IRS Earned Income Tax Credit (EITC) Initiatives

Addendum to the Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests

Implementation of Alternative Approaches to Improving the Administration of EITC

Department of the Treasury
Internal Revenue Service

2008

Implementation of Alternative Approaches to Improving the Administration of EITC

This report, *IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests*, dated January 2008, concludes a series of tests as part of an Earned Income Tax Credit (EITC) initiative that began in June 2003 to improve service, fairness, and compliance in the administration of the EITC. The Internal Revenue Service (IRS) learned a great deal 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 Automated Under-reporter (AUR) program. The purpose of this addendum is to clarify the status of implementation of tested approaches.

The EITC is recognized by many as the nation's most effective anti-poverty program. Participation is estimated to range between 75 percent and 80 percent of eligible claimants, though the participation rate for taxpayers with children is somewhat higher, around 85 percent. In 2007, over 22.6 million taxpayers received $43.4 billion in EITC payments. The administrative cost of the program is low, less than 1 percent of program expenditures. However the program suffers from an erroneous payment rate estimated between 23 percent and 28 percent (roughly $10-$12 billion per year). EITC recipients file a yearly tax return and claim the EITC as part of their annual individual income tax return. Currently, no verification of qualifications is required before claiming the EITC ("pre-verification"). If the credit exceeds the amount of taxes owed, a lump sum payment is paid to the claimant. While other Federal benefits programs may have lower erroneous payment rates, the administrative costs of these social welfare programs are significantly higher, as much as 20 percent of program expenditures. The higher administrative costs and lower erroneous payment rates for these programs can be attributable to mandatory pre-verification of eligibility, usually involving face-to-face interviews of the claimants with case workers.

Based on recommendations of an EITC Task Force convened by former IRS Commissioner Charles Rossotti, the Internal Revenue Service conducted this series of tests of alternative approaches to improve the administration of the EITC. The tests covered three basic areas: income reporting errors detected by the AUR program; filing status errors; and errors from mis-claimed qualifying children. IRS designed separate tests for each of these areas and conducted the tests over a three-year period.

Qualifying Child Residency Test

The Qualifying Child test showed promise in reducing inappropriate EITC claims in several ways. First, the certification requirements appeared to deter some ineligible claimants (a smaller number of eligible claimants appear to have been deterred by the certification requirements). Second, a substantial number of taxpayers could not substantiate their EITC claims by providing adequate evidence to show that the qualifying children listed on the tax return actually lived with the taxpayer for more than half the tax year. Third, an improved selection algorithm was developed by the IRS for the third year of the test, which appeared to be more effective than the original algorithm, both in detecting potentially problematic EITC claims and in deterring inappropriate EITC claims. In fact, one positive outcome of the study was that the IRS incorporated elements of the revised algorithm used to select the study participants into the examination selection process. Examination results have consistently improved, and part of this improvement can be attributed to incorporation of elements of the revised algorithm. Fourth, these compliance effects were larger in the first year the taxpayer experienced the EITC certification process than in subsequent years. That is, the compliance effect appeared to decay over time, but some effect persisted.

During the second and third years of the study when taxpayers were given the opportunity to certify qualifying child eligibility for EITC prior to the filing season, they generally did not voluntarily certify early despite having received letters and reminders. Only 17 percent of those that claimed the credit sought to certify prior to filing their tax return. The remaining 83 percent that claimed the EITC at the time of filing did not attach all or some of the required certification documents; therefore the IRS contacted these taxpayers and gave them repeated opportunities to submit the required documentation for IRS review. It is possible that as taxpayers became more familiar with the pre-certification process, these rates would improve over time.

The process of requiring certification after the filing of the tax return had several similarities to the IRS EITC examination process. Like EITC examinations, the taxpayer's EITC portion of the refund was frozen until they could substantiate the qualifying child residency requirement. If the taxpayer did not adequately certify that the qualifying child lived with them for more than half the tax year, the claim was not paid. The IRS process to disallow the credit followed standard tax deficiency procedures, which could take several months. One key difference was that taxpayers were allowed to use third party affidavits to support their residency determination for the qualifying child(ren). The affidavits broadened the definition of those allowed to certify the taxpayer's residency and were believed to give taxpayers more flexibility in the certification process.

The IRS weighed the costs of administering certification with the benefits certification generated and then compared these results with other potential investment options. The IRS considered the costs and benefits of scaling up a certification program as compared to the cost and benefits of the existing IRS portfolio of EITC compliance and education programs, particularly the EITC examination program. A return on investment (ROI) comparison was one of the factors that helped determine whether the IRS would proceed with a certification requirement.

Certification Implementation Options Analysis

The IRS contracted with an independent party to complete a separate effort which focused on analyzing existing and new potential certification implementation options and developing a cost analysis for each. One of the objectives was to assist IRS in making a decision about certification implementation. Conducting such an analysis required IRS and the contractor to develop operating models for a fully fleshed-out program and then the costs and benefits associated with those models could be estimated. (The purpose of the certification test on which much of this analysis focused was to evaluate how a certification requirement affected EITC error and participation. The test was not designed to develop an operating model for certification implementation. Therefore a number of assumptions and extrapolations were required to fully describe the various certification options.)

The IRS considered four possible options for a certification program:

1. **IRS Dedicated Certification –** This option most closely resembles the process used during the three-year certification test. One or more dedicated IRS units across multiple IRS sites would perform all certification reviews and handle calls from EITC claimants required to certify.

2. **IRS Embedded Certification –** This option attempts to leverage existing examination and accounts management functions to perform certifications and answer taxpayer calls about the certification process. The Accounts Management function of the IRS would be responsible for early (pre-filing) certifications and telephone calls and the Correspondence Examination function would process certifications after filing.

3. **Outsourced Certification –** This option involves using a contractor to perform the initial review of documentation, then sending recommendations about whether the taxpayer has adequately certified that the qualifying child lived with him or her for more than half the tax year to the IRS for review and a final determination of EITC eligibility. The IRS would review all recommendations made by the contractor for denial and audit a sample of recommendations made by the contractor for EITC approval. The IRS would be responsible for sending all notices to taxpayers except for additional requests for information that could be sent by the contractor. An administrative audit/review team would be required to oversee contractor activities and to ensure that taxpayer rights were preserved.

4. **Paid Preparer/ IRS Certification –** Under this option, paid preparers would be authorized to perform certification activities during filing season and receive compensation from taxpayers for providing this service. An IRS unit would process certifications and handle telephone calls from taxpayers trying to navigate the certification process without using a paid preparer. The IRS would establish an organization to approve paid preparers to perform certification. Also, an audit/review team would be needed to oversee and validate paid preparer results and to audit a sample of returns to ensure consistent application of the certification procedures.

Costs and ROI Associated with Certification Options

The certification tests were not intended to provide comprehensive costing data that would permit a definitive estimation of the resources needed to run the program at full scale. However, some of the data generated was used, in combination with several key assumptions in order to compare the four certification options. One of the assumptions was that at full scale, about 200,000 taxpayers would be selected for certification in any given year (this is just a fraction of the set of taxpayers where the IRS cannot systematically certify that the qualifying child likely lived with the taxpayer for more than half the tax year). Also, a range of staff workload rates were evaluated. The lower bound workload rate was based on productivity experienced during the test at the dedicated EITC certification unit in Kansas City, which administered the tests. The upper bound workload rate reflected efficiencies that may be realized once the process moved from a test program to a fully operational program. The analysis assumed no major technological enhancements for automation to reduce required staffing. However, the analysis observed that if certification were to be implemented on a large scale, necessary information technology investments would be a major cost factor.

The costing analysis reflected that certification processing done for the tests was manually intensive and therefore relatively costly. Differences between the Dedicated and Embedded IRS profiles are minimal with the exception of early certification processing. The Outsourced and Paid Preparer options pose significant barriers due to added process and integration complexity. And with these latter two options, the IRS would still be required to maintain responsibility for certain tasks (such as denying claims and reviewing work done by the third party). All of the options would require significant functional enhancements to enable certification processing. Each option has significant investment and other start-up costs, including specific information technology investments needed to launch a certification program nationwide. These cost estimates reflect conservative upper bound costs over the first five years of implementing a certification program.

The calculated benefits from the certification program are limited to the amount of erroneous EITC claims not paid due to the operation of the program. That is, benefits are viewed as EITC dollars not paid out because a taxpayer was deterred from making an erroneous claim by the certification requirements or the taxpayer's claim was denied because they did not produce the required documentation. Less tangible benefits, such as improved taxpayer knowledge of the requirements for claiming the EITC, were not incorporated into this analysis.

A preliminary return on investment calculation was done, under the assumption of constant benefits across the four options. This preliminary calculation indicated that the ROI for the lowest-cost Preparer option was the largest, at slightly over 4.14:1 for the five year period. The highest-cost Outsourced option had the lowest preliminary five-year ROI, slightly under 1.80:1.

Table 1: ROI with Key Costs

Profile	Investment Costs(1)	Operational Costs(2)	ROI	Peak IRS FTE(3)
Dedicated	$10,636,500	$199,762,185	2.67:1	528
Embedded	$11,122,028	$206,381,604	2.55:1	528
Outsourced	$11,922,743	$263,912,893	1.80:1	204
Preparer	$10,423,306	$139,893,153	4.14:1	393

1. Represents total costs for startup
2. Represents operational costs across 5 years
3. Represents peak year FTE within 5 years

Advantages and Disadvantages of Certification Options

In addition to the costs associated with the options, the IRS noted the following advantages and disadvantages of each option.

1. **IRS Dedicated Certification –** The advantage of this option is that it leverages lessons learned and components of the certification process used during testing. Under this option, all activities could be managed in-house by the IRS permitting management to make resource trade-offs. Disadvantages included the relatively large number of FTE (and related facilities/ equipment costs) needed to support the operation. Moreover, it is possible that there would be significant down-time if staff worked on certification alone and the workload was not evenly spread throughout the year (this disadvantage could be mitigated by providing similar sorts of non-certification work to this in-house staff).

2. **IRS Embedded Certification –** This option has the advantage that all activities would be performed and managed in house by the IRS. One disadvantage is that productivity may be lower due to competing non-certification responsibilities of the staff, such as working incoming correspondence inventories. Moreover, ongoing training requirements may be higher since certification work would only be a part of the staff responsibilities and regular retraining might be required. Additionally, the benefits associated with using the Accounts Management function for early certification might not be fully realized if the proportion of taxpayers choosing to certify prior to the filing season does not increase. The

option might require a significant amount of examination staff if most of the certification work is performed during the filing season.

3. **Outsourced Certification –** This option may allow greater flexibility if the number of certifications processed fluctuates greatly from year-to-year, since using a contractor allows for more rapid scalability. Under this option, the need for the IRS to hire new employees for certification and related costs would be reduced. However, this option would increase the administrative burden for IRS oversight and training of contractors. Moreover, this option imposes additional complexity because the IRS needs to ensure that the contractor clearly follows the relevant privacy, security, and disclosure laws. Additionally, the IRS anticipates stakeholder concerns regarding outside contractors performing certification activities. Overcoming this resistance would impose additional intangible costs on the IRS.

4. **Paid Preparer/ IRS Certification –** This option has the flexibility of scalability and reduced IRS operational costs. Although this option would leverage an existing channel already utilized by 70 percent of EITC claimants (paid preparers), taxpayer burden would be increased by additional fees charged by preparers to undertake the certification responsibility. The IRS would incur costs associated with accepting preparers to conduct certification and in carrying out the required oversight of the preparers' processes. Under this option, the IRS would still incur the cost to maintain a parallel certification process for taxpayers who do not use paid preparers. Lastly, this option also may generate stakeholder opposition, and could even require a statutory change, depending on how it is structured.

Update of Certification Option ROI and Comparison to Examination ROI

After reviewing the advantages and disadvantages of each option, the IRS concluded that of the four options, the two IRS options, Dedicated and Embedded Certification, were most realistic. The IRS then undertook an effort to refine the ROI estimates for these two options to account for final certification test results and additional cost variables. Again, the benefits were limited to EITC claims not paid to taxpayers in error. Most importantly, annual ROI computed in Table 1 used ongoing operational costs, those costs incurred during the operational phase of the certification process after the start-up phase has been completed.

Because labor is the most significant ongoing cost component to the IRS, the costing portion of the updated ROI computations (shown in Table 2) was limited to labor costs. The IRS then compared the ROI for these two certification options to the ROI from standard EITC examinations. This comparison indicated that ROI from the traditional ongoing correspondence examination of EITC claims is significantly higher than the ROI for the certification options, approximately 19:1 compared to 5:1.

Table 2: Labor Only ROI

	ROI
Dedicated Certification Option	5.23:1
Embedded Certification Option	5.09:1
Examination	19:1

Comparison of ROI for Certification and EITC Examinations

From an ROI perspective, certification is not as effective as the traditional correspondence examination operation applied to EITC claims. Start-up costs for the certification options can be significant and timeframes for introduction could be elongated.

While efficiencies could be gained through improved certification procedures and perhaps even better selection algorithms for the Qualifying Child certification program as it reaches operational scale, it is unlikely that the ROI for this program would ever exceed that for the existing EITC correspondence examination program. The examination program has become very efficient in recent years and has improved its selection methodologies to focus on those EITC claims most likely to be non-compliant. In contrast, the Qualifying Child certification program is a more complex endeavor combining elements of both a service and enforcement program. As part of the service component, the certification program seeks to educate taxpayers about the appropriate EITC rules prior to their filing an EITC claim. In addition, taxpayers are encouraged to call the IRS to receive help in navigating the certification process. However, if a taxpayer files a claim without adequate documentation to support the residency requirement of a qualifying child, the certification process becomes similar to a correspondence examination.

Compared to regular EITC examinations, the rate of EITC claimants denied the credit under the certification program is substantially lower. The rate of change or percentage of time EITC was denied for EITC returns selected for normal EITC examinations ranges between 86 percent and 94 percent. In comparison, the rate for those attempting to claim EITC under the test and denied the credit ranged between 29 percent and 39 percent using the original algorithm and was about 52 percent using the revised selection algorithm. This seems to support the contention that EITC correspondence examinations are a more efficient enforcement treatment than certification (though, as noted above, the certification program is not simply about enforcement).

Other Considerations

Burden

One goal of the study was to assess taxpayer burden associated with a certification program. Taxpayers in the study appeared to take more time off from work to obtain information needed for their tax return, including the EITC claim, and spent more time on their return than did similar taxpayers that did not go through certification. Also, the certification process could take up to several months to complete if the taxpayer did not submit adequate documentation at the time their return was filed. While increases in burden might be considered reasonable when weighed against increased accuracy of EITC claims, many advocates for the low-income community argue that the EITC claimant population already is challenged by tax administration requirements and that this population is disproportionately affected by even small increases in burden.

However, the certification program permitted, the use of affidavits by taxpayers as a means to prove qualifying child residency. These were believed to be easier for taxpayers to obtain than obtaining official documents or letters. The alternate Third Party Affidavit allowed anyone (except a spouse, dependent, qualifying child, or a parent of the qualifying child) to complete the form providing that they had personal knowledge or records showing that the taxpayer and qualifying child lived together during the tax year. Therefore, this list of acceptable signatories included most relatives, friends, and neighbors. The results show the IRS accepted affidavits at a higher rate than other forms of documentation and the pioneering use of affidavits in this study was a responsible way to reduce taxpayer compliance burden. However, further study of affidavits will be necessary before expansion of their use in EITC and other areas is implemented by the IRS.

Effect of Certification on Participation

The study showed certification deters or discourages ineligible EITC claimants. A test group selected under a revised algorithm in the third year of the test had the highest proportion of ineligibles deterred by the certification requirements, between 13 percent and 16 percent. On the other hand, it appears that 1 percent to 3 percent of EITC-eligible taxpayers were deterred from claiming the credit by certification requirements. In the studies, another 30 percent did not claim EITC for reasons unrelated to certification, and this is similar to the 30 percent annual turnover in the EITC claimant population. Although a 3 percent deterrence rate for eligible claimants might appear low, this deterrence rate could have broader significance and even conflict with the IRS goal of increasing EITC participation among the eligible population.

Qualifying Child Residency Study Conclusion

Taken as a whole, there is insufficient evidence for the IRS to conclude that implementing a full-scale Qualifying Child Residency certification program is warranted at this time. Based upon a comparison of ROI for the Qualifying Child Residency study, the certification test results, and other appropriate factors such as the impact on taxpayer burden and the effect on EITC participation, the IRS does not plan a full scale implementation of an EITC Qualifying Child Residency certification process in the near future.

Automated Underreporter (AUR) Test

In designing this test, the IRS began to include the amount of EITC that would be reduced as a result of correcting misreported income amounts as part of the selection process for determining which returns the IRS works as part of its AUR program. These tests modified the selection algorithm for a process that the IRS had been using for many years. The revised selection algorithm turned out to be a substantial improvement over the previously used methodologies. Accordingly, after two years of testing, the IRS adopted the revised selection method (including potential EITC changes as well as income tax changes from correcting misreported income) in the ongoing AUR program. This change has resulted in better cases being selected and a substantial increase in enforcement revenue collected by the IRS.

Filing Status Test

A significant source of error in EITC claims involves taxpayers inappropriately reporting their filing status. In particular, some taxpayers claim to be head of household, when in reality they should file as married (either on a joint return or a separate return). These taxpayers may inappropriately receive a larger EITC than they are entitled to receive. In the Filing Status test, the IRS attempted to devise a way to detect these errors. The basic approach was to use prior-year return information to determine if a taxpayer had recently changed filing status and then require the taxpayer to substantiate the new filing status. The selection methods used, however, could not detect a high percentage of cases that the IRS could definitively determine to be non-compliant. Taxpayers having to provide evidence to support the filing status claimed on their return generally experienced a substantial burden and the IRS did not observe a correspondingly large increase in overall compliance levels. After conducting this test for two years, the IRS decided this approach was not a worthwhile addition to the portfolio of EITC administration processes, and it was discontinued.

Conclusion

The IRS considered all components of the Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests highly successful. The tests provided the IRS with the detailed information needed to make valuable, data-driven decisions about future administration of the EITC Program. Based on the EITC Qualifying Child Residency study results, projected return on investment of implementation options, and other key program considerations addressed in this document, the IRS does not plan a full scale implementation of an EITC Qualifying Child Residency certification process in the near future. On the other hand, the AUR Test produced a revised selection algorithm for AUR EITC case selection that was incorporated into the AUR program and resulted in better case selection and a substantial increase in enforcement revenue collected by the IRS. Finally, the study approach to addressing errors in filing status did not detect a high percentage of cases that the IRS could determine were definitively noncompliant and the test was concluded without implementation.