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**IRS Earned Income Tax Credit (EITC) Initiatives**

*Report on Qualifying Child Residency Certification,  
Filing Status, and Automated Underreporter Tests*

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**Department of the Treasury  
Internal Revenue Service**

**2008**

## **Executive Summary**

In June 2003, the Commissioner of Internal Revenue announced an initiative to improve service, fairness, and compliance in the administration of the Earned Income Tax Credit (EITC). One goal of this initiative was to improve compliance with the EITC without adversely affecting eligible taxpayers' participation. To evaluate the alternative approaches to meeting this goal, the IRS conducted three studies over a three-year period: the EITC Qualifying Child Residency Certification Study, the EITC Filing Status Study, and the EITC Automated Underreporter (AUR) Study. The results from all three years of tests provide extensive information on the effects of the various alternatives. This report summarizes and assesses the results of the three test programs.

### **EITC Qualifying Child Residency Certification Study**

The Qualifying Child Study sought to determine the impact of a residency certification requirement on: (1) the amount of EITC claimed, including the amount of erroneous claims; (2) the number of children claimed for EITC purposes; (3) taxpayer participation in the EITC program; (4) taxpayer burden; and (5) the amount of erroneous claims that certification prevented from being paid to ineligible taxpayers.

The first year of the study (Tax Year 2003) focused on the nationwide population of EITC claimants for whom IRS could not establish residency of the qualifying child(ren) with the taxpayer claiming the EITC through available data. In the second study year (Tax Year 2004), the IRS sought to gain a better understanding of the likely effects of a full-scale program on individuals required to certify and on third parties who provide EITC claimants with documents and assistance by selecting a portion of the study group from a single community. In the third and final year (Tax Year 2005), IRS sought to reduce the number of eligible taxpayers subject to certification by improving upon the original selection algorithm.

Each of the qualifying child studies contained a test group consisting of taxpayers who were subject to the certification requirement. A second sample was selected containing taxpayers with similar characteristics to those in the test group; however, taxpayers in this control group were not required to certify the residency of any child supporting the EITC claim. The basic structure of the test was to compare the outcomes observed with the test group to those observed with the control group. This structure permitted the IRS to draw conclusions about the efficacy of the qualifying child certification requirement.

In each study year, the IRS mailed documents to taxpayers in the test groups prior to the filing season. These documents included a letter describing the study, a form offering three options for certifying residency of the qualifying children (letters, official records, or third party affidavits), the affidavits themselves, and IRS publications on the EITC.

The results of the study indicate that a well-designed certification requirement can deter ineligible taxpayers from claiming the EITC and thereby reduce the amount of erroneous payments. However, the deterrent effect appears to decay in subsequent years following the year in which the taxpayers were required to certify. A relatively small number of eligible taxpayers appear to be deterred by the process. For taxpayers who continued to claim the EITC, the certification process prevented erroneous payments to ineligible taxpayers. The revised

algorithm used in the third year of the test performed most efficiently. For taxpayers selected using the revised algorithm, the IRS estimates that 13 to 16 percent of the test group was ineligible and deterred by the process. For those in this test who did claim the EITC, over half were determined to be ineligible and their claim was not paid. The revised algorithm also substantially reduced the proportion of eligible taxpayers required to certify the residency of children on their EITC claims. However, the revised algorithm also identified substantially fewer ineligible taxpayers than the original method.

### **EITC Filing Status Study**

The EITC Filing Status Study focused on taxpayers who claim the EITC but who, if they used the proper filing status, might be either completely ineligible or their claims would be reduced. The Filing Status Study, conducted for TY 2003 and TY 2004, investigated the impact of requiring taxpayers to document marital status in order to validate the filing status on their tax return. In particular, the study tried to identify taxpayers who filed as unmarried head of household but who should have filed as married. The focus of the Filing Status study for TY 2004 was to improve upon the methods used in TY 2003 for identifying taxpayers with a high likelihood of filing returns with filing status and related EITC errors.

The results indicate that asking taxpayers who previously used a married filing status to substantiate their claim as head of household does reduce the number and amount of EITC claims paid erroneously. However, the results were different for taxpayers who filed as head of household but had not filed as married in recent prior years. Asking these taxpayers to substantiate that they qualified as head of household often caused them to change their filing status to single, but it did not change the number of EITC claims.

### **EITC Automated Underreporter (AUR) Study**

The EITC Automated Underreporter (AUR) Study focused on taxpayers who claim EITC but are either ineligible because their incomes are too high or eligible but overclaim the EITC because they misreport their incomes. The AUR study was conducted for TY 2002 and TY 2003 and sought to identify, through document matching, EITC claimants with a high likelihood of income reporting errors.

The AUR study focused on an existing IRS program and did not create new procedures. In past years, the AUR program normally would process about 300,000 returns claiming the EITC, but these returns were not selected specifically to address income misreporting that affected the EITC claim. Instead, these cases focused on the amount of income tax that might be due on returns with mis-reported income. The focus of the study was to improve the ways IRS selected these 300,000 returns (that claimed EITC) to address specifically EITC overclaims due to misreported income.

In the second year of the test, over \$500 million in additional taxes and reduced EITC claims were assessed. This was a substantial improvement over previous practices. Accordingly, in TY 2004, the IRS added the EITC AUR program to the already existing base of EITC compliance programs that include examinations and math error processing.

## **Summary**

This report concludes the series of tests conducted as part of the EITC Initiatives. The studies provided insight into how changes in procedures used to administer the EITC can improve the overall administration of the program by reducing inappropriate claims. Some of these lessons have already been incorporated into IRS practices (e.g., changes to the AUR program).

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# **IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests**

## **I. Introduction**

In June 2003, the Commissioner of Internal Revenue announced an initiative to improve service, fairness, and compliance in the administration of the Earned Income Tax Credit (EITC). One goal of this initiative was to improve compliance with the EITC without adversely affecting eligible taxpayers' participation. To evaluate the alternative approaches to meeting this goal, IRS conducted three studies over a three-year period: the EITC Qualifying Child Residency Certification Study, the EITC Filing Status Study, and the EITC Automated Underreporter (AUR) Study. The results from all three years of tests provide extensive information on the effects of the various alternatives. This summary report by IRS assesses the results of all the test programs. Detailed data tables are provided in Appendix A.

## **II. Background on the Earned Income Tax Credit (EITC)**

The EITC, enacted in 1975, provides a refundable tax credit for low-income working families. Originally intended to ease the burden of Social Security taxes and provide an incentive to work, the Congress has modified the EITC several times since its introduction. The credit now provides a substantial benefit to millions of American taxpayers and is one of the federal government's largest anti-poverty program. Eligibility for, and the amount of, the EITC depends on earned income and adjusted gross income, as well as the presence and number of qualifying children and the taxpayer's filing status. The credit amount is equal to a specified percentage of the taxpayer's income, up to a ceiling that varies by filing status and the number of qualifying children. To focus this benefit on the neediest taxpayers, Congress legislated that taxpayers with investment income greater than a specified amount are not eligible for the EITC. A qualifying child must meet residency, relationship, and age tests. In particular, the children must reside with the claimant for more than half of the tax year. Married taxpayers filing separately do not qualify for EITC.

The EITC program has grown significantly since its inception in 1975. In its first year, 6.2 million taxpayers claimed \$1.25 billion in EITC, or about \$4.5 billion in 2005 dollars.<sup>1</sup> At that time, the maximum credit was \$400, or approximately \$1,450 in 2005 dollars, and the income level at which the EITC phased-out completely was \$8,000, or about \$29,050 in 2005 dollars.

In Tax Year (TY) 2005, about 22 million taxpayers claimed about \$41 billion in EITC. The maximum credit and income level at which the EITC phased-out completely had grown to \$4,400 (for taxpayers with two or more children) and \$37,263 (for married filing jointly taxpayers with two or more children). See **Table 1** for the EITC parameters applicable to TY 2005.

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<sup>1</sup> Tax Year 2005 was the third and final year of the tests.

**Table 1: EITC Parameters for Tax Year 2005 by Filing Status and Number of Qualifying Children**

EITC Parameters	Filing Status					
	Single/Head of Household/ Qualifying Widow(er)			Married Filing Jointly		
	No Qualifying Children	One Qualifying Child	Two Qualifying Children	No Qualifying Children	One Qualifying Child	Two Qualifying Children
Credit percentage	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%
Phaseout percentage	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%
Maximum credit	\$399	\$2,662	\$4,400	\$399	\$2,662	\$4,400
Income at which begin maximum credit	\$5,200	\$7,830	\$11,000	\$5,200	\$7,830	\$11,000
Income at which begin phaseout	\$6,530	\$14,370	\$14,370	\$8,530	\$16,370	\$16,370
Income at which credit completely phased-out	\$11,750	\$31,030	\$35,263	\$13,750	\$33,030	\$37,263

### III. EITC Compliance Estimates

IRS studies of EITC compliance have consistently shown significant overclaim rates for the credit. The TY 1997 compliance study estimated between 23.8 percent and 25.6 percent of EITC claims should not have been paid. The TY 1999 EITC compliance study estimated that 27 percent to 31.7 percent of the EITC claims should not have been paid. Because of its depth and breadth, the TY 1999 study remains the primary source for insights about the reason for errors. The 1999 study identified three major sources of errors: qualifying child errors, filing status errors, and income reporting errors.<sup>2</sup>

The IRS provided Fiscal Year (FY) 2006 erroneous payments estimates to the Office of Management and Budget as part of reporting for the Improper Payments Information Act. These estimates were based on TY 2001 National Research Program (NRP) individual income tax underreporting data. The estimates included adjustments to the TY 2001 NRP data to incorporate estimates of the expected changes to EITC claims and compliance due to EITC-related legislative changes such as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For FY 2006, IRS estimated an EITC improper payment rate between 23 and 28 percent.

### IV. IRS Five-Point Initiative

In the summer of 2003, former IRS Commissioner Mark W. Everson announced a five-point initiative to improve service, fairness, and compliance with EITC rules. The IRS designed this initiative to:

<sup>2</sup> The 1999 study also identified another major source of error was known as the AGI-tiebreaker rule. This error involved taxpayers claiming EITC using a qualifying child who was also the qualifying child of someone else with a higher modified adjusted gross income. However, the Economic Growth and Tax Relief Reconciliation Act simplified the tiebreaker rule by replacing, in most cases, an adjusted gross income comparison rule with a relationship-based hierarchy for determining the party eligible to claim the credit in situations where a child may be the qualifying child of more than one person. Consequently, efforts to reduce EITC overclaims were not focused on this source of error.



- Reduce the backlog of pending EITC examinations to ensure that eligible taxpayers being examined receive their refunds timely
- Minimize burden and enhance the quality of communications with taxpayers by improving the existing audit process
- Encourage eligible taxpayers to claim the EITC by increasing outreach efforts and making EITC requirements easier to understand
- Ensure fairness by refocusing compliance efforts on taxpayers who claimed the credit but were ineligible because their income was too high
- Pilot a certification program to substantiate qualifying child residency eligibility for claimants whose returns are associated with a high likelihood of error

The EITC Qualifying Child Residency Certification Study, the EITC Filing Status Study, and the EITC Automated Underreporter (AUR) Study, address the last two points of the Commissioner's five-point plan. IRS designed the tests to determine how changes to the programs would affect EITC overclaims, participation rates among eligible taxpayers, and the associated burden on taxpayers and the IRS. Although the initial test results provided extensive information on the effect of the programs, the IRS undertook similar tests in subsequent years to gather and analyze additional data and to examine alternative approaches. The final study year addressed only the Qualifying Child Study.

## **V. EITC Qualifying Child Residency Certification Study**

The TY 1999 EITC compliance study indicated that qualifying child errors account for the largest share of overclaims. To claim a qualifying child, a taxpayer must satisfy relationship, age, and residency tests. However, the results from the TY 1999 EITC compliance study indicated the chief compliance issue associated with qualifying children involved the residency test. To meet the residency test, a child must reside with the claimant for more than half of the tax year.

The Qualifying Child Study sought to determine the impact of a residency certification requirement on the:

- Amount of EITC claimed, including the amount of erroneous claims
- Number of children claimed
- Taxpayer participation in the EITC program
- Taxpayer burden
- Amount of erroneous claims that certification prevented from being paid to ineligible taxpayers.

The first year of the study (Tax Year 2003) focused on the nationwide population of EITC claimants for whom the IRS could not establish qualifying child residency through available data. In the second study year (Tax Year 2004), the IRS sought to gain a better understanding of the likely effects of a full-scale program on individuals required to certify and on third parties that provide EITC claimants with documents and assistance by selecting a portion of the study group from a single community. In the third and final year (Tax Year 2005), the IRS sought to reduce the number of eligible taxpayers subject to certification by improving upon the original selection algorithm. The algorithm was revised to take into account lessons learned from the first two years of the study. To

evaluate the revised algorithm, a portion of taxpayers in the 2005 test were selected using the original algorithm and a portion were selected using the revised algorithm.

The studies included control groups that were of similar size and taxpayer characteristics as the test groups but who did not go through the certification process. Because the test and control groups were randomly selected from the same population of taxpayers, we believe the experiences of the control groups reflect what would have been observed for the respective test groups had they not been part of the certification test. Thus, we can attribute observed differences between the groups to the certification requirement.

## V.A Study Group Development

In developing the study groups for the Qualifying Child Study, the IRS took advantage of multiple data sets, including data from numerous internal and external databases that were used to develop computer algorithms to ascertain whether qualifying child residency requirements were met by EITC taxpayers.

The IRS computer algorithms used data from the following sources:

- **Federal Case Registry**—A Department of Health and Human Services (HHS) database that identifies presumed custodial relationships based on child support cases.
- **KidLink**—A Treasury database which uses Social Security Administration (SSA) data that identifies the relationship between birth parents and children born since 1998.
- **DM-1**—A database of taxpayer identification numbers (either Social Security Numbers or Individual Taxpayer Identification Numbers) and their associated name histories.
- **Numident**—SSA data that provides birth certificate information, including parent names.

The IRS employed a two-stage sample design for the study. The sample frame for the first stage of the design was the population of taxpayers who filed the prior year and claimed the EITC with at least one qualifying child. From this population, the IRS drew a 10 percent random sample. To this 10 percent sample of returns, the IRS applied a computer algorithm utilizing the above information to identify claimants that were likely to have met the residency requirements for qualifying children. The subset of claimants whose qualifying children could not be substantiated through the computer algorithm comprises the second stage sample frame. At this stage, a systematic sampling process was applied to draw taxpayers randomly for test and control groups.<sup>3</sup>

Mathematica Policy Research Inc., the U.S. Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA) favorably reviewed the Qualifying Child

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<sup>3</sup> The sampling populations for the National Tests were approximately 4 million each year. From this, nationwide samples of 25,000, 16,800 and 5,000 were drawn using the original algorithm for the TY 2003, 2004 and 2005 tests, respectively. The Community test was a census of all taxpayers in the community that could not be systemically certified and included approximately 8,200 taxpayers. The revised algorithm used in the TY 2005 test had a sampling population of approximately 600,000, from which a sample of 20,000 was drawn.

Study sample design.<sup>4</sup> In its review, Mathematica strongly endorsed the major elements of the study design, in particular, the decision to focus the certification study on a subset of taxpayers with a high likelihood of EITC overclaims (see Appendix B). Mathematica also commended IRS for its use of an array of data sources. GAO reviewed the steps that IRS has taken to implement the certification study and concluded that IRS “has struck a reasonable balance between preventing unreasonable burden on [EITC] taxpayers and balancing the need to obtain information on whether certification can be a useful approach to improving [EITC] compliance.” The objective of the TIGTA review was to determine the usefulness of the study in enabling IRS to make decisions regarding the future of the EITC program. TIGTA concluded that the “statistical sampling method used to select the samples for the [study] appears adequate and should provide reliable information on which to base future decisions.”

## V.B Qualifying Child Certification Process

The certification process was similar in each year of the test. IRS sent certification packages to test group taxpayers prior to the filing season that consisted of:

- A letter (Notice 84-A) describing the new certification requirement
- Form 8836, Qualifying Children Residency Statement, which offers three options (letters, records and affidavits) for certification (to be completed by the taxpayer and returned to the IRS)
- A Third Party Affidavit (Schedule A or Schedule B) form to be filed with Form 8836, attesting to the validity of the taxpayer’s child residency certification on Form 8836
- Publication 3211M, Earned Income Tax Credit Questions and Answers
- Publication 4134, Free/Nominal Cost Assistance Available for Low Income Taxpayers

IRS followed up the initial mailing with two reminder notices in the TY 2004 and TY 2005 tests.

The letters, forms, and publications were in English, like the tax packages that are mailed to individual taxpayers each December. The letter, Form 8836, and affidavit contained a note in Spanish referring Spanish-speaking persons to a telephone customer-service center for Spanish versions of these documents. (See Appendix C for copies of TY 2005 Notice 84-A, Form 8836, and Schedules A and B in both English and Spanish.)

Form 8836 requires proof of qualifying child residency in the form of records, a letter on official letterhead, or a signed affidavit (Schedule A) from any of the following: attorney, child-care provider, clergy, community-based organization, court or placement agency official, employer, health-care provider, Indian tribe official, landlord or property manager, law enforcement officer, school official, or social service agency or other government official. Taxpayers could submit any combination of documents described in Form 8836 or in the Third Party Affidavit. The taxpayers

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<sup>4</sup> In the fall of 2003, Mathematica Research Policy, Inc., and GAO completed their reports, *A Review of the Earned Income Tax Credit Residency Certification Pilot Study* and *Qualifying Child Certification Test Appears Justified, But Evaluation Plan is Incomplete*, respectively. In May 2004, TIGTA completed its report, *The Statistical Sampling Method Used in the Earned Income Tax Credit Proof of Concept Test Appears Valid*.

would fulfill the residency requirement if the documents, when taken in combination, showed that they lived with the child for more than half of the tax year.

The IRS designed the process to give taxpayers sufficient time to respond to requests for additional information or notifications of decisions. Tax examiners reviewed the documents a taxpayer submitted and determined whether they satisfied the residency requirement. When IRS determined the documentation the taxpayers originally submitted was incomplete or insufficient to establish the residency requirement, taxpayers were given repeated opportunities to provide additional documentation. Once the taxpayer established residency, the EITC claim was allowed.

When taxpayers did not substantiate the residency of a child claimed for the EITC, the IRS disallowed the credit through standard tax deficiency procedures. A statutory Notice of Deficiency, issued if the taxpayer did not respond to the first or either of the two prior letters of proposed changes, gives the taxpayer 90 days to respond to the proposed assessment. If the taxpayer does not respond within 90 days, the IRS makes an assessment. The completion of the certification process took several months for those taxpayers who did not respond immediately.

The certification test requirement has elements of an educational/outreach program, a soft-notice program,<sup>5</sup> and an examination (audit) program. Within the context of the certification test, the objective of the first two elements was to increase voluntary compliance by increasing taxpayers' awareness and understanding of the EITC qualifying child residency requirement. The IRS intended the materials sent to the taxpayers and the requirement to certify residency to help taxpayers make the correct decision about eligibility for claiming the EITC.

The examination element, which included holding taxpayers' EITC claim until the IRS reviewed the documentation for qualifying child residency and established residency, has several effects. First, it deters erroneous claims because it increases the chances of uncovering an incorrect claim. Second, it provides a process whereby the IRS can detect erroneous claims due to qualifying child residency errors. Thus, the certification requirement should deter taxpayers who would have intentionally made incorrect claims although they understood they did not meet the qualifying child residency requirement. It also allows the IRS to identify erroneous EITC claims that were made by taxpayers who still did not understand the qualifying child residency rules despite the pre-filing mailing.

## V.C Study Results

The EITC claim status and eligibility for each of the test groups is presented in **Table 2** (detailed tables in Appendix A, pages 2-8). In each of the tests conducted using the original algorithm (including the community test), 26 percent of the taxpayers did not claim EITC for reasons unrelated to certification. For the revised algorithm test group, 30 percent of the test group taxpayers did not claim the EITC for reasons unrelated to certification. We observe a similar degree of annual turnover among EITC claimants in the general EITC population, so rates of this magnitude are not unique to this study.

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<sup>5</sup> A soft notice is a letter sent to taxpayers generally advising them of a possible issue/error with their return. It generally does not require a response from the taxpayer but encourages them to review what they are doing for mistakes and to avoid repeating these mistakes on future returns.

**Table 2** also displays the estimated range of taxpayers who were eligible for the EITC but who were deterred by the process. This estimated range varied slightly from year to year, but the range for all the national test groups, including the revised algorithm test group, was between 0 and 3 percent. The community test group had a slightly higher estimated range of 3 to 4 percent of eligible taxpayers deterred by the process. For ineligible taxpayers, the TY 2003 national test group had the lowest range (4.5 to 5 percent) deterred by the process. As the IRS revised and modified the tests and selection procedures, a greater portion of ineligible claimants were deterred. The highest range of ineligible taxpayers deterred was under the revised algorithm test group with 13 to 16 percent.

The percent of eligible taxpayers who claimed the EITC with children was relatively constant under the original algorithm, including the community test (42 to 45 percent). For the TY 2005 study, the algorithm was revised to target better ineligible taxpayers. As a result, the percent of eligible taxpayers claiming the EITC with qualifying children who were subject to the certification requirements because they were selected by the revised algorithm declined significantly to 26 percent. Thus, the community test appropriately deterred more ineligible taxpayers from claiming the EITC than the original algorithm national tests, but also appeared to deter more eligible taxpayers from claiming the credit.<sup>6</sup> The revised algorithm performed most efficiently both in deterring ineligible taxpayers from claiming the credit and in reducing the number of eligible taxpayers subject to the certification process.

**Table 2: EITC Qualifying Child Residency Certification Study: Test Groups' EITC Claim Status and Eligibility by Study Year**

Status	Original Algorithm			Community Test	Revised Algorithm
	National Test				
	TY 2003	TY 2004	TY 2005	TY 2004	TY 2005
<b>Non-Claimants*</b>	<b>33%</b>	<b>37%</b>	<b>37%</b>	<b>42%</b>	<b>46%</b>
For Reasons Unrelated to Certification	26%	26%	26%	26%	30%
Deterred by Certification, Eligible for EITC	2.0-2.5%	0.5-3.0%	0.5-3.0%	3.0-4.0%	0.0-3.0%
Deterred by Certification, Ineligible for EITC	4.5-5.0%	8.0-10.5%	8.0-10.5%	12.0-13.0%	13.0-16.0%
<b>Claimants with Qualifying Children</b>	<b>67%</b>	<b>63%</b>	<b>63%</b>	<b>58%</b>	<b>54%</b>
Eligible	44%	45%	42%	44%	26%
Ineligible	23%	18%	21%	14%	28%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

*Note: Detail may not add to total due to rounding.*

*\*Includes taxpayers who claimed EITC without qualifying children.*

As described earlier, if taxpayers in the test claimed the EITC without first certifying that the qualifying child(ren) lived with them for more than half the year, the amount of the refund associated with the claim was frozen until the taxpayer certified. Hence, if the taxpayer did not successfully certify, the claim was not paid (under the presumption the taxpayer was not eligible for the EITC, this is termed “revenue protected”). Revenue was also protected by deterring ineligible taxpayers from

<sup>6</sup> However, because a lawsuit was filed against the IRS over the community test, the resulting publicity may have affected the process of obtaining certification documentation from city agencies and led to different results than had the lawsuit not occurred.

claiming the EITC in the first place. **Table 3** shows the estimated percent of revenue protected for each test. For the test groups selected using the original algorithm, including the community test group, about one-third of the estimated claims that would have been made without the certification test would have been paid erroneously. For the revised algorithm test group this amount is over 50 percent, another indication that the revised algorithm was substantially more efficient than the original one.

**Table 3: EITC Qualifying Child Residency Certification Study: Test Groups' Estimated Percent of Revenue Protected by Study Year**

	Original Algorithm			Community Test	Revised Algorithm
	National Test				
	TY 2003	TY 2004	TY 2005	TY 2004	TY 2005
<b>Estimated Revenue Protected</b>	<b>33-34%</b>	<b>34-37%</b>	<b>31-35%</b>	<b>32-33%</b>	<b>52-56%</b>
Protected through Deterrence	7-8%	13-16%	6-9%	16-17%	17-21%
Protected through Claims Adjustments	26%	21%	25%	16%	35%

## V.D Lessons Learned

### *Algorithms*

Based on the TY 1999 Compliance study, approximately 10 percent of the EITC claimants make qualifying child errors.<sup>7</sup> Projected to the TY 2005 population of approximately 22 million claimants, this means roughly 2.2 million taxpayers would be expected to make qualifying child errors. The original algorithm identified a population of approximately 4 million taxpayers with a probability of having qualifying child errors based on their prior year returns. Based on results of the tests, approximately 26 to 32 percent, or 1.0 to 1.3 million taxpayers in this population would have claimed the EITC in the test year but were actually ineligible. However, almost 50 percent of the taxpayers identified by the original algorithm were eligible for the credit. (The remainder dropped out for reasons unrelated to certification.) Thus, the original algorithm cast a wide net that captured between 45 and 59 percent of the taxpayers who make qualifying child errors, but it also subjected a large number of eligible taxpayers to the certification process.

The revised algorithm identifies a population of approximately 600,000. Based on results from the test, it reduced the number of eligible taxpayers subject to certification almost in half, compared to the original algorithm. However, while a large fraction (41-44 percent) of the taxpayers in this population were ineligible, this total (about 250,000) accounts for only about one-tenth of the estimated number of taxpayers deemed to be making qualifying child errors.

Thus, both the original algorithm and the revised algorithm did better than a simple random sample in identifying taxpayers with the potential for qualifying child errors. However, the original algorithm identified a relatively large number of eligible taxpayers as well. While the revised algorithm identifies a population with a smaller percentage of eligible claimants, it also does not identify a very large percentage of ineligible taxpayers.

<sup>7</sup> This percentage is from Holtzblatt and McCubbin, "Issues Affecting Low-Income Filers" in *The Crisis in Tax Administration*, Aaron and Slemrod, eds. Brookings Institution Press, 2004, page 165.

## *Affidavits*

The Qualifying Child Study pioneered the use of affidavits by IRS to support the determination of the residency of the qualifying children in the EITC claim. Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. The results show that affidavits had a higher acceptance rate than the other two types of documents. In each of the tests, about one-half of the records and statements or letters were accepted compared to approximately three-quarters of the affidavits. Thus, in general, affidavits seemed to provide a reliable way to substantiate claims in this context. The higher acceptance rate likely is due in part to the fact that the affidavits were special forms with dedicated lines than made it simpler for taxpayers to obtain all the required information.

## *Paid Preparers*

For the general population of EITC claimants, approximately two-thirds used paid preparers in each of the study years. For all of the test groups, about three-quarters of the taxpayers claiming the EITC with qualifying children used paid preparers. In each of the test groups, taxpayers who used paid preparers had a higher adjustment rate than those who did not use paid preparers.

## *Subsequent Taxpayer Behavior*

In addition to looking at what taxpayers did during the study year, we also looked to see if their behavior persisted over time. **Figure 1** shows the percent of taxpayers who did not claim the EITC with qualifying children during the study year or in the subsequent year. Based on this analysis, the deterrence effect of the certification requirement appears to decay after the first year for all tests. While not shown, we found that a similar pattern persisted in all subsequent years.

**Figure 2** shows the percent of taxpayers who claimed the EITC with qualifying children in both the study year and the subsequent year. For all tests, the percent of taxpayers claiming the EITC with qualifying children in the test groups is lower than the respective control groups. Thus, the certification process did have an effect on the percent of EITC claimants who claimed the EITC in the subsequent year.

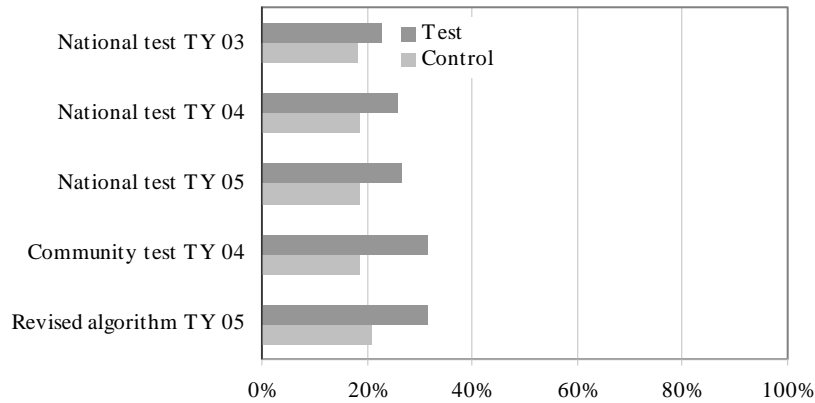
**Figure 3** compares the test group taxpayers whose claims were disallowed in the study year to the respective control group taxpayers that were selected by examination in the study year and had their claims disallowed as well. A lower percent of test group taxpayers claimed the EITC with qualifying children the subsequent year in some, but not all, of the tests. These mixed results indicate that certification and examination generally have about the same effect on subsequent-year EITC claims.

**Figure 4** shows the percent of taxpayers in each test group who successfully claimed the EITC with qualifying children in the study year and then claimed again in the subsequent year. For the control groups, most of the taxpayers were not selected for examination. Thus, these results indicate that successfully certifying qualifying children has no different effect than taxpayers who receive the claim under current operating procedures.

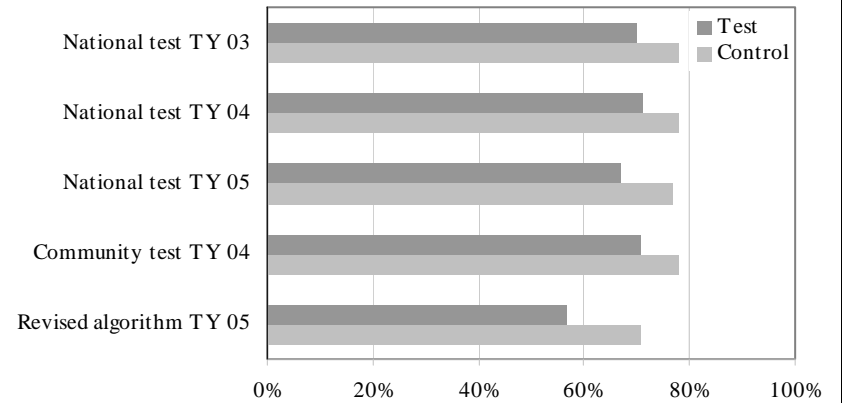
Taken together, the results indicate that the initial deterrent effect of certification is short-term and decays in the longer-term, and for those who do go through the process, the longer-term effect is virtually the same as that of current operating procedures. One difference, though, is that only a small percentage of EITC claimants go through examination in any one year.



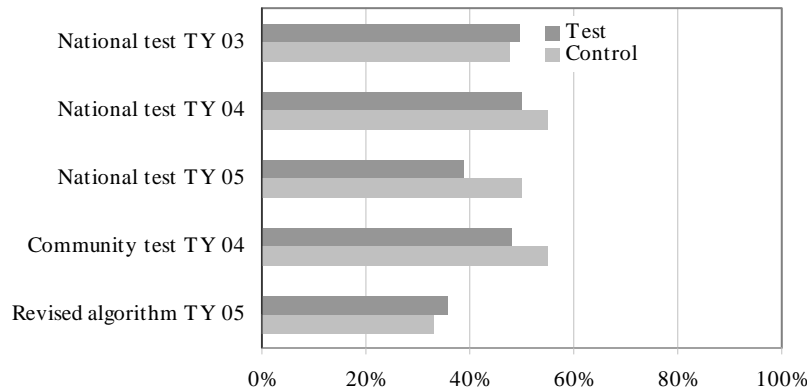
**Figure 1: Percent of Taxpayers who did not Claim EITC in the Study Year or the Subsequent Year**



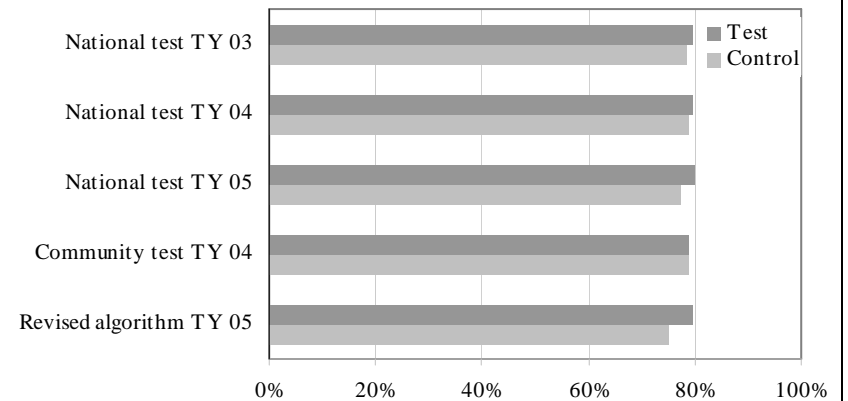
**Figure 2: Percent of Taxpayers who Claimed EITC in both the Study Year and Subsequent Year**



**Figure 3: Percent of Taxpayers whose Claim was Disallowed in the Study Year and they Claimed EITC the Subsequent Year**



**Figure 4: Percent of Taxpayers whose Claim was Allowed in the Study Year and they Claimed EITC the Subsequent Year**



## *Qualifying Children*

We also looked at administrative data to see what happened with the qualifying children. For the national test groups selected using the original algorithm, slightly over 50 percent of the test-group qualifying children were claimed by the same taxpayer in both the study year and the prior selection year compared to about 60 percent of the respective qualifying children in the control groups. For the community test group, 47 percent of the qualifying children were claimed by the same taxpayer in both years. Under the revised algorithm, 34 percent of the test-group qualifying children were claimed by the same taxpayer in each year compared to 47 percent of the control-group qualifying children. However, many of the children were claimed by another taxpayer as a qualifying child for the EITC. In the national tests, 21-23 percent of the children were claimed by another taxpayer compared to 17-19 percent of the control groups. For the community test, there was no difference between the test and control groups (19 percent). For the revised algorithm test group, 38 percent of the children were claimed by someone else as a qualifying child compared to 31 percent of the control group. Thus, it appears that, in some cases, certification caused a change in who claimed a child for EITC purposes, rather than the child not being claimed at all. If the new taxpayer claiming the child is eligible to do so, then certification both reduces non-compliance and increases participation.

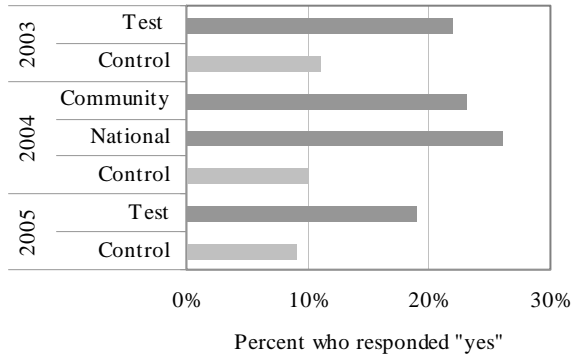
## *Taxpayer Burden*

Another focus of the study was to learn how certification affected the time and out-of-pocket costs associated with making an EITC claim. IRS conducted a survey of study group taxpayers each year to learn about their experience with the certification process. The taxpayer surveys included questions about time spent on the return and related activities, the cost of a paid tax preparer, and the amount of other out-of-pocket expenses. Because it would be difficult for taxpayers to separate certification time and costs from time and costs associated with preparing and filing their returns, we used the test/control group design of the study to address this issue. Rather than asking specific questions about burden associated with the actual certification process, we used the difference between the test and control group response to estimate the time and money cost of certification-related activities. In interpreting these comparisons however, one needs to be aware that the majority of the control group returns were not subject to examination. Thus, the comparison primarily is between the certification process versus no treatment, as opposed to certification process versus examination.

The responses to questions regarding the cost of a tax preparer and out-of-pocket costs indicate that the certification process did not cost test groups more (in terms of dollars spent) than their respective control groups who simply claimed the EITC. However, as shown in **Figure 5**, respondents in every test group reported taking time off from work to obtain information needed for their tax return more frequently than the respective control group respondents did. Likewise, **Figure 6** shows that respondents in the test groups reported it took longer to prepare their tax return than the respondents in the respective control groups. While the certification requirement did not appear to increase monetary burden, taxpayers experienced an observable time burden to comply with the certification requirement.

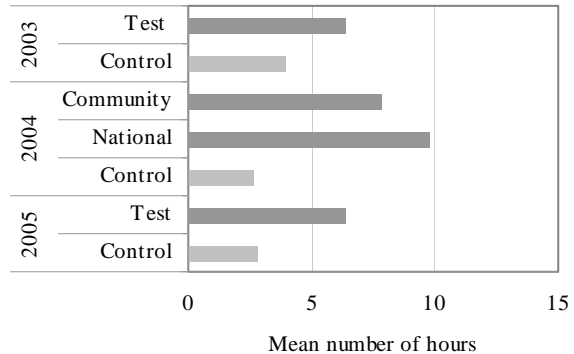
**Figure 5: Time Off From Work**

Did you take time off work to obtain information you needed for your income tax return, including claiming the EITC?



**Figure 6: Time Spent Preparing Return**

Roughly how much time did you spend on your return? Please include time for gathering your papers, talking with a tax preparer, getting copies of documents and talking with the IRS.



### ***Third Party Burden***

To understand better the experiences and burden of certification on third party document providers in the community test, the IRS contracted with Westat Corporation to conduct two focus groups of third parties indirectly affected by the certification requirement. The focus group participants learned of the certification process in a variety of ways. Most first learned of the certification process when a taxpayer requested documentation. Some knew of the certification process before receiving requests from taxpayers because of the nature of their work and the advance publicity about the certification test. Most focus group participants found the process of providing verification relatively simple once they had the first documentation request and figured out what was needed.

In addition to the focus groups, the IRS also examined how many documents each source provided. Among those who supplied documents, about 57 percent of the schools provided more than one letter or affidavit compared to 12 percent of childcare providers. The data indicated that several schools and health-care providers experienced very heavy burdens and provided more than 20 affidavits or letters.

### ***Taxpayer Opinions about Certification***

The taxpayer survey included several questions designed to capture taxpayers' opinions about the certification process. Taxpayers seemed evenly split in their assessment of the difficulty or ease of completing several of the activities associated with certification.

Taxpayers also appeared not to object to the concept of proving eligibility before receiving the EITC. In every year of the survey, approximately two-thirds of all respondents, in both the test and control groups, thought that taxpayers should prove they meet the EITC requirements before they receive the EITC.

## ***Population Mobility***

Although no data exactly portrays the extent of mobility in this population of EITC claimants, several items are suggestive. For instance, the Postal Service returned as undeliverable between 6 and 11 percent of the letters the IRS sent to taxpayers in the beginning of each study year even though addresses were current as of the prior spring when the taxpayers filed their returns. In addition, the IRS could not reach, either by telephone or by mail, almost one-half in TY 2003 and one-third in TY 2004 of the taxpayers who were selected for the follow-up survey. More dramatically, telephone numbers could not be found for 56 percent of the taxpayers selected for the revised algorithm TY 2005 test follow-up survey, and for those where a telephone number was found, 59 percent could not be contacted by telephone. Furthermore, of the taxpayers who were surveyed, between about 5 and 7 percent responded that they lived at their current address for less than six months. These observations suggest that the EITC claimants in these study groups are highly mobile.

## **V.E IRS Costs and Benefits**

One of the key factors that will ultimately determine whether the IRS will proceed with a broad certification requirement for EITC claimants is the program's Return on Investment (ROI). In other words, IRS must weigh the costs of administering certification with the benefits certification generates and then compare these results with other potential investment options.

Conducting such an analysis requires that the IRS determine an operating model for a fully implemented program and then estimate the costs and benefits associated with a large-scale operational program. However, the tests on which this report focused sought to evaluate how a certification requirement might affect EITC error and participation rates. The tests were not designed to develop an operating model for certification implementation. Thus, this report will not attempt to develop a comprehensive ROI calculation from which one could make decisions about full implementation of a certification program.

As noted earlier, certification has elements of an educational/outreach program, a soft-notice program, and an examination (audit) program. The most straightforward component of the benefit calculation is the amount of revenue protected during the certification process itself. In other words, the dollar amount of refunds that were denied to individuals who claimed the credit and who tried to certify but were unsuccessful. A second component of benefits is the amount of erroneous EITC claims that the IRS would have paid but that the certification requirement deterred.

The costs of a full-fledged certification program to the IRS are a combination of the cost associated with sending the initial certification letter (basically equivalent to a soft notice) and the cost of certifying taxpayers who continue to claim the EITC with qualifying children after receiving the soft notice (roughly equivalent to the cost of an audit for those pursuing the claim). Since the cost of an audit is greater than a soft notice, certification, because of the deterrent effect, might be expected to be less costly to the IRS than an audit program covering a similar number of taxpayers. However, a large percentage of taxpayers selected for an EITC audit do not respond and simply default on their

EITC claim. Attempting to account for this differential behavioral effect makes a comparison problematic.

The goal of the certification process was to increase taxpayers' awareness and understanding of the EITC qualifying child residency requirement. IRS intended this feature to help taxpayers make the correct decision about claiming the EITC at the time of filing. However, an unintentional consequence of the certification program could be to deter eligible taxpayers from claiming the credit. This deterrence could happen for several reasons. A taxpayer may feel that the certification process is too complicated or burdensome and therefore decide not to claim the EITC. Alternatively, the information may confuse taxpayers who then conclude that they are ineligible for the EITC when, in fact, they actually are eligible. In both instances, the certification process may inadvertently deter eligible taxpayers from claiming the EITC. Taxpayers who were not deterred by the process incurred costs in terms of compliance burden, for both themselves and the third party document providers. These additional costs need to be taken into consideration in performing a complete cost benefit analysis.

While the IRS can identify the elements needed for a cost-benefit analysis, without specifying the size and scale of a full-scale certification program, this report does not attempt to quantify these elements in a way that could support an investment decision.

## **VI. EITC Filing Status Study**

The TY 1999 EITC compliance study identified filing status errors as a major contributor to EITC overclaims. Many EITC claimants improperly filed as single or head of household, when they should have filed as either married filing jointly or married filing separately. In numerous cases, using the proper filing status would have substantially reduced the amount of EITC received or made those taxpayers ineligible for the credit altogether.

The Filing Status Study, conducted for TY 2003 and TY 2004, investigated the impact of requiring taxpayers to document marital status in order to validate the filing status on their tax return. The focus of the Filing Status study for TY 2004 was to improve upon the methods used in TY 2003 for identifying taxpayers with a high likelihood of filing returns with filing status and related EITC errors.

### **VI.A Study Group Development**

In the TY 2003 study, the sampling frame consisted of taxpayers who filed as single or head of household in TY 2002 and claimed the EITC but had filed as married filing jointly or separately in at least one of the three previous years. For the TY 2004 study, the IRS first identified taxpayers with possible filing status errors on their TY 2003 returns using an existing rules-based process. Based on data from the TY 2003 Filing Status Study, the IRS developed two selection algorithms. One algorithm was based on administrative data available internally to the IRS. The other algorithm used commercially available third-party information. These two algorithms were applied to the population of approximately 24,000 taxpayers identified by the existing rule-based process to determine the population of test taxpayers for each of the alternative algorithms. The IRS also selected a random sample from the same population as a comparison group.

In TY 2003, the IRS also conducted a small study involving 500 taxpayers who filed as head of household and claimed the EITC in TY2002 and had not filed as married filing jointly or separately in any of the previous three years.

## VI.B Process

When taxpayers in this study filed their returns, if they claimed the EITC and filed as single or head of household, the IRS held the EITC portions of their refunds and asked them to provide documentation of their marital status, such as a divorce decree or legal separation papers. The IRS examiners used this information to determine whether the claimant’s actual marital status was consistent with the filing status on the tax return. Taxpayers were given several opportunities to provide additional documentation if the IRS decided the original documentation sent was incomplete or insufficient to confirm the taxpayer’s filing status. Once the filing status was confirmed, the IRS allowed the EITC claim. If the taxpayer could not substantiate the filing status claimed, the IRS deemed the taxpayer to be married filing separately and denied the EITC claim altogether.

For the smaller study group in TY 2003, the IRS sent the taxpayers a notice that described the criteria for filing as head of household and asked the taxpayer to confirm their filing status. If the taxpayer did not respond, they were informed that if they claimed the EITC in TY 2004, their refund would be held until the IRS could confirm the filing status.

## VI.C Study Results

The disposition of the Filing Status Study Groups is presented in **Table 4** (detailed tables in Appendix A, pages 9-10). In the TY 2003 study, 22 percent of the taxpayers in the study were not able to document their marital status adequately and were subsequently denied the entire EITC claim. The TY 2004 study sought to test different algorithms for their ability to identify ineligible taxpayers. All of the TY 2004 test algorithms performed better than the TY 2003 selection algorithm. The algorithm using data already available to the IRS was the most efficient with 60 percent of the taxpayer claims having adjustments. The third-party data algorithm was less efficient with 39 percent of the claims adjusted. The percent of the dollars claimed but not paid (revenue protected) followed a similar pattern with the TY 2003 study seeing the lowest results (20%) and the TY 2004 IRS Data algorithm experiencing the best results (54%).

**Table 4: EITC Filing Status Study: Test Groups’ Outcome and Percent of Revenue Protected by Study Year**

	TY 2003	TY 2004		Existing Process
		IRS Data Revised Algorithm	3 <sup>rd</sup> Party Data Revised Algorithm	
Percent of Claims with Adjustments	22%	60%	39%	34%
Revenue Protected	20%	54%	37%	31%

For the smaller study, the IRS tracked taxpayers in TY 2004 to see if their filing status changed and if there was a change in the number of taxpayers claiming the EITC. Significantly fewer taxpayers

in the test group used the head of household filing status in TY 2004 than in the control group (81 and 86 percent, respectively). In the test group, 8 percent changed their filing status to single and 6 percent changed to married filing jointly or separately. In the control group, 5 percent changed their filing status to single and 4 percent changed to married filing jointly or separately. In both the test and control groups, 5 percent of the taxpayers did not file a return for TY 2004. However, there was no statistical difference between the test and control groups in the percent of taxpayers claiming the EITC (86 and 87 percent, respectively).

## **VI.D Lessons Learned**

### ***Algorithms***

Based on the TY 1999 Compliance study, an estimated 9 percent of all returns with EITC claims have filing status errors.<sup>8</sup> Therefore, all of the tests performed substantially better than a simple random sample. However, the TY 2003 test included a large number of eligible taxpayers. As expected, the current rules were enhanced by using additional data, but the algorithm using third party data was not as efficient as the one using additional IRS data.

The results of the small study appear to suggest that the information provided by the IRS helped taxpayers better understand the requirements for using the head of household filing status. However, the majority of the test group that changed their filing status switched to filing as single. Eligibility rules for EITC are the same for both single and head of household filers, which could explain why there was virtually no difference in the number of taxpayers claiming the EITC.

### ***Commercially Available Third Party Data***

One interesting result from the TY 2004 study was that the algorithm developed using commercially-available third-party data did not perform as well as the one using data already available to the IRS. One reason for this may be that IRS has more current data on the relevant taxpayer characteristics than many of the sources used in the commercially-available data.

### ***Paid Preparers***

For the general population of EITC claimants and for those in the Filing Status Study, approximately two-thirds used paid preparers in each of the study years. In each of the test groups except one (IRS data), taxpayers who used paid preparers had a higher adjustment rate than those who did not use paid preparers.

## **VII. EITC Automated Underreporter Study**

The TY 1999 EITC compliance study indicated that income misreporting is among the three most common errors made by taxpayers in claiming the EITC. The Automated Underreporter (AUR) Study was an IRS initiative to focus compliance efforts on taxpayers who claim EITC but are either

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<sup>8</sup> This percentage is from Holtzblatt and McCubbin, "Issues Affecting Low-Income Filers" in *The Crisis in Tax Administration*, Aaron and Slemrod, eds. Brookings Institution Press, 2004, page 165.

ineligible because their true income is too high or eligible but overclaim the EITC because of misreported income.

The AUR study focused on an existing IRS program and did not create new procedures. In past years, the AUR program normally would work about 300,000 cases where the EITC was claimed, but these cases were not selected specifically to address income misreporting that affected the EITC claim. Instead, these cases focused on the amount of income tax that might be due on returns with misreported income. The focus of the study was to improve the ways the IRS selected these 300,000 cases to address specifically EITC overclaims due to misreported income. The AUR study was conducted for TY 2002 and TY 2003.

## **VII.A Study Group Development**

The IRS receives information returns from third-party payers who report certain taxpayer income (e.g., wages on a Form W-2 or non-employee compensation on a Form 1099). The study groups were comprised of taxpayers whose self-reported income did not match the third-party reported income. Based in part on information from the TY 2002 study, the IRS made several enhancements to its procedures for identifying and selecting for review returns claiming the EITC that had apparent income discrepancies for the TY 2003 study. The IRS refined its measure of the potential outcome of a case to reflect both the net change to tax and credits associated with the apparent discrepancy and the likelihood that the apparent discrepancy truly reflects misreported income

## **VII.B Process**

It takes several months for the IRS to process and compile the third-party information.<sup>9</sup> Therefore, the data cannot be used for income verification when a taxpayer's return is filed. In this study, the IRS did not hold refunds or freeze EITC claims because the returns had already gone through the initial processing and the claims had been paid.

Once a taxpayer was selected for the AUR study, they were sent a notice informing them that there was an income or payment discrepancy between the amount reported by the taxpayer and the amount IRS had on file. The notice indicated the new balance due (assessment) by the taxpayer and requested the taxpayer respond by a specified date. If the taxpayer did not respond by the specified date, interest and penalties were added to the assessment. This process was the same as that applied to other individual income tax returns with apparent mis-matches between the income reported on the returns and that reported by third-party payers.

## **VII.C Study Results**

The results of the AUR study are presented in **Table 5** (detailed table in Appendix A, page 10). For the TY 2002 study, 72 percent of the taxpayers had assessments. The revised workload selection methodology used in TY 2003 brought the percent of taxpayers with assessments up to 82 percent. The aggregate change to EITC and tax net of other adjustments was about 35 percent higher for TY 2003 than for TY 2002 (\$518 million for TY03 compared with \$384 million for TY 2004). The EITC changes were slightly larger for TY 2003 than for TY 2002—about \$256 million compared with \$250

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<sup>9</sup> In 2004, IRS received 1.4 billion information and withholding documents.



million. The TY 2003 change to tax net of other adjustments, however, was nearly double the TY 2002 amount. For TY 2003 it was about \$262 million compared to about \$134 million for TY 2002. These amounts were substantially larger than the assessments the IRS had traditionally generated from applying AUR procedures to returns claiming the EITC.

**Table 5. Automated Underreporter Study: TY 2002 and TY 2003 Test Results (money amounts are in millions of dollars)**

	TY 2002	TY 2003
<b>Percent of Returns with Assessments</b>	<b>72%</b>	<b>82%</b>
<b>Total Amount of Assessments</b>	<b>\$384</b>	<b>\$518</b>
Assessment related to EITC	\$250	\$256
Assessment related to Tax	\$134	\$262

## VII.D Lessons Learned

### *Workload Selection Methodologies*

For TY 2004, the EITC AUR program was added to the already existing base EITC compliance programs that include examinations and math error processing. AUR used information from this study to enhance its inventory identification and case selection procedures. AUR also continues to enhance the case selection process by identifying additional business rules and increasing the number of variables being considered during case selection. The inventory identification and case selection procedures that were used to select the AUR EITC cases during the study were expanded to select all of the future inventory for individual income tax AUR cases. Thus, the study results had direct application to an important IRS operational program.

### *Identity Theft*

Through the AUR study, the IRS identified a sizeable set of issues consolidated under the label of “identity theft” where taxpayers indicated that the information documents associated with their taxpayer identification number (TIN) did not belong to them and it appeared that another individual or individuals were using the study taxpayers’ TINs. As a result of these findings, the IRS is developing procedures to address this issue.

## VIII. Summary

This report concludes the series of tests conducted as part of the EITC Initiatives. IRS learned a lot about how changes in procedures used to administer the EITC can improve the overall administration of the program by reducing inappropriate claims. Some of these lessons have already been incorporated into IRS practices (e.g., changes to the AUR program).