INTERNAL REVENUE SERVICE

IRS Fact Sheet

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EITC Reform Initiative

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Overview

The Internal Revenue Service (IRS) is responsible for administering the Earned Income Tax Credit (EITC), which is a refundable Federal income tax credit for low-income working individuals and families. Congress originally approved the tax credit legislation in 1975, in part to offset the burden of social security taxes and give these individuals an incentive to work. Since its adoption in 1975, the amount of the EITC has increased in dollar amount, as well as in the number of individuals and families benefiting from it. Approximately 19 million taxpayers - roughly one out of every seven families who filed - claimed over $32 billion of such credits on tax year (TY) 2002 returns.

Although the EITC has been successful in lifting millions of low-income taxpayers and their children above the poverty line, it has been plagued by persistent compliance problems. In 1997 the IRS released a compliance study that showed a high rate of noncompliance with the EITC. In response Congress provided a special $716 million appropriation for 5 years (FY 1998 to 2002) to reduce EITC errors through expanded customer service and public outreach programs, strengthened enforcement activities, and enhanced research efforts.

Despite these efforts, the IRS has been unable to significantly reduce noncompliance. The most recent compliance study (of TY 1999 returns), reported that between $8.4 and $9.9 billion in EITC claims (27% to 32%) had been improperly paid. Based on "significant compliance problems" associated with the EITC, the General Accounting Office has listed the administration of the credit as a "high risk area for the federal government."

The EITC is a social benefits program embedded in the tax code. While traditional government benefits programs generally require proof of eligibility prior to payment, the tax system primarily relies on self-reporting. Thus, unlike most benefits programs, the IRS has not required proof of eligibility prior to payment and has relied on a claimant's self-assessment that he or she meets the EITC eligibility criteria. In addition, it is difficult for the IRS to confirm or refute crucial facts about an EITC claimant's eligibility (e.g., marital status, residency of a claimed child) without resorting to an examination. For claimants selected for examination, the entire refund is frozen pending resolution of the disputed issues.

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EITC Reform Initiative

Recognizing the importance of the EITC to millions of hard working taxpayers, today the IRS is announcing a five-point EITC initiative to: (1) reduce the backlog of pending EITC examinations to ensure that eligible claimants receive the refunds quickly, (2) review the existing audit process to minimize the burden on taxpayers and improve the quality of communications with taxpayers, including notices, (3) increase outreach efforts to improve participation and to ensure that the requirements for claiming the credit are clearly understood, (4) enhance compliance efforts with regard to taxpayers who have claimed the credit but are ineligible because their income is too high, and (5) pilot a certification effort to establish prior to payment that certain higher risk taxpayers lived with the children they claim for the EITC for the required length of time (more than half of the year).

Reducing the Backlog of EITC Examinations

Currently, approximately 7 percent of pending EITC examinations have been in process for more than one year and are old under the agency's own guidelines. In many of these cases, refunds are frozen pending resolution of the examination. The agency will begin a review of current EITC examination inventories to determine how to reduce this backlog.

Reviewing the Existing Audit Process and Improving the Quality of Communications

Currently, an average EITC pre-refund examination takes 225 days to resolve. During an EITC examination, a taxpayer will receive a minimum of 2 different notices and can receive up to 6 different notices. Many claimants selected for EITC pre-refund examinations fail to respond. The agency will review the notices and letters sent to taxpayers to ensure that they clearly explain why the IRS is questioning a claim and tell taxpayers exactly what they must do to prove their eligibility. In addition, the IRS will look for other ways to improve the examination process and make it less burdensome for taxpayers.

Increasing Outreach Efforts

Currently, the IRS undertakes extensive EITC outreach and education efforts to encourage eligible taxpayers to claim the EITC and to ensure that taxpayers and their advisors understand the eligibility requirements. During FY 2002 and FY 2003, the IRS allocated $31 million on these activities. Through its Stakeholder Partnerships, Education and Communication (SPEC) organization the IRS has reached over 50 million EITC taxpayers. SPEC works with the media, national partnerships and local community-based coalitions to provide EITC information with utility bills, school report cards, Forms W-2, Forms 1099, and company newsletters; through direct mailings by housing authorities and social service agencies; and through advertising, workshops, seminars, and neighborhood outreach. To reduce errors, the IRS also made 600 visits

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and issued over 700 letters to paid preparers who were responsible for the highest number of returns with qualifying child errors. The National Taxpayer Advocate and SPEC also are working to develop additional partners and methods for increasing awareness of the EITC and to ensure that eligibility rules are clearly understood. The IRS also intends to expand its media campaign and increase its efforts to educate return preparers.

Increasing Focus on Taxpayers Who Circumvent EITC Income or Claim Limitations

Taxpayers who circumvent the EITC income or claim limitations include (1) taxpayers who fail to report all of their income, (2) married taxpayers who each file as single or head of household because their combined income is above the EITC limit, and (3) married taxpayers with 2 or more children who each file as single or head of household and split the children claimed, thereby receiving up to about $8,000—twice the maximum EITC claim limit. Taxpayers with income or filing status errors are responsible for about $4 billion in annual erroneous payments. The IRS will identify returns with the highest risk of income misreporting by using its document matching systems (Form W-2 and Form 1099 information). In 2004, it will request information from 175,000 taxpayers who appear ineligible for the credit because they have failed in the past to report all of their income. The IRS will also identify returns with the highest probability of filing status error by enhancing its error detection technology, using third party data and requiring EITC claimants to submit limited additional information about their marital status and, where applicable, about their spouse or former spouse. In January, the IRS will ask 5,000 taxpayers to document their filing status where it appears that married taxpayers may have avoided the EITC income or claim limitations by improperly filing as single or head of household.

Piloting a Qualifying Child Residency Certification Program

Individuals can claim a child for EITC only if the child has one of the legally-specified relationships with the claimant and the child has lived with the claimant for more than half the year. Qualifying child errors cause about $3.0 billion in annual erroneous payments. The vast majority of qualifying child overclaims are caused by residency errors—either alone or in combination with relationship errors. For this reason, the IRS will pilot a certification program to establish residency before the EITC is paid. Certification will only be required for certain taxpayers who have a high risk of claiming children who do not satisfy the residency requirement. Certification will not be required for taxpayers who pose significantly lower risk of error (such as mothers and married, joint-filing parents).

The IRS will select 45,000 of the higher risk claimants and ask those claimants to provide documentation to verify that the claimed EITC child or children resided with them for more than half the year. The claimants will be contacted initially in August of 2003. They will have from August until December to provide the required documentation prior to filing their returns and avoid any delay of their EITC claims. Claimants who choose not to pre-certify can submit documentation with their return, but the EITC-portion of their refund will be delayed until that documentation is processed.

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To establish residency, the IRS will ask claimants to provide documentation from third parties, such as clergy, doctors, daycare providers, community-based organizations and social services agencies, who have information about the residency of the claimant and child—either through their records or personal experience. Claimants who cannot obtain the suggested documentation can seek help at an IRS Taxpayer Assistance Center or through a special toll-free number to speak with IRS personnel specializing in the EITC qualifying child certification process. Additionally, claimants will be assigned one of the qualifying child specialists who will be responsible for handling the claimant's qualifying child issues from start to finish.

The goal of the certification pilot is to evaluate high-risk EITC claims before they are paid, using a process that is less burdensome to taxpayers and less costly to the government than an audit. In addition, the certification program will enable eligible, but high risk, taxpayers to receive their refunds faster than if they were subsequently challenged by the IRS. By helping to ensure that certain high-risk taxpayers receive the right amount of the credit before refunds are paid, the program will also reduce the burden that is imposed when taxpayers must repay erroneous refunds.

Throughout the pre-filing and filing season, the IRS will continually evaluate all aspects of the certification process, including claimant response to the certification proposal, to refine the process and to determine how to maximize participation and minimize burden for legitimate claimants. To help refine the certification proposal, the IRS is requesting public comments on how the agency can establish EITC claimants' qualifying child eligibility to the credit in advance of filing their returns.

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