eJournal of Tax Research

Volume 14, Number 2 November 2016
(Special Edition: Atax 12th

1. INTRODUCTION

The earned income tax credit (EITC) suffers an image problem. Introduced in 1975, today the EITC reaches more than 27 million households annually and is the most significant earnings-based refundable credit in the Internal Revenue Code.[2] While the EITC has long enjoyed bipartisan support and is lauded as a successful anti-poverty program, it is also criticised for its complexity and its difficulty to administer and enforce.[3] Despite the high audit selection rate for EITC returns[4] and a myriad of approaches aimed at improving accuracy an (at)8.3 (e -2)-1 a (t)8.2 (i)-2.6 (n)2 (g venueSa(r)-1.9

intentional and/or fraudulent, just as taxpayers intentionally underreport or hide income in other contexts.[13] Notably, it is important to understand and appreciate this distinction, because the two ends of the spectrum present different enforcement

note, however, that the IRS figure is 'at best a sophisticated guess', in part because no one knows the extent of the underground economy.[18]

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

eJournal

It is that the program is so complicated that people are inadvertently having difficulty figuring out where they fit and where they don't.'[38]

The most recent NRP study, published in August 2014, provides compliance estimates

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

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

This section compares two types of intentional noncompliance: EITC noncompliance and sole proprietor noncompliance. It provides a brief overview of selected theories of noncompliance.

4. RETURN PREPARERS AND EITC NONCOMPLIANCE

This section will discuss EITC noncompliance in the return preparer context, including ways in which return preparers enable or instigate noncompliance. It will evaluate some of the IRS initiatives in place to detect and deter noncompliance. This is8 -1.t457 0 Td [2d [/Bottsdte Subtype /H4.6 (on w)15.5 (Subtiah)10.9 3Td [(T)-4.910.9 (

Circular 230 regulatdns governing practice before the IRS and are not affiliated with a nationally known tax preparation firm.[91]

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

The Taxpayer Advocate and others mention EITC returns as a particular concern due to the size and refundable nature of the credit.[93]

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

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

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

If approximately one-half of EITC overclaims are due to income misreporting, then this is part of a broader noncompliance phenomenon, and one that has proven very difficult to [illegible]

The IRS makes efforts to educate return preparers about the due diligence requirements and Form 8867.Paid preparers who filed ten or more EITC returns without Form 8867 in filing season 2013 received a warning letter, and the IRS issued penalty letters to 225 of these preparers when they again filed ten or more EITC

4.2 Targeted return preparer education

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

4.3 Pursuing injunctions and permanent bars against the most egregious preparers

As the US District Court for the District of Columbia emphasised in its Loving opinion, 'Congress has already enacted a relatively rigid penalty scheme to punish misdeeds by tax return preparers.'[123] In addition to various monetary penalties, the Code permits the government to bring civil action to enjoin tax return preparers from engaging in certain conduct. The IRS and the Department of Justice Tax (DOJ) Division work together under this statutory authority to pursue injunctions and permanent bars against the most egregious offeim

5. SELF-PREPARED RETURNS AND TAXPAYER ERROR

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

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

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

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

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

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

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

[135] Working Families Tax Relief Act of 2004, Pub L No 108-311, 118 Stat 1166, Sections 201-208; see John Buckley, 'Uniform Definition of a Chw (-)TjhTw 1(C)7.3 7pt32xa

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

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

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

5.2.1 Accuracy related penalties apply to all overpayment claims

> Taxpayers who erroneously claim the EITC are subject to the section 6662 20% accuracy penalty,[143] regardless of whether the error was unintentional and intentional. In November 2013, in a decision that was viewed as quite favourable to low-income taxpayers, the US Tax Court held that this accuracy related penalty could not apply to the refundable portion of a credit (commonly referred to as the negative income tax): that is, the amount refunded to the taxpayer in excess the amount of tax shown on the return.[144] However, the Tax Court was legislatively overruled two years later when Congress amended the definition of underpayment to explicitly include refundable credits in the calculation of the accuracy related penalty.[145]
>
> I have argued elsewhere that the IRS is overly punitive in its application of section 6662 because it does not attempt to distinguish between intentional and unintentional EITC noncompliance.[146] As a result, unsophisticated taxpayers face penalties of $1,000 or higher even if their mistake was a wholly innocent one. To be clear, I do not wish to see the Service penalize inadvertent error. But as I will explain in section 6 below, increasing information with return filing may put the IRS in a better position to determine when the taxpayer is knowingly engaging in fraud.

5.2.2 Section 32(k) – taking away a right that one never rightfully had isn't a meaningful n y a rig7 (ng)10.9

> birth certificates, lease documents, school/medical records, for the purpose of claiming … EITC, or other refundable credits."[157]

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

I envision a similar program that would serve as an EITC-Task for first-time claimants. Imagine an example: Joe Taxpayer is claiming EITC for the first time this tax year because he married Jane Taxpayer and now has three stepchildren who are qualifying dependents.

I8 -18.0.315 (ag)12.(h)2 (i)heb’e b (b)2 (as)0.5 (E(c)1162 .0 Td ( )Tj 0.294.848-.042 Tw 0.29

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

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

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

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

> There are also real issues in subjecting EITC recipients to a pre-certification process that does not apply to any other tax filers. People do not need to pre

suggest is appropriate for most taxpayers in any event.) Taxpayers who do not opt in

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

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