

National Taxpayer Advocate

2009 Annual Report to Congress

*Annual Report to Congress*

**RUNNING SOCIAL PROGRAMS  
THROUGH THE TAX SYSTEM**

Annual Report to Congress

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## Running Social Programs Through the Tax System<sup>1</sup>

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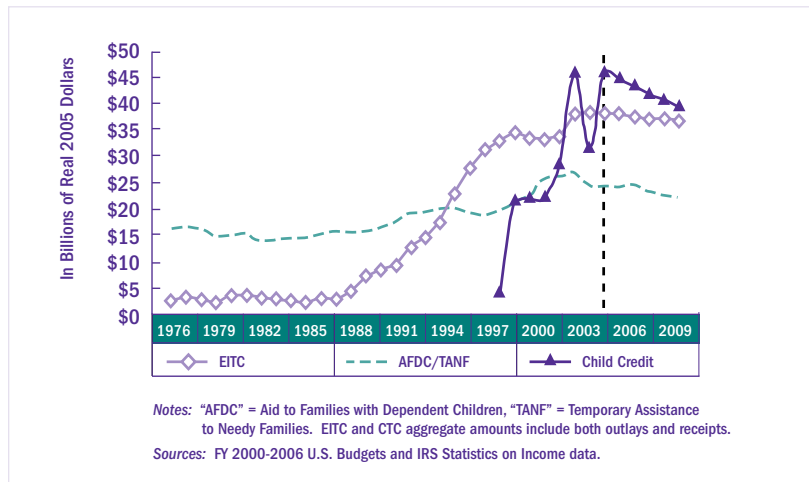
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**INTRODUCTION**

The passage of the American Recovery and Reinvestment Tax Act of 2009 (ARRA) and the Worker, Homeownership, and Business Assistance Act of 2009 (WHBA) demonstrates that Congress views refundable tax credits as a favored means of delivering social benefits and implementing policy.<sup>2</sup> The Congressional Budget Office has estimated that refundable credits will increase by approximately \$500 billion over the next ten years.<sup>3</sup> The chart below, created by the Tax Policy Center, illustrates the dramatic increase in federal spending on two refundable credits (the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)) compared to welfare (Aid to Families with Dependent Children / Temporary Assistance for Needy Families (AFDC/TANF)), a direct spending program, since 1976:<sup>4</sup>

**FIGURE 1: Real Federal Spending on the EITC, Child Credit, and Welfare (AFDC/TANF), Fiscal Year (FY) 1976-2010**



<sup>2</sup> Pub. L. No. 111-5, Division B, 123 Stat. 306 (2009); Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

<sup>3</sup> Doug Elmendorf, Congressional Budget Office, *Federal Budget Challenges* (Apr. 20, 2009), available at <http://www.cbo.gov/ftpdocs/100xx/doc10093/04-20-Harvard.pdf> (last visited Oct. 16, 2009).

<sup>4</sup> Tax Policy Center, *Tax Facts*, available at [http://www.taxpolicycenter.org/taxfacts/Content/PDF/eitc\\_child\\_historical.pdf](http://www.taxpolicycenter.org/taxfacts/Content/PDF/eitc_child_historical.pdf) (last visited Oct. 16, 2009). Social programs and refundable credits are not limited to low income individuals. For example, ARRA expanded the Work Opportunity Tax Credit, a tax incentive for businesses to hire workers belonging to any of 12 targeted groups. Pub. L. No. 111-5, Division B, § 1221, 123 Stat. 306 (2009). ARRA also created new tax incentives for certain taxable governmental bonds (Build America Bonds and Recovery Zone Economic Development Bonds) whereby the governmental issuer of such bonds may elect (in lieu of issuing tax-exempt bonds) to receive a direct refundable credit payment from the federal government, equal to a percentage of the interest payments on these bonds. Pub. L. No. 111-5, Division B, § 1531, 123 Stat. 306 (2009).

## BACKGROUND

### Tax Expenditure vs. Direct Spending Program

A government can distribute social benefits through either a direct spending program or a tax expenditure. Direct spending programs require an appropriation with specific dollar amounts, while tax expenditures can be viewed as benefit distribution programs channeled through the tax system. Another important difference between the two systems is that taxpayers generally declare their own eligibility before receiving the benefits.<sup>5</sup> In contrast, many direct spending programs such as food stamps and TANF include a bureaucratic determination of eligibility before releasing the benefit payments.<sup>6</sup>

Tax expenditures take a variety of forms:

- Exclusions, exemptions, and deductions, which reduce taxable income;
- Preferential tax rates, which apply lower rates to part or all of the taxable income;
- Tax credits, which can be refundable or nonrefundable. The former can create a refund greater than the amount of tax due, whereas the latter is limited to the amount of tax due; and
- Deferrals of tax, which result from delayed recognition of income or from claiming deductions in the current year for expenses attributable to a future year.<sup>7</sup>

### Refundable Credits, What Are They and How Are They Administered?

Refundable tax credits are a popular way to deliver social benefits, mainly because they are available to all eligible taxpayers, regardless of their tax liability. The refundability component allows the taxpayer claiming the credit to reduce his or her liability below zero dollars, creating a tax refund. The taxpayer claims the refundable credit in the section of the Form 1040 labeled "Payments." As such, refundable credits are available to taxpayers even if they owe no income tax.<sup>8</sup>

<sup>5</sup> However, there are exceptions to this general statement. The Health Coverage Tax Credit is an example of a tax expenditure for which eligibility is not initially determined by the taxpayer. Internal Revenue Code (IRC) § 7527. The Work Opportunity Tax Credit is another credit with eligibility determinations made by parties other than the taxpayer and the IRS. IRC § 51.

<sup>6</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 U.C.L.A. L. Rev. 1867 (2004).

<sup>7</sup> Jane G. Gravelle, Tax Policy Center, Urban Institute and Brookings Institution, *Tax Topic: Tax Expenditure*, available at <http://www.taxpolicycenter.org/taxtopics/encyclopedia/Tax-expenditures.cfm> (last visited Oct. 16, 2009).

<sup>8</sup> In any given year, more than 35 percent of American households, which are home to almost half of the nation's children, have no income tax liability. Lily L. Batchelder, Fred. T. Goldberg, Jr., and Peter R. Orsag, *Reforming Tax Incentives into Uniform Refundable Tax Credits*, Brookings Institution, Policy Brief Series No. 156 (Aug. 2006).

## Running Social Programs Through the Tax System

*Some Longstanding and Newly-Enacted Refundable Credits*

The IRS administers various refundable credits. Longstanding credits include, but are not limited to:

- Earned Income Tax Credit;<sup>9</sup>
- Health Coverage Tax Credit;<sup>10</sup> and
- Additional Child Tax Credit.<sup>11</sup>

The passage of the American Recovery and Reinvestment Tax Act of 2009 in February 2009 created many tax incentives for individuals and businesses.<sup>12</sup> For individuals, ARRA established two new refundable credits for individuals: the Making Work Pay Credit and the American Opportunity Tax Credit.<sup>13</sup> ARRA also enhanced the refundable First-Time Homebuyer Credit (FTHBC), and temporarily increased the refundable portions of the Additional Child Tax Credit and the EITC.<sup>14</sup> ARRA also provides that eligible employees who are involuntarily terminated are entitled to receive an employer-provided subsidy in the amount of 65 percent of the premium for health insurance coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA)<sup>15</sup> and are required to pay only 35 percent of such COBRA coverage. Employers must treat the 35 percent payment by

<sup>9</sup> IRC § 32.

<sup>10</sup> IRC § 35.

<sup>11</sup> IRC § 24.

<sup>12</sup> Pub. L. No. 111-5, Division B, 123 Stat. 306 (2009). Full a full description of the provisions under ARRA, see <http://www.irs.gov/newsroom/article/0,,id=204335,00.html?portlet=6> (last visited Oct. 11, 2009).

<sup>13</sup> The Making Work Pay Credit is a refundable tax credit up to \$400 for working individuals and up to \$800 for working married taxpayers filing joint returns. This tax credit is calculated at a rate of 6.2 percent of earned income and phases out for taxpayers with modified adjusted gross income (MAGI) in excess of \$75,000, or \$150,000 for married couples filing jointly. For taxpayers who receive a paycheck and are subject to withholding, the credit is typically handled by their employers through mandated withholding changes, which result in an increase in take-home pay. Thus, wage earners receive an advance through reduced payroll withholdings. The amount of the credit to which the taxpayer is entitled is ultimately computed on the taxpayer's 2009 income tax return filed in 2010. Taxpayers who do not have taxes withheld by an employer during the year can claim the credit on their 2009 tax returns. The new American Opportunity Credit for qualified education expenses modifies the existing Hope Credit for tax years (TY) 2009 and 2010, making the Hope Credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also expands the list of qualifying education expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of \$2,500 per student. The credit is fully available to individuals whose MAGI is \$80,000 or less, or \$160,000 or less for married couples filing a joint return, and phases out after those income thresholds. These income limits are higher than under the existing Hope and Lifetime Learning Credits.

<sup>14</sup> Before ARRA, the FTHBC provided a refundable credit of up to \$7,500 for first-time homebuyers purchasing a main residence in 2008. Taxpayers were required to repay the credit in 15 equal, annual installments beginning with the 2010 income TY. ARRA expanded the FTHBC by increasing the credit amount to \$8,000 for purchases made by November 30, 2009. For homes purchased in 2009, taxpayers do not have to repay the credit unless the home ceases to be the taxpayer's main residence within a three-year period following the purchase. For purchases during the 2009 time period, taxpayers could claim the credit after the closing date on an original or amended 2008 return, or on a 2009 return before the closing date. For more information, see IRS, *First-Time Homebuyer Credit*, at <http://www.irs.gov/newsroom/article/0,,id=204671,00.html> (last visited Oct. 11, 2009). ARRA also increased for tax years 2009 and 2010 the amount of the EITC for taxpayers with three or more qualifying children to a maximum of \$5,657 as well as increased the phase-out thresholds for all taxpayers. Pub. L. No. 111-5, Division B, § 1006, 123 Stat. 306, 316 (2009). For more information, see IRS, *ARRA and the Earned Income Tax Credit*, at <http://www.irs.gov/newsroom/article/0,,id=205666,00.html> (last visited Oct. 11, 2009). Finally, ARRA made a portion of the ATCT refundable and lowered the minimum earned income limit to \$3,000 (from \$12,550). For more information, see <http://www.irs.gov/newsroom/article/0,,id=205670,00.html> (last visited Oct. 11, 2009).

<sup>15</sup> Pub. L. No. 99-272, 100 Stat. 82 (1986).

eligible former employees as full payment, but are entitled to a refundable credit for the other 65 percent of the COBRA cost on their payroll tax returns.<sup>16</sup>

In November 2009, due to the success of ARRA's FTHBC provision in stimulating home purchases, Congress enacted the Worker, Homeownership, and Business Assistance Act of 2009.<sup>17</sup> WHBA expanded the FTHBC by extending the deadline for qualifying home purchases and providing a smaller credit for "long-time residents" making qualifying home purchases.<sup>18</sup>

## DISCUSSION

### Does the Refundability Component Attract or Influence Noncompliance?

Noncompliance is best described as a continuum of behavior rather than in the absolute. Taxpayers and tax preparers commit noncompliance at varying degrees, including: inadvertent error, negligence, reckless disregard of the law, civil fraud, and criminal fraud.<sup>19</sup> Many of these violations are "one-offs" or individual instances that are not routinely repeated. However, there is also a "cottage industry" of fraud perpetrators who search for opportunities to carry out schemes that involve minimal effort and risk.<sup>20</sup>

In administering refundable credit programs, the IRS has developed initiatives designed to reduce the varying degrees of noncompliance.<sup>21</sup> As discussed below, the refundability component of a tax-related social benefit program is not necessarily the main driver of noncompliance at any level, including fraud and abusive schemes. Nonrefundable tax credits and other expenditures are also subject to noncompliance, including fraudulent and abusive schemes, as long as the perpetrators have income tax to offset.

<sup>16</sup> For more details on the COBRA provision in ARRA, IRS, *COBRA Health Insurance Continuation Premium Subsidy*, at <http://www.irs.gov/newsroom/article/0,,id=204505,00.html> (last visited Oct. 11, 2009).

<sup>17</sup> Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

<sup>18</sup> Section 11 of WHBA extends the deadline for qualifying home purchases from Nov. 30, 2009, to April 30, 2010. Additionally, if a buyer enters into a binding contract by April 30, 2010, the buyer has until June 30, 2010, to settle on the purchase. The maximum credit amount remains at \$8,000 for a first-time homebuyer -- that is, a buyer who has not owned a primary residence during the three years up to the date of purchase. However, the new law also provides a "long-time resident" credit of up to \$6,500 to others who do not qualify as "first-time homebuyers." To qualify this way, a buyer must have owned and used the same home as a principal or primary residence for at least five consecutive years of the eight-year period ending on the date of purchase of a new home as a primary residence. For all qualifying purchases in 2010, taxpayers have the option of claiming the credit on either their 2009 or 2010 tax returns. Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009). For more information on WHBA, see IRS News Release, *First-Time Homebuyer Credit Extended to April 30, 2010; Some Current Homeowners Now Also Qualify*, IR-2009-108 (Nov. 24, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=215791,00.html?portlet=7> (last visited Dec. 3, 2009).

<sup>19</sup> For an analysis of compliance programs in response to varying degrees of noncompliance associated with the EITC, see Leslie Book, *The Poor and Tax Compliance: One Size. Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003). In addition, the Internal Revenue Code has various penalties to address these varying levels of noncompliance, including but not limited to: IRC § 6662 (accuracy-related penalty for negligence and reckless disregard of rules), IRC § 6663 (civil fraud penalty), and IRC § 7201 (criminal fraud).

<sup>20</sup> For a listing of some of the more significant abusive tax schemes prosecuted in 2009, see IRS, *Examples of Abusive Tax Scheme Investigations in 2009*, available at <http://www.irs.gov/compliance/enforcement/article/0,,id=187267,00.html> (last visited Dec. 21, 2009).

<sup>21</sup> Leslie Book, *The Poor and Tax Compliance: One Size. Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003). For a discussion of IRS initiatives to combat fraudulent schemes with the FTHBC, see *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

## Running Social Programs Through the Tax System

The issue of fraud is much more nuanced than is generally portrayed. Fraud includes “one-offs” where individual taxpayers intentionally underreport income or inflate deductions or credits on an individual return basis. On the other side of the fraud continuum are the perpetrators of abusive schemes who are searching for “quick hits” – tax provisions with limited requirements, minimal third-party reporting data, and large dollar amounts of benefits. These schemers can bombard the system with claims for refunds based on these quick hits with the hope that a portion of the fraudulent claims will go undetected before the IRS pays out the refunds. As the IRS develops more sophisticated screens for identifying fraudulent schemes in one tax program, fraudsters move on to other areas. For example, whereas EITC schemes were prevalent early in this decade, it appears that withholding schemes are the most common today.<sup>22</sup>

Thus, taxpayers in any income bracket can commit fraud with tax provisions other than refundable credits as long as they can offset tax. In fact, the data do not necessarily support the position that the refundability component actually attracts or influences noncompliance more than any other type of tax incentive. The amount of the benefit and the relative ease with which it can be obtained appear to be more significant factors. The following table illustrates that the refundability component of a tax benefit is not necessarily a main driver of substantial noncompliance. For example, fiscal year 2009 audits resulted in higher average audit adjustments for a few Schedule A itemized deductions than for some of the more common refundable credits.

**TABLE 1: IRS FY 2009 Average Audit Adjustments by Tax Provision<sup>23</sup>**

Tax Benefit	Average Audit Adjustment
Charitable Contributions (Sched. A)	\$8,376
Medical Expenses (Sched. A)	\$6,749
Alternative Minimum Tax (AMT)	\$6,155
Child Tax Credit (CTC)	\$3,531
EITC	\$3,397
FTHBC	\$3,041

Furthermore, National Research Program (NRP) data for tax year 2001 suggest that approximately 55 percent (\$109 billion) of the individual underreporting gap (totaling approximately \$197 billion) came from understated net business income, such as unreported

<sup>22</sup> During calendar year 2009 (through Dec. 2nd), the IRS’s Questionable Refund Program identified about 280,000 false and fraudulent returns claiming refunds of about \$1.9 billion. Of that total, the IRS disallowed about 192,000 returns, preventing the payment of about \$1.4 billion in improper claims. Most of the \$500 million balance of identified false and fraudulent claims was paid out as part of schemes before the IRS could act. The IRS reports that the vast majority of false and fraudulent refund claims involve income and withholding amounts ordinarily reported on Form W-2. IRS response to TAS information request (Dec. 16, 2009). As the IRS combats fraudulent noncompliance, financial institutions are also impacted by these abusive schemes, which often involve refund anticipation loans that give the schemer almost immediate access to the money.

<sup>23</sup> IRS Examination Operational Automation Database (EOAD), Compliance Data Warehouse (CDW) FY 2009. We acknowledge that the amounts of the refundable credits included in the chart are capped, which limits the amount of audit adjustments. However, the data still illustrate that tax provisions other than refundable credits are subject to high noncompliance.



receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent (\$17 billion) came from overstated tax credits.<sup>24</sup>

Based on these data, the National Taxpayer Advocate believes that noncompliance is not *necessarily* more prevalent in refundable credits than any other type of tax incentive. Refundability is needed to make the benefit accessible to the population of taxpayers without tax liabilities. It is not, in isolation, the main driver of noncompliance.

Instead, it is likely that the noncompliance often associated with refundable credits actually stems more from the overall design of the social benefit program rather than the refundability component. In a sense, refundability is akin to a Hitchcock “macguffin,” because it is perceived to play a leading role in the problems associated with the tax credit, but the component itself actually plays a minor role in noncompliance.<sup>25</sup>

### Design Elements that Impact Noncompliance Levels

The National Taxpayer Advocate believes that noncompliance associated with refundable credits stems from the overall design of the program. Specifically, the following elements contribute to the level of noncompliance in refundable credit programs: (1) fact-based eligibility requirements, (2) the lack of pre-certification procedures, (3) characteristics of the target population, (4) the large size of the benefit amounts, and (5) the role of return preparers in claiming the benefit.

#### *Fact-Based Eligibility Criteria Make Verification Difficult for the IRS.*

A main advantage of providing income-based social benefits through the tax code is that the IRS is the federal agency with the best access to income information of potential beneficiaries. However, the IRS’s data have limits. For example, many improper EITC claims arise because taxpayers fail to meet the requirement that a “qualifying child” must have lived with the taxpayer for more than one-half of the taxable year.<sup>26</sup> Although the IRS has done considerable work to develop screening criteria to distinguish valid from improper claims, the IRS has no way to systemically ascertain taxpayers’ living arrangements. The only way to verify eligibility of fact-based requirements is through taxpayer audits – unlike the caseworker model in traditional benefits programs, where the eligibility screening occurs before the taxpayer receives the benefit. The IRS could minimize the payment of improper claims if eligibility for tax benefits is based on criteria that the IRS can verify – ideally, before paying refunds.

<sup>24</sup> IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 12, 14 (Aug. 2, 2007). In addition, approximately 28 percent (\$56 billion) of the individual underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. Approximately eight percent (\$15 billion) came from overstated subtractions from income (i.e., statutory adjustments, deductions, and exemptions).

<sup>25</sup> Merriam-Webster Dictionary defines “macguffin” as a term coined by Alfred Hitchcock to mean “an object, event, or character in a film or story that serves to set and keep the plot in motion despite usually lacking intrinsic importance.” “Macguffin,” Merriam-Webster Online Dictionary (2009), available at <http://www.merriam-webster.com/dictionary/macguffin> (last visited Dec. 21, 2009).

<sup>26</sup> See IRC § 32(c)(3)(A) (incorporating with modifications the definition of a “qualifying child” contained in IRC § 152(c)). IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3, 13 (Feb. 28, 2002) (citing this requirement as one of the top three areas of EITC overclaims).

### *Pre-certification Could Minimize Error and Fraud.*

The IRS can combat noncompliance and reduce the number of frozen refunds associated with a refundable credit by performing eligibility certification before the filing season begins each January. Under such a program, the taxpayer demonstrates eligibility by producing documentation before filing a return. Pre-certification could be required for all taxpayers in the target population, or only for subsets of that population that have demonstrably high noncompliance rates. Pre-certification, however, moves the program closer to a traditional “welfare system” with direct benefit transfers and could have a negative impact on participation rates. Thus, before designing a pre-certification program for refundable tax credits, policymakers should weigh the burden imposed on taxpayers and IRS resources against the benefits of such a program. For example, the IRS gained experience performing eligibility pre-certifications during a pilot program for the EITC, which the IRS launched in 2003. The three-year test of pre-certification for the EITC incorporated a caseworker-like verification system. An IRS evaluation found certification a less efficient enforcement treatment than EITC correspondence examinations. Taxpayers subject to the certification requirement also made more phone calls to the IRS, which is not undesirable if those calls led to greater compliance. The results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers.<sup>27</sup> In light of these findings, the IRS halted the pre-certification program.<sup>28</sup>

Rather than discarding the idea entirely, the IRS could learn from its experience and design the precertification program to avoid the problems encountered with the pilot. For example, a redesigned program could require the taxpayer to demonstrate eligibility, but once the IRS processes this information, the taxpayer would remain eligible until either IRS systems flag a change in circumstances or the taxpayer voluntarily reports a change in circumstances that render him or her ineligible. Thus, the burden imposed on the taxpayer would be a one-time event and the taxpayer could avoid compliance issues relative to eligibility in the future. This approach may save IRS compliance resources downstream and be more attractive to taxpayers. Further, in order to prevent the decreased participation rate found in the pilot, the IRS could identify taxpayers who may be intimidated and perhaps add an incentive to encourage participation.

### *The Characteristics of the Target Population Can Lead to Compliance Challenges.*

A primary reason to make a credit refundable is to reach individuals without tax liabilities. An estimated 47 percent of individual taxpayers have zero or negative liability, and may

<sup>27</sup> IRS, *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* (2008); IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress* (Oct. 2005). The lower participation rate may be attributable to taxpayers determining that they were not, in fact, eligible for the credit.

<sup>28</sup> IRS, *A Service-Wide Approach to Individual Refundable Tax Credits: Executive Summary – Background Paper 3* (Jun. 1, 2009).

have no filing obligations.<sup>29</sup> Thus, a significant portion of the target population may be unfamiliar with the tax preparation process yet is required to file returns solely to claim the credit. Moreover, the eligibility requirements for the credits may be so complicated that they drive well-intentioned taxpayers to make inadvertent errors. A large portion of the target population may be unable to handle the complex procedures required to claim the benefits without the assistance of a paid or volunteer tax return preparer.<sup>30</sup>

### ***Large Refund Amounts May Attract Fraudulent Schemes and Increase Demand for Commercial Refund Delivery Products.***

Any tax incentive with a large dollar amount is ripe for abuse. Perpetrators of fraud quickly focus on tax provisions with large payouts. This is especially true for refundable credits, because the refundability component allows fraudsters to systematically claim refunds on behalf of fictitious taxpayers, or taxpayers whose identities were stolen, for tax dollars never actually paid into the system.

Further, an unintended consequence of delivering a sizeable social benefit through the tax system is that it could potentially drive more taxpayers to purchase costly commercial refund delivery products. Taxpayers are more willing to pay high fees associated with these products in order to access the sizable credit sooner. While some of these taxpayers may actually benefit from quicker access to the funds, many of them could wait a few more days to receive the money directly from the IRS at little or no cost. In addition, return preparers who market these products may have a financial incentive to artificially inflate refunds.<sup>31</sup>

### ***The Role of Return Preparers and Strengthening Due Diligence Requirements.***

The IRS considers tax return preparers its partners in tax administration due to their significant role in taxpayer compliance.<sup>32</sup> In a sense, preparers are the government's first line of defense against noncompliance because they act as screeners on the government's behalf. Preparers can facilitate either compliance or noncompliance. Several studies and

<sup>29</sup> Robertson Williams, Tax Policy Center, Tax Facts, *Who Pays No Income Tax?* Tax Notes at 1583 (June 29, 2009), available at [http://www.taxpolicycenter.org/UploadedPDF/1001289\\_who\\_pays.pdf](http://www.taxpolicycenter.org/UploadedPDF/1001289_who_pays.pdf) (last visited Oct. 11, 2009). These taxpayers may still need to file a return to claim a refund of overwithheld income taxes.

<sup>30</sup> Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration*, (Henry Aaron and Joel Slemrod, eds., Brookings Institution Press 2004). See also Michael S. Barr and Jane K. Dokko, *Tax Filing Experience and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey*, in *Recent Research on Tax Administration and Compliance: Selected Papers Given at the 2006 IRS Research Conference*, IRS Research Bulletin 193-212 (June 2006).

<sup>31</sup> National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (Most Serious Problem: *The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential*). See also Leslie Book, *Refund Anticipation Loans and the Tax Gap*, 20 Stan. L. & Policy Rev. 85 (2009).

<sup>32</sup> IRS, *Strategic Plan, Fiscal Years 2009-2013*; National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 74-116 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*).

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“shopping visit” initiatives by government watchdogs and regulators have identified preparers as a source of noncompliance for less sophisticated taxpayers.<sup>33</sup>

In the 2003 Annual Report, the National Taxpayer Advocate recommended that Congress strengthen the EITC due diligence provisions.<sup>34</sup> We believe similar and robust provisions should apply to other tax provisions, where there is demonstrated noncompliance.<sup>35</sup> Further, as we have recommended since 2002, there should be a system of regulating, testing, and certifying unenrolled preparers.<sup>36</sup>

### Ideal Design Features for the Administration of a Social Benefit Program Through the Tax System

While it is feasible to administratively address some systemic problems that unexpectedly develop in social benefit tax programs, many require legislative resolution. The fundamental issue when designing a social benefit program is whether the benefit should run through the tax system or whether it is better suited for a direct spending program. This determination relies on a variety of factors, many of which are discussed in this section.

#### *Evaluate Culture of the Potential Administrator*

Before charging any federal agency with the administration of a social benefit, consideration should be given to whether the agency’s culture is best suited for this role. For example, if a social benefit has a family or welfare component, such as the EITC and Child Tax Credit, the administrator needs both a service and enforcement staff well trained in strong social service, communication, outreach, and education skills.

When Congress enacts a social benefit in the form of a tax incentive, the IRS is charged with administering a social benefit program, a role separate and apart from its role as an enforcement agency. Examinations are designed on the traditional IRS exam model, which is comprised of post-filing compliance and audits, in the context of an enforcement agency mission and mentality. Thus, the current design of the IRS is purely for revenue collection.

<sup>33</sup> See Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*, *supra*; Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors 2* (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008); Statement of Jamie Woodward, Acting Commissioner, New York Dept. of Taxation and Finance, before IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009), available at [http://ftp.irs.gov/pub/irs-utl/ny\\_department\\_of\\_tax\\_statement.pdf](http://ftp.irs.gov/pub/irs-utl/ny_department_of_tax_statement.pdf) (lasted visited Oct. 18, 2009); Tom Herman, *New York Sting Nabs Tax Preparers*, Wall Street Journal (Nov. 26, 2008); Russell Hubbard, *Tax Preparers Cheating Customers, Government, Alabama Nonprofit Finds*, Birmingham News (Jan. 23, 2009); National Community Law Center, *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008); New York City Department of Consumer Affairs, Press Release, *NYC Department of Consumer Affairs Announces Citywide Enforcement Sweep of Income Tax Preparers* (Feb. 5, 2009).

<sup>34</sup> National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

<sup>35</sup> For a comprehensive discussion of the role of return preparers in tax administration, including due diligence requirements, see *Most Serious Problem: The IRS Lacks a Servicewide Return Preparer Strategy*, *supra*; National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2., 74-116 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*).

<sup>36</sup> National Taxpayer Advocate 2002 Annual Report to Congress 216-30.

When social program delivery is grafted to traditional IRS activities, there arises a potential conflict with the IRS's traditional mission. For example, when New Zealand's tax agency, Inland Revenue, was charged by the government with running social and family programs through the tax system through implementation of the Working for Families Tax Credits, the agency underwent a comprehensive analytical redesign process.<sup>37</sup> With the growth of these programs administered by the IRS, the agency should consider revising its mission statement to explicitly acknowledge its dual roles: tax compliance and social program delivery.<sup>38</sup>

### *Evaluate the Feasibility of a Direct Spending Program.*

Traditional direct spending welfare programs are perceived to be invasive and stigmatizing to the applicants and beneficiaries. One way to minimize public and participant aversion to such programs is to use the tax system to deliver the benefit, and thereby decrease awareness that the payment is inherently "welfare."<sup>39</sup> The EITC is an example of an income support program run through the tax system. While the credit is certainly beneficial for low income working taxpayers and families, it also forces a significant number of taxpayers with no filing obligations to file returns, and potentially incur high preparation, filing, and commercial refund delivery product fees, in order to claim the credit. An alternative approach would be to improve the direct spending welfare system by making the process less burdensome to participants.

### *Specific Identification of Targeted Population and Behavior.*

Because specific taxpayer populations respond to incentives differently, any new social benefit program's targeted population and targeted behavior should be clearly identified during the legislative drafting process. By clearly identifying the targeted behaviors and populations, the future administrator of the benefit program will be better situated to increase the participation rate by effectively planning outreach and education initiatives. The administrator can also design compliance initiatives based on the specific needs of the target population. Finally, clearly identifying these groups and behaviors up front will lead to better measures of the program's effectiveness and help uncover unintended consequences.

<sup>37</sup> Robert Russell, Chief Executive and Commissioner of Inland Revenue, New Zealand, *Managing Expanding Responsibilities: Inland Revenue New Zealand*, Paper 16 (March 2008); Hon. Peter Dunne, Minister of Revenue, *Address to International Fiscal Association Conference 2009 New Zealand Inland Revenue*, (March 20, 2009), available at <http://www.taxpolicy.ird.govt.nz/news/archive.php?year=2009&view=651> (last visited Jun. 14, 2009) (Hon. Peter Dunn stated, "A very big challenge to the efficiency of our tax administration has arisen over the last decade or so from the strain placed on Inland Revenue tax systems by an ever increasing number of non-tax programmes that are administered through the tax system – programmes such as student loans, Working for Families tax credits and KiwiSaver. ... Over recent years, Inland Revenue systems designed for tax collection have been progressively adapted to cope with these and other social policy programmes.")

<sup>38</sup> See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

<sup>39</sup> Marjorie E. Kornhauser, *Cognitive Theory and the Delivery of Welfare Benefits*, 40 *Loyola Univ. Chicago Law Journal* 253-96 (2009).

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### *Tax Return Filing Obligations of Target Population.*

Refundable tax credits are generally claimed at a higher rate than other forms of social welfare benefits.<sup>40</sup> A key reason is that most adult Americans file tax returns, so the added burden of claiming a credit is minimal compared with the need to file a separate application for other welfare benefits. Yet a significant number, estimated at 47 percent, of individual taxpayers have no filing obligations due to a zero or negative income tax liability.<sup>41</sup> Although many of these taxpayers may still have to file a return in order to get a refund of overwithholding, it is a quantum leap from filing a basic return to filing a return to claim a credit with complex eligibility requirements. Thus, the burden imposed on the intended recipient is a key factor in the design of a benefit program.<sup>42</sup> To minimize burden and maximize participation, a well-designed tax-based social program requires an understanding of the characteristics of the target population.<sup>43</sup>

### *Eligibility Hinges upon Available Data.*

The IRS touches a significant percentage of the U.S. population and has the income information and potentially other data necessary to gauge eligibility. The best-designed tax-based social programs are crafted in a way that eligibility to claim the credit is verifiable with data to which the IRS has access – ideally before the funds are even released.<sup>44</sup> Considerations include whether the credit requires information already captured on the income tax return or whether the IRS has direct or indirect access to other data sources that can serve as a proxy for eligibility. Alternatively, an eligibility determination might require information outside the current reach of the IRS absent an audit, making it difficult for the

<sup>40</sup> For example, the EITC participation rate is estimated at 75 percent (+/- two percent) for TY 2005. Dean Plueger, Wage & Investment Research, IRS and Amy O'Hara, Data Integration Division, U.S. Census Bureau, 2009 IRS Research Conference, *Earned Income Tax Credit TY2005 Taxpayer Participation Rate*, slide 15 (July 8, 2009). By comparison, TANF had an approximate 42 percent participation rate in 2004. Tax Policy Center, *Tax Facts: EITC, TANF, and Food Stamp Participation Rates, 1990-2004*, available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=273> (last visited Dec. 22, 2009). In addition, in 2008, approximately 3.8 million individuals received TANF as compared to 23.7 million receiving EITC. Department of Health & Human Services, Administration for Children and Families, 2008, *Temporary Assistance for Needy Families, Average Monthly Number of Recipients, Adults, and Children*, available at [http://www.acf.hhs.gov/programs/ofa/data-reports/caseload/2008/2008\\_15months\\_tan.xls](http://www.acf.hhs.gov/programs/ofa/data-reports/caseload/2008/2008_15months_tan.xls) (last visited Oct. 15, 2009); IRS, *EITC Statistics, EITC State Statistics at-a-Glance for Tax Year 2008*, available at <http://www.eitc.irs.gov/central/eitcstats/> (last visited Oct. 15, 2009).

<sup>41</sup> Robertson Williams, Tax Policy Center, Tax Facts, *Who Pays No Income Tax?* Tax Notes at 1583 (June 29, 2009), available at [http://www.taxpolicycenter.org/UploadedPDF/1001289\\_who\\_pays.pdf](http://www.taxpolicycenter.org/UploadedPDF/1001289_who_pays.pdf) (last visited on Oct. 11, 2009).

<sup>42</sup> During the presidential election campaign, President Obama proposed that the IRS develop pre-populated returns to enable certain taxpayers to file without having to prepare a return or pay a preparer to do it. At present, a significant limitation is that the IRS does not receive Forms W-2 until the tax-filing season has ended. But as technology improvements enable the IRS to receive and process third-party information reports earlier, pre-populated returns may be one way to help reach eligible individuals who otherwise do not have a filing requirement. For information on a pre-populated return program implemented in California, see Joseph Bankman, *Simple Filing for Average Citizens: the California Ready Return*, 107 Tax Notes 1431 (2005); State of California Franchise Tax Board, *ReadyReturn General Information*, available at <http://www.ftb.ca.gov/readyreturn/about.shtml> (last visited Dec. 22, 2009) (In order to be eligible to file using California's ReadyReturn, taxpayers can not have claimed a credit other than the nonrefundable renter's credit on the previous year's tax return). See Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

<sup>43</sup> Outreach and education – i.e., demystifying the program – are important tools in maximizing participation. An example of an effective nationwide public awareness campaign conducted by the IRS is the annual EITC Awareness Day. IRS News Release, IR-2009-8, *IRS and Partners Mark EITC Awareness Day with Nationwide Events; EITC Could Mean Bigger Refunds for Millions of Taxpayers* (Jan. 30, 2009) (The news release provides general information about the credit, eligibility, and the availability of free filing assistance).

<sup>44</sup> Timely access to eligibility data may require earlier submissions to the IRS by third party reporting agents, a later start of the filing season, and faster data processing by the IRS. See Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

IRS to screen for noncompliance. An example of eligibility criteria hinging on inaccessible data is the residency test to determine if a taxpayer has a qualifying child for the EITC, which the IRS cannot verify without requiring the taxpayer to submit additional paperwork and face additional burden.<sup>45</sup> Further, any requirement to submit documentation to substantiate eligibility could potentially impact the rate of electronic filing if IRS computer systems are not timely programmed to accept such documentation.<sup>46</sup>

Finally, when the IRS relies on documentation provided during audits to verify eligibility, it is placing an undue burden on the benefit recipients. For example, in connection with the Audit Barriers Survey project of 2007, TAS surveyed a random sample of taxpayers who claimed the EITC in TY 2004 to determine the type and frequency of barriers taxpayers face when dealing with EITC audits. The survey results found three main barriers: communication, documentation, and process. When asked about the documentation problems, over half of the audited taxpayers reported difficulties in obtaining requested documentation and nearly half did not understand why the IRS needed the information.<sup>47</sup>

### ***Incorporation of Third-Party Certifications Eases Verification Burden but Comes with Risks.***

Instead of performing pre-certifications itself, the IRS could alternatively rely on other government or private entities to certify eligibility for refundable credits. Such reliance on other entities comes with both benefits and risks. The IRS does not have to expend resources on eligibility determinations because the outside party has already performed that task and may be better situated to do so. However, this reliance on outsiders places the IRS in a position of less control, and any breakdown in a system on the outside negatively impacts the IRS's administration of the credit. With some credits, such as the Health Coverage Tax Credit, the IRS merely acts as a paying agent and has no role in eligibility determinations, yet is still pulled into eligibility disputes as taxpayers try to contest eligibility decisions made by other entities.<sup>48</sup>

The IRS encounters problems in administering the Work Opportunity Credit due to its reliance on third-party certifications performed by state workforce agencies. Administration of this credit relies on coordination between the IRS, the Department of Labor, and the state

<sup>45</sup> IRC §§ 32, 152(c).

<sup>46</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-400-13, *The 2009 Filing Season Was Successful, Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 2009). To reduce erroneous FTHBC claims, TIGTA recommended that the IRS require taxpayers to provide third-party documentation supporting the purchase of a home. The IRS disagreed with the recommendation because it would burden taxpayers and prevent up to two million taxpayers from e-filing.

<sup>47</sup> National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

<sup>48</sup> IRC § 7527 provides the Health Coverage Tax Credit, a federal tax credit that pays 80 percent of qualified health insurance premiums for eligible individuals and their family members. An eligible individual receives a registration kit from an entity that determines eligibility and submits the completed registration forms to the IRS. The IRS bills the individual for 20 percent of the monthly health care premium. Once the IRS receives the payment, the IRS will send directly to the health insurance company 100 percent of the premium. Alternatively, the individual can pay the entire monthly premiums throughout the year, bypass the monthly subsidies, and claim the credit on his or her tax return. For more information on the Health Coverage Tax Credit Program, see <http://www.irs.gov/individuals/article/0,,id=187948,00.html> (last visited on Oct. 12, 2009).

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agencies. When state agencies fall behind in issuing certifications of eligibility to employers, employers cannot claim the credit.<sup>49</sup>

### *Accelerating IRS Access to Reliable Third Party Information Reporting.*

As structured today, third party reporting is inadequate for identifying eligibility before the IRS pays out the refunds. The IRS uses third-party information returns (e.g., Form W-2, Forms 1099, and Schedules K-1) to verify the accuracy of income tax returns. However, the IRS does not process information returns until the filing season has ended and most refunds have been issued. Thus, the IRS does not have access to usable third-party data – reporting either income or other eligibility information – early enough to check the returns against the data as the returns are filed and before the IRS releases the refund (in a timely manner). Ideally, the IRS should receive and process information returns *before* it issues refunds. In designing social benefits through the tax system, Congress should require the Department of Treasury and the IRS to prepare a report identifying the administrative and legislative steps necessary to accomplish this goal.<sup>50</sup>

### *Separate the Income and Fact-Based Components of Eligibility.*

Tax administration would benefit if Congress designed refundable credits to target a very limited behavior. The IRS can effectively screen income-based eligibility criteria, but has difficulty screening the more facts-and-circumstances-based eligibility criteria, absent an audit. Thus, if Congress decides to deliver a benefit through the tax system, one approach is to isolate any income-based eligibility components to one credit and place the fact-based components in a separate credit. This design will result in more distinct credits with lower credit amounts. For example, rather than have a large credit like the EITC, the United Kingdom broke the credit into parts – the Working Tax Credit and the Child Tax Credit<sup>51</sup> In the 2005 and 2008 Annual Reports, the National Taxpayer Advocate recommended that Congress consolidate all family status provisions into just two credits: The Family Credit and the Worker Credit.<sup>52</sup> The earnings component of a credit can be easily verified through income reporting, leaving the more difficult family status eligibility verification to an isolated family credit. While the IRS would have more difficulty verifying the fact-based eligibility components, the amount at stake likely would be less than if the family-size

<sup>49</sup> Employers claim the Work Opportunity Credit for first year wages paid to an employee who is a member of a targeted group (the maximum credit allowed is \$2,400). The employer submits IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to the state workforce agency, which certified that the employee in question is a member of the targeted group. The employer needs the certification in order to claim the credit on IRS Form 5584, *Work Opportunity Credit*. The U.S. Department of Labor acts as a liaison with the state workforce agencies.

<sup>50</sup> For the National Taxpayer Advocate's legislative proposal to accelerate access to third-party reporting information, see Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

<sup>51</sup> For more information on the tax credits in the United Kingdom, see HM Revenue & Customs, *Tax Credits*, <http://www.hmrc.gov.uk/taxcredits/index.htm> (last visited on July 28, 2009).

<sup>52</sup> National Taxpayer Advocate 2005 Annual Report to Congress 397-406; National Taxpayer Advocate 2008 Annual Report to Congress 363-69. The President's Advisory Panel on Federal Tax Reform under the Bush administration also proposed replacing the standard deduction, personal exemptions, CTC, and head of household filing status with a family credit, and replacing the EITC and the refundable Child Tax Credit with a working credit. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005).



component was included in the worker credit. As noted above, lower benefits may make the program less susceptible to individual cheating and fraudulent schemes.

***Responsiveness of the Administrator to Deliver the Benefit in a Timely Manner.***

When Congress distributes benefits to a targeted population to influence a particular behavior, an effective distribution system needs to accommodate the taxpayer's needs and ability to accomplish the desired behavior. Delivering a social benefit through the tax code creates significant timing and responsiveness issues. Because the taxpayer typically claims the incentive on a tax return during filing season, he or she may not receive the funds in time to alleviate economic stress. However, the IRS has means available to pay the benefit out earlier. For example, timing was a main reason behind the creation of the advanced EITC, which suffers a low participation rate.<sup>53</sup> Likewise, the Making Work Pay (MWP) Tax Credit of ARRA was designed to spread payments throughout the year by reducing the amount of taxes withheld on the withholding tables. However, delivery through the withholding tables caused many taxpayers who are ineligible for the MWP tax credit to under-withhold income taxes.<sup>54</sup>

The United Kingdom tried to address the timing issue associated with its Child Tax Credit and Working Tax Credit by making weekly or monthly payments and requiring taxpayers to update their accounts promptly to reflect family and earning circumstances, with reconciliation at the year's end.<sup>55</sup> A thorough analysis of the AEITC, MWP, and UK experience will help identify those aspects of an advance payment option that increase responsiveness and participation.

<sup>53</sup> The advance EITC payment program allows taxpayers to receive part of the EITC through the employer. To participate in the program, the taxpayer must receive taxable wages, qualify for the EITC and have at least one qualifying child for the previous tax year. Taxpayers can determine eligibility and claim the advanced EITC (AEITC) by completing IRS Form W-5, *Earned Income Credit Advance Payment Certificate* and submitting to their employers. The maximum advanced EITC for TY 2009 is \$1,826. IRS Pub. 15, *(Circular E), Employer's Tax Guide For Use in 2009 20* (rev. May 29, 2009); IRS Fact Sheet, *EITC Eligibility Rules Outlined*, FS-2009-09 (Jan. 2009).

<sup>54</sup> See *The Making Work Pay Tax Credit*, <http://www.irs.gov/newsroom/article/0,,id=204447,00.html> (last visited Oct. 16, 2009); Treasury Inspector General for Tax Administration, *Millions of Taxpayers May Be Negatively Affected by the Reduced Withholding Associated With the Making Work Pay Credit*, Ref. No. 2010-41-002 (Nov. 4, 2009).

<sup>55</sup> See <http://www.hmrc.gov.uk/taxcredits/keep-up-to-date/changes-affect/how-when-report.htm> (last visited on Oct. 16, 2009); <http://www.hmrc.gov.uk/taxcredits/payments-entitlement/payments/next-payment-due.htm> (last visited Jun. 14, 2009). As discussed below, timing is also an issue in the administration of the First Time Homebuyer Credit. Taxpayers do not have access to the benefit in time to make a down payment, because the taxpayer can only claim the credit on the return once the taxpayer has purchased the home. To address this timing issue, the Federal Housing Administration (FHA) developed a program to advance the amount of the tax credits to first-time homebuyers. See Department of Housing and Urban Development, News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); Department of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last visited Oct. 16, 2009).

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*Resources of the Administrator.*

The IRS's core mission is to collect taxes, and it takes in about 96 percent of all federal receipts.<sup>56</sup> In recent years, considerable attention has been focused on the tax gap (the amount of tax due but not collected), and key members of Congress in charge of IRS oversight believe the IRS needs to do more to close the gap.<sup>57</sup> If the burden of administering new tax-based social benefit programs is excessive, it could impair the IRS's ability to deliver on its core tax-collection mission.<sup>58</sup> Implementing these provisions without adequate notice and resources will strain IRS systems and will likely lead the agency to divert resources from its core functions. In addition, like other federal agencies, the IRS faces a human capital crisis with more than 50 percent of its workforce eligible to retire in the near future.<sup>59</sup> Anticipated human capital problems are only exacerbated when the IRS is tasked with implementing entirely new programs.<sup>60</sup>

*Provide Enough Time to Implement New Provisions.*

Changes in the tax law create challenges for the IRS, especially when the changes occur late in the year. The IRS must do extensive work to incorporate tax changes, including programming multiple computer systems; printing forms, instructions and publications; coordinating with tax software providers; and providing up-to-date training to employees who answer taxpayer questions as well as to Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

Late-year and one-time tax law changes cause even more challenges.<sup>61</sup> For example, the IRS experienced difficulties administering the FTHBC in the early days of the 2009 filing season due to the late enactment of this provision. When ARRA expanded the FTHBC in February 2009, the IRS had to implement a compliance plan, and reprogram its computer systems with new compliance screening filters, at the height of the filing season. Due to the timing of the enactment, IRS systems were not programmed to timely process and

<sup>56</sup> See Department of the Treasury, Budget in Brief FY 2010, at 55.

<sup>57</sup> See, e.g., *Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?: Hearing Before the Senate Committee on Finance*, 110<sup>th</sup> Cong. (2007) (statement of Senator Max Baucus, Chairman of the Senate Committee on Finance), available at <http://finance.senate.gov/press/Bpress/2007press/prb041807b.pdf>. The IRS's most recent estimate of the voluntary compliance rate is 84 percent. Chairman Baucus urged the IRS to set a goal of achieving a 90 percent voluntary compliance rate by 2017.

<sup>58</sup> The IRS had to make certain tradeoffs to administer the Economic Stimulus Payment (ESP) program. See *The Status of Economic Stimulus Payments: Hearing Before the Subcomm. on Oversight and Social Security of the House Comm. On Ways and Means* (June 19, 2008) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Compliance Challenges Facing Financial Struggling Taxpayers: Hearing Before the Subcomm. on Oversight and Social Security of the House Comm. On Ways and Means* (Feb. 26, 2009) (statement of Nina E. Olson, National Taxpayer Advocate). For a detailed discussion of the implementation of the 2001 Advance Tax Rebate and Tax Rate Reduction Credit with little advance notice and the impact such implementation had on the IRS's other core functions, see W&I Research, IRS, *Lessons Learned from the IRS Implementation of the Advance Tax Refund and Tax Rate Reduction Credit Legislation*, Project Report 3-02-19-2-018 (Jan. 2003).

<sup>59</sup> TIGTA, Ref. No. 2009-10-118, *To Address Its Human Capital Challenge, the Internal Revenue Service Needs to Focus on Four Key Areas* (Aug. 19, 2009).

<sup>60</sup> See Press Release, United States Senate Committee on Finance, *Grassley Urges Accounting of Government Growth to Administer New Health Plan* (Oct. 1, 2009).

<sup>61</sup> For additional information see National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*). A discussion of the IRS's comprehensive efforts in FY 2007 to deliver the Telephone Excise Tax Refund, a one-time credit claimed on over 94 million 2006 federal income tax returns, is included in IRS, *The Budget in Brief: Fiscal Year 2009*, at <http://www.irs.gov/pub/newsroom/budget-in-brief-2009.pdf>.

screen the new FTHBC claims. As a result, returns processed early in the filing season were not subject to the new filters and potentially inappropriate FTHBC claims were paid.<sup>62</sup>

### ***Social Benefit Programs Increase Tax Code Complexity and Impact the Fair Distribution of Benefits.***

As more social benefit provisions are added to the tax code, they further complicate the task of simplifying the tax system. The existing refundable credits have few real common denominators. In part due to “legislative creep,” these provisions have different eligibility requirements, eligibility periods, income parameters, credit computations, phase-out thresholds and expiration dates. While many of these differences may be invisible to a significant number of taxpayers because they are addressed electronically in return preparation software, the increasing complexity raises the likelihood of mistakes. Complexity also makes it difficult for taxpayers to plan for taxes, and as a result, for lawmakers to incentivize behavior through the tax system.

The IRS has substantial experience administering previous tax provisions and may be able to head off problems by sharing lessons learned with legislators. The IRS, however, brings only one perspective to the table – that of the tax administrator. Thus, Congress also should consult with representatives of the target population, such as VITA program participants, Low Income Taxpayer Clinics (LITCs), and other nongovernmental organizations to learn the challenges faced by taxpayers in understanding eligibility for the program, computing and claiming the benefit on a return, receiving the benefit, and defending the claimant under audit or collection procedures.

New tax-based social benefit provisions may also interact with existing tax benefits in such a way as to undermine the incentives in the new provision. Because the various provisions have different phase-in and phase-out thresholds as well as eligibility requirements, the amount of the combined tax benefits actually reaching the targeted population may have an unintended and illogical result, including high marginal tax rates at eligibility phase-out or cliffs.<sup>63</sup>

### ***Complexity Imposes Transaction Costs on Taxpayers.***

Due to the complexity of claiming a tax credit or other tax-based social benefit provision, the applicant may feel compelled to pay a tax preparer for assistance. In effect, as the provisions become increasingly complex, the government is imposing a fee on the target population, which is frequently low income. For example, the criteria for claiming the EITC lead approximately 60 percent of EITC claimants to seek help from preparers.<sup>64</sup> This

<sup>62</sup> *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means 6* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009).

<sup>63</sup> Elaine Maag, Urban-Brookings Tax Policy Center, *Unified Credits for Low-Income Families*, Prepared for the American Tax Policy Institute (ATPI) Conference, “Tax Reform and the Low-Income Taxpayer” (Sept. 17, 2009).

<sup>64</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File and EITC Tables (TY 2008).

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scenario raises issues of preparer oversight, cost of return preparation, consumer protection from potentially abusive products such as refund anticipation loans (RALs), and the policy question of why the beneficiary must pay to receive certain government benefits but not others.<sup>65</sup> In addition, pushing the cost of the application on to the taxpayer may mask the true cost of the program. For example, the EITC may not be as cost-effective as it initially appears if the additional costs borne by the applicant, such as return preparation, filing, and commercial refund product fees, are factored into the calculation.<sup>66</sup>

### *Assessing the Impact of IRS Examinations on Beneficiaries of the Social Benefit Program.*

Tax-based social benefit provisions should be designed to minimize noncompliance. No matter how well designed, however, there will be a need for some sort of compliance initiative. The target population of the benefit might have particular needs or experience difficulties navigating the IRS, especially the examination process. Low income taxpayers may experience language barriers, or financial or functional literacy limitations.<sup>67</sup> They may be unable to obtain traditional audit documentation (because they are more likely to be unbanked and don't have financial records) and may not even receive IRS correspondence (because they are more likely to be transient). The Audit Barriers Survey conducted by TAS in 2007 found that taxpayers subject to EITC correspondence examinations for TY 2004 faced significant barriers when negotiating EITC audits. Taxpayers had communication issues throughout the audits, experienced difficulties in providing requested documentation, and had further problems navigating the process. The survey also found that represented taxpayers kept more EITC than unrepresented taxpayers.<sup>68</sup>

### *IRS Collection Actions Can Undermine the Intended Benefits of the Tax-based Social Benefit Provision.*

Complex eligibility criteria and credit calculations, coupled with high dollar values, can transform an otherwise beneficial refundable credit into a trap for the unwary. For example, because the EITC is so complex and mistakes are common, taxpayers who claim the credit are at least twice as likely to be audited as other taxpayers.<sup>69</sup> Yet because the EITC is a low income tax benefit, many taxpayers whose EITC claims are initially paid and then denied on audit have already spent their refunds. IRS collection procedures require that a Notice of Federal Tax Lien (NTFL) be filed whenever a taxpayer with a debt of \$5,000 or more is placed in currently not collectible (CNC) status.<sup>70</sup> This notice damages the

<sup>65</sup> For a discussion of the concerns surrounding refund anticipation loans, see National Taxpayer Advocate 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

<sup>66</sup> It is estimated that \$740 million in RAL fees were taken out of income tax refunds in 2003. Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers*, Brookings Institution (Apr. 2005).

<sup>67</sup> See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

<sup>68</sup> National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

<sup>69</sup> See *IRS Data Book, 2008*, Table 9a (showing an average audit rate of slightly more than 2 percent for taxpayers claiming the EITC as opposed to about 1 percent for taxpayers overall).

<sup>70</sup> IRM 5.19.4.5.2(3) (Apr. 26, 2006).

taxpayer's credit rating and negatively impacts a taxpayer's borrowing, employment, and housing opportunities.<sup>71</sup> In addition, under IRC §6402, the IRS generally will offset the full amount of refunds owed on future tax returns even if the taxpayer's income remains low, and he or she is otherwise eligible for low income tax benefits.<sup>72</sup>

To ensure that tax-based social benefit programs achieve their program goals, Congress should codify taxpayer rights protections associated with any new refundable credits. One such protection should limit the refund offset against the refundable portion of refunds attributable to means-tested credits.<sup>73</sup>

### *Tax-Based Social Benefit Provisions Need Built-in Measures to Determine Effectiveness.*

In addition to clearly defined policy goals, tax-based social benefit programs should incorporate a mechanism for evaluating their effectiveness. The collection of data pursuant to effectiveness measures will allow the administrator to determine if the program accomplishes its goals and to identify barriers to success. Periodic reports by the Department of the Treasury and the Joint Committee on Taxation are helpful in determining whether the program is achieving the intended result or whether and how it should be modified to achieve policy goals.

### *A Programmatic Approach Will Improve IRS Administration of Social Benefit Programs.*

Because social benefit programs typically have an explicit policy goal, successful administration through the tax system requires the IRS to take a programmatic approach. The IRS currently maintains program offices for both the EITC and the Health Coverage Tax Credit within the Wage and Investment (W&I) Operating Division. However, this program office structure has some limitations. For example, the EITC program office controls the use of appropriated funds, but does not have jurisdiction over procedures used by audit and collection resources with respect to the target population. This bifurcated approach results in the compliance functions not conforming their traditional enforcement procedures to the needs and characteristics of the target population. As noted above, failure to account for the target population's challenges can result in inaccurate audit results and unnecessary harm to the taxpayer.

Although not all tax-based social benefit programs will require a separate program office, those targeting taxpayer populations with special needs – such as EITC – will benefit from the programmatic approach. And unlike the current EITC program office, a comprehensive

<sup>71</sup> See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*, Vol. 1, *supra*.

<sup>72</sup> In the United Kingdom, HM Revenue and Customs cannot offset a tax credit more than 25 percent to satisfy a previous year tax debt, with exception. See HM Revenue and Customs, *Tax Bulletin Issue 74*, available at <http://www.hmrc.gov.uk/bulletins/tbissue74.htm> (last visited Oct. 12, 2009).

<sup>73</sup> For a legislative proposal on limiting refund offsets on refundable credit proceeds, see Legislative Recommendation: *Impose Collection Protections on Refund Offsets for EITC Recipients*, Vol. 1, *supra*.

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programmatic approach will necessitate the program office having jurisdiction over examination and collection guidance, if not the actual compliance personnel.

**Administrability Issues Specific to the EITC.**

The IRS faces challenges in administering social benefit programs designed as refundable credits. The following discussion sets forth issues specific to the administration of the EITC.

***Taxpayers Face Difficulty in Navigating Complicated EITC Eligibility Requirements.***

The EITC's complex eligibility requirements include income, housing, and family status elements. This complexity can lead even well-intentioned taxpayers to make errors and the IRS to pay inappropriate claims.<sup>74</sup> In fact, the complexity of claiming this credit drives over 70 percent of EITC taxpayers to rely on tax return preparers.<sup>75</sup> An IRS compliance study for TY 1999 attributed approximately 70 percent of EITC overclaims to tax returns completed by paid preparers.<sup>76</sup>

***IRS Faces Difficulty in Verifying Facts-and-Circumstances-Based EITC Eligibility Requirements.***

The EITC is a sizable credit, with approximately 23.7 million recipients receiving approximately \$49 billion for tax year 2008. However, the EITC's complex facts-and-circumstances-based eligibility requirements present the IRS with difficulties in verifying eligibility without auditing the taxpayers.<sup>77</sup> Eligibility to claim the EITC is based on the taxpayer's filing status, the taxpayer's earned income, and how many qualifying children the taxpayer can claim. For a taxpayer to claim an individual as a qualifying child, the individual must meet the following four tests (1) relationship test, (2) residency test, (3) age test, and (4) support test.<sup>78</sup> The IRS has the capability to verify the income and age elements of eligibility once it has received and processed third-party reporting data. However, the IRS has difficulties verifying the more personal facts-and-circumstances-based elements of relationship, residency, and support other than during the examination process.<sup>79</sup>

As discussed above, a less burdensome approach to administration of the EITC is to separate out the personal or fact-based component from the income component, resulting

<sup>74</sup> For example, a TY 2001 reporting compliance study estimated the level of improper overclaims for fiscal year 2007 to range from \$10.4 - \$12.3 billion and 23 percent (lower bound) to 28 percent (upper bound) of approximately \$44.5 billion in total program payments. Department of Treasury, *Fiscal Year 2007 Performance and Accountability Report*, Part IV, Appendix C: Improper Payments Information Act 280 (Nov. 15, 2007).

<sup>75</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

<sup>76</sup> GAO, GAO-08-800R, *Refund Anticipation Loans* (June 2008).

<sup>77</sup> IRS, EITC Database, Compliance Data Warehouse, Data Extracted on September, 16, 2009, available at <http://www.eitc.irs.gov/central/eitcstats/> (last visited Dec. 22, 2009).

<sup>78</sup> IRC § 32. For more details eligibility to claim the EITC based on the qualifying child determination, see Most Litigated Issue: *Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151, supra*.

<sup>79</sup> The IRS has access to Social Security data which can link a child's Social Security number (SSN) to the mother and father, if identified.

in two smaller credits with different eligibility criteria. The IRS could screen the income-based credit and pay benefits as soon as it obtains access to the income reporting data. The IRS may still have difficulties screening claims for the smaller relationship-based credit, but the amount at stake would be less than the current EITC, providing less incentive to cheat.

When the IRS is charged with administering a credit with personal factual eligibility criteria, as discussed above, the IRS should consider instituting a pre-certification requirement or option. Once the taxpayer produces the required documentation, the IRS computers would indicate eligibility and the taxpayer no longer would face this burden until he or she voluntarily reports a change in circumstances or the IRS systems flag such a change.

### *Taxpayers Face Difficulties Navigating the IRS EITC Correspondence Exam Process.*

EITC taxpayers under audit have demonstrated difficulty navigating the IRS correspondence examination process. For example, in a study performed by the Taxpayer Advocate Service in 2004, approximately 43 percent of taxpayers seeking reconsideration of audits that disallowed EITC in whole or in part received additional EITC through the reconsideration. Moreover, these taxpayers received, on average, 94 percent of the EITC they claimed on the original returns. Thus, for 43 percent of taxpayers seeking audit reconsideration, their original audit results did not reflect their eligibility for the EITC – they merely flunked the IRS audit process. In addition, in more than 40 percent of the cases reviewed, difficulties with IRS documentation requirements were identified as the reason for EITC audit reconsideration.<sup>80</sup>

As a follow-up to the audit reconsideration study, TAS conducted an Audit Barriers Survey project in 2007 that found this particular taxpayer population faces significant barriers when negotiating the EITC audit process. Taxpayers subject to EITC correspondence exams for TY 2004 returns had communication difficulties throughout the audits, experienced difficulties in providing requested documentation, and had difficulties navigating the correspondence exam process. In fact, 26.5 percent of the survey respondents did not even know they were subject to an IRS audit and 23 percent indicated they would have preferred to communicate with the IRS in person.<sup>81</sup>

Both the EITC Audit Reconsideration study and EITC Audit Barriers Survey highlight the problems taxpayers experience in meeting the IRS requirements for providing documentation to prove their EITC claims. This difficulty can cause taxpayers to become discouraged and possibly ignore the IRS request entirely. As part of the 2004 EITC certification study, the IRS piloted the use of affidavits (from third parties such as social workers and clergy) to allow taxpayers to prove they met the qualifying child residency requirement. The study results indicate the affidavit is the most effective and accurate means of proving eligibility

<sup>80</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

<sup>81</sup> National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

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and taxpayers prefer the affidavit to providing documents, records, or letters.<sup>82</sup> The IRS has indicated that it is poised to conduct another test with a larger sample to test the use of a third-party affidavit as alternative documentation to prove the residency requirement during an EITC exam.<sup>83</sup> Given the difficulties taxpayers face in obtaining needed documentation, the effectiveness of the affidavit, and taxpayers' willingness to use the new form, we commend the IRS for this initiative and encourage the IRS to expand the use of the affidavit to all EITC examinations. This approach may also encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information. Based on the EITC certification study, the IRS should also test other methods of proof to determine which are most accurate and best suited for IRS and taxpayer needs. The IRS can continue to gather data regarding the use of affidavits while expanding their use to all EITC examinations in the near future.<sup>84</sup>

In addition, to address the audit barriers faced by EITC taxpayers, the IRS should conduct research to determine the causes of noncompliance in the target population and tailor its different compliance techniques to address each specific cause.<sup>85</sup> The IRS also should increase awareness of legal assistance available through the LITC program, which can have a significant positive impact on the outcomes of EITC audits.<sup>86</sup>

Finally, although the IRS has a significant amount of research about the EITC population, this information is concentrated on the taxpayers' pre-filing and filing assistance needs. The IRS lacks sufficient research on EITC taxpayers' needs and preferences during examination and collection processes.<sup>87</sup> This lack of post-filing research results in a revenue-raising mentality rather than incorporating the agency's social knowledge into its compliance strategy.

<sup>82</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress* (Oct. 2005). The IRS conducted the second certification study from December 2004 through April 2005 for TY 2004. The study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child eligibility through available data. The 2004 certification study marked the first time IRS examination routinely used affidavits for tax administration purposes.

<sup>83</sup> See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

<sup>84</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 244 (Most Serious Problem: *EITC Examinations and the Impact of Taxpayer Representation*).

<sup>85</sup> See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003); Nina E. Olson, *Symposium: Closing the Tax Gap: A Ten-Step Program for Better Tax Compliance*, 20 Stan. L. & Policy Rev. 7 (2009).

<sup>86</sup> See National Taxpayer Advocate 2007 Annual Report to Congress vol. 2 at 94-116 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*).

<sup>87</sup> See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.



### *Timing of EITC Payments Limits Responsiveness and Increases Taxpayer Compliance Costs.*

EITC recipients use their EITC-related refunds to pay for necessities<sup>88</sup> and need the money as quickly as possible. Unless they elected to receive the Advance EITC, which suffers from a low participation rate,<sup>89</sup> taxpayers must wait to receive their benefits until they claim the refund on the next tax return. In addition, many taxpayers incur substantial fees associated with commercial refund delivery products in order to get their money quickly.<sup>90</sup> By contrast, the United Kingdom has a “pay as you go” system where the taxpayer receives the credit proceeds incrementally throughout the year. Under this system, the taxpayer is required to inform the administrator of any relevant change in circumstances and HMRC adjusts payment awards accordingly.<sup>91</sup>

### **Administrability Problems Specific to the Delivery of Economic Stimulus Payments**

The administration of the ESP program illustrates that the IRS can compromise its ability to perform its core mission when it is asked to take on non-core tasks. Congress passed the Economic Stimulus Act in February 2008; at the time, the IRS seemed like a logical agency to administer the delivery of the payments. However, this was a massive undertaking and came when the IRS was already in the midst of a challenging 2008 filing season.

While, on balance, the IRS did an outstanding job administering both the 2008 filing season and the ESP program, it certainly had to make significant trade-offs. For example, the IRS was not able to staff its telephone lines adequately and the level of service (LOS) on toll-free lines dropped sharply, from 83 percent during the 2007 filing season to 77 percent during the 2008 filing season.<sup>92</sup> In addition, because the IRS shifted customer service representatives from assisting with correspondence to answering phones, the productivity in processing paper correspondence declined and inventory rose sharply. The LOS for the IRS’s automated collection system telephone lines also declined due to a shift in personnel. These declines in service had serious consequences on taxpayers and increased their compliance burden. The program also created a burden on tax administration and impacted the public fisc as the reassignment of collection employees resulted in reduced collections.<sup>93</sup>

<sup>88</sup> Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor* (Aug. 17, 2005), available at <http://www.cbpp.org/cms/index.cfm?fa=archivePage&id=7-19-05eic.htm> (last visited Dec. 8, 2009).

<sup>89</sup> GAO, GAO-07-1110, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS’s Efforts to Reduce High Noncompliance* (Aug. 2007).

<sup>90</sup> GAO, GAO-08-800R, *Refund Anticipation Loans* (June 2008).

<sup>91</sup> For more information on the application and payments of tax credits in the United Kingdom, see <http://www.hmrc.gov.uk/taxcredits/start/who-qualifies/overview/what-are-taxcredits.htm> (last visited on Dec. 13, 2009).

<sup>92</sup> IRS, JOC Enterprise Telephone Data. Enterprise Snapshot. In fact, the IRS continued to experiencing a decline, with a 64 percent LOS during the 2009 filing season. TIGTA, Ref. No. 2009-40-127, *Unplanned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season 5* (Sept. 8, 2009). See Most Serious Problem: *IRS Toll-Free Telephone Service is Declining as Taxpayer Demand for Telephone Service is Increasing*, *supra*.

<sup>93</sup> For details of the impact the ESP program had on IRS services and enforcement activity, see *The Status of Economic Stimulus Payments: Hearing Before Subcomm. on Oversight and Social Security of the House Comm. on Ways and Means* (June 19, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

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The most significant challenges arose with respect to the approximately 20.5 million taxpayers who were eligible for a payment but had no current IRS filing requirement, *i.e.*, very low income taxpayers, including low income beneficiaries of Social Security and Veterans' benefits.<sup>94</sup> In hindsight, considering the burden imposed on both taxpayers and tax administration, it is reasonable to question whether the IRS was the appropriate forum to administer the ESP program to these individuals. The Social Security Administration (SSA) and the Department of Veteran's Affairs (VA) may have been better positioned to deliver the payments to their beneficiaries because the agencies have access to recipients' names, addresses, and bank account information. In fact, in ARRA, Congress chose the SSA, Department of Veterans Affairs, and the Railroad Retirement Board to administer the Economic Recovery Payment, a one-time \$250 payment to individuals who receive Social Security, Supplemental Security Income (SSI), Railroad Retirement and Veterans' Compensation and Pension benefits.<sup>95</sup>

### Administrability Problems Specific to the First Time Homebuyer Credit

As part of an effort to stimulate the United States housing market, Congress expanded the FTHBC in the American Recovery and Reinvestment Act of 2009 in February 2009, as the IRS was in the midst of the 2009 filing season. In fact, the IRS was tasked with administering two distinct FTHBC provisions during the filing season: the initial credit created under the Housing and Economic Recovery Act of 2008 (HERA) and the new expanded credit under ARRA.<sup>96</sup>

The expanded provision clearly affected home purchases. Through September 2009, the IRS processed FTHBC claims on more than 1.5 million returns.<sup>97</sup> Moreover, the Joint Committee on Taxation estimates that a majority of FTHBC claims will occur in 2010 when taxpayers file their 2009 returns.<sup>98</sup> Despite the successful impact on home purchases, the IRS faced significant challenges in administering the program and will continue to do so as it administers the newly expanded credit in the Worker, Homeownership and Business Assistance Act of 2009 (WHBA).<sup>99</sup> Under the new law, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010 and close on the home by June 30, 2010. For qualifying purchases in 2010, taxpayers have

<sup>94</sup> See *Implementing the Economic Stimulus Payment Program: Hearing Before Subcomm. On Oversight and Social Security of the House Comm. on Ways and Means 4-5* (June 19, 2008)(statement of Douglas H. Shulman, Commissioner, IRS).

<sup>95</sup> Pub. L. No. 111-5, § 2201, 123 Stat. 115, 450 (Feb. 2009)

<sup>96</sup> HERA, Pub. L. 110-289, 122 STAT. 2851 (July 30, 2008), created a FTHBC limited to \$7,500 for purchases of principal residences after April 8, 2008 and before July 1, 2009. The credit phased out when taxpayers had MAGI of more than \$75,000 for individuals (\$150,000 for joint filers) and the credit served as an interest-free loan to be paid back over a 15-year period. ARRA expanded the provision by raising the maximum amount to \$8,000, extended the time period for purchases to after January 1, 2009 and before December 1, 2009. Claimants were no longer required to pay back the proceeds under ARRA and could claim the credit on an amended TY 2008 return or 2009 return. ARRA, Pub. L. No 111-5, 123 Stat. 115 (Feb. 2009).

<sup>97</sup> *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. On Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

<sup>98</sup> United States Government Accountability Office, *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges, Testimony Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives*, GAO-10-166T (Oct. 22, 2009)

<sup>99</sup> Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

the option of claiming the credit on either their 2009 or 2010 return. The new law also raises the income limitations and authorizes the credit for long-time homeowners buying a replacement principal residence.

### *The Timing of FTHBC Payments Creates Monetization Challenges.*

Congress intended to stimulate the real estate market when it first enacted and subsequently enhanced the FTHBC. The credit was designed to assist taxpayers in making down payments on their first homes. However, timing of the payments quickly became an issue. To receive the credit proceeds, taxpayers could either file an amended return or wait to claim the credit in the next filing season. Thus, taxpayers would have to wait a potentially significant amount of time between closing on the home and receiving the funds. The delay in monetizing the credit threatened to undermine its intended incentive effect. To address this issue, the Federal Housing Administration developed a program to advance the credit to first-time homebuyers.<sup>100</sup>

### *The Timing of Credit Claims Created Audit Selection Challenges.*

Once Congress enacted the FTHBC as part of ARRA, the IRS took steps to implement a compliance plan through screening filters that would identify inappropriate claims. The screens identified and selected for audit the highest-risk FTHBC claims before issuing refunds. However, the screens were implemented incrementally because the expansion occurred at the height of the 2009 filing season. Thus, the IRS released some refunds associated with problematic returns, which will be subject to post-refund examinations. As of October 19, 2009, the IRS had selected more than 100,000 FTHBC returns for audit as a result of the screens.<sup>101</sup>

### *IRS Has Limited Means for Pre-Refund Verification of Eligibility.*

Eligibility to claim the credit relies on several factors, including income, date of home purchase, and whether the taxpayer owned a primary residence during the previous three years. To claim the credit, taxpayers must complete Form 5405, *First-Time Homebuyer Credit*, which requires the taxpayer to provide eligibility information and must be filed with the Form 1040. The IRS considered requiring taxpayers to attach additional documentation to substantiate eligibility, such as the HUD-1 Settlement Statement, but decided against this approach due to electronic filing concerns.<sup>102</sup> Thus, the IRS currently has no way to match documentation up front before paying out the sizable refundable credit.

<sup>100</sup> See Department of Housing and Urban Development (HUD), News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); U.S. Dept. of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last visited Jun. 25, 2009).

<sup>101</sup> *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H.Comm. on Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

<sup>102</sup> *Id.*

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It relies on compliance screens to catch inadvertent noncompliance as well as claims submitted pursuant to fraudulent schemes.

The FTHBC program could be reconfigured to minimize revenue loss by requiring third-party reporting to the IRS before it pays out these proceeds. The IRS could receive this information through electronically-filed third-party reporting received directly from the financial institutions or through HUD.<sup>103</sup> Alternatively, the IRS could require taxpayers to scan in their HUD-1 Settlement Statements and submit electronically with their returns. Either alternative may require the IRS to delay the FTHBC portion of refunds until it processes the third-party reporting information. However, requiring such eligibility documentation before paying out the proceeds could reduce fraud.<sup>104</sup>

### *Future Design of the FTHBC Program.*

If the IRS cannot receive and timely process eligibility documentation on the front end, it will continue to freeze a significant percentage of refunds containing these refundable credits. These delays will hurt the target population of these provisions, who factor the credit proceeds into their home-buying decisions. Taxpayers likely anticipate typical refund turnaround times and rely on the proceeds to pay expenses associated with the new home purchase. While it may be too late to resolve the issues associated with the existing expanded FTHBC, any similar future programs may be better structured as direct spending programs with payments administered directly by the agency with the most connection to the targeted behavior.

Thus, it is our belief that the FHA or a related agency would best administer the program. The closing agent would be required to conduct due diligence on behalf of the FHA at the sale and provide the necessary funds when needed by the purchaser – *i.e.*, at the time of purchase. The closing agent or lender also would have direct access to eligibility information due to its connection with the transaction.<sup>105</sup>

This design would benefit both the recipients and the federal government. As the program is currently designed, taxpayers do not receive the benefit in time to make a down payment, because they can only claim the credit on either an amended or original return once they have purchased the homes. In fact, in response to this perceived weakness in

<sup>103</sup> For example, the IRS could add a box on the Form 1098 or create a new form to provide information necessary for the IRS to effectively administer the credit. The box could provide the closing date and the purchase price of the home. The IRS would need to receive the Form 1098 before releasing the refund. Perhaps the closing agent could file a modified Form 1098 with the IRS within a reasonable time period after the closing. Thus, the filing deadline of the revised Form 1098, for purposes of the FTHBC, would be tied to the closing date rather than the filing season.

<sup>104</sup> At least one taxpayer who claimed the FTHBC submitted to the IRS a fake closing statement prepared by a commercial online company initially called falseexpense.com, a website which, at the time of drafting, redirects users to a website called salesreceiptstore.com (last visited Dec. 22, 2009).

<sup>105</sup> Income eligibility for the credit is based on the current year income. Thus, the closing agent would not have access to the data needed to determine eligibility with absolute certainty. However, through use of the existing Income Verification Express Service (IVES), the lender could verify the previous year income, which would provide an acceptable degree of certainty. The IVES program is used by mortgage lenders and others within the financial community to confirm the income of a borrower during the processing of a loan application. With the consent of the taxpayer, the IRS provides the return transcript, W-2 transcript and 1099 transcript information generally within two business days to a third party. IRS, *Income Verification Service*, at <http://www.irs.gov/individuals/article/0,,id=161649,00.html> (last visited Dec. 28, 2009).

the design of the program, the FHA developed a program to advance the amount of the tax credits to first-time homebuyers.<sup>106</sup> Congress can prevent the need for such retroactive efforts by addressing monetization issues in the design of the provision. Were the program designed as a direct spending program, directly administered by the FHA, there would be no monetization issue and improved compliance protections.<sup>107</sup>

Alternatively, the FTHBC program could be a hybrid of a tax credit and direct spending program. The FHA could advance the money to the purchaser in a manner similar to the FHA loan program currently in place. However, rather than have the taxpayer receive the funds in a tax refund and subsequently pay FHA, the IRS could transmit the money directly to FHA upon verification of the return. If the taxpayer fails to correctly claim the credit on the return, he or she would be liable to reimburse the FHA for any outstanding balances, because the FHA loan program attaches a second lien on the residence. This approach is less attractive than the above-discussed direct spending approach, because it really amounts to the IRS repaying another federal agency, but it does eliminate monetization concerns.

## CONCLUSION

The design of a social benefit program is key to its effectiveness. There are many advantages to running a program through the tax system, primarily due to the IRS's vast reach, store of financial data, and recent experience in administering similar programs. Refundable tax credits are often favored as the vehicle to deliver social benefits, yet they are also associated with noncompliance. The National Taxpayer Advocate believes that noncompliance is not necessarily more prevalent in refundable credits than any other type of tax incentive. Such noncompliance may actually stem from the design of the social benefit program rather than the refundability component of the tax credit. For example, eligibility determinations and benefit amount calculations may be too complex for the particular target population. The large monetary amount of the incentive also may attract abuse tax schemes. Further, it is difficult to prevent noncompliance if the administrator cannot access documentation needed to verify eligibility before paying out the benefit payment.

The optimal design of a social benefit program maximizes participation and compliance levels. To achieve the optimal design, it is necessary to learn from the experience of the IRS in running such programs as the EITC, FTHBC, and ESP programs. While the IRS does have broad experience in administering these programs, it has also faced significant

<sup>106</sup> See Department of Housing and Urban Development, News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); U.S. Dept. of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last Oct. 16, 2009).

<sup>107</sup> Congress took a similar direct spending approach in the recent "Cash for Clunkers" program. While Congress could have created a tax incentive to encourage taxpayers to purchase new fuel-efficient automobiles, it instead designed the Car Allowance Rebate System (CARS). CARS is administered by the National Highway Traffic Safety Administration (NHTSA), but the car consumers received their payments directly from their car dealers, which were subsequently reimbursed by the NHTSA through electronic funds transfer. For more information on the CARS program, see [www.cars.gov](http://www.cars.gov) (last visited Oct. 12, 2009); Consumer Assistance to Recycle and Save Program, 13 U.S.C. 1301 et seq.

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challenges, many of which could have been avoided if the program had been designed differently, and in some instances created as direct spending programs not administered by the IRS. Moreover, in addressing noncompliance, the traditional IRS approach to audits and collection can undermine the very policy goals the program was designed to achieve. Accordingly, the National Taxpayer Advocate believes it is crucial to understand the needs of the target population as well as the strengths and limitations of the proposed program administrator in order to structure an effective program.