

THE IRS EIC AUDIT PROCESS
— A CHALLENGE FOR
TAXPAYERS

2007

IRS Earned Income Credit Audits — A Challenge to Taxpayers

Executive Summary

This report outlines two key facets of IRS audits of taxpayers claiming the Earned Income Credit (EIC). The first section of the report details barriers faced by taxpayers when negotiating the EIC audit process. Potential EIC barriers were determined from targeted interviews with Low Income Taxpayer Clinic (LITC) attorneys and from tax preparer feedback at Taxpayer Advocate Service (TAS) focus groups with preparers at the IRS Tax Forums. Subsequently, a representative sample of audited taxpayers was surveyed to quantify the prevalence of these barriers. The second section of the report discusses EIC audit results which are likely related to the previously discussed barriers faced by taxpayers during EIC audits. Specifically, data show that taxpayers who are represented during an EIC audit fare significantly better than those taxpayers without representation during an EIC audit, even though relatively few EIC taxpayers obtain representation for their audit.¹

Barriers faced by taxpayers during EIC audits may be divided into three primary categories: communication, documentation, and process. Communication difficulties occur at the point of initial audit notification and throughout the audit as the IRS attempts to contact the taxpayer for information to verify the EIC claim. Audited taxpayers often reported difficulties obtaining requested documentation and substantial delays in IRS acknowledgment of provided documentation. The majority of taxpayers reported that they would prefer to communicate with the IRS about their audit in a manner other than by correspondence. Additionally taxpayers noted the necessity of sending in the same documents multiple times and providing new documentation not requested in the IRS' initial correspondence about the audit. Many respondents did not believe that the IRS considered all of the provided documentation when deciding the audit outcome.

The second section of this report compares EIC audit results from taxpayers with representation during the audit to taxpayers without representation. As mentioned, taxpayers fare better, in terms of keeping more EIC, if they have representation.² This report is an update of a previously published TAS Research report which examined EIC audit results from audits of tax year (TY) 2002 returns.³ Although the gap between EIC audit results of represented and unrepresented taxpayers has narrowed slightly between TY 2002 and TY 2004, the National Taxpayer Advocate is still concerned by the fact that unrepresented taxpayers do not receive as favorable an outcome as represented taxpayers. Moreover, the narrowing in the gap from TY 2002 to TY 2004 between the EIC audit outcomes of represented and unrepresented taxpayers is primarily attributable to represented taxpayers

¹ Only 1.8 percent of TY 2004 EIC audited taxpayers had representation during the audit, down from 3.5 percent in TY 2002.

² Results are based on TY 2004 audits completed by the end of June 2007.

³ Impact of Taxpayer Representation on the Outcome of Earned Income Credit Audits, August 2007, to be published in an upcoming Statistics of Income Research Bulletin.

having less success in the audit process, as opposed to unrepresented taxpayers faring better. Even though the results of TY 2004 audits show less favorable results than from TY 2002, the findings in this report show that unrepresented taxpayers are still significantly more likely to lose EIC during an audit than are represented taxpayers. Some will argue that represented taxpayers fare better in EIC audits because compliant taxpayers seek out representation; however, an analysis of self selection bias from the TY 2002 study showed that this presumption is not well founded.

The barriers faced by taxpayers during EIC audits and the gap in audit outcomes between represented and unrepresented taxpayers have important ramifications for the administration of EIC compliance. At a minimum, they suggest that corrective actions are necessary for the IRS to consistently reach the right conclusion on taxpayer eligibility for all taxpayers. While the National Taxpayer Advocate acknowledges the critical role that auditing serves in tax administration, IRS audit procedures must ensure that the correct audit determination is made. Failure to do so will erode taxpayer confidence in the fairness of the tax system. Moreover, inappropriately denying eligible taxpayers EIC deprives taxpayers of needed funds to support themselves and their families.

The key findings from this report are as follows:

Audit Barriers

- Less than one-third of EIC audited taxpayers thought the IRS audit notification letter was easy to understand, and only about half of the respondents felt that they knew what they needed to do in response to the audit letter.
- Over 90 percent of EIC audited taxpayers contacted the IRS about their audit.
- Nearly three-quarters of EIC audited taxpayers personally called or visited the IRS in response to the IRS audit notification letter, mostly due to communication issues. For example, 60 percent of those who contacted the IRS were seeking guidance on what documentation to send. More than half of the taxpayers undergoing an EIC audit reported that the IRS took more than 30 days to acknowledge receipt of their documentation or provided no acknowledgement.
- More than half of EIC audited taxpayers reported difficulties obtaining the documents requested by the IRS, and almost half of the taxpayers did not understand why the documents were requested by the IRS.
- More than 70 percent of EIC audited taxpayers stated a preference for an audit by a means other than correspondence.
- More than half of the EIC audited taxpayers who reported supplying all of the documents originally requested by the IRS also received an IRS request for additional documentation.
- More than one-third of the EIC audited taxpayers believed that the IRS did not consider all of their documentation.

Impact of Representation

- Taxpayers who use representatives are nearly twice as likely to be found eligible for the EIC as compared to taxpayers who are not represented during the audit process.
- Over 40 percent of all taxpayers with representatives emerged from their audit with their full EIC intact, whereas less than one in four taxpayers without a representative kept their full EIC.
- The taxpayers without representation were more likely to end up owing additional *tax* than taxpayers with representation (41 percent versus 23 percent).
- The vast majority of taxpayers who undergo an EIC audit do not have representation, and the number of taxpayers with representation during the EIC audit declined significantly from TY 2002 to TY 2004.

In response to these findings, the National Taxpayer Advocate makes the following recommendations.

- Increase taxpayer awareness of the legal assistance available at LITCs.
- Ensure all correspondence during the EIC audit provides taxpayers with references for contacting a LITC.
- Inform taxpayers of the closest LITC. Since these locations change annually taxpayers could be instructed to call TAS if the LITC is no longer participating in the program.
- If a taxpayer cannot provide all requested documentation to verify EIC eligibility, and the IRS has no information to dispute the EIC claim, allow the taxpayer to provide an affidavit from an IRS approved source to prove EIC eligibility.
- Assign one worker to each EIC audit. Provide the worker's name, phone number, and address in all correspondence with the taxpayer.
- Call taxpayers, whenever possible, to see if verbal communication can resolve any miscommunication.
- Revise EIC audit letters. Letters should be written to address the taxpayers' personal tax return and should specifically state that the taxpayers' tax return is being audited. The letters should clearly list the specific issues of the audit and explain what the taxpayer must do to resolve each issue, and should also explain how the documentation relates to the issue in question.
- Provide timely acknowledgements to all documentation and materials received from the taxpayer.
- Inform taxpayers of the right to a face-to-face audit and what steps must be taken to request the audit be changed to face-to-face.
- Provide a checklist that taxpayers can use to guide them in securing the proper documents and steps needed to validate their eligibility.

Introduction

The IRS administers the Earned Income Credit (EIC) to millions of taxpayers each year.⁴ An important aspect of effective tax administration is to ensure the accuracy of the EIC claims. One way the IRS does this is by auditing some of the returns filed. The outcome of the audit presumably validates the taxpayers' eligibility for the EIC. As a matter of fairness and effective tax administration, the IRS must work with taxpayers and their representatives to ensure the EIC is accurately claimed.

EIC audits represent approximately 40 percent of all IRS individual taxpayer audits.⁵ The vast majority of these taxpayers do not have professional representation during the audit. This is perhaps not too surprising, given the income level of these taxpayers and their likely unfamiliarity in dealing with the IRS on issues involving complicated matters of tax law. Anecdotal reviews of EIC audits, where EIC was disallowed, show that frequently there is no significant evidence that the taxpayer was ineligible. Instead, the taxpayer failed to prove EIC eligibility.⁶ For example, when asked to provide school records to verify the six months residency requirement, taxpayers often submit records for a single school year. Given that a typical school year overlaps two calendar years, this information is insufficient to prove residency to the IRS, but is not evidence that the taxpayer is ineligible for the credit.

The law clearly places the burden of proof on the taxpayer, but if the taxpayer cannot sufficiently understand the rules or negotiate the audit process, reaching the goal of a correct audit outcome is brought into question. The National Taxpayer Advocate is compelled to ask if the lack of representation during an audit puts EIC taxpayers at an inherent disadvantage over those taxpayers who are represented. Accordingly, the National Taxpayer Advocate wanted to both explore the audit process from the taxpayer's perspective and to examine the audit outcome, particularly with respect to whether the taxpayer had assistance with the navigation of the audit process. Taxpayer Advocate Service (TAS) Research approached the analysis of EIC audits in two ways. In one approach, TAS⁷ developed a study using surveys to obtain taxpayer information regarding their experiences with the audit process. This survey especially focused on barriers that taxpayers face in responding to an IRS EIC audit. In the second approach, TAS examined the outcome of EIC audits to determine if the use of a representative enabled a taxpayer to keep his or her EIC, or at least retain a larger amount of it after the audit.⁸

⁴ Over 22 million filers claimed EIC in TY 2004, EIC Fact Sheet for TY 2004 as of December 31, 2005.

⁵ IRS, *FY 2006 Data Book*, Table 9 (40.3 percent or 517,617 EIC audits).

⁶ Wage & Investment Research review of 43 closed EIC audits.

⁷ In conjunction with Wage & Investment Research and the EIC Program Office.

⁸ A representative includes an attorney, certified public accountant, enrolled agent, or an unenrolled preparer who prepared the tax return under audit.

Ideally, the EIC audit process would be painless for taxpayers, and the IRS would be able to reach the right outcome on EIC eligibility regardless of the presence of a representative.⁹ As we will see in the body of this report, taxpayers face several barriers during the EIC audit process. Furthermore, the use of a representative does appear to have a significant impact on the outcome of the audit and the amount of the EIC retained by the taxpayer. These findings suggest the IRS must work harder and smarter to reach an accurate resolution to the EIC eligibility issues, particularly when the taxpayer does not have a representative.¹⁰

Given scarce resources, the IRS and taxpayers will be challenged to find a way to better verify EIC eligibility in an audit environment. The IRS simply cannot provide a representative to each taxpayer. Nevertheless, the IRS can improve the EIC audit process as well as suggest free representative alternatives to taxpayers. The National Taxpayer Advocate believes this study compels the IRS to find new ways of reaching out to those taxpayers who do not have representation. The awarding of EIC to ineligible taxpayers costs the government billions of dollars; however, disallowing EIC to those taxpayers truly eligible for the credit is negatively impacting their already fragile financial well being.

Background

Prior IRS studies indicate a significant proportion of claimants historically have not been entitled to the Earned Income Credit (EIC). For example, of the approximately \$31.3 billion in EIC claims made by taxpayers who filed TY 1999 returns in 2000, it is estimated that between \$8.5 and \$9.9 billion (27 percent to 32 percent) should not have been paid.¹¹ These estimates were derived by auditing a sample of 3,457 taxpayer returns that claimed the EIC. TAS is interested in knowing if administrative barriers contribute to taxpayers being unable to prove EIC eligibility and if taxpayers would have fared better (*i.e.*, kept their EIC or lost less of their EIC) had they obtained representation.

TAS recognizes the critical role that auditing serves in tax administration. IRS audits help ensure taxpayer compliance and protect the tax revenue base. However, the National Taxpayer Advocate is concerned by the findings from recent focus groups and targeted interviews with taxpayer representatives regarding barriers taxpayers face during IRS audits. TAS conducted focus groups with taxpayer representatives at the 2005 IRS tax forums and also initiated targeted interviews with LITC attorneys to discuss problems with audit processes relevant to EIC. In particular, TAS sought to learn what barriers the representatives perceived that prevented the IRS and the taxpayers from reaching the correct outcome on EIC eligibility and amount claimed. The representatives identified several barriers including inconsistent IRS requests for documentation, lost paperwork, and poor

⁹ After controlling for self-selection by taxpayers that use a representative, the IRS would presumably find similar rates of EIC eligibility.

¹⁰ The IRS must also ensure that represented taxpayers do not unfairly receive EIC.

¹¹ IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns*, (Feb. 28, 2002). Tax returns were filed in 2000 for TY1999.

communication.¹² These identified barriers formed the basis for a TAS survey conducted in conjunction with the EIC Program Office and Wage & Investment (W&I) Research to obtain input from taxpayers regarding their EIC audit experiences, including barriers faced by taxpayers during audits.

The National Taxpayer Advocate is concerned that various barriers are preventing the IRS from treating taxpayers fairly. In particular, TAS wants to achieve a proper balance between EIC compliance and accurately determining taxpayers' eligibility for the EIC. If these barriers are preventing the IRS and taxpayers from accurately determining the correct amount of EIC, the IRS may be inadvertently denying taxpayers a credit they are legitimately entitled to.

EIC filers have several attributes that may hinder their ability to respond effectively to an audit.¹³ These attributes may impede the communication and understanding of requests made by the IRS during an audit of the taxpayers' EIC. These problems are exacerbated by the IRS administrative barriers raised in the previously discussed focus groups and interviews. TAS is concerned these taxpayer attributes and aforementioned barriers are leading the IRS to improperly deny taxpayers their EIC.

The National Taxpayer Advocate recognizes the repercussions this may have on tax administration. She tasked TAS Research to explore the following two issues:

Audit Barriers

- *Identify the type and frequency of barriers faced by taxpayers during EIC audits.*

Impacts of Representation

- *Determine if taxpayers who have representation fare better in EIC audits as compared to those who do not have representation?¹⁴*

If a significant number of taxpayers are affected by substantive audit barriers, and if represented taxpayers fare better in an EIC audit than unrepresented taxpayers, the IRS must reconsider its approach to EIC audits. The IRS will need to develop compliance programs that verify the EIC in such a way as to minimize the use of audits or modify the way the

¹² The National Taxpayer Advocate's Findings from Correspondence Examination Focus Groups, IRS Tax Forums June – September 2005, December 2005 and Taxpayer Advocate Service's Challenges for Taxpayers Claiming the Earned Income Tax Credit (EIC), from interviews with Low Income Taxpayer Clinics, September 2005. The studies suggested that taxpayers often possess only rudimentary literacy skills, and do not understand IRS' generalized correspondence; they do not understand what supporting documentation needs to prove; and they struggle because they do not have one IRS worker assigned to their case. Participants suggested that IRS should at least: review all relevant documents and information it possesses about a case in a timely manner and prior to requesting more documentation; assign one worker to each case and provide taxpayers with their name and telephone number; develop a checklist of information required for EIC claimants, and be specific about what information taxpayers should send and whether documents should be original or copies.

¹³ Attributes of EIC filers include: less likely to speak English; less education, lower income levels. *Playing by the Rules, but Losing the Game – America's Working Poor*, Urban Institute <http://www.urban.org/publications/410404.html>. These attributes suggest that EIC taxpayers may be less likely to understand IRS correspondence and less able to afford representation (i.e., power of attorney) with IRS.

¹⁴ This issue was explored through the analysis of three objectives: Determining rate of EIC change, proportion of EIC retained, and rate of tax change.

audits are conducted. Such potential changes could impact tens of thousands of taxpayers who claim the EIC.

Research Methods

Audit Barriers

The Audit Barriers study focused on taxpayers who claimed EIC for TY 2004 and whose tax returns were audited. Taxpayers were selected using the Automated Information Management System (AIMS) TY 2004 audit data. The original study data contained 387,821 TY 2004 returns closed between March 2005 and April 2006. Some taxpayers were excluded from sample selection as follows:

1. Taxpayers in a Federal Emergency Management Agency (FEMA) declared disaster area;
2. Taxpayers with undelivered¹⁵ audit notices, since they never participated in the audit process;
3. Taxpayers who filed a Form 1040X, due to insufficient data regarding the claim;
4. Taxpayers who were selected for audit as part of a special EIC projects (EIC Pre-Certification, EIC Post Refund Filing Status, EIC Single Issue Audit Test, EIC Criminal Investigation Fraud Referrals, and EIC Fraud projects¹⁶), since they received different audit notices;
5. Taxpayers who did not file a tax return prior to the audit, since they were not part of the target population; and
6. Taxpayers who were under criminal investigation.

A simple random sample (without replacement) was generated from the remaining population of 230,127 audited EIC tax returns. The sampling plan was designed to achieve an overall accuracy of plus or minus five percent at the 95 percent confidence level, assuming the rate of occurrence for a particular answer to a question to be 50 percent.

Using a multiple wave process, nearly 4,000 surveys were mailed to taxpayers who claimed EIC and were audited. The response rate for the survey was about 24 percent.¹⁷ An analysis of the respondents showed close similarity to the EIC audit population across a variety of demographic characteristics. Therefore, the survey results are likely reflective of the general EIC audit population for TY 2004, even though the response rate is relatively low.¹⁸ The mailing consisted of four different products: first, a postcard was

¹⁵ Undelivered mail was determined from the AIMS technique code field.

¹⁶ The project codes eliminated from this study were project codes 132, 576, 577, 579, 580, 581, 584, 585, 691, and 710.

¹⁷ Surveys were mailed to 3,960 taxpayers; however, mail was returned as undeliverable to 811 of these taxpayers. Surveys were returned from 754 different taxpayers.

¹⁸ Survey percentages in this report have a margin of error of plus or minus 4 percent at the 95 percent confidence level.

mailed approximately one week *prior* to the survey; the next mailing consisted of a cover letter, copy of the survey, and a self-addressed stamped envelope;¹⁹ the third mailing was a follow-up postcard (sent to everyone in the sample) as a thank you to respondents and as a reminder to those who had not responded, and a final mailing (sent only to non-responders) included a second survey cover letter, replacement survey, and self addressed, first-class postage paid return envelope.²⁰

Impact of Representation

The population studied in this analysis was comprised of TY 2004 returns audited for EIC issues. EIC returns were selected for audit through various means including Dependent Database (DDb) processing, Discriminate Income Function (DIF), and EIC Recertification procedures.²¹ TY 2004 was chosen since it is the most recent tax year for which most of the audits have been completed. We are also reporting on TY 2002 audits, so that we may review case activities that occurred subsequent to the close of the initial audit.²² For this study, TAS Research selected cases from the AIMS closed case database by project code. The list of project codes used to determine EIC audit cases was obtained from the EIC Program Office. We determined that some returns in these project codes never claimed or received EIC, according to IRS Masterfile data, and therefore removed them from our analysis. We removed some additional returns from our study because insufficient data was available for analysis.²³

We supplemented the AIMS population data with other individual tax return data to obtain items such as amount of EIC claimed by the taxpayer and allowed by the IRS, as well as income information from the return, and entity items such as filing status and return preparation method. Lastly, we used the Compliance Research Initiative Tracking System (CRITS)²⁴ to obtain additional data necessary to analyze the outcome of the audits. Most notably, we obtained the IRS Masterfile transactions²⁵ for the credit and debit of EIC. We used this transaction data to determine the amount of EIC claimed by the taxpayer, allowed by the IRS during return processing, and the amount of EIC ultimately allowed after the initial audit of the return. Masterfile transaction code data was also utilized to verify the presence of representation during the audit.

¹⁹ The first two mailings provided background to the survey, stressed the importance of the survey, and requested that the respondent reply quickly.

²⁰ Surveys were made available in English and Spanish. Each contact mailing also contained a message that if a Spanish language survey was preferred, taxpayers could request the materials in Spanish by calling a toll-free number. Those calling the number were asked to leave a message saying they needed the survey in Spanish and providing the control number at the top of the survey. A total of twelve taxpayers who were mailed a survey called and requested a Spanish survey. Only five of the twelve that were mailed the Spanish version actually returned the survey.

²¹ If EIC for any year after 1996 was denied or reduced for any reason other than a mathematical or clerical error, a Form 8862 is required to be filed with the next tax return if claiming EIC with qualifying children.

²² TAS Research previously published a report on the effect of representation on TY 2002 EIC audits. This report is designed to serve as an update of the previous analysis of TY 2002 audits; however, sufficient time has not elapsed to comprehensively review post audit activity on the TY 2004 EIC audits.

²³ See data limitations in the following section.

²⁴ CRITS data contains current Individual Returns Transaction File (IRTF) and Masterfile data elements.

²⁵ The IRS posts debits (*i.e.*, tax assessments) and credits (*e.g.*, EIC credit) to a taxpayer's account with different codes so that the type of each debit or credit may be clearly identified. Separate codes are also used to denote other account activity such as the authorization of a representative for a taxpayer.

We then split the population data into two groups: those taxpayers with representation during the audit and those without representation. The determination of whether a taxpayer was represented during audit was made by the presence or absence and timing of specific Masterfile transaction codes which show whether a taxpayer has representation. Additionally, we used the Centralized Authorization File (CAF) data to identify represented taxpayers. The CAF data also identifies the type of representative.²⁶ The CAF data was cross-referenced with the Masterfile transaction codes indicating the presence or removal of a representative. In a few cases, the CAF and Masterfile data were discrepant and these cases were removed from the study population.²⁷

We used Masterfile transaction codes to split transaction code data from the Masterfile into four time periods: before audit, first audit, second audit,²⁸ and after audit. Transaction codes with cycles posting before the Examination start date were included in the before audit time period. We included transaction codes with cycles posting between the Examination start date and the first audit disposition date in the first audit period. The second audit time period included transaction codes posting between the first audit disposition date and the second audit disposition date. We incorporated transaction codes after the last audit disposition date in the after audit time period. We defined representation,²⁹ EIC change,³⁰ and tax change³¹ for each of the time periods. This report includes analysis using the before audit and first audit time periods for TY 2004 audits. A separate section on the post audit period is also included for TY 2002 audit results.³²

Unless otherwise noted, the findings are based on a dataset containing 427,807 taxpayers. Of these returns only 7,688 (1.8 percent) were represented in the original audit. The original study data contained 476,178 returns³³ with an EIC project code. However, as described in the following limitations section, several circumstances necessitated the removal of returns from the study.

Limitations

When analyzing the data, TAS Research discovered several anomalies in the data for the population of TY 2004 EIC taxpayers who were audited. Based on this analysis, we eliminated returns with the following characteristics from the population:

²⁶ For example, attorney, certified public accountant, enrolled agent, or an unenrolled preparer, etc.

²⁷ 854 cases were removed for this reason.

²⁸ A small number of cases (225) did not have a transaction code 421 denoting the end of the audit. In these instances, we used the AIMS disposal date to determine the ending point of the audit. Because of the lag between AIMS and Masterfile, we added four cycles to the AIMS disposal date to determine the proper audit closing date.

²⁹ Representation is noted on a tax module by transaction codes 960, 961 and 962.

³⁰ EIC change was determined from transaction codes 764, 765, and 768.

³¹ We used transaction codes 290, 291, 294, 295, 300, 301, 304, and 305 to compute tax change.

³² Sufficient time has not elapsed to fully examine the TY 2004 post audit period.

³³ Data extracted as of August 2007.

1. Taxpayers who did not claim EIC on their tax return or did not check the box on their tax return to have the IRS compute EIC for them (10,060);
2. Taxpayers with undelivered³⁴ audit notices were removed since they never participated in the audit process (31,630);
3. Taxpayers whose filing status was Married Filing Separate (MFS). This group was eliminated due to incomplete information on changes to filing status (*i.e.* – Married Filing Separate to Head of Household) (20);
4. Taxpayers with missing tax return data on the CRITS or Compliance Data Warehouse (CDW) (115);
5. Taxpayers who filed a Form 1040X were removed due to insufficient data regarding the claim (5,692); and
6. Taxpayers with inconsistent representation information on Masterfile (transaction code 960) and CAF data (854).³⁵

During data analysis, TAS Research also observed instances where the data showed the taxpayer did not have qualifying children, but EIC before audit and the change in EIC due to the audit were greater than the maximum amount of EIC allowed for taxpayers without children. To correct for this anomaly, we updated the number of qualifying children based upon the EIC Table in Publication 596 for TY 2004.³⁶

Findings

Audit Barriers³⁷

The Audit Barriers Survey project was designed to determine the type and frequency of barriers faced by taxpayers during EIC audits. For reporting purposes, these barriers and their prevalence have been compiled into three objectives as described hereafter.

Objective 1: Identify and quantify communication problems associated with taxpayers' notification by the IRS of an EIC audit.

The IRS sends letters to notify taxpayers claiming EIC that their tax return is being audited. However, the letters are unclear and difficult for many of the recipients to understand. Overall, more than one-quarter of taxpayers receiving an EIC audit notice did not understand that the IRS was auditing their return. An even larger percentage, almost 40 percent, of the respondents did not understand what the IRS was questioning about their EIC claim.

³⁴ Undelivered mail was determined from the AIMS technique code field.

³⁵ The CAF data file contains information from the Form 2848, Power of Attorney and Declaration of Representative. For purposes of this study, a taxpayer was considered represented if the representative authorization appeared on both the CAF and the IRS Masterfile.

³⁶ There were 155 of these cases.

³⁷ Survey data for the Audit Barriers findings were cleaned to enforce skip patterns in the survey. A complete summary of the Audit Barriers survey findings are contained in a report by W&I Research entitled, EITC Audit Barriers Study Project # 6-05-12-048E, September 2007.

Similarly, only about half of the respondents felt that they knew what they needed to do in response to the audit letter.

More than 70 percent of the respondents did not think that the audit notification letter was easy to understand.³⁸ The majority of those respondents who struggled to comprehend the letter stated that the terms, explanations, and instructions made understanding the letter difficult. The most common complaints about the letter are summarized below:

TABLE 1, Understanding the Audit Letter

Difficulties with IRS Letter	Percentage of Respondents
Did not understand IRS was auditing return	26.5%
Did not understand what IRS was questioning	38.9%
Difficulties with Understanding Letter	
▪ Did not understand some words/terms	42.7%
▪ Letter did not explain what documents to send to the IRS	22.0%
▪ Instructions were hard to follow	16.2%
▪ Tone of letter scared taxpayer	16.4%
▪ Hard to read	11.2%

The remaining respondents listed other specific complaints or did not remember the letter sufficiently.

Even though slightly over half of the respondents indicated that they understood what was being questioned and knew what they needed to do, overall, more than 90 percent contacted the IRS. Seventy-two percent of the respondents said that they either called or visited the IRS in response to the letter. More than 75 percent of those taxpayers contacting the IRS about their audit letter did so by telephone. The most common reasons for contacting the IRS about the letter were for assistance with understanding the letter (45 percent) and for assistance with determining what documentation to send (60 percent).

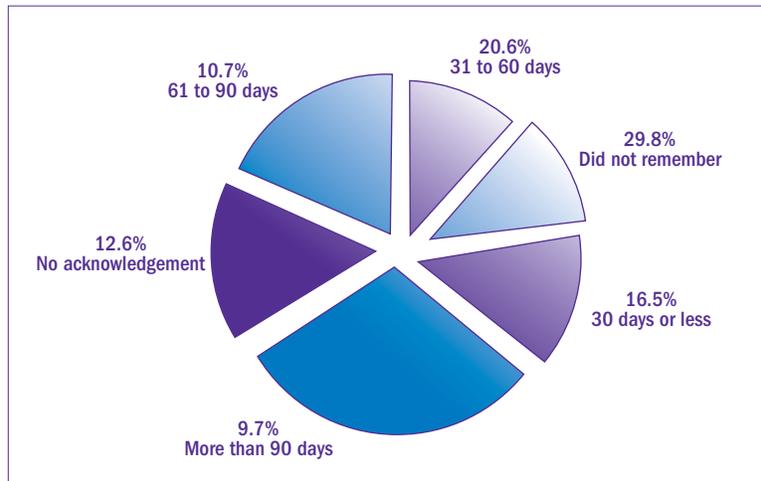
About 87 percent of respondents reported contacting someone for help after receiving the IRS letter informing them that their tax return was being audited. Respondents reported contacting the IRS more than any other avenue for help, followed by contacting paid preparers, a friend, relative, or neighbor, or a Low Income Taxpayer Clinic (LITC).

³⁸ Those who did not understand what the IRS was questioning on their tax return were much more likely than those who did understand what IRS was questioning to find the letter hard to read, to find terms difficult to understand, to have problems following letter instructions, to state that the letter did not say what to send to IRS, and to be scared by the tone of the letter.

Objective 2: Describe and quantify problems faced by taxpayers as they attempt to provide documents to substantiate their EIC eligibility.

As indicated in the following chart, taxpayers who responded to the IRS with documentation to support their EIC claim generally experienced long wait times for the IRS to acknowledge receipt of the documentation, with some claiming to receive no acknowledgement.³⁹

CHART 1, Time for IRS to Acknowledge Receipt of Documents

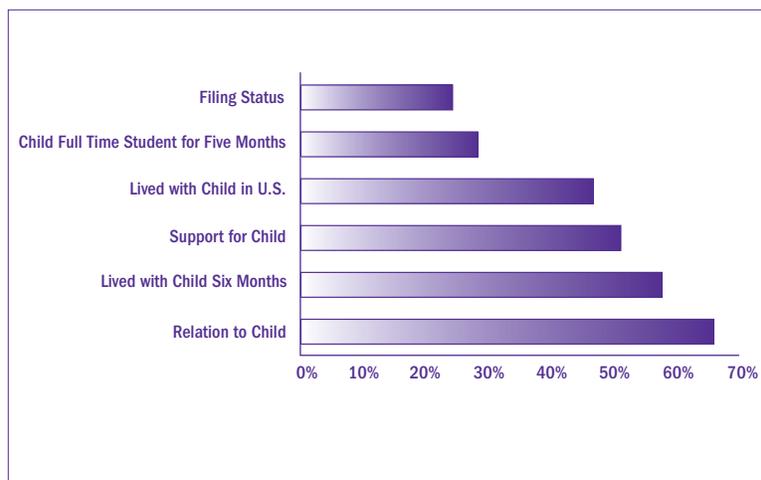


The IRS requests documentation to verify a variety of EIC eligibility factors. Most of the respondents were asked to prove more than one issue pertaining to EIC.⁴⁰ The following chart depicts the eligibility factors which taxpayers most frequently reported as being issues in their audit.

³⁹ Respondents who reported sending no documentation were directed to skip this question. Results are based on 621 respondents, which still provides a margin of error of plus or minus four percent at the 95 percent confidence level.

⁴⁰ Respondents were asked to provide documentation on multiple issues: 33.2 percent were asked to prove two to three issues, 33.2 percent were asked for documentation to prove four to five issues, and another 10.9 percent had to prove more than six issues.

CHART 2, Issues Requiring Additional Documentation



A little more than half of the respondents (55 percent) indicated an understanding of how the documents would answer the IRS questions about the EIC Claim.

About 41 percent of the respondents indicated that obtaining the required documentation was easy. The remainder reported a variety of obstacles in obtaining the documentation. The most common difficulties are summarized in the following table:

TABLE 2, Obtaining Documentation

Difficulty with Obtaining Documents	Percentage of Respondents
Take time off work	20.9%
Could not find all documents	17.6%
Did not keep records	15.9%
Did not know what documents needed	12.3%
Did not know where to get documents	10.3%
Had to pay for documents	10.2%

Nearly two-thirds of the respondents indicated that they sent the documents requested by the IRS.

Objective 3: Describe taxpayer experiences during the EIC audit, including process barriers which hinder prompt and accurate audit resolution.

In addition to problems with the IRS’s communication of the audit notification and required documentation, taxpayers also reported a variety of problems with the EIC audit process. Perhaps of most concern is that more than 70 percent of respondents prefer

to communicate with IRS in a manner other than correspondence, with 46 percent of respondents preferring to communicate about their audit with the IRS by telephone, and another 23 percent preferring to communicate in person. About a third of the respondents reported that it was easy to communicate with the IRS by correspondence, while more than half of the respondents reported that it was easy to communicate with the IRS by telephone. Nevertheless, the IRS routinely conducts the vast majority of its EIC audits by correspondence. Regarding their experience when contacting the IRS concerning their audit notice, only about half of the taxpayers rated the IRS as helpful. The most common complaints are summarized below:

TABLE 3, Contacting IRS

Experience When Contacting IRS	Percentage of Respondents
Could not talk to the same person	31.8%
Did not understand IRS response	18.7%
IRS did not have all documents regarding audit case	14.5%
IRS worker was not familiar with audit case	13.1%

One of the difficulties of the correspondence audit process is ensuring that the proper documentation is received and considered by the IRS. Only 42 percent of participants who stated they sent in all the documents requested in the initial letter were not asked for additional documentation. About 39 percent of the respondents reported having to send the same documents multiple times, while about 19 percent were asked for different documents than those stated in the IRS' initial request. When evaluating the result of the audit, 35 percent of the respondents believed the IRS had not considered all of their submitted documentation. The most common documents reported as not being considered are presented in the following table:

TABLE 4, Documents not Considered

Documents Not Considered	Percentage of Respondents
Birth Certificate	54.9%
School Records	48.1%
Social Security Number	46.2%
Medical Records	29.1%
Utility Records	26.1%
Lease Agreement	21.6%

Similar to the percentage of respondents who believed that the IRS did not consider all of their submitted documentation, 36 percent of respondents did not believe the IRS made the correct decision regarding their EIC audit.

Given the variety of difficulties with navigating the audit process, it is not surprising that few of the respondents attempted to respond to the IRS audit without some type of assistance. In many instances, the taxpayers sought assistance directly from the IRS, yet only about half of the respondents found the IRS to be helpful.

Given the significant barriers encountered by EIC taxpayers during the audit process, one must consider whether many audited taxpayers are truly ineligible for EIC, or whether they were just unable to successfully navigate the IRS audit process. To this end, the National Taxpayer Advocate has postulated that taxpayers with representatives during EIC audits fare better than their non-represented counterparts. The following section of this report will explore this possibility.

Impact of Representation

Objective 1: Determine if taxpayers with representation in EIC audits are more likely to be determined eligible for EIC (and to have a higher no change rate) than taxpayers without representation in EIC audits.

Finding: Represented taxpayers are nearly twice as likely to be found eligible for EIC and to have no changes made to their EIC.

Table 5 depicts the percentage of taxpayers who retained at least some EIC after audit. Clearly, represented taxpayers were much more likely to retain their EIC after audit than those taxpayers without representation. In fact, taxpayers who used a representative during the audit process were nearly twice as likely to be determined EIC eligible when compared to taxpayers without representation.⁴¹

TABLE 5, EIC Retained/Disallowed During Audit

Percentage of Taxpayers with:	Not Represented	Represented
No change in EIC ⁴²	23.1%	41.5%
EIC reduced	4.3%	6.1%
EIC disallowed in full	72.6%	52.4%
Total	100.0%	100.0%

Source: IRTF TY 2004 & CAF for TY 2004

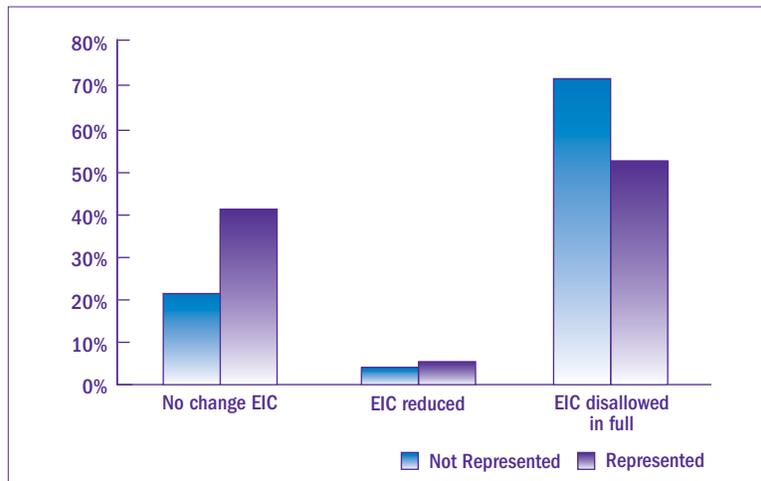
Likewise, Table 5 shows that the “no change” rate for represented taxpayers is also nearly double that for the unrepresented taxpayers. A comparison of the data in this table indicates that relatively few taxpayers remain eligible for EIC, but receive a reduced amount. This circumstance is likely attributable to the fact that EIC eligibility is mostly

⁴¹ The percentage of taxpayers retaining some EIC is 47.6 percent for taxpayers who were represented compared with 27.4 percent retaining some EIC for taxpayers without representation. The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

⁴² This “No Change” rate includes taxpayers who actually received additional EIC as a result of the audit. This includes 0.35 percent overall of unrepresented taxpayers and 1.0 percent overall of represented taxpayers.

based on hard and fast rules regarding a child’s relation to and residency with a taxpayer. Accordingly, little middle ground remains for a partial allowance of EIC, underscoring the importance of the IRS reaching a correct audit determination.

CHART 3, Impact of Representation on EIC Allowed During Audit



Source: IRTF TY 2004 & CAF for TY 2004

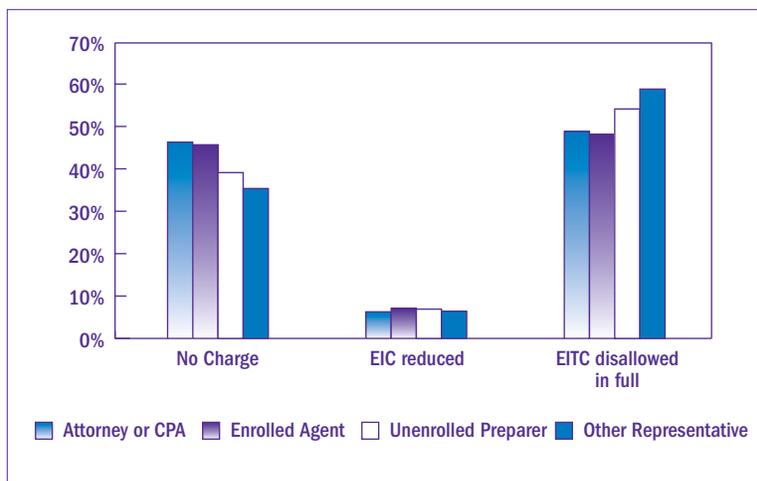
The type of representative also has an impact on the change in the amount of EIC received, as shown in the following Table 6. Nearly 46 percent of taxpayers represented by attorneys and CPAs retain the full amount of their EIC claim. Taxpayers represented by generally less sophisticated unenrolled preparers retained EIC for their clients only 39 percent of the time. This finding implies that representatives with more training are better able to successfully represent their clients and suggests that minimum standards should be considered to enable a representative to practice before the IRS. Nevertheless, it should be noted taxpayers using representatives with fewer credentials still achieve considerably more favorable results than taxpayers without representation.

TABLE 6, EIC Retained/Disallowed During Audit by Type of Representative

	Attorney or CPA	Enrolled Agent	Unenrolled Preparer	Other Representative ⁴³	Total ⁴⁴
Count	2,356	1,452	2,139	1,407	7,354
Percentage of taxpayers with no change in EIC ⁴⁵	45.8%	45.1%	38.9%	35.4%	41.7%
Percentage of taxpayers whose EIC was reduced	5.7%	6.9%	6.8%	5.5%	6.2%
Percentage of taxpayers whose EIC was disallowed in full	48.5%	48.0%	54.3%	59.1%	52.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: IRTF TY 2004 & CAF for TY 2004

CHART 4, EIC Retained/Disallowed During Audit by Type of Representative



Source: IRTF TY 2004 & CAF for TY 2004

⁴³ The “Other Representative” category includes fulltime employees (officers) of the taxpayer’s organization, family members, enrolled actuaries, law students and accounting students.

⁴⁴ Excludes 334 audited returns where the type of representative could not be determined from IRS data.

⁴⁵ This “No Change” rate includes taxpayers who actually received additional EIC as a result of the audit. Overall, 0.35 percent of unrepresented taxpayers and 1.0 percent of represented taxpayers received additional EIC.

Objective 2: Determine if taxpayers with representation in EIC audits retain a greater proportion of the EIC originally claimed than taxpayers without representation in EIC audits.

Finding: Represented taxpayers retain more of their EIC.

The prior section focused on the percentage of taxpayers whose EIC was reduced or remained the same. Another way to analyze the data is to look at the percentage of EIC dollars retained. Table 7 below shows that taxpayers with representation retained, on average, 45 percent of their EIC versus 25 percent for taxpayers without representation.

TABLE 7, Portion of EIC Retained During Audit

	Not Represented	Represented
Average percentage of original EIC retained	25.3%	44.8%

Source: IRTF TY 2004 & CAF for TY 2004

As in the prior section, taxpayers using representatives with more credentials had more favorable outcomes. Table 8 shows that taxpayers who used an attorney or CPA retained 49 percent of their EIC during the audit, almost seven points higher than unenrolled preparers and over ten percentage points higher than for other representatives.

TABLE 8, Portion of EIC Retained During Audit by Type of Representative

	Attorney or CPA	Enrolled Agent	Unenrolled Preparer	Other Representative	Total ⁴⁶
Count	2,356	1,452	2,139	1,407	7,354
Average percentage of original EIC retained	49.2%	48.8%	42.4%	38.3%	44.8%

Source: IRTF TY 2004 & CAF for TY 2004

The number of qualifying children is one of the key determinants of the amount of EIC to which a taxpayer is entitled. Table 9 shows that represented taxpayers retain a significantly greater share of their EIC for claims with children. Interestingly, unrepresented taxpayers fared better than represented taxpayers for EIC claims without children; however, these no children EIC claims accounted for less than one percent of the audited EIC claims.⁴⁷

⁴⁶ Excludes 334 audited returns where the type of representative could not be determined from IRS data.

⁴⁷ No children EIC audits in this study population included 556 unrepresented taxpayers and eight represented taxpayers.

TABLE 9, Portion of EIC Retained During Audit by Qualifying Children

	Not Represented	Represented
No Qualifying Children	53.9%	46.5% ⁴⁸
One Qualifying Child	23.7%	43.3%
Two Qualifying Children	26.4%	45.8%

Source: IRTF TY 2004 & CAF for TY 2004

Another consideration is the impact a given change has on the taxpayer. For example, perhaps the 45 percent of EIC retained by represented taxpayers is offset by the absolute amount of the reviewed credit, because taxpayers without representation have higher claimed amounts. In other words, disallowing in full an EIC of \$100 will have less effect on a taxpayer than reducing a \$4,000 credit by half.

Table 10 shows the averages for EIC received, changed, and net final amount. The first observation we can make is that represented and unrepresented taxpayers have similar before-audit EIC amounts, a difference of \$36. Second, the average EIC disallowed is \$587 higher for not represented taxpayers. The overall result is that taxpayers with representation retain \$623 more than taxpayers without representation, even though the initial difference is only \$36.

TABLE 10, EIC Amount Before and After Audit⁴⁹

Average EIC Amount:	Not Represented	Represented	Difference (Rep.- Not Rep.)
Before audit	\$2,981	\$3,017	-\$36
Disallowed during audit	\$2,250	\$1,663	-\$587
After audit	\$731	\$1,354	\$623

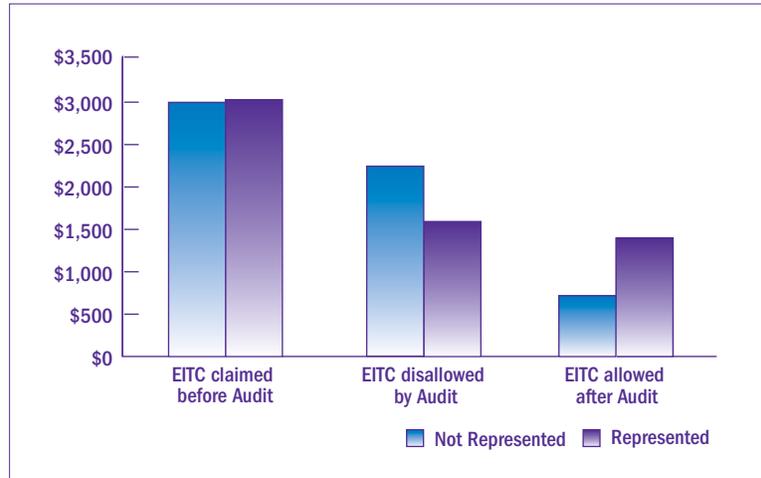
Source: IRTF TY 2004 & CAF for TY 2004

In summary, represented taxpayers retain more of their EIC in both percentage and absolute dollars than taxpayers without representation.

⁴⁸ These taxpayers received more EIC after audit than originally allowed by IRS after return processing.

⁴⁹ The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

CHART 5, Amount of EIC Before & After Audit



Source: IRTF TY 2004 & CAF for TY 2004

TAS also wanted to examine what happens to taxpayer accounts in the post-audit period. Several occurrences may cause a taxpayer’s EIC to be adjusted after the conclusion of an audit. The taxpayer may request the IRS to reconsider audit findings based on other information that could not be made available at the time of the audit. Taxpayers may also pursue administrative and legal remedies to disagree with audit findings, and the results of these proceedings may not adjust a taxpayer’s EIC until after the close of the audit case. The following table compares after audit results for represented and unrepresented taxpayers for TY 2002.

TABLE 11, EIC Retained/Disallowed After Audit⁵⁰

Percentage of Taxpayers with:	Not Represented	Represented
Some EIC Restored	77.8%	94.8%
No EIC Restored	22.2%	5.2%
Total	100.0%	100.0%

Source: IRTF TY 2002 & CAF for TY 2002

Table 11 shows that represented taxpayers were significantly more likely than their unrepresented counterparts to have EIC restored for TY 2002 during the after audit period.

Similarly, Table 12 below shows that the represented taxpayers also have a significantly larger amount of EIC allowed in the after audit period when compared to those taxpayers without representation.

⁵⁰ Includes only cases with an EIC adjustment after audit. Ninety-nine of these cases were Appeals or Tax Court cases. An additional 171 Appeals and Tax Court cases are not represented in this table because the administrative appeal or litigation resulted in no after audit change to EIC.

TABLE 12, EIC Dollars Allowed After Audit

Average EIC Allowed After the Audit	Mean
Not Represented	\$1,320.46
Represented	\$2,286.03

Source: IRTF TY 2002 & CAF for TY 2002

Objective 3: Determine if the tax recommended for taxpayers with representation in EIC audits is less than the tax recommended for taxpayers without representation in EIC audits.⁵¹

Finding: Fewer represented taxpayers owe additional tax.

The prior findings focus on the impact of representation on the EIC. There may be other issues addressed during an audit in addition to the EIC. In this section, we investigate the impact of representation on the net tax resulting from the audit.

The average amount of additional tax due after audit for both unrepresented and represented taxpayers is similar, as shown in Table 13 below. Nevertheless, there are significant differences in the percent of taxpayers within these two groups who actually owe additional tax. Over 71 percent of the represented group owed *no* additional tax, while almost 41 percent of unrepresented taxpayers *owe* additional tax at the conclusion of the audit.

TABLE 13, Tax Change During Audit⁵²

Percentage of taxpayers:	Not Represented	Represented
whose tax increased during audit	40.8%	22.6%
with no change in tax during audit	53.1%	71.7%
whose tax decreased (refund) during audit	6.1%	5.7%
Average Tax Change (increase) during audit	\$210	\$133

Source: IRTF TY 2004 & CAF for TY 2004

The one positive result for unrepresented taxpayers is that a slightly higher percentage of them received a reduction in tax due compared to represented taxpayers. However, this needs to be considered in combination with the greater share of unrepresented taxpayers (41 percent) who pay additional tax.

⁵¹ This objective focuses only on tax change which is separate from changes in refundable credits such as EIC.

⁵² The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

Conclusions

- The IRS struggles with effectively communicating with taxpayers during EIC audits.
- Generally, taxpayers are trying to comply with IRS requests for information and documentation.
- Given that over 90 percent of respondents reported contacting the IRS about their audit, with close to 30 percent contacting IRS more than once, IRS' poor communications place a *burden* on taxpayers and on limited IRS resources.
- IRS requests EIC taxpayers provide proof for several complicated eligibility factors, and the taxpayer often does not understand how the verification documentation requested by the IRS will prove EIC eligibility.
- Many taxpayers question whether the IRS considers all submitted documents, and, in turn, whether the IRS reached the correct determination regarding their EIC eligibility.
- Taxpayers who use representatives are nearly twice as likely to be found eligible for the EIC as compared to taxpayers who are not represented during the audit process.
- Over 40 percent of all taxpayers with representatives emerged from their audit with their full EIC intact, whereas less than 1 in 4 taxpayers without a representative kept their full EIC.
- The taxpayers without representation were more likely to end up owing additional *tax* than taxpayers with representation (41 percent versus 23 percent).
- The barriers reported by taxpayers from their experiences with the IRS EIC audit process are likely important factors in why taxpayers who obtain representation during their EIC audit have significantly more favorable audit outcomes.
- The vast majority of taxpayers who undergo an EIC audit do not have representation and the number of taxpayers with representation during the EIC audit declined significantly from TY 2002 to TY 2004.

Recommendations

The following recommendations are based on study findings.

- Increase taxpayer awareness of the legal assistance available at Low Income Taxpayer Clinics (LITCs).
- Ensure all correspondence during the EIC audit provides taxpayers with references for contacting a LITC.
- Inform taxpayers of the closest LITC. Since these locations change annually, taxpayers could be instructed to call TAS if the LITC is no longer participating in the program.
- If a taxpayer cannot provide all requested documentation to verify EIC eligibility, and the IRS has no information to dispute the EIC claim, allow the taxpayer to provide an affidavit from an IRS approved source to prove EIC eligibility.

- Assign one worker to each EIC audit. Provide the worker's name, phone number, and address in all correspondence with the taxpayer.
- Call taxpayers, whenever possible, to see if verbal communication can resolve any miscommunication.
- Revise EIC audit letters. Letters should be written to address the taxpayers' personal tax return and should specifically state that the taxpayers' tax return is being audited. The letters should clearly list the specific issues of the audit and explain what the taxpayer must do to resolve each issue, and should also explain how the documentation relates to the issue in question.
- Provide timely acknowledgements to all documentation and materials received from the taxpayer.
- Inform taxpayers of the right to a face-to-face audit and what steps must be taken to request the audit be changed to face-to-face.
- Provide a checklist that taxpayers can use to guide them in securing the proper documents and steps needed to validate their eligibility.