EITC for Working Families*, OFF THE CHARTS BLOG (Oct. 19, 2011, 2:49 PM), http://www.offthechartsblog.org/new-research-highlights-importance-of-eitc-for-working-families/?utm_source=facebook&utm_medium=FACEBOOK&utm_campaign=CBPPFACEBOOK.

136. *Id.*

137. *Id.*

repeat claimants.

C. Audit Rates and Reasons

With its limited resources for tax administration and compliance initiatives, the Service often takes the path of least resistance. In this case, the path of least resistance is auditing the “easy” returns. For the Service, EITC returns are easy returns: low-income returns tend to be simple, with fewer items of income and few, if any, deductions;¹³⁸ EITC claimants rarely respond to correspondence examination correspondence;¹³⁹ nearly the entire process is automated and has limited Service personnel involvement;¹⁴⁰ EITC claimants are unlikely to be able to afford or even secure free representation.¹⁴¹ For the Service, EITC returns are the proverbial low-hanging fruit.

To illustrate the over-emphasis on EITC audits, commentators often compare EITC and self-employed audits.¹⁴² Auditing self-employed taxpayers would likely yield more revenue than auditing EITC claimants, given that twenty percent of the tax gap is attributable to self-employed taxpayers (as opposed to only five percent of the tax gap attributable to EITC

138. EITC is not available for taxpayers with over \$2200 in investment income. I.R.C. § 32(i)(1).

139. *Hearing on the Tax Gap and Tax Shelters Before Sen. Comm. on Fin.*, 108th Cong. 17, n.43 (July 21, 2004) (written statement of Nina Olson, National Taxpayer Advocate) [hereinafter Olson, *Sen. Comm. on Fin.*] (“Data provided by the EITC Program Office to TAS for FY 2003 indicate nearly a 40 percent no response/undeliverable rate for EITC correspondence. The no response/undeliverable rate including Statutory Notice of Deficiency is fifty-three percent.”).

140. See PROGRAM HAS MADE ADVANCES, *supra* note 104 at 23.

141. See NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 102.

142. Brown, *Separate but Unequal*, *supra* note 17, at 776.

[W]hile the IRS estimate of the EITC noncompliance rate is high, it is not the highest. The IRS estimates that taxes owed but unpaid by individual and corporate taxpayers is over \$100 billion (the “tax gap”). In addition, the IRS states that its enforcement efforts only resulted in the collection of about 25% of the tax gap. Underreported income by self-employed taxpayers was nearly \$30 billion of the tax gap. The estimated tax gap for the EITC exceeded \$1 billion. The EITC therefore represents less than 1% of the tax gap. The IRS estimates that self-employed individuals generally underreport their income by 64%, and self-employed individuals who operate in a cash business underreport their income by 89%. Small corporations and sole proprietors constitute 29% of the tax gap. Thus, significant noncompliance areas that generate greater revenue losses than are estimated for the EITC go unaudited.

Id.

overpayments).¹⁴³ However, examination of self-employed taxpayers would likely take significant time and personnel resources to produce revenue, because discovering underreported income is much more labor-intensive than verifying documentation provided by an EITC taxpayer.¹⁴⁴ Moreover, it would be more difficult to audit self-employed taxpayers via correspondence exams given the alleged levels of underreported income.¹⁴⁵ The audit rate for self-employed taxpayers is 1.9%, and the audit rate for EITC taxpayers is 2.1%,¹⁴⁶ which is nearly 10% higher.

The audit rate for taxpayers with less than \$25,000 income is 1.22%, which is significantly higher than the rate for taxpayers with \$25,000-\$200,000 of income which is 0.73%–1.00%.¹⁴⁷ The audit rate does not rise to the level that the lowest-income taxpayers experience until income goes above \$200,000.¹⁴⁸

This should not be surprising given the history of resources specifically earmarked to police the EITC.¹⁴⁹ Both scholars and reporters have noted the 1990s compromise between President Clinton and Congress that resulted in an increase in the Service's budget by \$100 million specifically to audit EITC returns.¹⁵⁰ The legacy continued in 2002 when Treasury Secretary Paul O'Neill stated, "[i]f you look at why we're doing a relatively heavy audit of low-income [taxpayers], it is because we've been directed by the Congress to examine the devil out of the so-called earned income tax credit filers."¹⁵¹ The overemphasis of EITC audits continues today.¹⁵²

Limited Service resources and congressional will are not the

143. See BICKLEY, *supra* note 24, at 3–5.

144. *Id.* at 4. ("Much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect.")

145. *See id.*

146. *See* IRS, 2011 DATA BOOK 21–25 (2011) (reporting 574,372 of 26,861,559 EITC returns and 278,092 of 14,867,564 non-farm business individual returns).

147. *Id.*

148. *Id.*

149. *See* DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE 130 (2003) (explaining that in 2001, the IRS audit rate of those who applied for EITC totaled more than eight times that of individuals earning over \$100,000).

150. *Id.* at 132; *see also* Brown *Race and Class*, *supra* note 22, at 797, 808; John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX REV. 273, 293 (2002).

151. *See* Brown *Race and Class*, *supra* note 22, at 807 n.103.

152. *See* IRS, *supra* note 146, at 21–25 (listing the audit rates for both EITC and self-employed taxpayers).

only drivers of high EITC audit rates. Improper payment law requirements are certainly a driver, as they require the Service to demonstrate and execute a plan to bring down EITC improper payments.¹⁵³ Other commentators believe that heavy EITC compliance initiatives are attributable to the perception that EITC is “welfare” and the cultural belief that “cheating on one’s income tax [is] . . . less seriously wrong than committing welfare fraud.”¹⁵⁴ Still others have suggested that EITC compliance initiatives may be driven by “the belief that EITC errors are the result of fraud [which] is a function of racial stereotyping about EITC recipients.”¹⁵⁵ Regardless of why EITC claimants are chosen for audit, the data demonstrate that they are chosen for correspondence examinations at a higher rate than comparable groups of taxpayers

D. An EITC Correspondence Examination

Once an EITC return is selected for audit via scoring, a letter is generated asking for information or documentation to verify one or more of the EITC requirements.¹⁵⁶ The correspondence typically requests the EITC claimant to submit documentation to prove relationship to, or residency of, the qualifying children.¹⁵⁷ A 2010 study by the Taxpayer Advocate Service “TAS” of 400 EITC cases noted that “[i]n ninety percent of the cases reviewed, the primary issue raised by the IRS involved either the Relationship Test or the Residency Test under the uniform definition of a ‘qualifying child.’”¹⁵⁸ These are the lynchpins in securing EITC, and they create proof issues during a correspondence examination. These proof issues are discussed below in Part IV.¹⁵⁹

IV. Correspondence Examinations Impede Access to EITC

The previous Part addressed how, why, and how often EITC claimants are chosen for examination. The following Part will explore the conduct of EITC correspondence examinations and lay

153. See Olson, *Ways and Means*, *supra* note 63, at 9 (discussing IRS programs designed to reduce improper payments to EITC claimants).

154. Zelenak, *supra* note 22, at 1899 n.142.

155. See Brown, *Separate but Unequal*, *supra* note 17, at 780.

156. See PROGRESS HAS BEEN MADE, *supra* note 121, at 1.

157. See NAT’L TAXPAYER ADVOCATE, FISCAL YEAR 2012 OBJECTIVES REPORT TO CONGRESS, *supra* note 98, at app. VIII-3 nt. 346 (explaining the test to determine whether a child is a “qualifying child”).

158. See *id.* at app. VIII-3.

159. *E.g.*, Olson, *Ways and Means*, *supra* note 63, at 13 (describing the documentation required to show proof).

a foundation for the ultimate conclusion that the manner in which EITC correspondence examinations are conducted is unduly burdensome.

A. Proof for EITC is Document-Intensive

As stated above, the majority of EITC examinations address the Relationship Test, the Residency Test, or both.¹⁶⁰ These can be very challenging to prove, particularly in non-traditional family arrangements. For example, an aunt caring for a niece must produce three birth certificates to satisfy the Relationship Test.¹⁶¹ She must produce the niece's birth certificate to document her parentage as well as the niece's mother's birth certificate and aunt's birth certificate to demonstrate that they have the requisite familial relationship.¹⁶² This may be challenging if the mother is not present in the home. It also may prove challenging for transient families, particularly those who have been evicted or are homeless. In addition, the Internal Revenue Manual lists only a few items that are acceptable documentation to prove relationship.¹⁶³

Residency of more than six months of a qualifying child can be even more challenging to prove, particularly when the Service only accepts certain documentation.¹⁶⁴ Only copies of records from

160. See Holt, *supra* note 60, at 197 ("In the EITC Compliance study of Tax Year 1999, nearly 60 percent of the amount improperly claimed involved misapplication of the qualifying child and filing status rules.").

161. Olson, *Ways and Means*, *supra* note 63, at 13.

Assume Granduncle claims the EITC with respect to Grandnephew. Assume further that the IRS questions the claim based on the relationship requirement. To document his relationship to the qualifying child, Granduncle may be required to produce his own birth certificate, a birth certificate for his sibling showing common parents, a birth certificate for his niece showing that Granduncle's sibling was the niece's parent, and a birth certificate for Grandnephew showing that the niece was Grandnephew's mother. That is four birth certificates in all. Depending on the states in which these four individuals were born and the restrictions those states impose on who may obtain birth certificates, it may be extremely time-consuming or even impossible for Granduncle to obtain the requisite substantiation. As a result, the IRS may deny the claim even though it was legitimate.

Id.

162. See *id.*

163. IRS, INTERNAL REVENUE MANUAL 4.19.14.5.6 (listing acceptable documentation to prove relationship to a qualifying child, including "[b]irth certificates or other official documents of birth[,] [m]arriage certificates that verify your relationship to the child[,] [l]etter from an authorized adoption agency[,] letter from the authorized placement agency or applicable court document").

164. Acceptable documentation to prove the residency of a qualifying child includes:

Photocopies of school (no report cards), medical, childcare provider

certain places (e.g., schools, medical providers, child care providers or social service agencies) can be used as acceptable documentation.¹⁶⁵ While in theory school records should be easily used to prove residency in the EITC claimant's home, the practice does not work well. School records document residency during a school year, which usually runs August–December (five months) and January–May (five months). Both semesters of a school year are less than the six months necessary to prove EITC residency, which is measured on a tax year basis (January through December).¹⁶⁶

The atypical documentation that claimants often must submit can prove challenging during correspondence exams for a number of reasons. The types of documents used to prove the relationship and residency tests are not the types of documents that the Service specializes in dealing with, such as W2s, 1099s, and other returns.¹⁶⁷ With respect to traditional documentation, the Service has established processes for data matching and analysis.¹⁶⁸ The Service struggles, however, to data mine atypical documentation. The Service's struggle to administer the First-Time Homebuyer Credit (FTHBC) illustrates this point well.¹⁶⁹ This program required the Service to consider and examine home purchase settlement statements—new documentation for the Service.¹⁷⁰ The Service also used new Form 5405.¹⁷¹ Unfortunately, the Service's difficulty in processing settlement statements and the new Form 5405 led to errors in FTHBC administration that

(provider can't be a relative) or social service records[,] [a] letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of child's parent or guardian, child's address and the dates that they lived with taxpayer.

Id.

165. *Id.*

166. See Olson, *Ways and Means*, *supra* note 63, at 31 (discussing the IRS payments for EITC claims in Tax Year 2009).

167. See IRS, INFORMATION REPORTING AND DOCUMENT MATCHING (IRDM)—PRIVACY IMPACT ASSESSMENT (June 28, 2011), <http://www.irs.gov/pub/irs-pia/irdm-pia.pdf>.

168. See *id.*

169. TREASURY INSPECTOR GEN. FOR TAX ADMIN., A COMPREHENSIVE STRATEGY IS BEING DEVELOPED TO IDENTIFY INDIVIDUALS WITH FIRST-TIME HOMEBUYER CREDIT REPAYMENT REQUIREMENTS 6–8 (2010) [hereinafter COMPREHENSIVE STRATEGY]; TREASURY INSPECTOR GEN. FOR TAX ADMIN., ADDITIONAL STEPS ARE NEEDED TO PREVENT AND RECOVER ERRONEOUS CLAIMS FOR THE FIRST-TIME HOMEBUYER CREDIT 14–16 (2010).

170. COMPREHENSIVE STRATEGY, *supra* note 169, at 3.

171. See NEED FOR IMPROVED CONTROLS, *supra* note 101, at 4.

easily could have been discovered through appropriate processing.¹⁷² Moreover, the novelty of these forms hampered the Service from accepting settlement statements electronically.¹⁷³ These types of atypical documentation present an even greater challenge when the production is conducted via automation, as is the case with EITC correspondence examinations.¹⁷⁴

B. The Service's Correspondence Issues

EITC claimants selected for audit face difficult proof burdens;¹⁷⁵ however, these difficulties pale in comparison to the challenges in navigating the EITC examination process itself.¹⁷⁶ Simply put, dealing with the Service during a correspondence examination is difficult.

EITC claimants chosen for audit have virtually no alternatives to the correspondence exam process: once a claimant is chosen under the computerized system, the claimant is almost

172. *Id.* (“[T]he IRS had not developed and implemented examination filters to identify potentially erroneous claims for the Homebuyer Credit.”). TIGTA identified the following:

Taxpayers claimed Homebuyer Credits although they had not made home purchases but reportedly would in the future. These taxpayers listed home acquisition dates on their Forms 5405 that were subsequent to the dates the claims were processed by the IRS.

.....

Taxpayers claimed Homebuyer Credits for homes for which at least one other taxpayer also claimed the Credit and the combined amounts for each address exceeded \$8,000.

.....

Some taxpayers claimed Homebuyer Credits for homes purchased before April 9, 2008, the effective date of the HERA legislation.

Id. at 4–5.

173. See *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges Before the H. Comm. on Ways and Means Subcomm. on Oversight*, 111th Cong. 5–6 (2009) (written testimony of James R. White, GAO); see also *Tax Filing Season Update: Current IRS Issues Before the S. Comm. on Fin.*, 111th Cong. 8 (2010) (written testimony of Nina Olson, National Taxpayer Advocate) (“[T]he specific requirements of each revision of the FTHBC involve enhanced documentation that prevents taxpayers from electronically filing their tax returns, causing administrative problems for the IRS.”).

174. See Landsmann, *supra* note 4, at slide 13 (on file with author).

175. See Olson, *Ways and Means*, *supra* note 63, at 14 (describing the effect of difficult proof burdens on improperly denied claims).

176. See Marchbein, *supra* note 15 (“For most taxpayers, an examination is fraught with anxiety, which can only be compounded if correspondence explaining the taxpayer’s position or providing requested information or verification seems not to have been duly taken into account by the IRS.”).

certain to face a correspondence examination.¹⁷⁷ In 2010, nearly ninety-seven percent of audited EITC returns were undertaken with correspondence examination.¹⁷⁸ Under Treasury regulation 301.7605-1, a taxpayer may petition to change the venue, which could mean changing from a correspondence examination (i.e., campus examination) to a face-to-face office examination.¹⁷⁹ This regulation gives the Service the discretion to grant the request after considering six factors.¹⁸⁰ Despite the list of factors, “[m]any IRS service centers take the view that correspondence examinations will be transferred only in instances of hardship.”¹⁸¹

The ability to take advantage of the very slim opportunity to transfer from a correspondence examination turns on the taxpayer’s ability to understand the correspondence sufficiently to find the regulation to transfer, comprehend the availability of the option, and successfully argue for transfer.¹⁸² Ironically, these are the precise skills that a taxpayer needs to successfully navigate a correspondence exam. If the taxpayer lacks these skills to begin with, there is virtually no chance he or she will successfully argue for a more navigable and comprehensible examination.

Assuming that a taxpayer is chosen for correspondence examination, navigation of the process involves successful with the

177. See IRS, 2010 DATA BOOK, *supra* note 4, at tbl. 9a.

178. *Id.*

179. Treas. Reg. § 301.7605-1(e) (1993).

180. The Department of Treasury Regulations state:

The Service will consider, on a case-by-case basis, written requests by taxpayers or their representatives to change the place that the Service has set for an examination. In considering these requests, the Service will take into account the following factors—

- (i) The location of the taxpayer’s current residence;
- (ii) The location of the taxpayer’s current principal place of business;
- (iii) The location at which the taxpayer’s books, records, and source documents are maintained;
- (iv) The location at which the Service can perform the examination most efficiently;
- (v) The Service resources available at the location to which the taxpayer has requested a transfer; and
- (vi) Other factors that indicate that conducting the examination at a particular location could pose undue inconvenience to the taxpayer.

Id.

181. Marchbein, *supra* note 15.

182. Cf. Jonathan P. Schneller et al., *The Earned Income Tax Credit, Low-Income Workers, and the Legal Aid Community*, 3 COLUM. J. TAX L. 177, 178 (2011) (arguing that the correspondence system is “uniquely challenging to low-income taxpayers who may lack the skills required to navigate the tax return and audit processes”).

Service.¹⁸³ Interpreting the Service's correspondence is not easy for any taxpayer (nor any practitioner), but it is particularly difficult for low-income taxpayers who are more likely to have functional literacy¹⁸⁴ and financial literacy¹⁸⁵ challenges.¹⁸⁶ The Service's correspondence suffers from deficiencies in basic readability. The systems that the Service uses to generate taxpayer correspondence are admittedly antiquated.¹⁸⁷ While some EITC correspondence has been redesigned to address readability issues, many others have not and continue to appear in the same, unchanged form.¹⁸⁸ The typeface, layout, and whitespace make it difficult to read old, unchanged correspondence.¹⁸⁹ The aesthetics are compounded by the substantive readability problems. The sentences are complex and not written in plain language, and worse, the letters use Service and tax jargon that mean nothing to the average taxpayer.¹⁹⁰ In a study of EITC taxpayers, more than seventy

183. The communication process begins with a letter from the Service to the EITC claimant being audited. *Id.* at 200.

184. 'Functional literacy' is defined by UNICEF as "the ability to use reading, writing, and numeracy skills for effective functioning and development of the individual and the community." U.N. EDUC., SCIENTIFIC AND CULTURAL ORG., EDUCATION FOR ALL GLOBAL MONITORING REPORT 158 (2006).

185. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD), THE CASE FOR FINANCIAL LITERACY IN DEVELOPING COUNTRIES: PROMOTING ACCESS TO FINANCE BY EMPOWERING CONSUMERS 2 (2009) ("Financial literacy is the combination of consumers'/investors' understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being.").

186. See Book, *Compliance Regime*, *supra* note 5, at 396 (discussing literacy issues with low-income taxpayers); Lipman, *supra* note 3, at 471 ("[L]iteracy limitations are sharply higher among low-income adults." (citing Jeffrey S. Gold, *Proposed IRS Consortium Deal for Return Prep and e-Filing is Flawed*, 96 TAX NOTES 1645 (2002))); see also THE NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2006 OBJECTIVES REPORT TO CONGRESS 34–35 (2007) ("Financial literacy plays an important role in tax compliance because taxpayers who do not understand basic financial transactions are unlikely to understand the difference between employee and independent contractor status or the EITC's complex eligibility rules.").

187. See Jodi Patterson, *Making a Noticeable Difference: Presentation to the Monthly PLAIN Meeting*, slides 1–3 (Mar. 9, 2011), available at www.plainlanguage.gov/news/files/IRS_PLAINpresentation.ppt (illustrating issues with the Service's correspondence).

188. Compare IRS, EITC ELECTRONIC REJECTS, NOTICES AND CORRESPONDENCES (July 2, 2009) <http://www.eitc.irs.gov/rptoolkit/toolsandtips/eitcnoticeschart/> (associating meanings with electronic reject codes), with IRS, UNDERSTANDING YOUR IRS NOTICE OR LETTER (July 30, 2012), <http://www.irs.gov/individuals/article/0,,id=96199,00.html> (displaying the new forms for correspondence CP-11A, CP-12, and CP-13A along with older forms for other correspondence).

189. See Patterson, *supra* note 187, at slide 2.

190. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 104 (commenting that 42.7% of the study participants "[d]id not

percent thought that examination correspondence was difficult to understand.¹⁹¹ The tone of the Service's correspondence is often overly harsh and legalistic, which tends to frighten taxpayers.¹⁹² The most concerning results of the EITC audit correspondence study were the conclusions that, after reading the Service's correspondence, over a quarter did not understand that the Service was auditing their return, and nearly another quarter did not understand what documents to send to the Service.¹⁹³ The failure to understand the substance of the Service's correspondence makes it nearly impossible to comply with its requests.

C. The Service's Phone Issues

Confusing correspondence prompts taxpayers to call the Service for clarification and assistance. Unfortunately, phone contact with the Service creates a host of additional issues. In Fiscal Year 2008, the Service's level of service (LOS) for its toll-free lines was fifty-three percent.¹⁹⁴ Almost half of taxpayers who called the Service in FY 2008 were not helped. Since then, the Service's phone LOS has been "in the low-seventy percent range."¹⁹⁵ The Service's goal is to answer eighty percent of its calls, and the IRS Oversight Board believes that even getting to the eighty percent level, where a full twenty percent of taxpayers are not assisted when they call, will cost another \$100 million.¹⁹⁶

The Service's failure to answer the phone when taxpayers call is a significant issue. An inability to reach the Service to clarify questions can cause taxpayers to give up, resulting in a failure to respond to the Service's notices.¹⁹⁷ Inaction by an EITC taxpayer will cause them to lose, in many cases, thousands of EITC dollars that could be keeping their family out of poverty.

D. Access to Examiners

Correspondence examination cases are only assigned to an

understand some words/terms").

191. *Id.*

192. *See id.* (16.4% of study participants agreed that "[t]one of the letter scared taxpayer").

193. *Id.*

194. *See* Olson, *Sen. Comm. on Fin.*, *supra* note 139, at 2.

195. IRS OVERSIGHT BD., FY 2012, *supra* note 11, at 21.

196. *Id.* at 4 ("Achieving this level of service requires both the \$23.3 million increase in FY 2012 to reach the President's policy level and the \$81.3 million initiative in FY 2012 to *Improve Taxpayer Service*").

197. *See* Olson, *Sen. Comm. on Fin.*, *supra* note 139, at 3.

examiner after correspondence is received from the taxpayer.¹⁹⁸ Cases in which a written response is not received are worked completely through an automated audit system.¹⁹⁹ The correspondence examination process is designed to minimize contact with the Service's personnel, which is how the cost savings are realized.²⁰⁰ A taxpayer who calls the Service does not necessarily trigger the Service's filters to be labeled as a responsive taxpayer, and can find him or herself on the receiving end of additional correspondence stating that he or she has failed to contact the Service along with a notice of deficiency.²⁰¹

This is a problem when, as a study suggests, ninety percent of EITC audited taxpayers attempted to contact the Service about their audit, with nearly seventy-five percent of them calling or personally visiting the Service.²⁰² As noted above, however, these are not the actions that get a correspondence case assigned to a person.²⁰³ These EITC claimants are contacting the IRS because they do not understand the letter, or are having difficulty with the documents the Service seeks.²⁰⁴

Until very recently, the Service's initial EITC correspondence did not designate an employee who could be contacted about the examination.²⁰⁵ Even now, the correspondence only designates a supervisor, and callers are routed to any available employee,²⁰⁶ assuming that the call is even answered.²⁰⁷ Evidence has indicated that the phone line where EITC calls were routed was not staffed,²⁰⁸ and callers were forced to leave a message.²⁰⁹ Anecdotal evidence suggests that return calls were rarely made from the

198. See Landsmann, *supra* note 4, at slide 13 (on file with author).

199. *Id.*

200. See NAT'L TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS, *supra* note 8, at iii.

201. See Landsmann, *supra* note 4, at slide 20 (on file with author).

202. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 104.

203. See Landsmann, *supra* note 4, at slide 13 (on file with author).

204. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 104.

205. See PROGRESS HAS BEEN MADE, *supra* note 121, at 2.

206. See Marchbein, *supra* note 168 ("Correspondence from the IRS bears only the name of a supervisor. If the practitioner calls the supervisor, the IRS typically refers the call to whatever employee is available."); see also PROGRESS HAS BEEN MADE, *supra* note 121, at 2 ("Practitioners shared that the IRS did not designate, in the various letters, an employee who could be contacted to further define the issues or answer taxpayer questions.").

207. See Olson, *Sen. Comm. on Fin.*, *supra* note 139, at 17 n. 43.

208. See PROGRESS HAS BEEN MADE, *supra* note 121, at 2.

209. *Id.* at 5.

EITC voicemail.²¹⁰

E. Document Logging and Matching

Even when EITC claimants understood correspondence or were able to receive clarification about the documents sought, forwarding the documents to the Service often made little difference in the examination.²¹¹ Document matching is a serious problem for the Service.²¹² The Service has significant delays in mail routing and in reading received mail.²¹³ If mail is not logged into the Service's system correctly or in a timely fashion, the automated correspondence system continues actions based on the belief that the taxpayer has not responded or submitted the requisite substantiation.²¹⁴ The Service has admitted that the premature issuance of statutory notices of deficiency is based on mail handling problems.²¹⁵ Although some areas of the Service utilize barcode correspondence for document matching purposes, the EITC area in Small Business/Self Employed does not, and has refused to implement such a provision.²¹⁶ While the Service claims to have addressed its mail handling issues,²¹⁷ this author believes that problems with logging, matching, and processing correspondence remain, and result in denial of EITC taxpayer rights.

F. Studies Show EITC Audit Failure, Not Necessarily Claimant Failure

Given all of the audit barriers that EITC claimants face,²¹⁸ it

210. *Id.*

211. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 95–96.

212. *Id.*

213. See Marchbein, *supra* note 15.

Also, correspondence tends to not be reviewed for several months, resulting in the IRS' sending letters advising the taxpayer that it needs additional time to review it. When the IRS finally issues reports, in some cases the proposed adjustments are incorrect because it has not properly considered and evaluated documents and substantiation furnished by the taxpayer or his or her representatives.

Id.

214. *Id.*

215. See Landsmann, *supra* note 4, at slide 21 (on file with author).

216. In 2011, SB/SE rejected a Taxpayer Advocacy Panel request to implement a barcoding system for mail matching and logging purposes. TAXPAYER ADVOCACY PANEL, 2011 ANNUAL REPORT (on file with author).

217. *Id.*

218. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS *supra*

would not be surprising that EITC claimants who should be entitled to the EITC are unable to obtain it. In 2004, TAS published a study²¹⁹ in which TAS examined 679 random EITC audit reconsideration cases.²²⁰ Audit reconsideration is a Service appeals process in which a taxpayer asks to have their examination reviewed for accuracy.²²¹ Between forty percent and forty-five percent of EITC claimants whose EITC claims were denied or reduced during the correspondence examination process received additional EITC upon audit reconsideration.²²² In other words, nearly half of EITC claimants failing the audit process were in fact eligible for EITC. It follows that being declared ineligible during the correspondence examination process is not necessarily indicative of ineligibility. Research from TAS suggests “that the EITC claims of many taxpayers are denied for lack of documentation even if they could meet applicable residence and relationship requirements.”²²³

A lack of taxpayer response cannot be viewed as indicative of a lack of ineligibility either. In the same TAS study, forty-two percent of the taxpayers were categorized as “late response” or “no response”;²²⁴ however, nearly half of these taxpayers ultimately received favorable outcomes.²²⁵ In other words, the initially non-responsive taxpayers received some amount of EITC. This outcome rate is comparable to taxpayers who were responsive.²²⁶ Extrapolating these findings would cut the alleged improper payment rate nearly in half.

In 2005, TAS further researched the challenges EITC claimants face during examination.²²⁷ This study underscored many of the findings of the 2004 TAS Audit Reconsideration Study, particularly that barriers, not necessarily ineligibility,

note 6, at 95–96.

219. See NAT'L TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS, *supra* note 8.

220. *Id.* at 9.

221. IRS, INTERNAL REVENUE MANUAL 4.13.1.2 (2006) (defining audit reconsideration).

222. See NAT'L TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS, *supra* note 8, at 9.

223. NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2012 OBJECTIVES, *supra* note 98, at 7 (citing Olson, *Ways and Means*, *supra* note 63, at 10–11).

224. NAT'L TAXPAYER ADVOCATE, 2004 ANNUAL REPORT TO CONGRESS, *supra* note 8, at 21.

225. *Id.* at 29.

226. *Id.* at 27.

227. IRS, CHALLENGES FOR TAXPAYERS CLAIMING THE EARNED INCOME TAX CREDIT 2 (2005).

inhibit EITC claimants. The 2005 study notes that EITC claimants often do not understand examination correspondence nor do they understand what they need to prove during a correspondence audit to claim EITC.²²⁸ While the study attributes this to challenging correspondence, the study also notes that the personal characteristics of some claimants (limited financial and actual literacy, transient homes) impact EITC accessibility.²²⁹ The study suggested that “the majority of their clients were truly eligible for EITC, but . . . have difficulty assembling the requested documentation and just give up, forgoing the credit.”²³⁰

G. EITC Overpayment Rate is Likely Incorrect

In the 2004 TAS Audit Reconsideration Study, “over forty percent of all taxpayers with representatives emerged from their audit with their full EIC intact.”²³¹ Another way of looking at this is that of a subset of 427,807 taxpayers claiming EITC who received payment and were later audited (the Service would call these improper payment post-audit), a substantial portion, perhaps even as many as forty percent, may not have been improper, if they had access to representation during audit.²³² Without the extraordinary efforts relating to this study, the Service would have considered the forty percent in the EITC improper payment calculation.²³³ Taking it a step further, if, as in the TAS study, forty percent of EITC audits are not improper payments, and assuming we could translate this to the overpayment rate, then the EITC annual overpayment rate drops to between fourteen to seventeen percent.

A potential criticism is that this calculation cannot be extrapolated because the sample population was arguably a motivated subset of individuals who felt they were wrongly denied access to EITC.²³⁴ Admittedly, this is not a representative sample. It is nonetheless indicative of the existence of serious, widespread, and systematic barriers for claiming the EITC.²³⁵ Even if the forty percent error rate found for EITC improper payments in the TAS study cannot be directly applied because of methodological issues,

228. *Id.* at 1–2.

229. *Id.* at 5–6.

230. *Id.* at 2.

231. See NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 96.

232. *Id.* at 102.

233. *Id.* at 101–03.

234. *Id.* at 100–01.

235. *Id.* at 95.

it establishes that the twenty-three to twenty-eight percent improper payment rate is suspect.²³⁶ The National Taxpayer Advocate has come to a similar conclusion, stating, “[s]ignificant statistical questions about the IRS estimates remain.”²³⁷

The EITC improper payment data is erroneous for other reasons too.²³⁸ First, the rate is based on three studies of EITC errors that considered a claimant’s inability to document EITC as an overpayment, which (as shown by the TAS study) may “reflect premature and incorrect judgments.”²³⁹ Second, the error rate does not consider underpayments.²⁴⁰ In a February 2011 report, TIGTA demonstrated that the Service ignores EITC underpayments in its improper payment calculation, in contravention of the OMB guidance.²⁴¹ Additionally, in cases where the incorrect parent may have claimed EITC, the Service does not research, calculate, or include the possible underpayment (or lack of payment) to the appropriate EITC parent.²⁴²

The actual rate of EITC improper payments is probably not nearly as high as the Service reports.²⁴³ In addition, several commentators have discussed the role of unintentional error due to complexity as a significant contributor to the reported improper payment rate.²⁴⁴ As Professor Book has stated, “[e]ven though the IRS has studied and reported on EITC extensively there is very little data regarding how much EITC noncompliance relates to intentional conduct and how much relates to unintentional error.”²⁴⁵

V. Continued Use of Correspondence Examinations Contravenes Executive Order 13520

The previous four Parts have attempted to explain the intersection of improper payment law, the earned income tax credit, and correspondence examinations. The ultimate conclusion should be obvious: the manner in which the Service uses correspondence examinations to administer the EITC unduly

236. *Id.* at 67.

237. See Olson, *Ways and Means*, *supra* note 63, at 6.

238. See WANCHECK & GREENSTEIN, *supra* note 97, at 1.

239. *Id.* at 5–6.

240. *Id.*

241. See REDUCTION TARGETS, *supra* note 85, at 14–15.

242. See WANCHECK & GREENSTEIN, *supra* note 97, at 6.

243. *Id.* at 5.

244. See Book, *The Poor and Tax Compliance*, *supra* note 127, at 1184–86; Book, *Compliance Regime*, *supra* note 5, at 371–72; Holt, *supra* note 60, at 185–86.

245. Book, *Preventing the Hybrid from Backfiring*, *supra* note 60, at 1113.

burdens access to EITC for many low income taxpayers, and this undue burden is contrary to Executive Order 13520.²⁴⁶

A critical look at EITC correspondence examinations suggests that many eligible EITC claimants fail during the correspondence examination process, albeit not necessarily because of their ineligibility.²⁴⁷ The claimants' failures to document EITC requirements within the narrow confines allowed in the Internal Revenue Manual are the measurement for EITC improper payments.

The burden is on the taxpayer to read the voluminous instructions, determine EITC eligibility (with virtually no Service assistance), and correspond in writing (with limited telephone access to Service personnel).²⁴⁸ Executive Order 13520 is clear in its direction that agencies must minimize improper payments without unduly burdening program participation.²⁴⁹ The current use of correspondence examination inhibits lawful EITC participation.²⁵⁰ Continued Service use of correspondence examinations, as undertaken with full automation and nearly no access to Service personnel for clarification or assistance, to manage EITC improper payments contravenes Executive Order 13520.²⁵¹

VI. Possible Solutions

The most obvious solution is to simplify eligibility for EITC so that claiming and verifying EITC eligibility is accessible and possible for the low-income taxpayers EITC is designed to help. This, of course, requires congressional action. The current polarized political climate, as shown by the current struggle within Congress to agree to any tax compromises and Congress's decade-long propensity for brinkmanship in tax legislation, limit hope for this solution. As is typical with tax issues on which Congress cannot or will not take action, it falls to the Service to address the problem.

It is not the intent of this Article to cast the Service as the

246. See Exec. Order No. 13520, 74 Fed. Reg. 62,201–02 (Nov. 20, 2009).

247. See NAT'L TAXPAYER ADVOCATE 2004, *supra* note 8, at 29.

248. See Landsmann, *supra* note 4, at slides 12–21 (on file with author).

249. See Exec. Order No. 13520, 74 Fed. Reg. 62201 (Nov. 20, 2009) ("Because this order targets error, waste, fraud, and abuse—not legitimate use of Government services—efforts to reduce improper payments under this order must protect access to Federal programs by their intended beneficiaries.").

250. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra* note 6, at 103–04.

251. *Id.*

lone villain in the EITC examination story. Service actions are problematic, but the Service is faced with its own burdens of revenue collection with a tight budget and antiquated systems that have not been fully modernized.²⁵² The Service has periodically undertaken pilots in an attempt to study possible changes to EITC administration.²⁵³ Some have been unsuccessful, but others show promise and, more importantly, reflect the possibility that the Service is aware of the EITC's examination undue burden.²⁵⁴

A. Precertification Pilot

Given the pressure on the government to reduce expenditures, it is hard to foresee the Service willingly discarding its inexpensive (but arguably ineffectual) correspondence examination process or the minimal staffing it uses with correspondence examinations.²⁵⁵ This realization, that change is unlikely to emerge on its own, informs the purpose of this Article, which is to suggest the possibility of a legal catalyst to force change.

The Service has undertaken certain pilot programs for EITC, that demonstrate the Service's recognition of the undue burden that correspondence examinations create for EITC taxpayers.²⁵⁶ Just a few years ago, the Service piloted an EITC precertification program to minimize improper payments.²⁵⁷ Unfortunately, precertification added another layer of burden for EITC claimants.²⁵⁸ The Service ultimately concluded that, despite a variety of alternatives, precertification deterred EITC participation by eligible beneficiaries.²⁵⁹

B. State Data Pilot

In 2010, the Treasury Department began a pilot to assess the

252. See Book, *Compliance Regime*, *supra* note 5, at 371–81.

253. *Id.* at 382–90.

254. See IRS, EARNED INCOME TAX CREDIT INITIATIVES, *supra* note 122, at 11.

255. See PROGRESS HAS BEEN MADE, *supra* note 121, at 2.

256. *Id.* at 1–11; see also Partnership Fund for Program Integrity Innovation, *Assessing State Data for Validating EITC Eligibility*, PARTNER 4 SOLUTIONS (Nov. 23, 2010), http://partner4solutions.gov/sites/www.partner4solutions.gov/files/EITC_Data_Matching_pilot_concept.pdf.

257. EARNED INCOME TAX CREDIT INITIATIVES, *supra* note 122, at 3–4.

258. *Id.* at 5.

259. *Id.* at 9 (“Although a 3 percent deterrence rate for eligible claimants might appear low, this deterrence rate could have broader significance and even conflict with the IRS goal of increasing EITC participation among the eligible population.”).

ability to use state Supplemental Nutrition Assistance Program (SNAP) and TANF data to assist in validating EITC eligibility.²⁶⁰ The pilot has four goals: minimizing improper EITC payments, advancing efficiency in the administration of the EITC, improving communications, and reducing barriers to EITC access.²⁶¹ While the Treasury Department identified claimant privacy and consent as possible issues to implementation,²⁶² a bigger concern is that erroneous state data will create another possible barrier for claimants and serve as a basis for more audits or improper denials during audits.²⁶³

C. Examiner Contact Pilot

The Service has recently begun two pilots that have much less risk for harm and also reflect a better understanding of the burdens of EITC examinations.²⁶⁴ The Service is piloting a modified correspondence exam process for a selected set of EITC claimants.²⁶⁵ In this study, the National Taxpayer Advocate and Low Income Taxpayer Clinic directors trained a group of correspondence examiners who will make personal phone calls to audited EITC claimants twice during the examination process to answer questions.²⁶⁶ This pilot is essentially a pilot of a non-correspondence audit process. Based on previous EITC claimant success in the TAS Audit Reconsideration Study,²⁶⁷ EITC claimants likely will have far more success in this pilot than if they were left to the automated system. Improvement in the EITC claimant success rate in this pilot would evidence that solely automated correspondence exams are a bad match for EITC compliance, and impede access to program benefits. Success in this study would be evidence that Service personnel *personal* involvement is necessary to administer the EITC examination process.²⁶⁸

260. See Partnership Fund for Program Integrity Innovation, *supra* note 256, at 1.

261. *Id.*

262. *Id.* at 4.

263. *Id.* at 2.

264. See Olson, *Ways and Means*, *supra* note 63, at 19–20.

265. *Id.*

266. *Id.*

267. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONG., *supra* note 6, at 115.

268. See Olson, *Ways and Means*, *supra* note 63, at 19–20.

D. Affidavit Pilot

In another pilot, the Service is testing an expansion of the very limited list of acceptable proof during an EITC correspondence examination.²⁶⁹ In addition to the list of official records and select letters on official letterhead, examiners will also accept third-party affidavit evidence to prove qualifying child relationship and residency,²⁷⁰ which are two of the largest proof hurdles. The Service has already concluded, during its precertification study, that affidavits are “easier for taxpayers to obtain than official documents or letters” and “had a higher acceptance rate than the other two types of documents.”²⁷¹ This study can also help alleviate some of the proof burden for EITC claimants.

E. Future Possibilities

If expanded for all twenty-six million EITC claimants,²⁷² these two pilots have the possibility to alleviate some of the burdens of EITC correspondence examinations: a lack of personal contact with Service personnel and documentary proof issues. These two pilots are not, however, a panacea for all of the ills of this process. They do not address, for example, that establishing eligibility for the credit is still far too document intensive, the Service's telephone LOS is likely to remain at abysmally low seventy to eighty percent levels, or the troublesome document logging and matching problem. A more looming reality is that, even if these pilots are successful, the Service is unlikely to secure funding for the universal expansion of telephone contact for all EITC examinations.²⁷³ The economic and political climates make that funding very unlikely.²⁷⁴ Without it, the EITC correspondence examination process will continue as an unfair and undue burden.

Conclusion

Correspondence examinations have proven insurmountable for many EITC claimants.²⁷⁵ According to a TAS study, many

269. *Id.* at 20.

270. *Id.*

271. *Id.* (citing EARNED INCOME TAX CREDIT INITIATIVES, *supra* note 122, at 14).

272. IRS, *EITC Statistics*, EITC CENTRAL (Dec. 2011), <http://www.irs.gov/central/eitcstats/>.

273. See Romney, *supra* note 26, (detailing the failing economy and large government debt); Bradford, *supra* note 25.

274. See Romney, *supra* note 26; Bradford, *supra* note 25.

275. See NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS, *supra*

EITC claimants just give up because proving their eligibility and navigating the correspondence examination process is too daunting.²⁷⁶ Such barriers to program participation are precisely what Executive Order 13520 proscribes in its attempts to limit improper payments.²⁷⁷ Two current Service pilots, which aim to expand access to Service personnel during an EITC correspondence examination and to accept affidavit evidence to document qualifying children, have promised to lessen the burden of these audits.²⁷⁸ Unfortunately, the personnel expansion necessary for examiner contact during all EITC correspondence examinations is unlikely to receive funding, even if the pilot is successful.²⁷⁹ Accordingly, it may fall to Executive Order 13520 to become the necessary legal lever for change.

note 6, at 95.

276. See Olson, *Ways and Means*, *supra* note 63, at 13–14.

277. See Exec. Order No. 13520, 74 Fed. Reg. 62,201 (Nov. 20, 2009).

278. See Olson, *Ways and Means*, *supra* note 63, at 19–20.

279. See Romney, *supra* note 26; Bradford, *supra* note 25.

