



2015 IRS-TPC Research Conference

Session 4: Helping Taxpayers Get it Right

Moderator:

Theresa Pattara
H&R Block

**The Nontaxable Combat Pay Election
and the Earned Income Tax Credit**

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**Pilot Project to Assess Validation of
EITC Eligibility with State Data**

Elaine Maag
The Urban Institute

IRS Preparer-Level Treatment Tests

Karen Masken
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Discussants:

Deena Ackerman *Treasury Office of Tax Analysis*
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The Nontaxable Combat Pay Election and the EITC

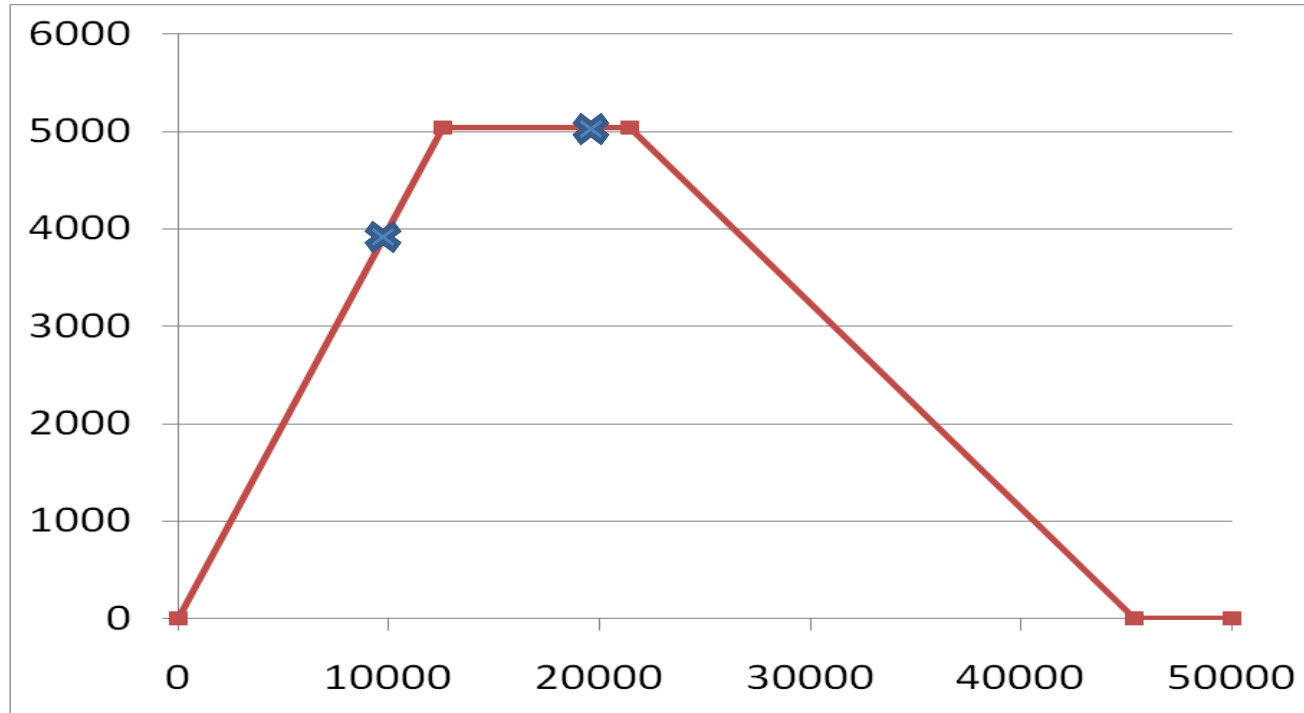
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*These views are the authors and do not necessarily reflect those of the U.S. Department of the Treasury or the U.S. Department of Defense.

Background

- Combat zone tax exclusion: Military service members do not pay income taxes on any income received in any month in which they spent time in a combat zone.
 - Capped at \$88,416 in 2009.
- Earned income tax credit (EITC) is calculated based on earnings.
- Exclusion of combat zone earnings will reduce the EITC among some low-income military members.

2009 EITC for Married Filing Jointly Couple with 2 Qualifying Children



Nontaxable Combat Pay Election (NCPE)

- Created in tax year 2004.
- Gives service members the option to include nontaxable combat pay in EITC earnings.
- Default setting is to exclude nontaxable combat pay.
- NCPE gives military personnel the option to include or exclude *all* of their nontaxable combat pay.

Questions

- Do military service members optimize their EITC?
 - Do observable characteristics differ between optimizers and non-optimizers?
- To what extent are service members eligible for the EITC because of the combat zone tax exclusion?
 - Do observable characteristics differ between those who are newly eligible and always eligible?
- What is the cost of the nontaxable combat pay election?

Motivation

- Federal income tax system has become more complex as policy makers continue to use taxes to provide income support and incentivize certain behaviors.
- To what extent do targeted populations understand how to correctly claim credits on their own or is a tax preparer necessary?
- Evidence that people do not understand the relationship between earned income and EITC (Chetty and Saez, 2013).

Data

- Merge individual level military personnel characteristics from the Department of Defense to IRS tax return and W-2 data for tax years 2005-2009.
- Restrict data to EITC-eligible military service members with nontaxable combat pay reported on their W-2s.
 - EITC-eligible includes all individuals who are eligible when combat pay is excluded from EITC earned income
 - Almost 1 million individuals
 - Represents 30% of service members with nontaxable combat pay.

EITC Optimization

- Calculate EITC earned income both with and without nontaxable combat pay and compare amounts to IRS reported EITC earned income.
- Calculate EITC both with and without nontaxable combat pay to determine optimal amount.
- 82% optimize EITC.

	Should Use NCPE	Should Not Use NCPE
Use NCPE	45,909 (4.6%)	9,514 (1%)
Do Not Use NCPE	18,490 (1.9%)	913,454 (92.5%)

Summary Statistics by EITC Optimization

- Distributions by service and pay grade are similar.
- On average, non-optimizers are older, more likely to file as unmarried, and have lower AGI than optimizers.
- Among non-optimizers, 62% are filers who do not claim EITC, 31% are non-filers, 4% claim EITC and use the NCPE, 3% claim EITC and do not use the NCPE.

	Non-optimizers	Optimizers
Adjusted Gross Income	\$12,127 (14,047)	\$17,522 (10,756)
Nontaxable Combat Pay	\$23,635 (16,004)	\$21,887 (14,970)
Paid Preparer	0.28 (0.45)	0.60 (0.49)
Notes: In millions of 2009 dollars		

Do military service members optimize their EITC?

	<u>All</u>	<u>Should Use NCPE</u>	<u>Should Not Use NCPE</u>
Optimization Rate	82%	71%	83%
Average Loss Among Non-Optimizers	\$1,191	\$1,571	\$1,145
Use a Paid Tax Preparer	54%	57%	54%

Optimization Rate By Paid Preparer Use:

No Paid Tax Preparer

Optimization Rate	73%	54%	74%
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Average Loss Among Non-Optimizers

Average Loss Among Non-Optimizers	\$1,232	\$1,769	\$1,171
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Yes Paid Tax Preparer

Optimization Rate	91%	84%	91%
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Average Loss Among Non-Optimizers

Average Loss Among Non-Optimizers	\$1,083	\$1,123	\$1,077
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Observations

987,454

64,399

922,968

Percentage

6.52%

93.47%

Distribution of Personnel Who Do Not Optimize the EITC by Size of EITC Loss

	<u>All Non-Optimizers</u>	<u>EITC Claimants</u>	<u>Non-EITC Claimants</u>	
			<u>Filers</u>	<u>Non-Filers</u>
EITC Loss \leq 100	12%	13%	13%	8%
100<EITC Loss \leq 500	47%	31%	53%	38%
500<EITC Loss \leq 1000	5%	21%	4%	4%
1000<EITC Loss \leq 2000	10%	23%	8%	11%
2000<EITC Loss	30%	12%	21%	39%
Observations	172,808	12,011	106,637	54,160

Excluding those with EITC Loss \leq \$500:

- Reduces sample by over 100K
- Increases optimization rate from 82% to 92%
- Disparity in optimization rate by those who should (79%) and should not use the NCPE (93%) increases.

EITC Eligibility

- Always Eligible if individual qualifies even if combat pay were required to be included in EITC earned income.
 - Includes those with zero taxable earnings.
- Newly Eligible if individual would not qualify if combat pay were required to be included in EITC earned income.
- 56% are Newly Eligible.

Summary Statistics by Always and Newly Eligible

	Always Eligible		Newly Eligible	
Optimize EITC	0.87	(0.34)	0.79	(0.41)
Use NCPE	0.13	(0.33)	0.00	(0.03)
Age	27.97	(5.71)	32.14	(6.75)
Single	0.07	(0.26)	0.26	(0.44)
Any EITC Kids	0.97	(0.16)	0.60	(0.49)
Claim EITC	0.90	(0.30)	0.79	(0.41)
EITC	\$2,902	(1,399)	\$1,335	(1,482)
Nontaxable Combat Pay	\$13,867	(8,894)	\$28,658	(15,869)
Observations	431,590		555,777	

Cost Estimates

	2005	2006	2007	2008	2009
Total Cost of NCPE	9.3	7.2	8.0	9.6	15.1
Total Cost of Combat Zone Tax Exclusion	3,500	3,400	3,900	3,800	3,600

Notes: In millions of 2009 dollars

- Total Cost of NCPE is the difference between the EITC claimed with the inclusion of combat pay and the amount of EITC that would have been claimed if nontaxable combat pay were excluded from EITC earned income:
 - Restricted to individuals who use the NCPE.
- The cost of the NCPE represents <1% of the total cost of the Combat Zone Tax Exclusion.

Conclusion

- 82% optimize EITC.
- Optimization rates are lower for those who should use the NCPE. These differences remain when conditioning on paid tax preparer use and are larger among those who do not use a paid tax preparer.
- The combat zone tax exclusion increases EITC eligibility.
- NCPE cost is <1% of the total cost of the combat zone tax exclusion in any given year between 2005-2009.
- The NCPE increases complexity in the tax code while the segment of the military population who benefits from the NCPE is small.

Using Supplemental Nutrition Assistance Program Data in EITC Administration

June 18, 2015

Elaine Maag

IRS-TPC Research Conference



TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

- Goal: Reduce improper payments of EITC claims
- In 2007, 21.2-25.8% of EITC payments estimated to be overclaims; \$13.7 - \$16.7 billion
- Leading cause when type of error is known is claiming non-qualified child
- Can state benefit program data help reduce improper payments?

Key EITC Qualifying Elements



Marital Status

Income

Relationship

Residency

Citizenship Status

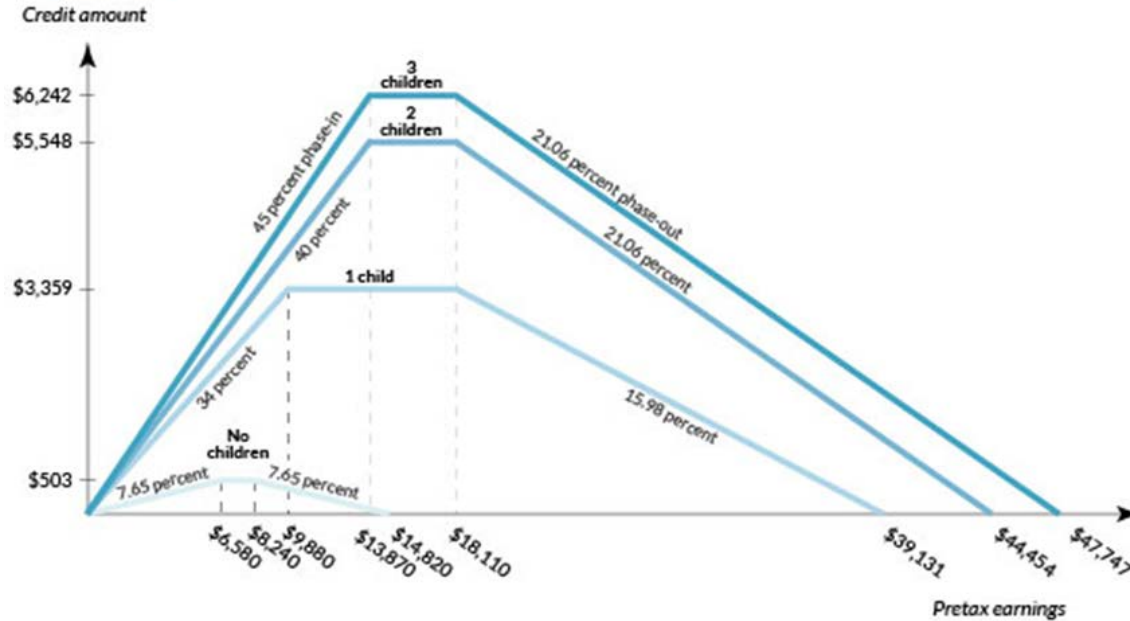
Student

Disability

Description of EITC



FIGURE 1. EARNED INCOME TAX CREDIT, 2015



Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income \$5,520 higher than shown.
 Source: Tax Policy Center, 2015

Description of SNAP



Table 1. SNAP Income Test October 1, 2014 through September 30, 2015

Household Size	Gross Monthly Income (130 percent of federal poverty level)	Net Monthly Income (100 percent of federal poverty level)
1	\$1,265	\$973
2	1,705	1,311
3	2,144	1,650
Each additional member	+440	+339

Source: USDA Food and Nutrition Services, <http://www.fns.usda.gov/snap/eligibility#Income>, 2015.

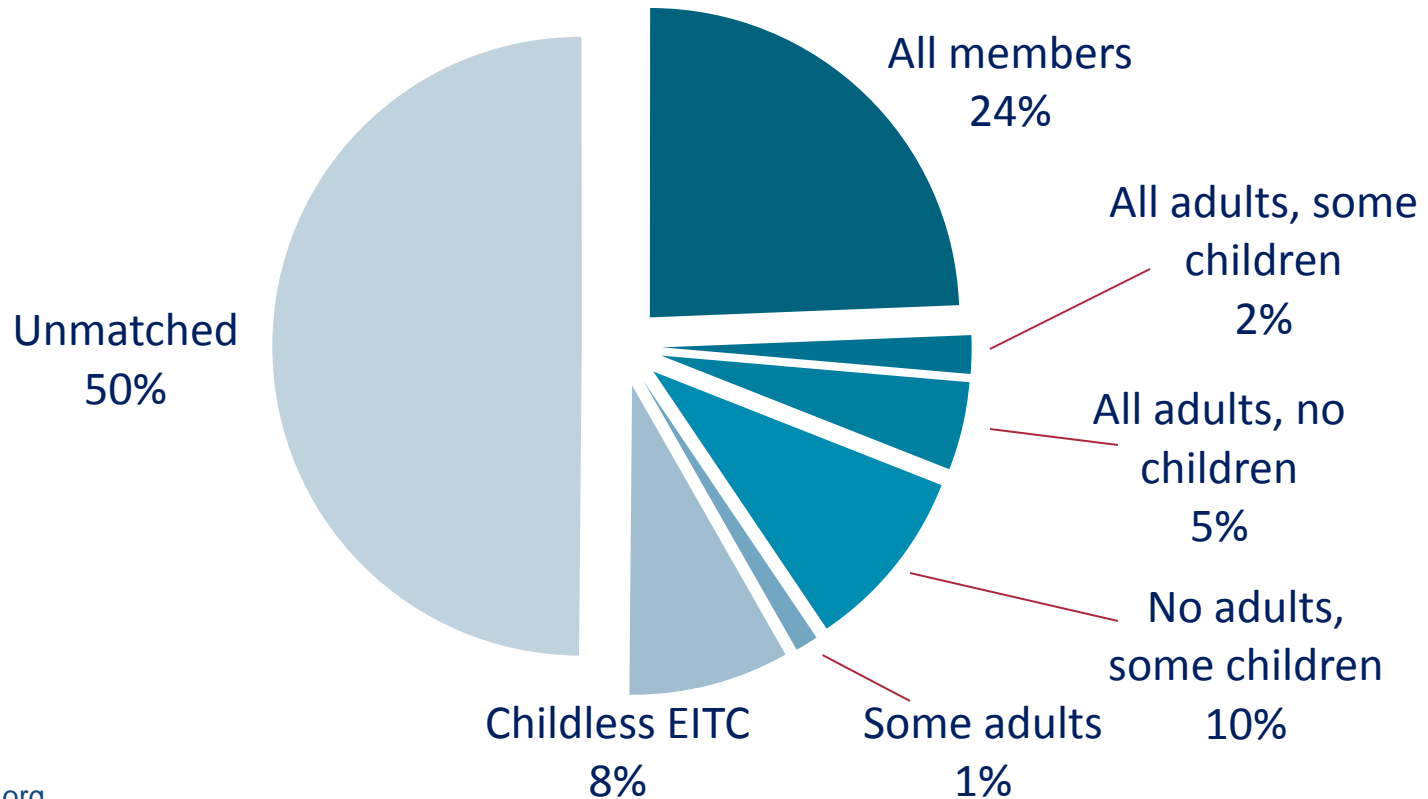
Why SNAP Data Might be Helpful



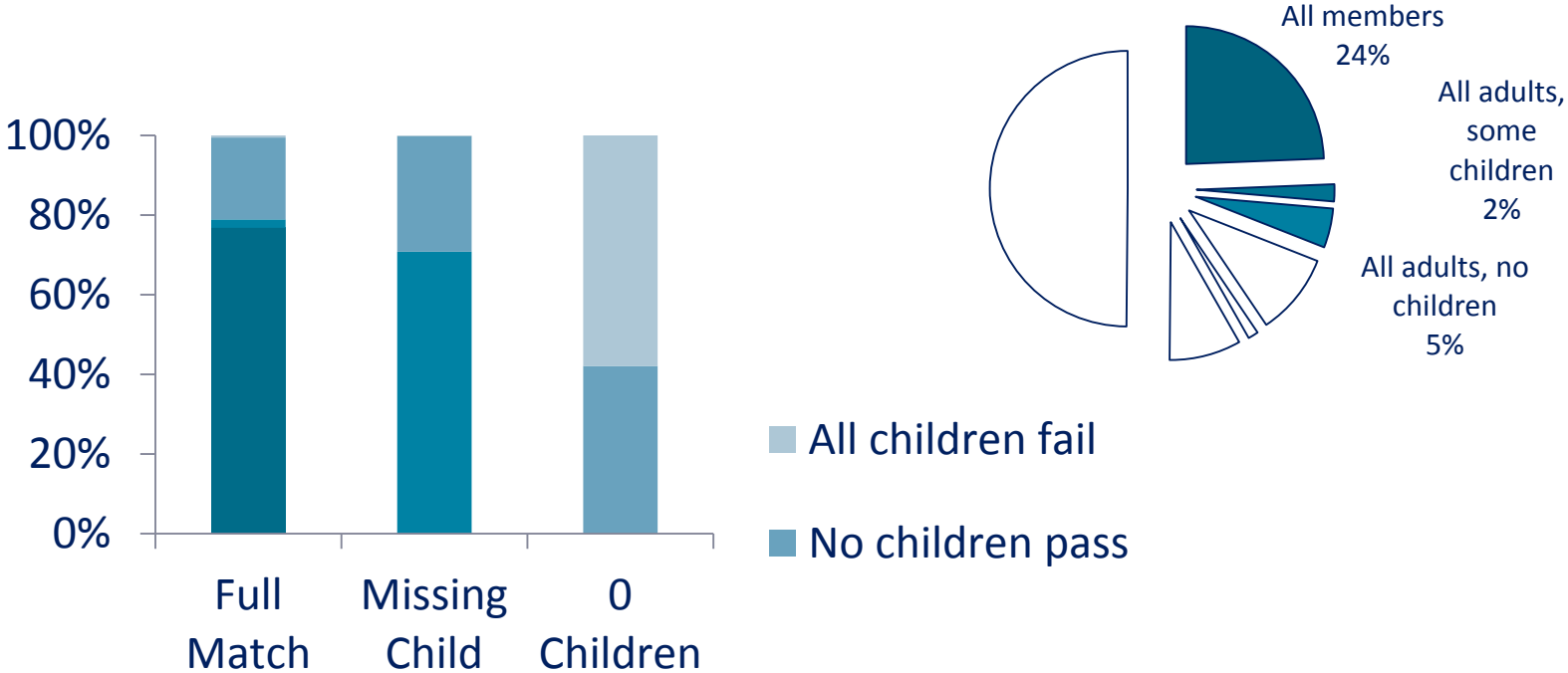
- Some overlap in recipients anticipated
 - But...some SNAP beneficiaries have no earnings
 - And...EITC provides benefits to some people with higher incomes than SNAP allows
- SNAP benefits based on the group of people who share meals
 - Can include multiple tax units
 - SNAP applicants and beneficiaries report living arrangements and relationships to other household members

- Recertify only once or twice each year
 - We assume if we observe a household that looks the same in two periods, we assume it looked that way in the intervening period.
- Monthly vs. annual data
- Timing inconsistent with tax year
- Self-reported

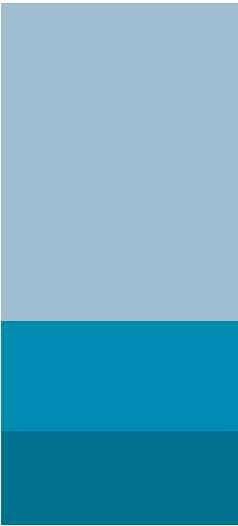
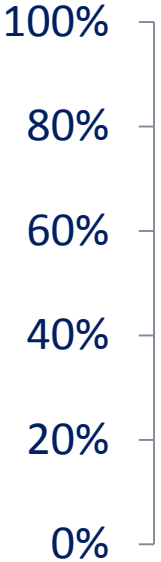
Tax units in Florida SNAP data



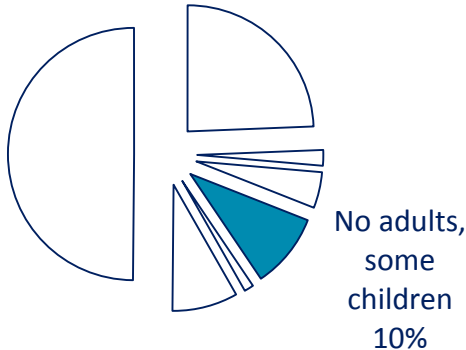
Residency Test: Families with Children



Residency Test: Children Claimed by People Not in SNAP Unit

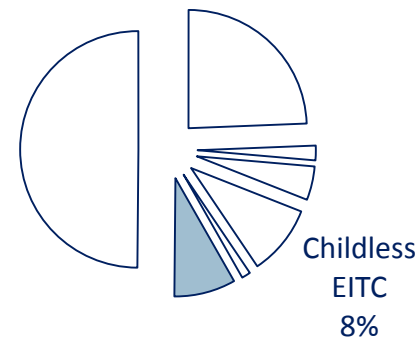


■ All children fail



- Some evidence that people claim different people on their tax returns than they report to SNAP offices
 - Observe adults in the data without children for at least 6 months
 - Observe children in the data with different adults for at least 6 months

“Childless” EITC Claims: Presence of Qualifying Child



- Some people in SNAP data with earnings don't file tax return
 - Most have no earnings, are not citizens, or do not have a qualifying childre
- 11,600 adults appear eligible for the EITC for workers with children

- SNAP data can contribute to understanding residency during audit selection, but data are not of high enough quality to use in pre-refund math error authority
 - Must make assumptions about household stability
 - Most returns identified with SNAP data were already identified by IRS during audit selection



IRS Preparer-Level Treatment Tests

Karen Masken
June 18, 2015



Disclaimer

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The views expressed here are those of the author and do not necessarily represent the views of the IRS

Introduction

- Background
- Motivation
- Issues Addressed
- Preparer Selection
- Treatments
- Evaluation Technique
- Results
- Summary

Background

- In 2010, the Internal Revenue Service (IRS) adopted regulations aimed at establishing standards among tax return preparers.
- By January 1, 2011, preparers were required to register with the IRS in order to receive a preparer tax identification number (PTIN) and enter it on returns they prepare.
- The objective was to improve voluntary compliance by supporting the paid preparer community and providing oversight of the industry with the goal of reducing errors on tax returns.
- The Return Preparer Office (RPO) was formed to meet this objective. The three primary strategic goals of RPO are:
 1. Register and promote a qualified tax professional community
 2. Improve the compliance and accuracy of returns prepared by tax professionals
 3. Support a stakeholder-focused culture that encourages voluntary compliance and continuous improvement

In 2012 RPO implemented a multi-year study to test the effectiveness of various treatments in moving preparers and their clients toward greater voluntary compliance

- Goals of the study
 - What types of treatments are cost effective
 - Is effectiveness persistent (recidivism)
 - Segmentation of preparers to minimize costs

Compliance Spectrum



Compliant

Those towards the compliant end of the spectrum might be moved by inexpensive light touches / nudges
e.g., letters

Noncompliant / Fraud

Those towards the noncompliant end of the spectrum may require more expensive and intrusive treatments
e.g., audits / injunctions

Motivation (cont.)

- Scarce treatment resources
- Little is known about the effectiveness of preparer-based treatments
- Traditionally IRS has focused enforcement resources on the non-compliant / fraud end of the spectrum
 - These treatments are expensive
 - Finding less costly but effective treatments for those in the middle of the spectrum could have a significant impact on voluntary compliance
- Relied on non-targeted services (e.g., tax forums, webinars, etc.) to nudge preparers to be more compliant

Issues Addressed

- **Schedule C Net Income**
 - Schedule C accounts for almost 30% of Individual Income Tax gap (~\$68 billion)
 - Around 75% of Schedule C returns are paid prepared
 - About 75% of paid prepared returns with Schedule C have errors
- **Additional Child Tax Credit (ACTC)**
 - Emerging Issue, particularly children w/ ITINs
 - Around 65% of ACTC claims are paid prepared
 - ~1% of preparers responsible for 60% of children w/ ITINs

Preparer Selection: Schedule C

- Error detection model developed using National Research Program (NRP) data
- Modeled at the taxpayer level then rolled up to the preparer
- Endogeneity issue led to decision to select preparers with majority of their Schedule C returns flagged by the model

Preparer Selection: ACTC

- No error detection model development
- Based on prevalence of ACTC returns
- Children w/ ITINs:
 - At least 20 returns had ACTC children w/ ITINs
 - At least 15% of ACTC returns had children w/ITINs
- General ACTC:
 - Did not meet above criteria
 - At least 20 returns had ACTC claims
 - Majority of returns had ACTC claims

Treatments: Schedule C

First Year (1250 preparers in each treatment):

1. Educational visit by Revenue Agent
2. Letter reminding preparers of due diligence requirements and warning they and or their clients may be audited
3. Letter with same message of due diligence but also suggesting preparer take continuing education regarding Schedule C

Second Year (1250 preparers in each treatment):

1. Educational Visit repeated
2. Due Diligence Letter sent to subgroup
3. Continuing Education Letter dropped

Treatments: ACTC

1. Educational letter explaining introduction of Schedule 8812 with emphasis on when children with ITINs qualify (3500 preparers)
2. Educational letter explaining introduction of Schedule 8812 (5000 preparers)

Evaluation Technique

Difference in Differences used for both

- Schedule C

1. Difference in success rate* before and after treatment
2. Difference between test and control groups

* predefined as a 5 percentage point drop in returns selected

- ACTC

1. Difference in ACTC claims before and after treatment
2. Difference between test and control groups

Results: Schedule C

Percentage Point Difference Between Test and Control Groups: Success Rates

	<u>Year 1</u>	<u>Year 2</u>
Educational Visit	12	13
Due Diligence Letter	7	9
Continuing Education Letter	8	n.a.

Percentage Point Difference Between Test and Control Groups: Recidivism Rates for Year 1 in Year 2

Educational Visit	-6
Due Diligence Letter	2
Continuing Education Letter	-1

Results: Schedule C (cont.)

For Successful Test Group Preparers in Year 1:

	Educational Visit	Due Diligence Letter	Continuing Education Letter
Number of Returns in 2013	140,900	113,000	123,800
Number of returns with Sch C	37,000	31,200	32,000
Average percentage point decline in clients flagged	19%	17%	18%
Est. number of taxpayers moved toward voluntary compliance	7,100	5,400	5,800

Percentage Point Difference Between Test and Control Groups : Decline in Average Number

	ITIN Letter	General Letter
ACTC Claims	4	4
ACTC Children Claimed	5	4
ACTC Children w/ ITINs	10	n.a.

Summary: Schedule C

- All 3 treatments were found to be effective
- Letters less effective overall but also much less costly
- Results in year 2 are consistent with year 1
- Results in year 1 are persistent in year 2
(Recidivism non-apparent)

Summary: ACTC

- Both treatments were found to be effective
- An educational letter can be a cost-effective way to improve voluntary compliance
- Targeted messaging, instead of expensive error detection models, can be a cost-effective way to improve voluntary compliance



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