



Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC)

From Interviews with Low Income Tax Clinics

September 2005

Challenges for Taxpayers: Examinations of Earned Income Tax Credit Returns EXECUTIVE SUMMARY

Introduction

Taxpayer Advocate Service, working in collaboration with the EITC Program Office and Wage and Investment Research Division (W&I Research), is conducting research into some of the challenges tax examinations pose for low income taxpayers, particularly EITC claimants. Initial efforts involved interviewing persons knowledgeable about the challenges faced by taxpayers who claim EITC and are subsequently subjected to examination of their tax return.

Methodology

A total of eight attorneys in Dallas, TX; Seattle, WA; New Orleans, LA; and Burlington, VT were interviewed about barriers EITC taxpayers face as a result of an examination of their income tax return. (Interviews are a type of qualitative research conducted with a small section of the population, and consequently, results should not be generalized to the population.) These sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of a LITC Office. The number of tax cases the attorneys worked each year varied by location (30 to more than 100) depending on time devoted solely to tax issues, with 15 to 50 percent involving EITC issues.

Findings

Interviewees identified the following as challenges that taxpayers face when undergoing an examination of claimed earned income tax credits. **This summary includes only a few important findings, see the full text for additional findings and suggestions.**

IRS Aggressive Stance

One of the primary issues with EITC audits is the approach IRS takes while examining these returns. The attorneys noted that “IRS looks to reject” EITC claims rather than looking for ways to accept the claim as valid.

Eligibility Requirements

Many taxpayers do not understand what they must prove to the IRS to claim EITC, and IRS does not explain what supporting documents need to prove when requesting additional information from taxpayers.

Correspondence and Information Clarity

IRS interacts with EITC filers mainly through written correspondence. However, the letters and notices are written without considering the customers’ literacy level. Correspondence is too generalized, particularly since many in this taxpayer segment possess only rudimentary literacy skills and are not familiar with the specifics of the eligibility requirements.

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Documentation

Documentation is difficult for this segment of the population. The attorneys noted that many of their clients' lives are chaotic; they move frequently, pay cash for items, and do not keep records. Often it is the lifestyle that makes it especially difficult for this population to maintain records. The lack of records makes it challenging for these taxpayers to substantiate their claims.

Contacting IRS

The attorneys find that clients would like to be able to contact one person about their case. Some clients prefer to meet with IRS personnel rather than calling, and most do not have the skills needed to correspond via written means.

Eligibility

The attorneys stated that the majority of their clients were truly eligible for EITC, but the claimants must be very persistent to obtain the credit. Many people have difficulty assembling the requested documentation and just give up, forgoing the credit. Many of the EITC problems with taxpayers claiming EITC who really are not eligible are tied to preparers who are not diligent in verifying that taxpayers actually qualify based on requirements.

Additional challenges

The attorneys noted other difficulties include non-traditional living arrangements, time lines, RALs, recertification requirements, job classifications, language and literacy issues, inconsistent IRS requirements and enforcement, centralization, and others.

Suggestions for Reducing Burden for EITC Examinations

- Change the writing style of IRS correspondence to improve clarity and reduce the education level needed to understand the information.
- Develop a checklist for taxpayers' that shows acceptable documents and stresses what the documents must prove.
- Instruct taxpayers to gather the supporting documents and keep them with their copy of the tax return in case there are questions about eligibility later.
- Regulate small tax preparers and require them to attend some training classes annually (such as VITA volunteers attend).

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Introduction

Taxpayer Advocate Service, working in collaboration with the EITC Program Office and Wage and Investment Research Division (W&I Research), is conducting research into some of the challenges tax examinations pose for low income taxpayers, particularly EITC claimants. IRS would like to determine if people who are eligible to claim the credit are adversely impacted by procedures established to reduce overclaims for the Earned Income Tax Credit, and if so what areas cause the taxpayers problems.

Taxpayer Advocate Service (TAS) representatives met with Low Income Taxpayer Clinic attorneys in four cities to discuss audit issues pertaining to their Earned Income Tax Credit (EITC) clients. The discussions focused on the areas that are most difficult for taxpayers claiming EITC, particularly those taxpayers whose returns are selected for examination. This information will be used to develop a quantitative study to identify and investigate burdens that EITC taxpayers face when their returns are selected for examination.

Background

TAS Research conducted interviews with Low Income Taxpayer Clinic attorneys about barriers taxpayers face in EITC examinations. For efficiency's sake, these interviews were held in the same cities and facilities as another study being conducted on EITC customer service needs. Interviews were held with attorneys from low income clinics in four cities exploring their experiences with clients claiming the Earned Income Tax Credit.

Methodology

Taxpayer Advocate researchers were responsible for conducting the first stage of research into the EITC audit barrier project. Initial efforts involved interviewing persons knowledgeable about the challenges faced by taxpayers who claim EITC and are subsequently subjected to examination of their tax return. (Interviews are a type of qualitative research conducted with a small section of the population, and consequently, results should not be generalized to the population.) The collected information will be used by W&I researchers to develop a quantitative study of taxpayers whose returns were examined based on EITC claims. W&I Research will design and implement the follow-up study (with input from the EITC Program Office and TAS) in late 2005.

A total of eight attorneys in the following cities were interviewed about barriers EITC taxpayers face as a result of an examination: Dallas, TX; Seattle, WA; New Orleans, LA; and Burlington, VT. These sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of a LITC Office. The number of tax cases the attorneys worked each year varied by location (30 to more than 100) depending on time devoted solely to tax issues, with 15 to 50 percent involving EITC issues.

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Findings

The following issues have been identified as barriers EITC taxpayers face during IRS income tax examinations.

IRS Aggressive Stance

One of the primary issues with EITC audits is the approach IRS takes for these returns. The attorneys noted that “IRS looks to reject” EITC claims rather than looking for ways to accept the claim as valid. This results in qualified clients giving up their efforts to obtain the EITC. Often, the IRS will accept documents sent by the tax clinic that it will not accept from the taxpayer, such as affidavits.

If there is one mistake on the return, IRS denies everything associated with the return and requires taxpayers to prove all aspects of eligibility. Even if IRS knows the required relationship exists between claimant and child, the taxpayer is still asked to provide the documents to prove that relationship. This creates undue burden on the taxpayer and requires IRS to assimilate and review more documents than needed to prove the claim.

IRS is strictly enforcing the 30 day deadline for records and looking for ways to reject claims. If school records are sent that establish residency, but are one day short of the 6 months (due to when school lets out for break), the IRS rejects the documentation. The attorneys find that taxpayers become frustrated and disheartened and give up trying to claim EITC.

Eligibility Requirements

Most taxpayers claiming the earned income tax credit pay someone to prepare their tax return. Consequently, they trust the preparer to know the tax laws and eligibility requirements to claim various tax credits and do not understand these requirements.

Filing status and dependency are some of the most common issues questioned in EITC examinations, even though they may not necessarily be EITC related. Eligibility requirements for claiming head of household filing status are confusing to taxpayers. The most confusion involves the issue about providing more than half of the cost of keeping up a home when claiming head of household status. Another area that is not clear to taxpayers is what types of government aid count as someone else providing a portion of the cost of maintaining the home and must be included in computations. One attorney noted the difference in how tenant based (most rural) and building based (most urban) rent subsidies are counted in calculations about maintaining a home. She felt

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that rural community residents are discriminated against in these computations because of the limited types of housing assistance available in rural areas.¹

Correspondence and Information Clarity

IRS interacts with EITC filers mainly through written correspondence. However, the letters and notices are written without considering the customers' literacy level. Correspondence is too generalized, particularly since many in this taxpayer segment possess only rudimentary literacy skills and are not familiar with the specifics of the eligibility requirements. The explanation sent to taxpayers does not adequately explain the problem with the return, why the claim was denied, or what point the taxpayer needs to address.

Examples: Taxpayers are directed to provide school records or utility bills, but they are not told, and do not understand what the documents need to prove. This leads to getting the materials in a 'piecemeal fashion', asking the taxpayers for an item, receiving the item (which is insufficient to prove residency or relationship), and then asking for additional items.

The IRS denies a dependent, but does not specify which dependent and what to send to resolve the issue. For instance, in this example the letter

¹ In Public Housing, and in other building-based subsidies such as the LIHTC (Low Income Housing Tax Credit) program, the government subsidizes the tenant's rent by subsidizing the owner of the building. This means that the rent is just lower for the tenant than it would be if the tenant were paying the full fair market rent. When the tenant who lives in a LIHTC property prepares her taxes, she hasn't received a government payment, such as a rent subsidy payment. This means that she, the taxpayer, paid all the rent.

In contrast, in the Section 8 Housing Choice Voucher Program (Voucher), a tenant receives a voucher from a Housing Authority (which has received money for the program from the federal government). The S8 voucher tenant can use her voucher to rent any available apartment. The Housing Authority negotiates the rent that the owner of the apartment will receive and then pays, each month, part of the tenant's rent to the landlord. The tenant pays the remainder of the rent. How much the tenant and Housing Authority pay depends on tenant's income. The amount of rent paid by the Housing Authority to subsidize tenant's rent is considered government support to tenant's dependents for income tax purposes. Thus, when this tenant prepares her taxes and compares the amount of support she provided for keeping a home vs. the amount of support the government provided, this tenant must include the pro rata amount of rent the Housing Authority paid to subsidize her tenancy (or her child's portion of it) as government support. Thus, this taxpayer, by virtue of the type of housing subsidy she receives, is less likely to have provided more than half the support to keep a home for her dependants.

Because rural areas have more Section 8 Vouchers and less Public Housing, rural taxpayers are more likely to be tenants with vouchers and thus have rent subsidies counted as government support of their homes, possibly making them ineligible for certain filing statuses or dependency exemptions. Rural tenants are less likely to meet the requirements than their urban counterparts who live in Public Housing where government support of subsidized housing is not calculated as support of the home.

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may suggest that the taxpayer should send school records, but does not state what any additional documentation needs to prove, such as these records need to show that “Johnny” lived with you for at least six months during the year.

Letters are lengthy and overwhelming to clients. Letter tone and content are such that they have meaning to the IRS, but sound threatening to taxpayers, and the terminology does not mean anything to taxpayers. Taxpayers lack a level of sophistication and often do not understand the 30-day letter.

For example, many do not understand the terms residency and relationship. Likewise, the term ‘notice of deficiency’ does not mean anything to taxpayers. The letter should explain what this term means, and how it impacts their ability to disagree with the findings.

The attorneys described letters as very dense with little white space, making them difficult for educated people to understand, much less semi-literate people.

The EITC population has difficulty reading and understanding tables (due to literacy levels). It would be more effective to use flow-charts, or a question and answer format to present information to this segment of the population. This pertains to all written materials including tax packages, instruction booklets and publications.

Documentation

The attorneys find that clients do not understand what requested documentation must prove. Taxpayers do not make the connection with school records needing to show the child lives at the same address as the taxpayer for at least a six month period of time. The attorneys stated that sometimes sufficient documentation is submitted, but does not get associated with the tax return; this too causes confusion for the taxpayer.

Documentation is difficult for this part of the population. The attorneys noted that many of their clients’ lives are chaotic; they move frequently, pay cash for items, and do not keep records. Often it is the lifestyle that makes it especially difficult for this population to maintain records. The lack of records makes it challenging for the clients to substantiate their claims. Many clients’ jobs do not provide paid leave, so a trip to the doctor’s office to obtain records (if their child goes to the doctor) may cost them their job or at least some income. Additionally, transportation is difficult for many in this population. Most rely on public transportation which adds to the difficulty of getting supporting documentation.

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The Vermont site finds that nearly two out of every three clients do not keep records and suggests that even fewer of the EITC claimants maintain documents. The low income population tends to be mobile, moving frequently and living with family and friends. This lifestyle is not conducive to extensive record keeping.

Another frequently heard comment concerning documentation indicates that taxpayers are asked for documents in a piecemeal fashion. Taxpayers gather and send documents to IRS only to be told that they need to provide additional information and different types of documents. IRS is not consistent in its acceptance or rejection of documents across all campuses, adding to taxpayers' frustration, fear and anger toward the IRS.

Contacting IRS

The attorneys find that clients would like to be able to contact one person about their case. A portion of the clients feel more comfortable visiting walk-in offices due to language and trust issues (clients like to look someone in the eyes to gauge whether to trust someone or how much trust to place in the answer provided), rather than calling or writing to the IRS. Taxpayers find it more comfortable to speak their language (not rely on interpreter), especially the elderly who tend to be less literate.

The attorneys expressed a desire to talk to a person in examination about a case but stated it is nearly impossible to talk with an examiner (cannot get anyone on the phone). One of the biggest challenges when calling the IRS is being able to talk to a person with knowledge of a specific tax situation. It is currently impossible to talk to the same person twice. Consequently, the caller must explain the situation multiple times. The IRS assistor often does not have all of the information available to determine what is needed to alleviate the problem.

Taxpayers must be very persistent when trying to talk to the IRS about their case. It takes a lot of time and patience to get the appropriate department and most EITC taxpayers do not have skills or savvy to negotiate the system.

Timing

The attorneys noted one of the biggest difficulties they face involves the timing of their involvement in the problem. Most clients do not seek help until a few days before a significant deadline (such as the 30 day letter), often because the clients are scared of the IRS and intimidated by the notices. In fact, they noted that many times clients bring in correspondence that has not been opened. IRS often is unbending in adhering to the 30 day deadline, forcing cases into Appeals or Tax Court when they could have been resolved with extended time deadlines.

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Non - Traditional Living Arrangements

Many clients do not live in a traditional family setting. This adds to the difficulty involved in proving EITC eligibility. Court records detailing child custody are often outdated or nonexistent, adding to the difficulties of proving relationship and residency issues.

One example is a case where the client has suitable school records and utility bills, but does not have a copy of the court order showing the legal relationship to the child.

One attorney stated that overall her EITC clients were less healthy, less educated, and less capable than the general population. She explained that many ended up in this position from a catastrophic illness, domestic violence situation, or from a lack of basic skills.

Refund Anticipation Loans (RAL)

The attorneys noted a problem with clients and refund anticipation loans. Often the EITC claim is disallowed after the client has taken out a refund anticipation loan and spent the money. The client then owes money to the bank and the IRS. One attorney notes seeing this in cases with divorce in which the wife has the children, but the husband files first and claims EITC prior to the wife. They also see this as a conflict of interest with tax preparers. The preparers benefit financially by selling RALs to their clients and getting the money even if the client is not eligible to claim dependents or when the RAL may not be in the best interest of the taxpayer.

When taxpayers win an appeal and have their EITC reinstated the refund goes to the bank or preparer and not the individual. Often the banks have collected some of the money from the taxpayer and it is difficult for the taxpayer to refute fees or recapture previously paid money when the bank or tax preparer has the money.

One attorney discussed a case in which the client lost her job because of the excessive number of telephone calls she was receiving at work from the bank who had issued her a refund anticipation loan (she did not receive the expected refund and had no way to pay the loan back).

Eligibility

The attorneys stated that the majority of their clients were truly eligible for EITC, but the claimants must be very persistent to obtain the credit. Many people have difficulty assembling the requested documentation and just give up, forgoing the credit. They also felt that it was unfair to withhold the refunds on the front-end since IRS does not do that for any other type of taxpayer.

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Many of the EITC problems with taxpayers claiming EITC who really are not eligible are tied to preparers who are not diligent in verifying that taxpayers actually qualify based on requirements. They claim EITC with dependents even if the taxpayer does not meet the eligibility requirements for relationship and age. Since taxpayers find EITC charts very confusing, they have difficulty determining if they are eligible to claim this credit and rely on the preparers' advice.

Recertification

The attorneys do not like the fact that taxpayers must recertify if a previous EITC has been denied. This places claims that do not provide sufficient documentation (in a timely manner) in the same category as potentially fraudulent claims, and the attorneys feel that position should be proved not assumed. They felt this policy forever brands taxpayers as suspect.

General Comments-Taxpayers

The attorneys feel a major part of the problem is trying to use administrative records to prove that a child resides with a qualified taxpayer for EITC purposes. Documentation requirements are not realistic given the lifestyles of many low income taxpayers who in fact qualify for the Earned Income Tax Credit. Children and parents move frequently which makes it difficult to establish residency and keep records, particularly when parents live with several different family members and children do not regularly visit doctor offices or remain in the same school for extended periods of time.

Most problems involve proving the relationship or the residency of the qualifying child. This happens particularly if the child and the parent/guardian have different last names, if the parents are divorced, when the child is a foster child, or if the taxpayer is part of the immigrant community.

In many instances, a divorce decree specifies that the children are split between the parents for tax circumstances so one parent can claim one child and the other parent can claim a different child. However, this often does not match with tax laws. IRS should educate the divorce courts about tax laws. Typically this type of case will go to Appeals or Audit Reconsideration, and waste valuable taxpayer and IRS resources.

The EITC population tends to think only about the short-term. They do not plan for the future (part of documentation problem). They also tend to be less skilled, educated,

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healthy, and capable than the general population. Approximately half of those with IRS problems incurred their problems due to a major catastrophic illness.

Taxpayers are challenged to prove head of household status due to their lifestyles. Often they do not have a bank account and are paid via money order or cash. They do not have long-term leases which makes it difficult to prove residency issues. They move often and do not keep good records (to prove residency, relationship, etc.).

The contract labor vs. employee issue affects many of these taxpayers. Often they think they are employees but instead are given a Form 1099 and reported as a contract laborer, thus compounding their tax return complexity.

The attorneys find that low income taxpayers are susceptible to unqualified and/or unethical tax preparers. Non-English speaking taxpayers go to tax preparers who speak their native language.

Many EITC taxpayers are financially illiterate. Perhaps educating this population would help reduce errors and the subsequent paperwork caused by these errors.

Language is an issue – taxpayers should have the option of corresponding in the language of their choice. Some may speak a language but may not be able to write the same language. The Spanish translation used for some materials is pretty good – example: ITIN brochure, while others are not so good – very formal and written beyond a college level. Many translations use Puerto Rican Spanish instead of Mexican Spanish. It would make more sense to use the Mexican version of Spanish given the large influx of immigrants from Mexico.

Taxpayers might be willing to certify at time of filing if that keeps them from being audited later.

Most LITC clients have a phone (landline), or cell phones. Only a few do not have a telephone and use friends or families numbers to receive messages. However, these low income clients often just disappear without providing a forwarding address or means of contact.

Low income taxpayers generally have less availability and access to computers than the general population. About half of Dallas area clientele are computer illiterate, with around ten percent having a computer at home (only one with internet access) and one

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third have access to a computer at work or at a library. Studies have shown that more than half of VT households earning less than \$20,000 have a computer at home and almost 93 percent of VT households with computers have internet access at home.² If there are children in the household (computer with internet access), they are slightly more likely to have high speed internet access.

General Comments-IRS

IRS does not consistently follow procedures, resulting in varying demands on taxpayers. Exam appears to use the date when the letter is generated rather than when it is mailed to determine 30 days. If taxpayers question something, they are often told to wait for the next letter. If the taxpayers wait, they may have exceeded the time allotted to appeal the decision and only have tax court as a means of disputing IRS's finding.

IRS should seek out facts such as who prepared the return and how it was prepared and whom to contact with questions.

Centralization makes the process difficult – supporting documents often are separated from the return.

IRS assistors do not seem to understand the purpose of Form 8821. Form 8821 designates people the IRS can provide with informational copies of tax documents. Many times, however, IRS assistors refuse to provide this information to the designated individual.

The attorneys see patterns of taxpayers experiencing problems with RALs from certain banks and preparers. One company even requires clients sign an arbitration clause to waive the right to take them to court if there are problems with the return.

LITC Suggestions to Improve EITC Audit Process

- Understanding documentation requirements is the biggest problem for EITC taxpayers. IRS should spell out what they are looking for in a manner similar to the following example:

² The Digital Divide in Vermont, A Policy Brief, University of Vermont, December 2004, p. 5 - 6, <http://crs.uvm.edu/digitaldivide/> .

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We need a lease agreement or utility bill that includes a date to prove where you live. In order to prove the child lived with you, we need school or doctor records that show the same address as your utility bill or lease agreement and that show that both you and your child lived together for at least six months of the tax year.

- Change the writing style of IRS correspondence to improve clarity and reduce the education level needed to understand the information. This is especially true of terminology such as residency, relationship, and income. Correspondence should be clear and express what was denied (or whom), why it was denied and what is needed to substantiate the claim.
- Develop a checklist for taxpayers' that shows acceptable documents and stresses what the documents must prove. This could be set up to show that one or two items are needed from each column to claim EITC. Or since the supporting documentation chart is very confusing to these taxpayers, using a flowchart to present the information may be more effective.
- Modify terminology that is misleading and confusing, particularly the phrase that refers to children as "...care for as your own..." which causes people to believe that they can claim a child even if the parent is eligible to claim the child.³ Partner with other government agencies to educate taxpayers on financial issues through outreach activities such as demonstrations at community centers.
- Instruct taxpayers to gather the supporting documents and keep them with their copy of the tax return in case there are questions about eligibility later. These directions should be included in the instruction booklets, publications, etc.
- Published EITC materials should be available in different languages. Add story examples in the instruction booklets and publications tailored to the immigrant community.

³ Restrictions on claiming children were recently modified and the attorneys may have been referring to situations they encountered on previous years' tax returns.

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- Provide a name and phone number of a local examiner for clients to discuss their EITC claim (should be able to contact the same person every time for efficiency and effectiveness). The assigned auditor should have the knowledge and authority to make a decision.
- EITC filer's family relationships are blended and are not easily defined. Examples in the instructions and information booklets should give scenarios that mirror the real life situations of taxpayers.
- Consider living arrangements and develop a list of acceptable supporting documentation based on non-traditional living arrangements.
- Partner with other government agencies to educate taxpayers on financial issues through outreach activities such as demonstrations at community centers.
- Regulate small tax preparers and require them to attend some training classes annually (such as those that VITA volunteers attend).
- Include a phone number in large type font for taxpayers to call with questions.