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# Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor through the Tax System

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**Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor through the Tax System**

I. Introduction

A. The Earned Income Tax Credit (EITC): Participation, Costs and Errors

A refundable credit worth as much as \$4,400 in cash for lower-income workers with at least two children, the EITC is one of the largest federal transfer programs and is the country's primary means of reducing poverty among families with children.<sup>1</sup> In 2003, workers claimed over \$38 billion in EITC, with over 88 percent of the EITC refunded directly to taxpayers, rather than reducing pre-credit income tax liability.<sup>2</sup> Unique among transfer programs in that it relies on a system of self-declaring eligibility (in the form of an annual filing of a tax return), rather than extensive, and often in-person, pre-eligibility screening, the EITC benefits from extraordinarily high participation rates<sup>3</sup> and low direct administrative costs relative to other transfer programs.<sup>4</sup>

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\* Professor of Law and Director of the Federal Tax Clinic, Villanova University School of Law. I dedicate this article to the memory of Janet Spragens, a tireless advocate who thought about and fought for the rights of the low income taxpayer. I learned much from her, and will miss her smile, wisdom, and advice. I would like to thank Leandra Lederman and Lawrence Zelenak for helpful comments on an earlier version of the article.

I am grateful for the work of my research assistants, Katrina Kayden, Meegan Hollywood, Si Nae Lim, and John Guinan.

<sup>1</sup> Steve Holt, *The EITC at Age 30: What We Know* 8 (Feb. 2006), available at [http://www.brookings.edu/metro/pubs/20060209\\_Holt.htm](http://www.brookings.edu/metro/pubs/20060209_Holt.htm) (highlighting the EITC's effect on reducing poverty and encouraging work); Alan Berube, *The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s* 2 (Feb. 2006), available at [http://www.brookings.edu/metro/pubs/eitc/20060209\\_newsafety.htm](http://www.brookings.edu/metro/pubs/eitc/20060209_newsafety.htm) (noting that the EITC is the country's largest antipoverty program targeted to families with children).

<sup>2</sup> Alan Berube, *The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s* 1 (Feb. 2006), available at [http://www.brookings.edu/metro/pubs/eitc/20060209\\_newsafety.htm](http://www.brookings.edu/metro/pubs/eitc/20060209_newsafety.htm).

<sup>3</sup> Participation in the EITC greatly exceeds that in other transfer programs. For example, as a result of cumbersome pre-certification process involved in obtaining food stamps, the participation rate for the food stamp program (FSP) is only a little higher than 50%. On the other hand, the participation rate among eligible families for the self-declaring EITC is approximately 90%. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1004-05 (2004).

<sup>4</sup> See, e.g., Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1882 (2005).

High participation and low direct administrative costs suggest that the relatively recent experiment of using the tax code to deliver refundable credits to supplement low-wage labor and reduce poverty is a success.<sup>5</sup> In fact, academics and policymakers alike have praised the EITC as a tool for transferring benefits.<sup>6</sup> Yet, the IRS is facing a crisis in administration. Rather than receiving praise for its efficient administration, the IRS is often caught in a vise, criticized by some in the executive and legislative branches as permitting too much program error, with almost 1/3 of the EITC claimed erroneously.<sup>7</sup> In response to these criticisms, the IRS has implemented a series of compliance efforts that the media, advocates and some legislators have criticized as heavy-handed and unfair to the country's working poor.<sup>8</sup>

The EITC's error rate is high, in large part because the IRS has no extensive bureaucracy to pre-determine eligibility, and instead has largely relied on a small number of post-application correspondence-based eligibility audits following the filing of a tax return to determine whether a claimant is eligible.<sup>9</sup> While high error rates are indirect costs, not directly appearing as line items on the IRS's budget, they detract from the program's effectiveness.

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<sup>5</sup> The EITC was enacted in 1975. Revenue Adjustment Act of 1975, H.R. 9968, 94th Congress (1975). It was expanded significantly in the 1990s. For a discussion of the history and growth of the EITC, see Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, 53 NAT'L TAX J. 983 (2000).

<sup>6</sup> This is not to suggest necessarily that all transfer programs should be effected through the tax system. For a discussion of how institutional design should influence which part of government houses a program, see David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1010-12 (2004) (noting the EITC's lower administrative costs and high participation, but pointing out key institutional differences between traditional transfer programs and benefits delivered through the tax system); see also Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995) (noting that the tax system is not ideally situated to perform all of welfare's functions, including responsiveness to recipients' shorter term needs).

<sup>7</sup> See OMB Calls IRS EITC Compliance 'Ineffective' (2006), available at LEXIS, Tax Analysts, Tax Notes Today, 2006 TNT 26-43.

<sup>8</sup> See *The I.R.S. Goes After the Poor*, N.Y. TIMES, Apr. 7, 2003, at 12; David Cay Johnston, *I.R.S. Move Said to Hurt The Poor*, N.Y. TIMES, Jan. 11, 2006, at C6 (discussing the refund freeze).

<sup>9</sup> The numbers are small relative to other benefits' programs where there is universal pre-benefits eligibility test. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1877-78 (2005). The numbers do not seem small when compared with other taxpayers, as EITC claimants face higher audit rates than other taxpayers. For data on the audit rate of EITC claiming taxpayers compared to returns without EITC claims, see National Taxpayer Advocate, 2005 Annual Report to Congress, 102, Table 1.5.2 (2.25

Congressional concern with the EITC's high error rates has led to an extensive compliance initiative over a seven-year period that has not materially reduced the EITC's error rate and thus the proportion of undeserving claimants receiving EITCs. The failure to reduce errors through traditional means in the tax system led to proposals that have their pedigree in compliance efforts found in traditional benefits programs, like certification of eligibility prior to the establishing eligibility<sup>10</sup> and a civil penalty disallowance regime that would prevent even eligible individuals from claiming the EITC if in past years they recklessly or fraudulently claimed the EITC.<sup>11</sup> These radical proposals would fundamentally change the administration of the EITC and the nature of the IRS. It has also led the IRS to take extraordinary actions<sup>12</sup> that jeopardize basic due process rights, like freezing without notice and hearing refunds suspected to arise from fraudulent claims.<sup>13</sup>

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percent audit rate for individuals claiming an EITC compared with an approximate 1.8 percent audit rate for individuals with receipts in excess of \$100,000; non EITC-claiming lower-earning taxpayers had even lower audit rates).

<sup>10</sup> The IRS's certification program focused on EITC claimants establishing that they had the same principal place of abode for more than one-half of a year. Announcement 2003-04, 2003-1 C.B. 1132 (discussing IRS plans to require certain taxpayers to establish that they satisfied the residency requirement with a child or children prior to or at the time of the filing of a tax return); *see also* IRS Status Report to Congress, IRS Earned Income Tax Credit (EITC) Initiative, ii-vi (2005) (discussing the results of the IRS's first pilot program requiring 25,000 taxpayers to certify residence). Preliminary data taken from the certification pilot indicates that certification efforts on the part of the IRS may have the effect, in the aggregate, of protecting against millions of dollars of erroneous EITC claims. Certification of eligibility is almost universal for other means-based benefits programs. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1869-71 (2005).

<sup>11</sup> I.R.C. § 32(k) provides a disallowance period if there is a final determination that the EITC was due to reckless or intentional disregard of rules or regulation (two years) or fraud (10 years). For a similar disallowance provision in the food stamp program for making false or misleading statements, withholding or misrepresenting facts, *see* 51 U.S.C. § 2015(b) (disqualification period varies based on the number and type of violation).

<sup>12</sup> In an extremely perceptive article, Professor Alstott noted that the EITC's susceptibility to error resulted, in part, from its tax-based administration and that reducing some of the EITC's weaknesses (like error rate) required "either compromising the benefits of tax-based administration or undertaking a major restructuring of basic institutions of the federal tax system." Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV L. REV. 533 (1995). The recent certification and refund freeze proposals reflect the type of changes Professor Alstott foreshadowed over 10 years ago.

<sup>13</sup> *See* 2 NAT'L TAXPAYER ADVOC. ANN. REP. (Dec. 2005); *Guilty Until Proven Innocent*, N.Y. TIMES, Jan. 20, 2006, at 16; David Cay Johnston, *I.R.S. Move Said to Hurt The Poor*, N.Y. TIMES, Jan. 11, 2006, at C6 (criticizing the refund freeze program).

## B. The Potential Backfire Risk

Critics of the IRS's extraordinary actions to prevent error in the EITC have been vocal, emphasizing the unfairness of IRS focus on the poor and the likely negative effects that the IRS's actions would have on program participation.<sup>14</sup> The media and many in Congress have challenged the IRS's refund-freeze policy as unfair, and it is alien to the traditional governmental standards of affording notice and hearing prior to what can be a long period of delay.<sup>15</sup> With this context in mind, it is important to emphasize that the IRS has a difficult task in administering the EITC. Founded as an agency with its primary mission to collect revenues (not an easy job in its own right), it has, largely by historical accident, found itself responsible for distributing funds that can mean the difference between living in or out of poverty. Congress and other parts of the executive branch have taken the IRS to task about the EITC's error rate. When the IRS reacts and attempts to reduce the error rate, it has found its actions largely ineffective.<sup>16</sup> Moreover, its actions seem heavy-handed, spurring legislators and others to criticize the IRS as unfairly picking on the little guy when there are far bigger fish to fry.<sup>17</sup>

In a recent and insightful article, Professor Lawrence Zelenak notes that the controversy surrounding the IRS's compliance and enforcement efforts is a consequence of its status as a hybrid tax-transfer program. Its precarious position, according to Zelenak, stems from its administration largely as a tax program, but its economic effect largely as a welfare-type

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<sup>14</sup> See, e.g., Robert Greenstein, *The New Procedures for the Earned Income Tax Credit*, 99 TAX NOTES 1525 (2003) (arguing that IRS pre-certification efforts would decrease participation among eligible participants); *See Guilty Until Proven Innocent*, N.Y. TIMES, Jan. 20, 2006, at 16. (noting the opposition to the IRS's efforts to freeze EITC-generated refunds).

<sup>15</sup> *See Guilty Until Proven Innocent*, N.Y. TIMES, Jan. 20, 2006, at 16.

<sup>16</sup> Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in THE CRISIS IN TAX ADMINISTRATION 148, 179 (Henry J. Aaron & Joel Slemrod eds., 2004) (noting that recent compliance efforts have reduced some of the noncompliance, especially among so-called tie-breaker errors where more than one potentially eligible person could claim the EITC, but that error rates "may still be considered too high").

<sup>17</sup> *See Guilty Until Proven Innocent*, N.Y. TIMES, Jan. 20, 2006, at 16 (noting how IRS focus on the EITC seems shortsighted, given the compliance issues facing wealthier taxpayers, such as the IRS's scant efforts to pursue the illegal sheltering of offshore income, costing approximately \$20 billion to \$40 billion a year).

program. Zelenak argues that the EITC's hybrid status is a benefit in that its tax pedigree helps ensure a combination of high participation and lack of direct administrative costs, making it preferable to other transfer programs which have lower error rates, but higher administrative costs and lower participation. Zelenak offers little in terms of prescriptive advice as to how the IRS or Congress should fashion its compliance efforts, other than the suggestion that too much resistance to compliance initiatives could backfire, and result either in (1) a Congressional rejection of the "EITC as tax" analogy and transfer administration away from the IRS or (2) a refrain from meaningful reduction in the error rates that could ultimately lead to an undermining of the program's support and ultimate reduction or elimination.<sup>18</sup>

The backfire risk that Zelenak posits is a significant cause for concern among those, myself included, who believe that the low-cost high participation benefits of the tax-based administration of the EITC are significant and worth maintaining.<sup>19</sup> This article considers further the hybrid nature of the EITC, and argues that as a starting point in compliance efforts, the government should consider strategies that are less likely to require significant administrative costs or decrease participation among eligible participants. To that end, the government should shift additional compliance costs onto commercial tax return preparers, who play a significant role in the EITC's delivery. Part II of the article examines the basic structure of the EITC, as well

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<sup>18</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1915-16 (2005); Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 589 (1995) (noting strong public and political reaction to error rates makes it improbable that there will be an acceptance of high EITC error rates).

<sup>19</sup> Delivering benefits through the tax system is also less stigmatizing than traditional welfare programs that are dependent upon often difficult and costly in-person pre-eligibility screening processes. For a possible framework evaluating the tradeoff between errors and participation, see David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1011 (2004) (considering such factors as the characteristics as those receiving overpayments and the social costs to those who do not participate). Like Zelenak, in comparing the food stamp program to the EITC, Weisbach and Nussim conclude that the EITC's pattern of errors is preferable. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1011 (2004). In addition to high participation and low direct costs, transferring benefits through the tax system rather than through traditional welfare administration is thought to be less stigmatizing. See Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995).

as providing an overview of the program's compliance problem and the use of commercial tax return preparers. Part III explores the EITC's welfare and tax characteristics, and analyzes Professor Zelenak's article further. Part IV reveals that how the particular tax characteristics of the EITC, namely little discretion in eligibility and the presence of the marketplace in assisting with the delivery of the benefits, suggest prescriptive policies that will not compromise the benefits of the tax system's administration of the EITC. In Part V, building on the understanding of the tax characteristics of administering the EITC and the likely causes of errors attributable to commercially prepared returns, I argue that policymakers should focus on shifting additional compliance costs to commercial return preparers in the form of heightened due diligence rules.

## II. The EITC: The Basics, the Noncompliance Problem and the Use of Commercial Preparers

### A. Summary of the EITC

The EITC provides a refundable credit for low-income working claimants. Originally enacted in 1975 as an offset to Social Security taxes and to provide an incentive to work, it has been expanded significantly since inception. The credit provides a substantial benefit to 21 million Americans, with over \$38 billion claimed in 2003 and almost 88 percent refunded directly to claimants, and an average amount claimed of \$1,788.<sup>20</sup>

The amount of the EITC depends on earned income and the presence of up to two qualifying children who satisfy residency,<sup>21</sup> relationship<sup>22</sup> and age<sup>23</sup> requirements. The credit

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<sup>20</sup> Berube, *The New Safety Net*, supra n. 2 at 1.

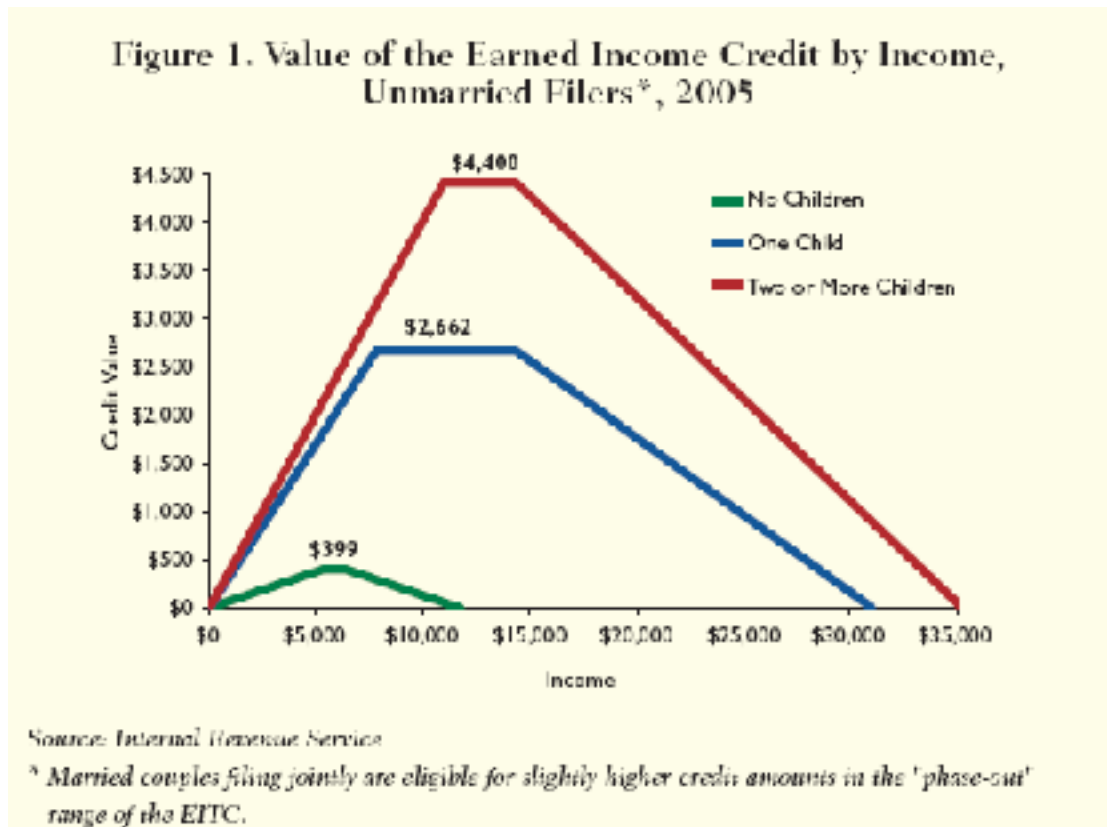
<sup>21</sup> I.R.C. § 32(c) (requiring that qualifying child live in the United States with the taxpayer for more than half the year).

<sup>22</sup> I.R.C. § 32(c) (requiring that qualifying child be a son; daughter; stepchild; eligible foster child; a descendant of a son, daughter, stepchild, eligible foster child; brother; sister; half brother; half sister; stepbrother; stepsister; or a descendant of a brother, sister, half brother, half sister, stepbrother or a stepsister).

<sup>23</sup> I.R.C. § 32(c) (requiring that qualifying child is under the age of 19 or under the age of 24 and a student or permanently and totally disabled at any time during the year, regardless of age).

amount is based upon a percentage of the claimant’s income,<sup>24</sup> with a ceiling that varies by filing status and the number of qualifying children, though there is no additional benefit for more than two qualifying children. To help target the EITC to the poor or near poor, claimants with excess investment income are not eligible,<sup>25</sup> and married claimants cannot file separately.<sup>26</sup>

The following table illustrates the value of the EITC, according to income and the presence of up to two qualifying children:



<sup>24</sup> I.R.C. §§ 32(a), (b). The amount is indexed to account for inflation. I.R.C. § 32(j). This is a complex calculation, and the IRS publishes annual tables to help with this computation. See IRS Publication 596, Earned Income Credit Appendix (2005 Earned Income Credit Table).

<sup>25</sup> I.R.C. § 32(i) (denying the EITC for individuals with excessive investment income). The limitation is indexed for inflation. I.R.C. § 32(j). For 2005, the maximal amount of investment income is \$2700. IRS Publication 596 p. 8.

<sup>26</sup> I.R.C. § 32(d). In addition, to ensure that the benefit does not accrue to undocumented workers, the taxpayer and the children claimed must have Social Security numbers valid for employment in the United States. I.R.C. § 32(m).



## B. The Overclaim Problem

### 1. What We Know

A significant number of people who file returns purporting to be eligible for EITC benefits are not in fact eligible or are unable to demonstrate eligibility. In a study of EITC claims from 1999, of about 18.8 million tax returns with approximately \$31.3 billion in claims, the IRS estimated that between \$9.7 billion and \$11.1 billion of EITC claims were erroneous.<sup>27</sup> IRS enforcement activities prevented or recovered approximately \$1.2 billion in improper claims. Thus, using upper range estimates, the IRS should not have paid approximately \$9.9 billion of the claims. Analysis of tax year 1999 compliance data shows that 80 percent of the overclaims and 75 percent of overclaim dollars are attributable to three types of errors.<sup>28</sup> These included: (1) approximately \$3 billion to qualifying child errors on 1.6 million returns; (2) approximately \$2 billion to filing status errors on 1.3 million returns; and (3) approximately \$1.9 billion to income misreporting errors on 3.6 million returns.<sup>29</sup>

The most common qualifying child error was claiming a child who did not live with the taxpayer for over half the taxable year and therefore did not satisfy the residency requirement.<sup>30</sup> Another common qualifying error was claiming a child who did not meet the necessary

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<sup>27</sup> IRS, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns (2002) (noncompliance range is attributable to differing assumptions for those claimants who did not respond to the IRS compliance study). Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* 148, 163 (Henry J. Aaron & Joel Slemrod eds., 2004).

<sup>28</sup> Internal Revenue Service, EITC Reform Initiative, FS-2004-14, June 2003, [www.irs.gov/newsroom/article/0,,id=110296.html](http://www.irs.gov/newsroom/article/0,,id=110296.html) (last visited Sept. 24, 2005).

<sup>29</sup> Internal Revenue Service, EITC Reform Initiative, FS-2004-14, June 2003, [www.irs.gov/newsroom/article/0,,id=110296.html](http://www.irs.gov/newsroom/article/0,,id=110296.html) (last visited Sept. 24, 2005).

<sup>30</sup> Internal Revenue Service, Announcement 2003-40, Administration of the Earned Income Credit, [www.irs.gov/newsroom/article/0,,id=110298,00.html](http://www.irs.gov/newsroom/article/0,,id=110298,00.html) (last visited Sept. 24, 2005).

relationship test to the taxpayer.<sup>31</sup> There was much overlap among the common errors, as most who did not meet the relationship requirement also did not meet the residency requirement.<sup>32</sup>

In response to the persistent noncompliance problem, Congress and the IRS have undertaken a far-reaching and at times radical approach to the problem. Congress has authorized over a special appropriation of approximately \$150 million per year over a five-year period to combat EITC errors.<sup>33</sup> While there have been significant legislative and administrative efforts to reduce noncompliance,<sup>34</sup> recent IRS studies indicate that the compliance rates for the EITC are not substantially different from those for 1999, the last major EITC compliance review.<sup>35</sup>

## 2. What We Do Not Know

Even though the IRS has studied and reported on EITC noncompliance in four separate studies in the past fifteen year, there is very little data relating to how much EITC noncompliance relates to intentional conduct and how much relates to unintentional error. A sometimes quoted study pegs the intentional EITC noncompliance rate at about 30 percent;<sup>36</sup> IRS

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<sup>31</sup> Internal Revenue Service, Announcement 2003-40, Administration of the Earned Income Credit, [www.irs.gov/newsroom/article/0,,id=110298,00.html](http://www.irs.gov/newsroom/article/0,,id=110298,00.html) (last visited Sept. 24, 2005).

<sup>32</sup> Internal Revenue Service, Announcement 2003-40, Administration of the Earned Income Credit, [www.irs.gov/newsroom/article/0,,id=110298,00.html](http://www.irs.gov/newsroom/article/0,,id=110298,00.html) (last visited Sept. 24, 2005).

<sup>33</sup> Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers in THE CRISIS IN TAX ADMINISTRATION* 148, 161 (Henry J. Aaron & Joel Slemrod eds., 2004).

<sup>34</sup> Those efforts have included tightening the definition of qualifying child so that only children or are blood relatives or placed with a claimant by a state authorized placement agency can potentially qualify, simplifying tie-breaker rules so that it is less likely that claimants would inadvertently claim an illegible child, applying filters to electronically filed returns, creating a Dependent Database from the Federal Case Registry of Child Support Orders to identify possibly erroneous qualifying child claims from claimants who are less likely to be custodial parents, imposing potentially draconian civil disallowance penalties on claimants who erroneously claim qualifying children, imposing due diligence requirements on commercial preparers who prepare and file returns where an EITC is claimed, the use of summary math disallowance procedures when claimants who have previously had their EITC disallowed in audit file a subsequent return claiming the EITC without appropriate additional proof with the return, and criminal investigation of commercial preparers suspected of fraudulently preparing EITC claimants' returns.

<sup>35</sup> See IRS, IRS Earned Income Tax Credit Initiative, 3 (Oct. 2005) (noting that preliminary data from the 2001 taxable year reflects estimates that are not substantially different from the 1999 study, but noting that some of the compliance initiatives were not in place in 2001).

<sup>36</sup> See Janet Holtzblatt & Janet McCubbin, Dept. of Treasury, *Administrative Issues with Low Income Filers*, 29 (2002) (noting the difficulty the IRS has in evaluating taxpayer intent in its EITC compliance studies). Using data from the 1980s, Liebman estimates that at least 32% of EITC overclaims are attributable to intentional taxpayer behavior. *Id.*

estimates considered the intentional error rate closer to 50 percent, but one thoughtful observer commenting on the 50 percent estimate doubted its accuracy and stated that “it is virtually impossible to distinguish taxpayer confusion from intentional misreporting.”<sup>37</sup>

Part of the challenges that the government faces with respect to reducing the EITC error rate is that while the government has data on the elements that claimants are unable to satisfy, there is little understanding of the underlying nature of the noncompliance. Sociologists have identified various types of noncompliance, helping focus on the underlying causes of the error, rather than just what legal element was unsatisfied.<sup>38</sup>

Writing about tax noncompliance generally, sociologists Robert Kidder and Craig McEwen identified a typology of noncompliance to help identify the underlying nature of noncompliance.<sup>39</sup> Kidder and McEwen argue that noncompliance is best understood when one considers the complex interaction between taxpayers and the tax system, with the result that even broad categories like intentional and unintentional are insufficient to understand fully the dynamics of noncompliance. In an article in the *Kansas Law Review*, I applied the Kidder and McEwen typology to what little we know of the nature of EITC noncompliance. In looking at EITC noncompliance, I argue that it is likely that there is likely not one compliance problem, but a series of sometimes distinct compliance problems that calls for a more focused but still multifaceted approach to reflect specific types of noncompliance problems.

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<sup>37</sup> See Janet McCubbin, *EITC Compliance: the Misreporting of Children and the Size of the EITC*, 6 (1999), available at <http://ideas.repec.org/p/wop/jopovw/132.html>.

<sup>38</sup> I have written on this previously, applying the work of sociologists Robert Kidder and Craig McEwen. Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145 (2003), citing Kidder and McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 TAXPAYER COMPLIANCE 57 (1989).

<sup>39</sup> See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 TAXPAYER COMPLIANCE 47 (1989). Kidder and McEwen categorized noncompliance in terms of procedural noncompliance, lazy noncompliance, unknowing noncompliance, brokered noncompliance, symbolic noncompliance, social noncompliance, and habitual noncompliance. I briefly discuss lazy and unknowing noncompliance below. For an application of the other categories in the EITC context, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. KAN. L. REV. 1145 (2003).

Determining the underlying causes of the error is crucial, because government action should vary depending on what truly inspired the error. For example, for low-income taxpayers, I believe, based upon my experience in representing many taxpayers in a low-income clinic, that procedural noncompliance (errors relating to administrative complexity), unknowing noncompliance (inadvertent errors that claimants themselves make) and brokered noncompliance (errors facilitated by unscrupulous or ignorant return preparers), are significant factors in the overclaim rate. Understanding the underlying causes of noncompliance helps the government tailor an appropriate response, as well as facilitating a discussion as to whether the government should focus its resources on particular types of noncompliance.<sup>40</sup>

### 3. The Role of Paid Preparers

The Kidder and McEwen typology as applied to low-income taxpayers is helpful, for it allows a clearer look at what the government can do to reduce particular types of noncompliance. Importantly, government responses to some types of noncompliance will be ineffective or perhaps even counterproductive with other types of noncompliance.<sup>41</sup> Given that EITC claiming taxpayers disproportionately rely on paid preparers to prepare and file their EITC claims,<sup>42</sup> brokered noncompliance is especially important for EITC-claiming taxpayers. Understanding the relationship of paid preparers to the EITC compliance problem is crucial.

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<sup>40</sup> See GAO, *Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, 17-18GAO-05-753 (July 2005).

<sup>41</sup> See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145, 1186 (2003) (discussing how Congressional efforts to reduce the possibility EITC program error increased the perceived injustice of the EITC, especially for unmarried household partners with the working partner not the biological parent of a minor child).

<sup>42</sup> See *infra* at [ ]

As the GAO recently reported, many American taxpayers view completing and filing a tax return as a “daunting task.”<sup>43</sup> People use tax preparers for many reasons, including because they do not understand the tax laws; they lack time and patience to complete the forms; or they hoped to obtain a larger or faster refund through a preparer.<sup>44</sup> In 2001, for lower-income EITC-claiming taxpayers, the percentage of taxpayers who paid someone to prepare their returns is higher than that of non-EITC claimants, with approximately 68 percent having used paid preparers, compared to 59.4 percent of the general population.<sup>45</sup> In addition to the complexity of tax returns claiming an EITC, reasons why low-income taxpayers are particularly likely to use a preparer include limited literacy skills, language barriers and the promise of faster refunds through access to electronic filing or loans facilitated by preparers.<sup>46</sup>

The cost of return preparation, although paid by EITC recipients, is properly viewed as a hidden administrative cost of the EITC program. Perhaps these preparers offer a productive way

<sup>43</sup> GAO, *Most Taxpayers Believe They Benefit from Paid Tax Preparers, But Oversight for IRS is a Challenge*, GAO-04-70 1 (Oct. 2003).

<sup>44</sup> GAO, *Most Taxpayers Believe They Benefit from Paid Tax Preparers, But Oversight for IRS is a Challenge*, GAO-04-70 7-8 (Oct. 2003).

<sup>45</sup> DEPARTMENT OF THE TREASURY, EARNED INCOME TAX CREDIT PROGRAM EFFECTIVENESS AND PROGRAM MANAGEMENT [hereinafter PROGRAM EFFECTIVENESS], 4 (Aug. 8, 2003). Recent data more specifically identifies the distribution ranges of EITC applicants who use paid preparers.

Parents Under 65 Who File Tax Returns, Tax Year 2000		
Income (as % of federal poverty level)	Receive help preparing taxes	Head count the EITC
< 50%	75.0%	67.0%
50-100%	70.0%	71.0%
100-150%	65.0%	72.0%
150-200%	68.0%	71.0%
200% or more	56.0%	77.0%
Received AFDC/TANF in the past	77.0%	91.0%
Received Food stamps in the past	75.0%	85.0%
Total	68.0%	66.2%

The use of commercial preparers among EITC claimants is increasing. Alan Berube, *The New Safety Net*, Brookings Inst., 8 (Feb. 2006) (increase in proportion of EITC claimants who use paid preparers to 71 percent in 2003). Berube notes that lower-income non-EITC claimants used commercial preparers at the much lower rate of 52 percent. *Id.* at 8.

<sup>46</sup> See, e.g., Francine Lipman, *The Working Poor are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 WIS. L. REV. 461, 472 (2003). These loans are secured by the anticipated refund.

to use private markets to improve social service delivery, but the economic effect of the fees they charge is a reduction in net EITC benefits received.<sup>47</sup>

For those unfamiliar with the tax system it is sometimes surprising that there are no minimum national qualifications applicable for those wishing to prepare federal tax returns. As the National Taxpayer Advocate (NTA) recently testified, before the 1990s' expansion of the EITC, the vast majority of return preparers were Certified Public Accountants (CPAs) or attorneys subject to state licensing, and often to a continuing education requirement, or enrolled agents, who are in the business of preparing tax returns, and must pass a rigorous IRS-administered examination and complete 16 hours of continuing professional education every year.<sup>48</sup> However, as the NTA testified, with the boost in the EITC and the advent of electronic tax return filing that facilitated preparers' arrangements for taxpayers to receive almost instantaneous loans monetized by the refunds, a new class of preparers has emerged -- one that is not engaged primarily in the business of preparing taxes. Rather, these preparers use tax preparation as a means to attract customers for some other product or service they offer that is unrelated to return preparation or even financial or tax planning. These products include check cashing, automobile sales, sale of pawned items [or "pawn services"], furniture rentals, and even -- through the use of payday-type loans issued on debit cards that are honored at only a few locations -- the provision of general household necessities that are sold at grossly inflated prices during the filing season.<sup>49</sup> For these preparers, unlike the CPAs, attorneys, or enrolled preparers, there is no benchmark to evaluate their competency. Furthermore, even if competence were not

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<sup>47</sup> Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 590 (1995). See the discussion, *infra*, at II. D regarding the importance of insights from the field of behavioral economics in respect of lower-income taxpayer use of commercial preparers.

<sup>48</sup> National Taxpayer Advocate, July 20, 2005, Testimony Before House Ways and Means Oversight Subcommittee.

<sup>49</sup> Statement of Nina Olson, National Taxpayer Advocate, Internal Revenue Service, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (July 20, 2005).

at issue, the tax system creates incentives for preparers to overstate refunds, especially if the preparers' profits depend, in part on selling services or products that taxpayers will purchase with their EITC-generated refund.

Recent studies indicate that a significant amount of EITC overclaims is associated with returns that commercial preparers prepare. Of the approximately \$11 billion in upper range estimated erroneous EITC claims made in 1999, approximately 57 percent of the overclaims was attributable to returns prepared by commercial return preparers. The overall error rate among taxpayers identifying themselves as using a preparer is 34.6 percent, compared with 37.8 percent among those who did not identify a paid preparer.<sup>50</sup> There are significant variations in the error rate among the different type of preparers. In 1999, approximately 31 percent of claimants had their return prepared by a CPA, attorney or a nationally recognized preparation service, and among those, about 25 percent of the EITC was claimed in error. Among the 35.2 percent of the claimants using other commercial preparers, the error rate was much higher, at 36.2 percent.<sup>51</sup>

The presence of the EITC-generated refund, and the ability to monetize the anticipated refund immediately (and thus pay the preparation and related costs), contributes to the presence of both the national marketplace leaders like H & R Block and others, as well as local “mom and pop” storefront preparers who often are not enrolled agents or accountants, but who are self-employed or working for smaller local firms. It is unclear why among classes of preparers there is a difference in error rates—whether it is attributable to the preparers' skills or scruples, or the client characteristics of those using the different preparer types.<sup>52</sup>

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<sup>50</sup> Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* 148, 170 (Henry J. Aaron & Joel Slemrod eds., 2004).

<sup>51</sup> Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* 148, 171 (Henry J. Aaron & Joel Slemrod eds., 2004).

<sup>52</sup> Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* 148, 171 (Henry J. Aaron & Joel Slemrod eds., 2004).

D. Simplification: The Silver Bullet for Reducing Low Income Taxpayer Use of Preparers?

Given that low income EITC claimants saw approximately 20 percent of their claimed EITC benefits go toward tax return preparation costs and ancillary services and products in recent years, some who have analyzed the high incidence of preparers among low income taxpayers have recommended that simplifying the tax law generally and the EITC specifically would result in less use of commercial preparers.<sup>53</sup> What follows is a brief consideration of the factors that contribute to EITC claimants' use of preparers, with an analysis of the likely sticky nature of claimants' use of those preparers. Two of the most discussed simplification proposals for the EITC are combining the EITC with other family-related benefit provisions,<sup>54</sup> such as the child tax credit and dependency exemptions, and the plan by Professors Yin and Forman to replace the EITC with an exemption from the employee's share of social security taxes up until the first \$5,000 or \$10,000 in wages.<sup>55</sup>

Simplifying the tax code, especially for taxpayers who are the least sophisticated and most likely to suffer from literacy and language barriers, intuitively seems like good policy. While, like baseball and apple pie, it is hard to oppose simplification, I am skeptical that simplification will have a significant effect on the use of paid preparers. For many lower to

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<sup>53</sup> Michael O'Connor, *Tax Preparation Services for Lower-Income Filers: A Glass Half Full or Half Empty?*, 90 TAX NOTES 231, 232-37 (2001); Francine Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 WIS. L. REV. 461, 476 (2003); ; Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 175 ("first, and most importantly, Treasury and Congress need to continue efforts to simplify the EITC").

<sup>54</sup> Robert Cherry & Max Sawicki, *Giving Tax Credit Where Credit is Due: A Universal Unified Child Credit that Expands the EITC and Cuts Taxes for Working Families*, The Economic Policy Institute, [http://www.epinet.org/content.cfm/briefingpapers\\_eitc](http://www.epinet.org/content.cfm/briefingpapers_eitc) (Apr. 2000). Recent legislation provides a more uniform definition of qualifying children for purposes of the related family status benefits' provisions, but it does not unify the refundable nature of the child tax credit and earned income tax credit. Tax Administration Good Government Act, S. 882, 108th Cong. § 501-508 (2004).

<sup>55</sup> George K. Yin, et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 1 AM. J. TAX POL'Y 225 (1994). The exemption proposal would also provide a universally available refundable family allowance credit based upon the number of children residing in the household and would not be dependent on income or employment status.



moderate-wage workers, tax time is not about the pain of paying, but the benefits of obtaining refunds occasioned by excess withholdings and refundable credits like the earned income tax credit. Rather than view preparation fees as costs, taxpayers, especially financially unsophisticated taxpayers, view refunds as money they never had anyway.<sup>56</sup> While costs are not irrelevant, taxpayers likely view preparation, and associated fees like refund anticipation loans (RALs) and check-cashing fees, quite differently than costs they would have to incur on top of additional tax liabilities that are paid to the government.

Thus, I believe it is not complexity per se that increases the likelihood that taxpayers will and do use paid preparers and their ancillary services, but that the use of paid preparers is closely tied to taxpayers' receipt tax benefits in a lump sum following the filing of a tax return. If payments or benefits were evenly spread during the year, at tax-return filing time, people would be forced to reach into their pockets and spend money that they already had separately accounted for. Rather than view tax preparation costs as a reduced gain, if the government spread payments evenly,<sup>57</sup> filers would likely view those preparation costs as losses, and given individuals' general aversion to losses,<sup>58</sup> would likely be much more sensitive to the costs inherent in return preparation. Moreover, removing or reducing the lump sum nature of the refundable aspect of the tax benefits removes the reason taxpayers seek RALs in the first place, i.e., they will not need to get money back but will have already enjoyed the benefit of the money over the period in which either their wages are exempt from withholding taxes or credits were being paid.

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<sup>56</sup> E.g., Chris O'Malley, *Loans for Tax Refunds Can Be Quite Costly*, INDIANAPOLIS STAR, Mar. 14, 2004, at D1 (referring to one preparer noting that Americans' craving for instant benefits combined with their belief that the refund was money they never had produces an intense demand for tax preparation services).

<sup>57</sup> There is the possibility to receive a portion of the EITC in advance, but it is seldom used. IRC Sec.3507.

<sup>58</sup> DANIEL KAHNEMAN & AMOS TVERSKY, *Conflict Resolution: A Cognitive Perspective*, CHOICES, VALUES, AND FRAMES 473, 481-83 (Daniel Kahneman & Amos Tversky eds., 2000).

Research from the field of behavioral economics supports the insight that the nature of the payment rather than the complexity is the driving force to taxpayer use of costly preparation services. For example, people respond differently to the same situation, depending on whether it is explained, or “framed,” as a potential gain or a potential loss.<sup>59</sup> Further, Richard Thaler suggests that the loss function of framing is steeper than the gain function.<sup>60</sup> This means that people are more sensitive to losing something they already own than they are to gaining the same item.<sup>61</sup> Therefore, when taxpayers view refunds as money they are gaining, rather than something they already had, they will be less concerned about losing some of that money to fee payments and high interest rates. However, if taxpayers were able to view RALs and fees as losses, they probably would be more likely to avoid them, and be less inclined to take out costly RALs.

Even if Congress did not adopt simplification that eliminated or reduced the lump sum nature of the EITC, the insight from law and behavioral economics does not, however, eliminate other policy reasons to favor other simplification proposals. There may be valid policy reasons for simplifying or unifying family status benefit provisions, including that it might limit the work disincentives inherent in the benefit reduction formulas under current law<sup>62</sup> and that it would

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<sup>59</sup> Howard Latin, “Good” Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193, 1235 (1994). For example, suppose there are two gas stations across the street from each other. Both have prices of \$1.55 for paying with a credit card, and \$1.45 for paying with cash. The first gas station frames the advertisement as a potential gain with a sign that reads, “DISCOUNT FOR PAYING CASH!” The second gas station simply puts up a sign in tiny print that reads “credit card surcharge.” Because the first gas station is framed as a potential gain, people are more likely to go to that gas station, even though the prices are exactly the same. This illustrates the human aversion to loss. BARRY SCHWARTZ, THE PARADOX OF CHOICE: WHY MORE IS LESS, 65 (Ecco. 2004). For more examples, see Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOL. 341, 343 (1984).

<sup>60</sup> Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. Rev. 630, 739-740 (1999).

<sup>61</sup> *Id.*

<sup>62</sup> Lee A. Sheppard, *Making the EITC More European*, 2002 TAX NOTES TODAY 220-3 (Nov. 13, 2002); see also Gene Steuerle, *Combining Child Credits, the EITC, and the Dependant Exemption: First of Two Parts: Is a New Momentum Being Created?*, 87 TAX NOTES 567 (Apr. 24, 2000); Gene Steuerle, *Combining Child Credits, the*

likely contribute to greater taxpayer understanding of the benefits they are receiving. The greater understanding of the provisions would likely reduce the number of unintentional mistakes that taxpayers or preparers make, which could reduce the EITC error rate. Nonetheless, simplification, if not backstopped by an increased likelihood that taxpayers will not receive the benefit of the refundable nature of the proposals in a lump sum, will likely not lead to significant reductions in the use of paid preparers, and especially pricey services such as RALs.

While the use of RALs might decrease with wholesale simplification accompanied by a more even distribution of benefits, there are other factors that would still result in significant use of paid preparers and incur preparation costs even if Congress were to adopt wholesale simplification backstopped by an even distribution of tax benefits. First, many lower-wage workers suffer from significant literacy and language barriers<sup>63</sup> that might prevent them from preparing an appropriate tax return, even if the benefits were much more understandable and based on uniform standards. Moreover, data suggests that the people who claim refundable credits vary significantly from year-to-year. For example, nearly 30 percent of EITC claimants in 2001 were different from those who claimed the credit in 2000.<sup>64</sup> This flux in the EITC-claimant pool combined with the generally low literacy and financial sophistication skills of lower-income taxpayers suggests that there will likely continue to be a robust market for paid preparers to complete and file the appropriate tax return, as new entrants will be less likely to benefit from the simplification benefits and less willing to self-prepare and file a tax return.

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*EITC, and the Dependant Exemption: Part Two of Two Parts: The Various Rationales*, 87 TAX NOTES 703 (May 1, 2000).

<sup>63</sup> Michael O'Connor, *Tax Preparation Services for Lower-Income Filers: A Glass Half Full or Half Empty?*, 90 TAX NOTES 231, 232-37 (2001) (describing a literacy study, which found that "46 to 51 percent of the nation's adult population lack the most basic skills to prepare a tax return").

<sup>64</sup> DEPARTMENT OF THE TREASURY, *EARNED INCOME TAX CREDIT PROGRAM EFFECTIVENESS AND PROGRAM MANAGEMENT*, 3 (Aug. 8, 2003).

Given the above, I believe it is highly likely that commercial return preparers will continue to remain an important part of the landscape for lower-income taxpayers and EITC claimants in particular.

### III. The EITC's Welfare and Tax Characteristics

#### A. The EITC—Fish or Fowl?

One way to consider the government's efforts at administering the EITC is a growing awareness that the EITC is performing distributive functions previously the domain of other programs and agencies. Faced with the task of delivering benefits, rather than collecting taxes, the IRS has looked at administration of other benefits programs in an effort to assist it with some of the challenges associated with delivering benefits through the tax system.

The dramatic expansion in the 1990s of the EITC is often understood as a component to welfare reform.<sup>65</sup> Congress expanded the EITC to both attract and retain former welfare recipients in the labor market. To understand the EITC as part and parcel of welfare reform has serious policy implications. Its bipartisan support<sup>66</sup> is on less stable grounds when the EITC is within welfare's shadow. To be sure, the analogy between welfare and the EITC is far from perfect. As Professor Alstott noted, traditional welfare programs provided little benefit to the working poor.<sup>67</sup> Unlike the EITC, which varies with the amount of earned income, traditional benefits programs focused largely on those without earned income.<sup>68</sup> Moreover, there are other key distinctions, given that EITC recipients do not "fit the traditional definition of welfare

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<sup>65</sup> Jason DeParle, *A War on Poverty Subtly Linked to Race*, N.Y. TIMES, Dec. 26, 2000 at A1 (noting how President Clinton viewed the growth of the EITC as an essential component of welfare reform); Gene Steurle, *Summers on Social Tax Expenditures*, 89 TAX NOTES 1481 (Dec. 11, 2000) (noting that welfare reform "would not have been possible without the supports provided by the EITC and some other programs.").

<sup>66</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative*, 3 (Oct. 2005) (noting the tradition bipartisan support for the EITC).

<sup>67</sup> Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 [ ] (1995)

<sup>68</sup> Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995).

recipients,”<sup>69</sup> the political poison that is usually associated with the racial and gender undertones associated with discussions of welfare,<sup>70</sup> and the annual lump-sum nature of the EITC which makes it less helpful than other benefits for relief from short-term crises.<sup>71</sup> Yet, while not a perfect analogy, the debate about the EITC is now often couched in terms similar to that revolving around welfare policy.

An important context for any discussion about the EITC is one’s frame of reference for looking at the issues of error rates and claimant costs. Considering the program in the context of overall tax noncompliance, EITC noncompliance does not seem that bad. After all, the EITC is a relatively small part of the total tax gap.<sup>72</sup> Moreover, there are other more costly areas of systemic noncompliance (like income and deductions from sole proprietorships and the use of offshore accounts and entities to hide income from Uncle Sam),<sup>73</sup> and scarce IRS compliance

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<sup>69</sup> See Dorothy A. Brown, *The Tax Treatment of Children: Separate But Unequal*, 54 EMORY L.J. 757, 793 (2005). When people refer to “welfare,” they typically mean the Aid to Families with Dependent Children (AFDC), which aided mostly single mothers and their children, or its replacement, Temporary Assistance for Needy Families. *Id.*

<sup>70</sup> See Dorothy A. Brown, *The Tax Treatment of Children: Separate But Unequal*, 54 EMORY L.J. 757 (2005) (citing Joel F. Handler & Yeheskel Hasenfeld, *The Moral Construction of Poverty: Welfare Reform in American* 159, 160 (1991) (“Because the EITC does not apply to most welfare mothers – those who do not earn, those who are most stigmatized – it escapes much of the debate over the domestic code, and it is generally devoid of the gender and racial undertones that have beset much of the controversy on AFDC.”); see also, Brown, *supra* note ##, at 760-61 (discussing the racial overtones associated with EITC and showing how many EITC beneficiaries are actually white families). “[T]he public perception of welfare is raced black. Therefore, whenever EITC recipients are compared to welfare recipients, there is a racial overtone – whether or not one was intended.” *Id.* Professor Brown attempts to break some of the misperceptions surrounding race and the EITC “Whites are more likely than Blacks to be eligible for the EITC – in fact, the EITC-eligible pool includes twice as many Whites as Blacks.” *Id.* at 839.

<sup>71</sup> Jennifer L. Romich & Thomas Weisner, *How Families View and Use the EITC: Advance Payment versus Lump Sum Delivery*, 53 NAT’L TAX J. 1245, 1258 (2000) (discussing how the behavioral life cycle theory suggests that people are likely to spend money from different mental accounts on different things; “wealth,” such as tax money, along with the EITC, is more likely to be spend on large-ticket items, while current income or evenly distributed benefits are likely spent on everyday needs and consumption).

<sup>72</sup> Recent compliance estimates for the 2001 year peg an 85 percent voluntary compliance rate, with a \$257-298 billion net tax gap (tax not collected due to nonfiling, underreporting and nonpayment). See GAO, “Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches, GAO-06-1000T 4-5 (July 2006). Most recent estimates suggest that the net tax gap attributable to the EITC is approximately \$ 9.9 billion. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1885 (2005).

<sup>73</sup> For example, recent estimates peg the tax gap attributable to underreporting of income attributable to (i) non-farm sole proprietor to be in the range of \$59 to \$65 billion and (ii) certain flow-through entities (partnerships and S-corporations) to be between \$16 and \$24 billion. See GAO, “Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches, GAO-06-1000T 10-11 (July 2006).

resources often get a bigger bang for their buck when directed at those other problem areas.<sup>74</sup>

Considering EITC errors in light of other benefits' programs, however, is a different story. EITC error rates are excessive—almost five times the error rates than in the food stamp program, for example.

## B. The Hybrid Aspects of the EITC

One approach to the EITC's compliance problems then is to decide what the EITC is – is it a tax program or a welfare program? Once defining its essence, then perhaps policy prescriptions should flow.<sup>75</sup> Having set this context, I confess to believing that these perspectives should be less important to the policy choices facing EITC administration. The perspectives-based analysis contributes to a more formalistic approach to policy consideration.<sup>76</sup> Understanding the tax or welfare pedigree of the EITC does not lead necessarily to policy decisions. It also fails to reflect the truly hybrid nature of the EITC, with almost 88 percent of it refunded to claimants, with the balance applied to income taxes (and a significant amount also to employment taxes). Neither fish nor fowl, the EITC is part welfare, part tax credit.

In a recent article, Professor Lawrence Zelenak considers the hybrid tax/welfare nature of the EITC. Zelenak's initial insight is that the EITC is more a welfare program in economic effect but a tax program in administration. He considers the recent controversy over the appropriate level of government enforcement efforts as a consequence of its status as a hybrid tax/welfare program. Compared to other tax benefits, where self-declared eligibility is the norm,

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<sup>74</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1898-99 (2005).

<sup>75</sup> Many advocates take this approach. See, e.g., Janet Spragens, *The EITC Certification Initiative Should be Stopped*, 24 ABA Tax Section News, Quarterly 2005 10 (Summer 2005).

<sup>76</sup> Cf. Jerry L. Mashaw, *Due Process in the Administrative State* 10-12 (1985) (criticizing the historical approach to due process as relying on arguments by analogy than can dull the merits of perspective choices).

and there is a sense of rough justice in which the system emphasizes efficiency over accuracy,<sup>77</sup> Zelenak notes that government EITC compliance efforts are intense. Compared to other welfare benefits, however, where universal pre-screening eligibility is the norm, the level of government enforcement is actually low.

To back his descriptive claim, Zelenak looks at the practices and attitudes associated with tax and welfare enforcement. First, he examines the controversy surrounding pre-certification for benefits. He notes that for most EITC claimants, claimants self-declare eligibility, with the transfer of the EITC dependent solely on filing the appropriate tax return and accompanying schedules. The exception to pure self-eligibility is found in the IRS's auditing, certification, math error and pre-certification programs. Looking at all of those compliance programs, only about 10 percent of EITC claimants are required to establish eligibility prior to its receipt. In contrast, Zelenak notes that establishing eligibility prior to receiving food stamp and welfare benefits is the "core" of those programs. Applicants often have pre-benefit face-to-face meetings with caseworkers, verification of eligibility, and recertification following an initial benefits period.<sup>78</sup>

Zelenak draws the obvious but important conclusion that requiring pre-certification will result in fewer overpayments than will self-declared eligibility.<sup>79</sup> From this, he concludes that the different approaches toward pre-certification under the EITC (limited), nonrefundable tax credits (almost none), and welfare (universal pre-certification), reflect that "[c]ongressional

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<sup>77</sup> For more on the notion of rough justice that characterizes the American tax system, see Ann Mumford, *Taxing Culture: Towards a Theory of Tax Collection Law*, 38-40 (2002).

<sup>78</sup> For more on the pre-benefits' eligibility review and certification procedures, see Note, *The Doorkeeper and the Grand Inquisitor: The Central Role of Verification in Means-tested Welfare Programs*, 36 COLUM. HUM. RTS. L. REV. 663 (2005).

<sup>79</sup> Following Zelenak's article, the IRS published results of its initial certification pilot, comparing a test group and control group of 25,000 each. See IRS Earned Income Tax Credit Initiative (Oct. 2005) (test results that certification of eligibility reduced EITC claims by approximately 10 percent and also had an effect on preventing the payment of erroneous claims for cases where the EITC was requested but the individual was unable to establish the residency of the qualifying children).

tolerance for overpayments is greatest for overpayment of tax benefits, least for overpayment of welfare programs and somewhere in between but closer to the tax end of the spectrum-for overpayment of the EITC.”<sup>80</sup>

To buttress his claim that Congress treats errors with the EITC as somewhat in between welfare and tax errors, Zelenak looks at other kinds of evidence. For example, Zelenak looks at the administrative costs as a percentage of program benefits, with the assumption that the higher the ratio of costs to benefits indicates low tolerance for overpayments. Zelenak notes that there are relatively high administrative costs associated with food stamps and welfare, with administrative cost associated with food stamps at approximately 20 to 25 percent of program benefits and welfare at 10 percent of program benefits. While there is little data on how much the IRS spends directly on EITC administration, costs as a percentage of benefits are no more than 1.85 percent and are likely much less than that.<sup>81</sup> Looking at the IRS’s audits of EITC claimants compared to other returns, Zelenak likewise notes that EITC returns are several times more likely to be selected for audit. Zelenak considers the percentage of the IRS’s enforcement budget devoted to the EITC in relation to enforcement resources directed toward the rest of the tax gap. Using that barometer, Zelenak notes that in 2003 the IRS dedicated about 3.8 percent of its enforcement dollars to the EITC, while the EITC only accounted for about 2.8 percent of the tax gap. This “suggests that the IRS overemphasizes EITC enforcement relative to other tax enforcement issues, but only moderately so.”<sup>82</sup>

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<sup>80</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1881 (2005).

<sup>81</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1884 (2005); *see also* Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in THE CRISIS IN TAX ADMINISTRATION 148, 161 (Henry J. Aaron & Joel Slemrod eds., 2004) (noting that the special appropriation to reduce EITC noncompliance is approximately .5 percent of the 2001 tax year EITC claims, and that it is likely that the other costs relating to administering the EITC do not exceed 1 percent).

<sup>82</sup> Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1885 (2005). He rightly notes that the rational tax administrator would consider a cost-benefit analysis, and “attempt



Other evidence supports Zelenak’s claim that welfare overpayments are more objectionable than excessive tax reductions, and that the EITC overpayments are viewed as an intermediate case. The ratio of underpayments to overpayments is illustrative. While pre-screening for eligibility and other compliance efforts are effective in reducing overpayments, such efforts should also cause underpayments, both in terms of reduced benefits to eligible participants and a lack of payments to eligible participants. For example, food stamp error rates hover at around 6 percent, with underpayments approximating 30 percent, with the ratio of underpayments to overpayments at about 5:1. Conversely, while there is little firm data on EITC underpayments, using GAO data and recent IRS compliance studies Zelenak estimates that the EITC features errors in favor of individuals that are larger than errors favorable to the government as somewhere between 2 and 3:1. This estimate includes those not claiming EITCs who are eligible. Looking at non EITC tax benefits, Zelenak estimates that the errors in favor of the taxpayers exceeded errors in favor of the government somewhere in the neighborhood of 5:1.<sup>83</sup>

After his persuasive march through the evidence, and his compelling application of Murphy and Nagel’s everyday libertarianism<sup>84</sup> as an explanation as to why the government and

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to equalize the marginal returns on enforcement dollars” and attempt to produce the same amount of revenue from the last dollar spent on EITC as on other issues. He notes, however, that there is little data that integrates both the direct and indirect effects of compliance efforts, while the little data surrounding direct benefits suggests that the IRS likewise suggests a slight overemphasis on the EITC. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1886 (2005).

<sup>83</sup> Zelenak backs his conclusions with further evidence, looking at the IRS’s relative lack of criminal prosecutions and limited use of civil penalties in connection with EITC errors compared with food stamps and welfare prosecutions and penalties, and the OMB’s failure to classify any IRS administered noncompliance problem as within the jurisdiction of the Improper Payments Information Act of 2000, except the EITC. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1898-1900 (2005).

<sup>84</sup> The theory of everyday libertarianism posits that people believe that they earn their money without government assistance; as such, in the compliance context, people are less concerned with those who fail to pay taxes on income they earned (as that money is still seen somewhat as the earner’s own money), while views on overpayments of welfare are negative, because those overpayments reflect “the wrongful taking of the pretax income of others, and as such it is an unmitigated wrong.” Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax*

the public view welfare errors as worse than EITC noncompliance,<sup>85</sup> Zelenak strikes a pragmatic conclusion. If total administrative costs are to be viewed as the sum of direct administrative costs and benefit overpayments, then tax-based administration of the EITC and welfare-based administration of food stamps are “very similar.” If one concludes, as Zelenak does, that it is better to spend money on benefits for the nearly eligible rather than burn money on direct administrative costs,<sup>86</sup> then the EITC cost pattern is preferable to non-IRS administered benefits’ programs. Pointing out that the EITC’s existence is possibly fragile, and that how even with the IRS’s stepped up compliance efforts over the past decade, the IRS’s enforcement efforts place the EITC as more similar to ordinary tax enforcement than welfare-type enforcement, Zelenak cautions advocates from objecting too strenuously to EITC enforcement actions:

Vociferous objections could easily backfire, in either of two ways. First, the objections might lead Congress to reject the EITC as tax analogy in favor of the EITC as welfare analogy, and to transfer the program to welfare bureaucracy (or keep the program within the IRS but require universal precertification) Second, Congress might initially defer to the objections and refrain from special EITC compliance initiatives, only to decide that the level of noncompliance was unacceptable and that the entire credit should therefore be repealed.

The real surprise is not that the IRS overstates efforts at reducing EITC errors more than excessive tax reductions; rather, that EITC recipients are not made to go through the eligibility and verification gauntlet in the same manner as other benefits’ recipients. What is especially insightful about Zelenak’s article is that it provides a basis for appreciating how good EITC claimants have it, while it also applies a critical theoretical framework to the failure to treat welfare overpayments as the same or even less objectionable than excessive tax reductions. Its

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*Credit*, UCLA L. REV. 1867, 1902 (2005), applying Liam **Murphy** and Thomas **Nagel**’s, *The Myth of Ownership: Taxes and Justice* (2002) to issues pertaining to tax administration.

<sup>85</sup> Zelenak also analyzes the history as to how the EITC developed in the way it did, suggesting that as the EITC expanded to become more of a transfer program rather than a tax reduction, Congress reflexively retained self-eligibility. Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1906-11 (2005).

<sup>86</sup> Others have recently reached the same conclusion. David A Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1010-12 (2004).

limitation, however, is that it does not provide a sufficient basis for the government to refine its EITC compliance efforts, save for accepting almost anything that is less comprehensive or burdensome than food stamp or welfare recipients are forced to endure.

This limitation is troubling, because the IRS is searching for guidance in this area, claimants' benefits hang in the balance, and the IRS's efforts to reduce EITC errors attract a firestorm of criticism that may have broader implications in terms of respect for the tax system. Yet, Zelenak's insights allow us to peel back how IRS compliance efforts can take advantage of EITC's placement in the tax system, and not reflect weaknesses associated with welfare administration.

#### IV. Compliance Insights Attributable to an Understanding of the Hybrid Nature of the EITC

The debate surrounding government efforts to reduce EITC noncompliance has suffered from formalism. Critics of the IRS lament that the EITC compliance efforts are unfair compared to other parts of the tax code, while the IRS emphasizes the EITC claimants' relatively light burdens, compared with recipients in other benefit programs. Nonetheless, it is worth exploring the analogy a bit further, though not for the sake of defaulting to an approach just because it is consistent with tax or welfare administration. Rather, the goal here is to understand ways in which the differences between the EITC's welfare and tax pedigrees reveal policy choices that could assist with its administration and improve its delivery. As discussed below, there are two key differences between the EITC that have implications for reducing the EITC's error rate, the lack of discretion associated with its eligibility and the presence of return preparers who prepare and file tax returns for a fee.

##### A. The Lack of Discretion in EITC Eligibility

Until the mid-1960s, caseworkers in welfare programs often had discretion over the provision and cessation of welfare benefits.<sup>87</sup> The 1960s era civil rights movement and the upsurge in procedural protections following such landmark decisions as *Goldberg v. Kelly*<sup>88</sup> saw a decrease in caseworker discretion and an increase in formal protections and transparency for welfare recipients.<sup>89</sup> By the 1990s, there was a significant backlash against the formalism, with the belief that discretionary provision of benefits would enhance flexibility and allow caseworkers greater freedom to wean people off the dole and encourage work participation. As such, the mid-1990s was accompanied by a paradigm shift in the way most people interacted with welfare administrators. The 1996 welfare reform shifted the relationship between beneficiaries and administrators, requiring beneficiaries to satisfy work requirements and face time limitations on receipt.<sup>90</sup> Moreover, many states have attempted to reduce the numbers of participants by adopting diversionary programs where administrators funnel people away from ongoing receipt of benefits and toward a lump-sum payment, and impose job-search requirements while benefits' applications are pending.<sup>91</sup> Accompanying these changes is a return to greater caseworker discretion and less public accountability among caseworkers reviewing

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<sup>87</sup> Barak Y. Orbach, *Unwelcome Benefits: Why Welfare Beneficiaries Reject Government Aid*, 24 *LAW & INEQ.* 107, 124 (2006).

<sup>88</sup> 397 U.S. 254 (1970) (due process requires hearing prior to termination of benefits received under federal program of Aid to Families with Dependent Children).

<sup>89</sup> Barak Y. Orbach, *Unwelcome Benefits: Why Welfare Beneficiaries Reject Government Aid*, 24 *LAW & INEQ.* 124 (2006); see also Charles H. Koch, Jr., *A Community of Interest in the Due Process Calculus*, 37 *HOUS. L. REV.* 635, 639 (2000) (noting that there was an explosion in procedural innovation following *Goldberg v. Kelly*); Henry J. Friendly, *Some Kind of Hearing*, 123 *U. PA. L. REV.* 1267, 1268 (1975) (noting that after *Goldberg*, “[w]e have witnessed a due process explosion in which the court has carried the hearing requirement from one new area of government action to another”).

<sup>90</sup> The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2185, included work requirements and time limitations in an effort to stop what was perceived to be the endless welfare cycle. See Joel Handler, *The “Third Way” or the Old Way?*, 48 *KAN. L. REV.* 765, 778 (2000) (detailing changes to the welfare state in 1996, tying welfare to employment and enacting time limitations). The rhetoric surrounding the debate over welfare reform in the 1990s focused on the traditional criticism that welfare encouraged idleness. “It was believed that the primary cause of pauperism was the indiscriminate giving of aid which destroyed the desire to work.” *Id.*

<sup>91</sup> Matthew Diller, *The Revolution In Welfare Administration: Rules, Discretion, And Entrepreneurial Government*, 75 *N.Y.U. L. REV.* 1121, 1147 (2000).

benefit applications, which is an outgrowth of an attempt to incorporate private sector or entrepreneurial techniques in the field of government administration. These private sector techniques in welfare administration include funding incentives and performance-based evaluation.<sup>92</sup>

The receipt of tax benefits stands in sharp contrast to the emerging post-welfare model of benefits transfer, and is instead reminiscent of the period subsequent to the post-civil rights era reform and prior to the mid-1990s welfare reform period. Receipt of the EITC, while dependent upon individuals earning income, is largely based on satisfaction of detailed eligibility rules relating to income and household composition that have little room for administrative discretion.<sup>93</sup> While the IRS may challenge EITC eligibility, individuals have administrative and judicial appeal rights, rights meant to ensure that people can prove eligibility to detailed statutory requirements that focus mostly on the presence of qualifying children in the taxpayer's household, the taxpayer's proper filing status, and the correct amount of a taxpayer's earned income—variables that can affect eligibility for or the amount of an EITC. Unlike the in-person interview accompanying most benefits applications and some renewals, IRS challenges to eligibility are mostly accomplished through remote correspondence-based examinations that are based almost solely on a consideration of detailed statutory rules.<sup>94</sup> Discretion plays no part in

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<sup>92</sup> Matthew Diller, *The Revolution In Welfare Administration: Rules, Discretion, And Entrepreneurial Government*, 75 N.Y.U. L. REV. 1121, 1176 (2000).

<sup>93</sup> Effective for 2005, Congress has repealed the one subjective aspect of qualifying child eligibility, whether certain children are cared for as the taxpayer's own child. See P.L. 108-311 § 205. This subjective test only applied to a limited class of children, namely those placed by an authorized placement agency or siblings or descendants of siblings. 32(c)(3)(B)(iii), prior to the 2005 amendment.

<sup>94</sup> Relative to the almost 100% rate of contact with the administrators on other benefits' applications, IRS correspondence audits touch few applicants; in TY 2001 there were 367,288 audits out of more than 19.5 million taxpayers claiming the EITC. Yet this distinction in models between tax benefits and other benefits contributes to the relative efficiencies of delivering benefits through the tax system. Department of the Treasury, *Earned Income Tax Credit Program Effectiveness and Program Management*, 2 (Aug. 8, 2003); see also Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1877 (2005) (noting that "in recent years, the IRS has audited approximately 400,000 EITC claims annually"). Accordingly, an EITC audit is a "correspondence audit," which is generally conducted by mail. An audit is conducted before the EITC refund has

determining the existence or the amount of the EITC, though the taxpayer's lack of appropriate evidence or documentation in the audit process can require administrators to exercise judgment in determining satisfaction of eligibility criteria.

#### B. Paying for Your Tax Benefits

One's starting point greatly effects how one views delivering benefits through the tax system. In traditional welfare programs, applying for benefits does not produce significant direct claimant costs, though there are indirect costs associated with acquiring the documentation needed to establish eligibility and time spent on face--to face eligibility determinations with caseworkers.<sup>95</sup> As mentioned above, in the tax system, there is an active private market component, both with respect to preparers and the sale of tax preparation software and guidebooks.<sup>96</sup>

Professor Lipman notes that the marketplace serves a significant drain on the delivery of benefits, with estimates from 2002 suggesting that of the \$30 billion claimed, \$1.7 billion was

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been issued, and the refund is frozen until the pending audit is resolved. In TY 2002, the IRS conducted 367, 314 EITC correspondence audits, 5,970 EITC field audits, and 4,655 EITC office audits. Department of the Treasury, *Earned Income Tax Credit Program Effectiveness and Program Management*, 2 (Aug. 8, 2003).

<sup>95</sup> See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145, 1192 (2003) (discussing the process involved in applying for food stamps). The average application for food stamps takes about five hours of the applicant's time, and costs him approximately \$10.35 in out of pocket expenses. Recertifying one's eligibility takes about half the time as the original application process, and costs about \$5.84. During the mid 1990s an effort was made to increase recertification, and with that national food stamp participation fell. In 1998 participation dropped to around 50%, with 15% of eligible households claiming costs of participation as the most important factor in their decision not to participate. *Id.*

<sup>96</sup> See Paul J. Lim, *So Much Software, But So Little Time*, N.Y. TIMES, Feb. 13, 2005, at 34 (discussing the barrage of tax software infiltrating the private market). The private market has discovered a booming business opportunity providing tax preparation alternatives tailored to fit the needs of various taxpayers. Tax preparation software such as CCH CompleteTax, TaxACT, TaxCut and TurboTax promises taxpayers a stay-at-home way to sit back, relax and file their taxes from their home computers. Moreover, there is a world of tax self-help guidebooks lying on the shelves of bookstores spanning the country. Some popular titles include: "Complete Idiot's Guide to Doing Your Income Taxes," the "Procrastinator's Guide to Taxes Made Easy," and "Taxes 2005 for Dummies." Barnes & Noble Online,

<http://search.barnesandnoble.com/booksearch/results.asp?userid=6A8SaEcBe8&WRD=taxes&sort=S&Go%21.x=11&Go%21.y=16> (lasted visited June 21, 2005). As indicated infra at [ ], for many reasons, including the skills of low income taxpayers and the perceived and actual complexity of tax benefits, a greater percentage of lower-income taxpayers uses commercial preparers, rather than self-preparing.

diverted to the market in the form of preparation and delivery costs.<sup>97</sup> The welfare perspective on the tax system's delivery mechanism is typically critical, focusing on the way that preparers drain benefits from the working poor through the peddling of ancillary products and fees associated with ensuring the delivery of the cash refund to the claimant.<sup>98</sup> The tax system's perspective on preparers has largely been favorable, with a view that preparers are an integral part of the system, assisting in the providing of information, helping taxpayers meet their filing responsibilities, and playing a role in the EITC's relatively high participation rates.

In effect, however, the role of preparers is both part of the problem and part of the solution.<sup>99</sup> There is no doubt that taxpayers are easy marks at tax filing time, and that certain practices of preparers take advantage of the situation. Yet, the high participation rates associated with the EITC are dependent, in part, on the preparer presence. In the next section, I consider the compliance implications associated with a system that relies on a largely nondiscretionary delivery of benefits facilitated by a significant market presence.

#### V. The Compliance Implications Associated with the High Use of Commercial Preparers

Accepting Professor Zelenak's powerful descriptive argument still leaves open the question as to what the government should do about the EITC compliance problem. Looking at the compliance efforts over the past few years, the government is trying measures that are not

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<sup>97</sup> Francine Lipman, *The Working Poor are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 WIS. L. REV. 461 [ ] (2003).

<sup>98</sup> See, e.g., Carol Elliott, *Instant money refund loans under fire from consumer groups*, S. BEND TRIB., Feb. 6, 2005, at B1 (quoting Chi Chi Wu, NCLC staff attorney, "That's money that is supposed to help working poor families out of poverty. What they (refund anticipation loans) do is siphon off that money into the pockets of big tax preparer companies and lenders."); *Rapid refund interest rates prey on poor*, IOWA CITY PRESS-CITIZEN, Feb. 22, 2005, at 11A. "Some years ago, a few Americans fed up with their tax rates each send their 1040s written on a T-shirt with a note saying that since the government had taken everything else they own, it ought to have the shirt off their back, too. These days though, that shirt might as well be given to tax preparers offering rapid refund loans." *Id.*

<sup>99</sup> See, e.g., Janet Spragens, Testimony Before the IRS Oversight Board 2 (Jan. 26, 2004) <http://www.ustreas.gov/irsob/meetings/1-26-04/auftc.pdf> (discussing how despite the cost of preparation, low income taxpayers rely on preparers to help them meet their filing responsibilities and ensure the claiming of intended benefits). Spragens perceptively notes that despite the existence of unscrupulous and incompetent preparers, commercial preparers are part of the solution, as well as part of the problem. Spragens, at 2.

typically associated with the tax system. It is looking, in part, to approaches that have their pedigree in the welfare system and impose direct costs on taxpayers themselves, like pre-certification and civil sanctions that ban the claiming of the benefit after a prior erroneous claim. While pre-certification may have merit in decreasing the likelihood that improper claimants seek the EITC and in detecting erroneous claims, in order for it to be widely implemented, the IRS will have to dedicate significant resources, at significant cost.<sup>100</sup> Likewise, because the use of civil penalties requires a determination of the intent of the claimant (as only reckless or fraudulent conduct triggers the penalty's application), it presupposes that the IRS puts the resources on the ground to determine whether the penalty is appropriate<sup>101</sup> and collect on assessed penalties.<sup>102</sup> Thus, these remedies could reduce improper payments, but result in significant increases in direct administrative costs.

The lack of discretion in administration and the central role of commercial preparers, two of the tax characteristics of the hybrid tax/welfare EITC, suggest an approach that could rely to a greater extent on properly regulated preparers in reducing EITC noncompliance. The goal would be to shift some of the compliance costs onto third parties and, to a lesser extent, the claimants themselves. The lack of discretion associated with eligibility for the EITC is important, because it is generally inappropriate for the market to exercise judgment in applying the law or subjective

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<sup>100</sup> The total cost to administer the initial certification pilot program, which comprised 50,000 total taxpayers (half in a test group and half in a control group), was \$6.6 million. IRS, EITC Initiative, Final Report to Congress, 44 (Oct. 2005). While there would likely be some economies of scale, the IRS estimated that approximately 54 percent of the certification pilot's costs were attributable to labor, suggesting that even if other marginal costs were smaller the costs for a broad implementation of certification would be substantial.

<sup>101</sup> The rare imposition of the penalty reflects the fact that the IRS has not dedicated those types of resources to make preliminary penalty determinations. National Taxpayer Advocate, 2003 Annual Report 281-82 (Jan. 2004) (detailing that in FY 2004, the IRS was only conducting 240 audits of preparers); Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145, 1178-84 (2003), discussing the difficulties associated with imposing civil penalties without significantly increasing government resources on investigating the merits of claims; Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, UCLA L. REV. 1867, 1896 (2005) noting how seldom the IRS imposes civil EITC disallowance penalties.

<sup>102</sup> As the National Taxpayer Advocate has detailed, the IRS seldom collects on civil preparer penalties imposed. See National Taxpayer Advocate, 2003 Annual Report 281-82 (Jan. 2004) (the IRS only collected 12 percent of the \$2.4 million in civil penalties assessed in calendar years 2001 and 2002).



standards to determining eligibility for benefits or relief from burdens.<sup>103</sup> Likewise, the relatively clear-cut eligibility requirements of the EITC lessen the likelihood that preparers would play the role of ambiguity exploiters,<sup>104</sup> a common characteristic and problem, as the debate concerning preparers' role in the recent corporate tax shelter controversy illustrates.<sup>105</sup> It is thus theoretically possible for well-intentioned and qualified preparers to act as front-line evaluators of eligibility, a role that many in fact perform in the current system. The question is whether there are legislative or administrative changes that could further enhance this role, without ratcheting up government costs or taxpayer costs to unacceptable levels.

Before considering the specific proposals that are available, it is worth considering further the nature of the relationships surrounding commercial return preparers. In part because of the complexity of the tax system, but also because the annual lump sum nature of benefits delivered through the tax system allows people to painlessly part with money in a way that makes expenses less like a cost and more like a smaller windfall,<sup>106</sup> individuals are transferring approximately \$1.92 billion to commercial preparers for preparation costs and related

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<sup>103</sup> An interesting comparison point concerns the recent legislation allowing the IRS to contract with certain private debt collectors to collect certain federal tax debts. On October 22, 2004, the President signed the American Jobs Creation Act of 2004 to permit private collection agencies (PCA) to help collect Federal tax debts. Pub. L. No. 108-357, 118 Stat. 1418 (2004). A key aspect of the legislation is the PCA's lack of discretion in these cases. Congressional Research Service, *The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress* (Jan. 11, 2006) (noting the restrictive guidelines in which the IRS could refer cases to private debt collectors, including that "PCA's would be assigned cases that were likely to be resolved with one or two phone calls and required no exercise of discretion by the IRS").

<sup>104</sup> Marshal Blumenthal and Charles Christian, *Tax Preparers*, in *THE CRISIS IN TAX ADMINISTRATION* 201, 202 & 217 (Henry J. Aaron & Joel Slemrod eds., 2004) (discussing how preparers can play the role of ambiguity exploiters when there are unclear legal requirements)

<sup>105</sup> See John Braithwaite, *Markets in Vice Markets in Virtue*, 106 *Oxford Univ.Press* (2005) (discussing the tax shelter advice market in the United States. Braithwaite analyzes the role of supply (preparer) and demand (taxpayer) on the rise of tax shelters in the US and Australia, and ways governments can minimize tax avoidance and promote a general respect for tax integrity. John Braithwaite, *Markets in Vice Markets in Virtue*, Oxford Univ.Press, 197-211 (2005). Braithwaite refers to interesting research which suggests that using an agent when there is unambiguous income sources encourages compliance, but that when there is ambiguity the use of an agent encourages noncompliance.. John Braithwaite, at 198 (where the "law is clear, tax agents do a lot of the tax authority's work in educating taxpayers on what the law requires.")

<sup>106</sup>See text surrounding note [ ]

products.<sup>107</sup> A large private sector industry exists to prepare tax returns and peddle products like refund anticipation loans.<sup>108</sup> The relationship between the government, claimants and tax preparers resembles a partnership, in which the entities all experience significant benefits: the government gets to deliver benefits relatively cheaply, without the need for systemic delivery offices along the lines accompanying other benefits' programs; the government has facilitated the private preparers' ability to offer lucrative electronic filing and refund anticipation loans by revealing to preparers information about a taxpayer's other debts that would make it unlikely that preparers would get paid.<sup>109</sup> The IRS benefits further from the efficiencies associated with preparers' facilitation of electronic return filing, rather than the paper filing that would likely be done by lower-income taxpayers who are less likely than the average taxpayer to have a computer or internet access. The typical claimant happily pays high fees to preparers for the delivery of the refund, a refund which taxpayers often do not fully understand, but certainly appreciate and use for important life-improving purchases.<sup>110</sup>

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<sup>107</sup> Chi Chi Wu & Jean Ann Fox, *All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans*, National Consumer Law Center and Consumer Federation of America 4, [http://www.consumerlaw.org/initiatives/refund\\_anticipation/](http://www.consumerlaw.org/initiatives/refund_anticipation/) (Jan. 2004) (estimating the amount an average EITC claimant would spend on commercial tax preparation). A taxpayer receiving a \$2100 refund in the form of a RAL from a major tax preparation chain could expect to pay: 1) a RAL loan fee of \$100; 2) a system administration fee of \$30; and 3) a return preparation fee of \$120. Thus, the average EITC claimant should expect to pay approximately \$250 in fees for the preparation of her tax return.

<sup>108</sup> Tax preparation giants such as H&R Block and Jackson Hewitt have created an enormous business niche with respect to professional tax preparation. See Robert Baker, *Doing the Numbers on a Tax Preparer*, BUS. WK., Apr. 26, 2004, at 120 (noting the value of giant tax preparers like Jackson Hewitt and H&R Block and that at "tax time people sure are easy marks").

<sup>109</sup> For a discussion of the information the IRS shares with tax preparers, see George Guttman, *IRS Reinstates Debt Indicator to Increase Electronic Filing*, 85 TAX NOTES 1125, 1125 (1999); See also NCLC, *Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed from the Working Poor and the U.S. Treasury*, NCLC and CFA at 20 (2002). The IRS provides preparers a debt indicator service, which screens RAL applicants and informs electronic preparers of any federal, state or child-support debts that could result in an offset of a taxpayer's refund.

<sup>110</sup> Jennifer L. Romich & Thomas Weisner, *How Families View and Use the EITC: Advance Payment Versus Lump Sum Delivery*, 53 NAT'L TAX J. 1245, 1260 (Dec. 2000).

While partnerships suggest a sharing of losses and profits,<sup>111</sup> preparers for the most part share only in the upside. Apart from rarely imposed and even rarer enforced civil penalties there is no significant risk or cost associated with preparers who prepare inaccurate returns—as Professor Spragens astutely observes, when the IRS detects errors “it is the taxpayer who is left holding the bag in terms of money due, time and stress expended, and potential loss of benefits in future years.”<sup>112</sup>

A. Toward a More Refined Understanding of Brokered Noncompliance

As I have previously written, noncompliance associated with or facilitated in some way by preparers is known as brokered noncompliance.<sup>113</sup> As discussed above, over 57 percent of the EITC overclaims stem from returns prepared by commercial return preparers. The current error rate among taxpayers using commercial return preparers suggests that the system is not working as well as it should. The problem, however, is that while we know the overall error rate among taxpayers and we know the rate broken down by class of preparer, we do not know why those errors arose. The key to tailoring effective government responses to noncompliance is understanding, from a ground-up perspective, what triggers the errors.<sup>114</sup>

I have directed low-income taxpayer clinics for the past nine years. In that time, my students and I have represented many hundreds of taxpayers who have improperly claimed the

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<sup>111</sup> See PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS J. WILLIAM CALLISON AND MAUREEN A. SULLIVAN §10:3 (2005); see also Uniform Partnership Act § 401(b) (1997).

<sup>112</sup> Janet Spragens, Testimony Before the IRS Oversight Board (Jan. 26, 2004). The government can likewise be left with costs associated with inaccurate returns, reflecting resources spent on addressing the noncompliance problem and the incorrect benefits that the government credits to taxpayers who are not eligible or who overstate the amount of EITC.

<sup>113</sup> Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145 (2003). In this article, I did not focus on the compliance issues relating to return preparers. *Id.* at 1154.

<sup>114</sup> See GAO, Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap, 17-18GAO-05-753 (July 2005) (noting that understanding the reasons for noncompliance is critical for IRS and Congress to tailor efforts to reduce the overall tax gap).

EITC, and roughly two thirds had their tax returns prepared by commercial return preparers. In my experience, there are three main reasons why a tax return prepared by a commercial return preparer may have an erroneous EITC claim:

1. Incompetence: The preparer is incompetent, and is unaware of a relevant substantive rule regarding EITC eligibility or does not have the skills or incentive necessary to gather the facts that are relevant to determine eligibility. For example, in the Villanova Tax Clinic, we often see taxpayers claim children as qualifying children even though they do not satisfy the residency requirement due to shared or split custody,

2. Preparer Dishonesty: The preparer is dishonest, and wishes to generate more revenues from preparing returns or selling additional products or services through improperly received or overstated EITC claims.

3. Taxpayer Dishonesty: The preparer is both honest and competent, but the taxpayer is gaming the system and lies to the preparer when asked questions regarding relevant facts to determine eligibility. For example, in the Villanova Tax Clinic, we have seen numerous situations when taxpayers “borrowed” children from relatives who had more than two children or who had no earned income. This borrowing resulted in taxpayers claiming relatives (often nephews or nieces or grandchildren) even though the taxpayer did not live with the child. On inquiry in the Clinic, we have had numerous clients who misrepresented their living situation to preparers, who prepared the returns accurately, if one takes into account what their clients told them.

B. The Inadequacy of the Current System to Reduce the Above Types of Errors

. The first two types of brokered noncompliance described above are in essence, supply driven, namely the errors arise due to the actions of those providing the tax return filing services.

The third category, relating to taxpayer dishonesty, is demand driven, that is the errors arise not because of the preparer's actions, but because the taxpayer herself chooses to provide incorrect information to the preparer.

That there is a high rate of error among returns prepared by commercial preparers suggests that the government's current methods of regulating practitioners are inadequate. We do not know necessarily whether the government's efforts should be tailored to reducing the problems of preparer skills, or addressing honesty of either the taxpayer or the practitioner. What we do know is that there are different problems, which the government could address by differing solutions. As a starting point, as a number of observers have echoed since I adapted the Kidder-McEwen typology to lower-income noncompliance, the IRS should focus its research efforts on understanding the underlying causes of noncompliance.<sup>115</sup> With that information, the government can better assess what efforts it should undertake, (including possible nonenforcement actions like educational outreach), as well as properly comparing a proposal's costs to its possible benefits. Failing that information, as I suggest below, there are shorter-term steps that the government can take which take advantage of the presence of commercial preparers and the lack of discretion associated with EITC eligibility, and which would likely have an effect on reducing errors irrespective of the source of the problem at relatively low cost to the government.

There are current penalty and due diligence provisions meant to address return preparer honesty and competence. The Internal Revenue Code defines a tax return preparer as anyone

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<sup>115</sup> GAO, GAO, Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap, pp. 17-18 GAO-05-753 (July, 2005) (noting that information relating to the underlying causes of noncompliance is "critical" to the government's efforts at reducing the tax gap); NTA, Testimony Before the Senate Finance Committee on the Tax Gap and Tax Shelters (July 21, 2004) ("Once the key components of the tax gap have been identified and analyzed, we should consider (1) the causes of noncompliance and (2) ways to reduce the opportunity for noncompliance. By understanding what triggers or causes a taxpayer or segment of taxpayers to be noncompliant, the IRS can choose the appropriate method to foreclose noncompliance opportunities . . .").

who prepares, for compensation, or who employs one or more persons for compensation, a tax return or refund claim.<sup>116</sup> While lawyers, enrolled agents and accountants are subject to their own professional standards and Treasury Department rules for IRS practice,<sup>117</sup> so-called unenrolled preparers are generally only covered by the Code's penalty and due diligence provisions.

The civil and criminal preparer penalty provisions in the Code meant to ensure minimum standards of conduct. A \$250 civil penalty applies to a preparer who takes a position on a return or refund claim for which he or she should have known that there was "not a realistic possibility of being sustained on the merits," with the possibility of an increase to \$1,000 if the understatement is attributable to a willful attempt to understate a tax liability or due to a reckless or intentional disregard of rules and regulations.<sup>118</sup> In addition, the Code provides that preparers must provide a copy of a return to taxpayers, sign and place an identifying number on the return, and maintain a copy of the return for three years. Failing to comply with these requirements subjects a preparer to a \$50 penalty for each failure, up to an annual maximum of \$25,000.<sup>119</sup>

In addition to civil penalties, criminal penalties can also apply to return preparers who (i) engage in a willful attempt to evade tax,<sup>120</sup> (ii) make false statements under penalties of perjury<sup>121</sup> or (iii) who willfully assist, aid, abet, counsel or advise in the preparation of any document in connection with the revenue laws that is false or fraudulent with respect to a material matter.<sup>122</sup>

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<sup>116</sup> I.R.C. § 7701(a)(36).

<sup>117</sup> Treasury Department Circular 230 describes who may practice before the IRS and sets minimum standards and aspirational best practice policies, as well as a disciplinary procedure for violations of its standards. 31 CFR part 10.

<sup>118</sup> I.R.C. §§ 6694(a), (b).

<sup>119</sup> I.R.C. §§ 6695(a)-(d). The Code also provides civil penalties for a return preparer's (i) inappropriate disclosure or use of tax return information (ii) endorsing or negotiating a federal tax refund check. I.R.C. §§ 6713, 6695(f). In addition, the IRS has the authority to bring a civil action in federal district court seeking injunctive relief to prohibit certain actions of preparers. I.R.C. § 7407(a).

<sup>120</sup> I.R.C. § 7201.

<sup>121</sup> I.R.C. § 7206(1).

<sup>122</sup> I.R.C. § 7206(2).

There are also specific due diligence requirements addressed to preparers filing EITC returns, with preparers required to meet certain due diligence requirements.<sup>123</sup> With respect to tax returns or refund claims involving the EITC, due diligence requirements require return preparers to complete checklists (“EITC Checklists”) and worksheets regarding information pertaining to eligibility for the EITC and the amount of the EITC. In addition, the preparer must have no knowledge or reason to know that the information used to determine eligibility or the amount of the EITC is incorrect. Preparers may be subject to a \$100 penalty for each failure to comply with the above requirements.<sup>124</sup>

The IRS rarely invokes and enforces those provisions.<sup>125</sup> For example, in fiscal year 2001, of the low \$1.6 million in net assessed civil preparer penalties under Code sections 6694 and 6695, the IRS collected only about 1/3 of that amount.<sup>126</sup> The IRS has not prioritized assessing or enforcing preparer penalties,<sup>127</sup> and criminal prosecutions of preparers are rarely undertaken.<sup>128</sup> Likewise, audits of EITC return preparers are not a priority for the IRS, as the IRS planned to conduct only 241 due diligence visits in fiscal year 2004, and resource restraints limited those audits to only 180 visits.<sup>129</sup>

### C. Recent Proposals to Bolster the Regulatory Regime

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<sup>123</sup> I.R.C. § 6695(g).

<sup>124</sup> I.R.C. § 6695(g).

<sup>125</sup> See, e.g., National Taxpayer Advocate’s Annual Report to Congress, Nina Olson National Taxpayer Advocate, FY 2004 Annual Report to Congress, 77 (2004) (arguing that professional tax preparers go largely unregulated, creating a serious oversight problem); see also Jay Soled, *Third Party Civil Tax Penalties and Professional Standards*, 2004 WIS. L. REV. 1611 (noting the inadequacy of the current civil penalty regime).

<sup>126</sup> National Taxpayer Advocate, 2004 Annual Report 77 (Jan. 2005).

<sup>127</sup> National Taxpayer Advocate, 2003 Annual Report 282 (Jan. 2004) (noting that the IRS stated that it “cannot afford to make these low dollar paid preparer cases a priority given their responsibility for addressing billions of dollars in uncollected taxes”).

<sup>128</sup> IRS Criminal Investigation Division (CI) initiations of investigations during the three year fiscal year period 2002 through 2004 totaled 254, 229, and 206, with conviction during that period at 64, 67 and 117. National Taxpayer Advocate, 2004 Annual Report 78-79 (Jan. 2005). CI also investigated preparers as part of its overall “Questionable refund Program” though it did not break down its investigations in that program between preparers and taxpayers. *Id.*

<sup>129</sup> National Taxpayer Advocate, 2004 Annual Report 78 (Jan. 2005). Of the 180 visits, the IRS assessed penalties for failing to comply with the due diligence rules on 29 preparers.

In response to this relatively light approach to government regulation of preparers and the high error rate associated with commercially prepared returns, there has been a recent interest in increasing the regulation of commercial preparers. The reform effort has taken three broad approaches, all of which comprise the most recent legislative proposal, The Taxpayer Protection and Assistance Act of 2005:<sup>130</sup> 1) increasing the scope and severity of penalties directed toward commercial preparers generally, 2) IRS registration, testing and certification of those who prepare federal income tax returns, and 3) improving and focusing the EITC due diligence rules to better address the more common qualifying child EITC errors.

The most controversial of these is the proposal to require registration, certification, and continuing education of preparers.<sup>131</sup> Cono Namorato, the former Director of the Office of Professional responsibility, the internal IRS office most likely to have direct responsibility over such a program, has stated that, for a registration and certification program to be adequately administered, there would have to be a significant expansion of administrative resources.<sup>132</sup> While there are possibilities to shift the costs of registration and certification proposal onto third parties, it is likely that given the size and diversity of the preparer community, a meaningful

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<sup>130</sup> S. 832 (2005)

<sup>131</sup> S. 832 S, Sec. 4 (2005).

<sup>132</sup> See e.g., Sheryl Stratton, *ABA Tax Section Meeting: Namorato Chastises Errant Professionals*, 107 TAX NOTES 1087, 1087 (2005) (discussing Namorato's recent speech delivered to the American Bar Association Tax Section Meeting, regarding regulatory efforts to raise the bar for professional tax preparers). Namorato argued that enacting S. 832 would "pose some nightmares for the IRS Office of Professional Responsibilities (OPR) due to the high costs involved in realizing the regulations. The OPR would have to grow enormously in order to keep up with these regulatory efforts." Others have made similar comments. Janet Spragens, Testimony before IRS Oversight Board (Jan. 26, 2004), *available at* U.S. Dept. of Treasury, IRS Oversight Board, *at* <http://www.ustreas.gov/irsob/meetings/1-26-04/aufc.pdf>. (suggesting that mere proposals to regulate members of the professional tax community are fruitless without efforts toward effective enforcement; however, noting that IRS resources are not unlimited and may not be available to enforce proposed regulations); Taxpayer Advocate's Annual Report to Congress, National Taxpayer Advocate, FY 2004 Annual Report to Congress, 73 (2004) (in response to IRS arguing that the IRS does not have the resources necessary to administer a federal regulation of tax preparers program).



administration of such a program would be a substantial undertaking<sup>133</sup> Likewise, the IRS's abysmal imposition and enforcement of penalties directed toward preparers is reflective, in part, of an unwillingness to ratchet up the significant direct administrative costs associated with investigating and pursuing or prosecuting preparer misconduct.

The real open question regarding certification is exactly what benefit it will provide to the system. The proposal relies on a significant portion of the errors associated with commercially prepared returns reflect errors that stem from preparer incompetence. After all, by requiring preparers to establish competence and continue their education and training, one would expect a decrease in overclaims that arise from preparer incompetence. That there is a difference in error rate among different classes of preparers, and that of the estimated 1.2 million commercial return preparers, approximately 779,000 filed only between 1 and 9 returns, suggests perhaps that skills play a large role, but it does not in any way prove that point.<sup>134</sup>

The real challenge, however, in evaluating the merits of a preparer registration and certification plan is that we do not have any reliable data on whether the errors associated with the commercially prepared returns arose from lack of skills, or the other reasons I have identified. The IRS simply does not have this data, (nor has it adequate plans to capture this data),<sup>135</sup> so, even assuming that one could control the program's administrative costs and tailor it so that it would improve competence to make a material difference in reducing skill-based errors,

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<sup>133</sup> See NTA (modifying the initial proposal to permit the annual competency requirement to be met either by testing or completion of continuing professional education, involving administration by professional groups and contracting out much of the program's administration on a self-funding basis). Olson testimony Before House Ways and Means Oversight Subcommittee on July 20, 2005.

<sup>134</sup> See Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers in THE CRISIS IN TAX ADMINISTRATION* 148, 171 (Henry J. Aaron & Joel Slemrod eds., 2004) (noting that the difference might be attributable to the characteristics of those who seek different kind of preparers). Likewise, it could relate to different scruples among classes of preparers. National Taxpayer Advocate, 2002 Annual Report 225-26 (Jan. 2003).

<sup>135</sup> GAO, Tax Compliance: Better Compliance data and Long-term Goals Would Support . . . , 05-753 (July 2005) (In talking about the tax gap generally and the IRS's inability to understand the underlying causes of noncompliance, the "IRS does not have firm or specific plans to capture this data"). TIGTA (stating that the NTA's registration plan would reflect a major change and at substantial cost) GAO, (stating that there is precious little data about the size of the problem, much less the benefits of implementing a registration plan).

it is hard to evaluate its need. For example, it is hard to see how a registration proposal would address unscrupulous preparers. It could, in fact prove to cause misguided reliance on a preparer who wears the IRS-certified badge.<sup>136</sup> In addition, it is hard to see how the registration proposal would in any way address demand-driven noncompliance, that is, noncompliance involving a claimant who misstates facts regarding his income, children or filing status to ensure EITC eligibility or maximize the amount of EITC receipt.

This is not to suggest that the proposal has no merit; to the contrary, the NTA, the principal voice advocating for this (though other nationally recognized groups have likewise called for its adoption)<sup>137</sup> has presented a thoughtful proposal, and has been sensitive to modifications that would likely reduce the administrative costs. Further, it has benefits beyond EITC compliance. Yet, as errors associated with the EITC, have, in part, driven this issue, more data is needed to evaluate the likely benefits in terms of specifically reducing the EITC overclaim rate. For example, if data suggested that a significant portion of errors relate to preparer incompetence, then the rationale for the proposal is more compelling.<sup>138</sup>

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<sup>136</sup> Spragens, Testimony before the IRS Oversight Board (Jan 26, 2004), (“testing low income preparers for technical knowledge would not deal with the issue of reigning in fraudulent or unethical preparers” . . . and could “cause unsuspecting taxpayers to rely more confidently on a fraudulent preparer”).

<sup>137</sup> ABA Members Submit Comments on Practitioner Licensing Plan (2004), *available at* LEXIS, Tax Analysts, Tax Notes Today, 2004 TNT 24-19.

<sup>138</sup> One complication, however, is that errors may also relate to competence that is beyond preparers’ substantive tax knowledge. This is especially true with respect to low-income taxpayers, many of whom may not share the preparer’s language or culture. There is little doubt that some errors relate to the bridge in culture that exists between preparer and taxpayer, as my experience in the clinic demonstrates that establishing basic facts can be a significant challenge. For example, among clients not born in the United States, we have seen a looser understanding as to who is referred to as a relative, thus creating confusion when we attempt to determine if the relationship test is satisfied. While language and cultural skills can be imparted through continuing education and sensitivity, errors due to language or cultural shortfalls, rather than substantive tax knowledge, reflect the general challenges associated with boosting preparer competence.

D. Require More Meaningful Due Diligence Rules that Preparers Must File, Including the Possibility of Different Due Diligence Requirements Depending Upon the Class of Preparer

As indicated above, honesty of both the preparer and the taxpayer, as well as preparer competence, are the likely causes for the high error rates among EITC returns prepared by professional preparers. Without adequate data regarding the relative importance of these factors, it is difficult to tailor precise remedial measures. However, increasing the requirements on preparers to inquire, record, retain, and report information, and significantly raising the penalty for failing to do so, has the potential to address all three sources of errors.

The current EITC due diligence worksheet is not appropriately tailored to the type of errors specific to the EITC, and should be appropriately focused to address the most important errors. Current rules require that the preparer keep a record of how and when the information used to complete the EITC Checklist was obtained, and retain those records for three years.<sup>139</sup> The preparer currently does not sign the EITC Checklist under penalties of perjury, nor does he furnish it to the IRS. This requirement should be modified and directed toward the residency issue.<sup>140</sup> The IRS should require that all preparers complete, sign, and file with the tax return the EITC Checklist itself. The EITC Checklist should require the preparer to state on what basis the preparer established that each of the claimed qualifying children lived with the taxpayer for a minimum of six months.<sup>141</sup> For example, the EITC Checklist could list certain common ways that the preparer obtained this information, such as the taxpayer's statements, school records or other original documentation.

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<sup>139</sup> Treas. Reg. § 6695-1 (year).

<sup>140</sup> Other issues which contribute to the error of the EITC, such as an improper filing status or misreported income (with the exception of the odd EITC incentive of a taxpayer overstating income), are not EITC specific errors and contribute to understatements of tax generally. For the odd incentive that the EITC craves to overstate or fabricate income, perhaps the due diligence requirements should elicit information about self-employed taxpayers who first report earned income and who do not have any income statements from payors.

<sup>141</sup> National Taxpayer Report, 2003 Annual Report 293 (Jan. 2004).

For some high-risk taxpayers, or individuals claiming a qualifying child for the first time, the due diligence rules should require that they furnish documentation with the tax return or to preparers that demonstrate that the child satisfies the appropriate eligibility requirement. In addition, there could be a more detailed due diligence worksheet that would have to be completed for such taxpayers whom the IRS identifies (the high-risk taxpayers) or who are claiming a qualifying child for the first time. To reflect the differing error rates among types of preparers, the IRS could require differing EITC checklists that vary by preparer type or on the basis of the number of EITC returns a preparer submitted in a prior taxable year.<sup>142</sup> It is possible that the rules might expand to require certain taxpayers to furnish documents, similar to a version of the current certification pilot the IRS is undertaking. A way to reduce the government cost in this arrangement is to permit preparers to receive documentation on behalf of the IRS. Preparers who receive documentation establishing the residence of the child would indicate that in a submitted EITC due diligence EITC Checklist, and be required to retain those records. In the absence of such documentation, the rules should require the preparer to describe on the modified EITC Checklist why the taxpayer does not have the documents, such as that they do not exist or are unable to be obtained. For taxpayers unable to provide documentation but who tell the preparer that the child resided with the taxpayer for the appropriate period, the preparer would likewise disclose to the IRS why such documentation was insufficient or unable to be obtained.<sup>143</sup>

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<sup>142</sup> Braithwaite similarly suggests that the government should target audits from taxpayers with the greatest risk profile to “clients of tax preparers whose portfolio of clients as a group have the worst compliance record.” Braithwaite Markets in Vice, at 13. While this is challenging due to the hundreds of thousands of small preparers, the notion of differing compliance strategies or requirements based upon the likely quality and scruples of the preparer has merit. Less onerous requirements should apply to honest accurate preparers, thus creating additional incentive for taxpayers to use preparers who may be able to assist in limiting noncompliance.

<sup>143</sup> For example, it is possible that frequent moves or periods of homelessness would prevent taxpayers from documenting residence of children.

What are the benefits of this? Shifting this requirement to the worksheet would thus ensure that preparers transmit this information to the IRS, whereas now, only the handful of preparer audits results in any government consideration of this information. This could reduce the incidence of errors attributable to preparer incompetence, as the affirmative obligation would likely result in preparers actually thinking through and understanding the appropriate eligibility requirements.<sup>144</sup> Requiring the preparer to sign and submit the worksheet likely would also deter taxpayers who are dishonest, as the increasing preparer questions on the subject might chill taxpayers who would otherwise slide by without a preparer focus in the issue. In addition, it would allow better educated and more literate preparers the opportunities to explain taxpayer circumstances. This reduces chances of miscommunication in correspondence from the IRS to taxpayers.

What about the issue of unscrupulous preparers? Likewise, requiring the preparer to describe on what basis he knows that the residency requirement is satisfied may make it less likely that an unscrupulous preparer will feign ignorance. Yet, it is hard to imagine that these rules would have a significant effect on preventing the actions of dishonest preparers unless they were backstopped by an increase in the severity and type of civil penalties that can be imposed on preparers, a more meaningful IRS auditing of the preparer community, and a commitment to collecting on any properly imposed civil penalties.<sup>145</sup> Yet, any meaningful audit and penalty

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<sup>144</sup> National Taxpayer Advocate, 2003 Annual Report 293 (Jan. 2004).

<sup>145</sup> Recent empirical literature addressing compliance suggests that given the odds of detection and severity of penalties, most taxpayers are irrationally compliant. See Braithwhite, at 198. Bolstering audit rates and severity of penalties would change the calculus, but note again that the uncertainty in understanding whether the noncompliance is more demand or supply driven brings into question where the government should focus its efforts. Better data would allow Congress to draft appropriate penalties and the IRS to commit sufficient resources on the ground. For a discussion of an increased civil penalty regime that could be applied to preparers, see National Taxpayer Advocate, 2003 Annual Report 293 (Jan. 2004). The government should eliminate incentives that encourage preparers whose dishonesty may be dependent upon taxpayers' eligibility for the EITC. Thoughtful proposals have been made to reduce the demand for products like refund anticipation loans, and the likelihood that taxpayers would visit commercial return preparers who push ancillary products. See, e.g., Michael Barr, *Banking the Poor*, 21 YALE

regime would ratchet up government costs. Given that the IRS lacks an understanding of the reasons why commercially prepared returns have a high error rate, it is understandable that the IRS has not shown that commitment. As such, the discussion of prescriptive policy proposals would greatly benefit from research examining the underlying causes of errors associated with commercially prepared returns.<sup>146</sup>

## VII. Conclusion

The EITC is a strange part of our nation's anti-poverty landscape. Not purely tax, nor purely welfare, its administration has been part of the tax administration and its effect increasingly redistributive. While the EITC cannot replace other benefit provisions due to the inherent structural limitations of the tax system, it does offer many benefits, including lower administrative costs and higher participation.

The EITC's Achilles Heel has been its relatively high error rates, relative to welfare programs. There has been little careful analysis concerning the methods with which the government should tackle the EITC's error rates, with some low-income-taxpayer advocates

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J. ON REG. 121 (2004) (arguing that governmental incentives can harness market and technological forces to expand access to financial services for the poor). Barr argues that the IRS should expand free tax preparation and electronic filing availability, and that the IRS should permit refunds to be direct deposited into more than one bank account so "tax preparers could compete by offering tax preparation services that are paid not out of the proceeds of RALs, but paid directly to them electronically out of tax refunds through direct deposit to them of a portion of the refund, diminishing the risk to the preparer and eliminating one reason to take out a RAL." *Id.* at 175.

<sup>146</sup> While this article does not focus on the errors associated with self-prepared returns, or returns prepared by volunteer organizations that prepare low income tax returns for free, a similar understanding of the reasons why errors appear on those returns would also greatly assist policymakers. Recent studies looking at volunteer return preparers have found significant errors on volunteer-prepared tax returns, and have suggested how certain practices at those sites could reduce errors. See Treasury's Inspector General for Tax Administration (TIGTA), "Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites," August 2004, 2004-40-154. The following year's study found some improvement: 23 out of 35 returns (66%) were incorrect. TIGTA, "Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided," November 2005, 2006-40-004 (noting how in some volunteer programs volunteers did not refer to appropriate checklist questions nor perform adequate quality control).

bemoaning the IRS's relatively high attention to lower-income taxpayers, with the IRS and some academics noting that relative to welfare recipients EITC beneficiaries have faced much less compliance activity. Recent years have seen compliance proposals that are radical in terms of tax administration but consistent with the burdens in other benefit programs. This article reveals that the prism that the government should use in its efforts to reduce the error rate should reflect the EITC's unique characteristics, including the high use of commercial preparers and the relative lack of discretion associated with benefit eligibility. There is the potential for an increased shifting of some of the compliance costs onto those in the private market who prepare tax returns. The lack of data associated with the underlying causes of EITC noncompliance hamper any discussion of prescriptive policies requiring a significant commitment of government resources. Absent that data, this article argues that compliance efforts should take advantage of the presence of commercial return preparers, and the relative lack of discretion associated with eligibility