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ISSUES TO CONSIDER IN ASSESSING IRS' PROPOSALS REGARDING EITC PRE-CERTIFICATION

The Internal Revenue Service has proposed major changes, beginning this year, in application procedures for the Earned Income Tax Credit. Certain EITC claimants raising a child would be required to "pre-certify" their eligibility by proving that the child lived with them for more than half of the year. The new procedures, which would be phased in over several years, could ultimately make it more difficult for substantial numbers of low-income working families to receive the credit.

The new procedures would impose requirements that many eligible taxpayers may find difficult or even impossible to satisfy despite their best efforts. Past experiences with EITC audit and examination procedures in which IRS has asked filers for more documents have resulted in significant numbers of eligible filers being denied the EITC because they did not respond, were unable to satisfy IRS examiners' requirements, or otherwise fell through the cracks of the bureaucracy. This risks undermining the EITC's basic purpose by reducing substantially the proportion of eligible working-poor families that receive the EITC. Such a development would have serious consequences: the EITC currently lifts more children out of poverty than any other social program or category of programs and has been found to be highly effective in spurring and enabling low-income people who are raising children to move from welfare to work.

Under the pre-certification plan that the IRS disclosed earlier this year, all EITC filers who claim children — other than married parents or single female parents claiming their own children — ultimately would be subject to the new pre-certification procedures as a condition of receiving the EITC. The affected group would include all grandparents, aunts, uncles, and other such relatives who are raising their grandchildren, nieces, or nephews, as well as single fathers raising their children, stepparents, and foster parents.

More recently, in mid-June, the IRS unveiled a modified version of these plans and requested comments on them. The IRS is proposing that a pilot group of 45,000 filers drawn largely or entirely from the aforementioned categories receive pre-certification notices in August 2003. The IRS stated earlier this year that it planned to expand pre-certification to cover two million families next summer and even more families in subsequent years. The IRS's plans and timetable to expand the use of these procedures are now less clear, but the IRS apparently still intends to extend these procedures in coming years to larger numbers of filers.

The proposed procedures ask filers to complete a new tax form, Form 8836. Filers also would have to attach either documents proving that the filer and the child or children claimed for the EITC lived together for more than six months during the year, or an affidavit from a third party, signed under penalty of perjury, attesting that the signer has "personal knowledge" or records showing that the filer and the child lived together at a specific address for more than half of the year. The form and documents would have to be returned by December 31, 2003. Otherwise, filers could submit them with their tax returns, but would experience delays in

receiving refunds. EITC claims submitted by filers who were subject to these procedures but did not return the form and documents that IRS examiners found acceptable would be denied.

IRS Comment Period

On June 13, 2003, the IRS announced a public comment period on the proposed pre-certification procedure. Comments had to be submitted by July 14, 2003, to be considered prior to the start in August of the pre-certification pilot test involving 45,000 filers. The IRS invited comments on *both* the draft Form 8836 and the pre-certification process. (Comments on *implementation* of the pilot may be submitted until December 31, 2003. Comments on how the certification program works during the tax filing season may be submitted until April 15, 2004.

Substantial changes have been made to the draft pre-certification forms and instructions that the IRS designed earlier this year (and that the Center on Budget and Policy Priorities analyzed in earlier reports). In particular, the earlier Form 8856 — which sought to verify the relationship of the EITC claimant and the qualifying child and required that many filers submit marriage certificates — has been dropped. Changes have been made to the remaining Form 8836, which seeks to verify residency of the child with the claimant.

Problems with the Pre-Certification Procedures and Our Views on Them

Pre-certification May Deny the EITC to Eligible Workers

The proposed pre-certification procedure establishes requirements that many filers eligible to claim the EITC may find difficult or even impossible to meet. This risks denying EITC claims to significant numbers of eligible working-poor families and discouraging other eligible workers from filing a claim at all. The hardships will fall mainly on lower-income grandparents and other relatives who have assumed responsibility for raising a child.

People who have limited literacy or speak a language other than English or Spanish may find the new procedures particularly challenging. The need to consult third parties to obtain documents or an affidavit to verify the residency of the child and filer may add a stigma to claiming the EITC or otherwise discourage some eligible workers from claiming it. Such verification requirements in advance of claiming a tax credit are not demanded of other taxpayers who claim tax benefits.

Lack of Assistance Available to Taxpayers

The IRS plans to send out the new EITC pre-certification form this summer and ask for the forms and the accompanying documents to be returned by December 31, before the tax-filing season starts. But free tax preparation sites — and most commercial tax preparation sites, as well — are not open during those months. Many of the EITC filers attempting to understand and respond to these new requirements may have no place to go for assistance during these months. If they are confused and submit inadequate documentation or are unable to respond, their EITC refunds will be delayed. This is a significant penalty for workers who often will, in fact, be eligible.

Taxpayers who receive these notices and do not submit the forms and documents by December 31 can still submit them when they file their tax returns. Some may not understand,

however, that they should do so or may no longer have the forms on hand at the time that they file their return. It seems unlikely that the pre-certification forms will be in the IRS tax booklets and unclear that Volunteer Income Tax Assistance (VITA) sites or commercial tax preparers will be provided either the forms or any way to know whether a taxpayer is in the group subject to pre-certification requirements. Since there are few resources in place to assist filers receiving pre-certification notices, and little time remaining to develop such resources this summer, we believe that if the IRS is intent on proceeding with pre-certification, it should delay implementation of pre-certification until the summer of 2004.

Size of Pilot Appears Excessive

The IRS now refers to the impending application of the pre-certification procedures to 45,000 filers as a pilot. But 45,000 may exceed the number of filers needed to conduct a pilot that will produce statistically valid results. Earlier this year (before it began using the term "pilot"), the IRS indicated that the 45,000 level was chosen because that was the number of filers to which it could apply the pre-certification procedures in what would be an initial ramp-up toward two million filers next year. The IRS now describes this year's pre-certification initiative as a pilot test, but it has not adjusted the number of filers that will be subject to these procedures to reflect the number needed to conduct such a pilot, which may be a smaller number. Given that the effects of these procedures are not known and that there is significant potential for sizeable numbers of eligible families to lose the EITC, the IRS should set the number of filers subject to pre-certification at the number needed for the pilot, rather than at a larger number.

Need for Evaluation before Expansion

The IRS should not expand pre-certification beyond the initial group of filers who are involved in the pilot test until a comprehensive evaluation has been completed that demonstrates that pre-certification is effective in reducing overpayments and can be conducted without significant harm to eligible filers. The newly-appointed Commissioner of the IRS, Mark Everson, has stated his commitment to conducting an evaluation of the pilot test beginning in 2003.

The IRS has not yet clearly indicated how extensive this evaluation will be. The evaluation should measure both the effect of the pre-certification procedure in reducing overpayments and the degree to which eligible filers do not respond to pre-certification notices (or drop out during correspondence with the IRS) and lose the EITC. The IRS has indicated that the evaluation will include an examination of filers who do not respond to pre-certification notices; the exact scope of that part of the evaluation is unclear at the present time. The evaluation should determine what aspects of the pre-certification procedure deterred such eligible filers from participating.

The IRS should use such an evaluation, the results of which should be made public, to assess the impact of pre-certification *before* making any decision to expand it to a much larger number of tax filers. Treasury and IRS officials have acknowledged that, assuming the pre-certification pilot proceeds this summer, they will *not* yet have received these evaluation results by the spring of 2004. Accordingly, the IRS should defer its earlier announced plans to expand pre-certification to as many as two million filers in the summer of 2004. No decision on

Estimates of EITC Error May be Overstated

The IRS plan is based on the results of a study of error in EITC claims for tax year 1999. While EITC payments made in error are of serious concern and should be addressed, the conclusion that as much as $10 billion in EITC payments are *now* being made in error is likely to be an exaggeration. The National Taxpayer Advocate has recently stated her view that the IRS study "overstates the overclaim rate"[1] and has significant methodological deficiencies that may have resulted in some premature judgments that EITC payments were made in error.

Furthermore, important changes have been made in the EITC since tax year 1999 to reduce errors, and, for this and other reasons, the IRS study of EITC claims in 1999 almost certainly overstates the present rate of error (for more detail, see the Center's paper, "What is the Magnitude of EITC Overpayments?" at www.cbpp.org/eitc-precert.htm):

- The IRS will be able, beginning in the 2004 tax filing season, to deny all EITC claims submitted by filers who show up in the National Case Registry as the non-custodial parents of the children they are claiming.
- The "AGI tiebreaker rule" was substantially changed and simplified beginning in tax year 2002. Under the previous rule, custodial parents living with another relative could not claim the EITC for their own children if the relative's income was higher, even if the relative did not claim the EITC. This created confusion and unintentional errors, and in the past was one of the leading causes of EITC errors. Errors related to this rule, which frequently involved non-parent caretakers of children, have now largely been eliminated.
- The definitions of earned income and modified adjusted gross income used in the EITC were changed beginning in tax year 2002 so that the EITC definitions are now the same as the income definitions commonly used elsewhere in tax returns.
- The residency rule to claim a foster child for the EITC was changed to conform to the same "more than half the year" requirement as for other qualifying children, eliminating another area of inconsistency and potential confusion.

A recent paper by Treasury experts Janet Holtzblatt and Janet McCubbin, "Complicated Lives: Tax Administrative Issues Affecting Low-Income Taxpayers" (to be published in a forthcoming Brookings volume on issues in tax administration), estimates that the EITC changes enacted in 2001 could reduce EITC overpayments by approximately $2 billion a year.

expansion should be made until evaluation results are in hand, which will not be until after next summer.

If the IRS proceeds with its pre-certification pilot now and then expands pre-certification next year despite the lack of evaluation results on the effect on eligible families, the consequence could well be that tens or hundreds of thousands of eligible EITC filers will lose the EITC or experience lengthy delays in receiving their refunds. IRS can choose a wiser course and assess the lessons from the pilot test before any expansion.

[1] Taxpayer Advocate Service, Internal Revenue Service, "The National Taxpayer Advocate's Report to Congress: Fiscal Year 2004 Objectives," June 30, 2003, pp. 20-21.

Different Approaches to Control EITC Errors

There are other approaches — in addition to the measures enacted in 2001 that were not in effect when the most recent study of EITC overpayments was amended in 1999 — that can help reduce EITC errors. For example, the definition of a child used to claim the dependent exemption and the Child Tax Credit differs from the definition of an EITC qualifying child. Workers who correctly claim their child for the dependent exemption and the Child Tax Credit may reasonably assume they are able to claim the child for the EITC as well, but can find their EITC claim to be in error. Legislation to create a Uniform Definition of Child has been introduced in Congress in 2003 and has passed the Senate. It would make the child definitions used in other parts of the tax code more closely conform to the EITC qualifying child definition. This should reduce inadvertent errors somewhat and ease administration of the EITC.

Nearly 70 percent of EITC claims are filed using commercial tax preparers. There has been little regulation of the private preparer market. Very few tax preparers receive even the small fines that can be levied for failure to exercise "due diligence" in submitting accurate claims for the EITC. IRS data show that error rates among returns filed by commercial tax preparers are as high as in self-prepared returns. Since many taxpayers are unfamiliar with the complex rules for the EITC, and since commercial preparers can be tempted to base their fees on the size of the tax refund, a system for greater accountability and training of preparers should be developed, along the lines proposed by the National Taxpayer Advocate. In this vein, it should be noted that EITC claims submitted by preparers who are not CPAs or enrolled agents have been found to have substantially higher rates of overpayment than EITC claims on returns submitted by other preparers. This suggests that more training and regulation, focusing on such preparers, might reduce errors.

The Pre-Certification Form

The form allows the filer one of three ways to provide verification of residency. For many filers, however, none of the three types of documentation may be available. As a result, significant numbers of eligible low-income working families may be denied the EITC because they are asked to provide documents that are not possible for them to secure.

The first option is to provide documents such as school records, medical records, day care provider records, leases, utility bills, or social service agency records that, ideally, show the name of the EITC filer, the name of the child, the address at which the filer and the child lived, and the exact dates during which the child and the EITC filer lived together at this address.

- The problem here is that many such records do not include this type of specific information regarding dates during which the children lived with the EITC filer at the same address. For example, school records typically indicate the child's dates of attendance and the address provided for the child, but they do not normally document dates during which the child lived with the individual or individuals who are raising the child or these persons' addresses.

- This means that an EITC filer may need to gather one or more documents, such as school records, to show the qualifying child's residency for more than half the

year. If the address of the tax filer is not on the child's school records, the filer may also need to collect completely different documents, such as utility bills or social service agency records, to verify that the filer resided at the same address during the same time frame as shown on the documents collected for the child. Putting together the correct combination of documents may be daunting in many situations and will be even more complex if there are two qualifying children. As a result, tax filers who submit school records, medical records, or the like risk having their documents rejected by IRS examiners. In addition, the need to search out multiple documents and to request they be provided to the filer adds an exceptional time-consuming burden, which may also prove costly if the filer must take time during work hours to obtain documents.

- Filers may run into complications obtaining documents that adequately show the dates the child lived with the taxpayer. This risks rejection by IRS examiners if suggested documents turn out not to meet all IRS requirements. For example, what if a child's school records indicate a different address than the document provided to verify the filer's residency because the family moved during or after the school year? The GAO has found glaring inconsistencies in how IRS examiners responded to the documents that were submitted by EITC claimants during examinations of their claims, which in many cases are similar to the documents that would be required under EITC pre-certification. The GAO found that IRS "examiners are inconsistent in how they assess supporting documentation provided by taxpayers."[2]

  GAO also found that in other examinations of EITC claims, IRS examiners often rejected school records, since a school year, which may run from September of one year to May or June of the next year, is generally insufficient to document residency of the child for more than half of a January-December tax year. GAO found that "…some taxpayers may not easily discern that they need to obtain school records for 2 school years."[3]

  Form 8836 similarly falls short in not providing clear direction on these matters. Instructions indicate generally that documents "when taken together" must show that the child and filer lived together at the same address for more than half the year. A filer might not understand that a school record covering January to June 15, for example, is not sufficient. The form and instructions need to be clear and explicit on exactly what information must be present on the document for the document to be accepted. Otherwise, filers are likely to spend hours securing documents and submitting them in good faith, only to have IRS reject the documents because the documents do not meet a standard of which the filer was not informed.

- The instructions are not specific that, in some circumstances such as foster care or a relative assuming care of child part way through the year, the filer may not be

[2] General Accounting Office, (GAO-02-449), p. 20

[3] Ibid. p. 11

> able to document residency of a child sufficiently until later in the year, when the child has lived with the filer for more than six months. Filers should be instructed that they should wait to file the form and other documents until they have collected all documentation sufficient to demonstrate the child lived with them for more than six months of the current calendar year.

The second option that Form 8836 allows is a variant of the first option. Under the second option, a tax filer may attach a letter on official letterhead from the child's school, health care provider, landlord, etc., that contains the same information as is required under the preceding option. Once again, many of these agencies will not have specific information on the living arrangements of both the EITC filer and the child or children being claimed, and multiple letters may be required.

Under the third option, the tax filer would submit an affidavit from a third party who declares under penalty of perjury that the third party has "personal knowledge" or records that the EITC filer and the child lived together at a specific address from a specific day of a specific month to a specific day of another month.

Since securing such documentary proof that a child and filer lived together can be difficult, many filers are likely to seek to obtain an affidavit instead. However, the IRS rules are problematic here as well.

The major deficiency in the current affidavit provisions is that particular categories of people most likely to know that a filer and child resided together would not be allowed to complete the affidavit. Given the requirement for "personal knowledge" or records that the claimant and the child lived together for the period specified and the explicit perjury warning, most third parties are unlikely to be willing to complete this affidavit unless they have detailed first-hand knowledge of this information or possess specific records. In addition, the form indicates that the IRS may directly contact the person who signs the affidavit, which should further discourage potential signers who do not possess detailed first-hand knowledge. Despite these safeguards, however, the IRS form continues to bar important categories of people who would have first-hand knowledge from filling out the affidavit. This is likely to make it difficult for many eligible families to fulfill this requirement.

In particular, the IRS would not allow neighbors or relatives to complete the affidavit. Other federal programs, in contrast, encourage use of neighbors as a source of third-party information. For example, food stamps — which has succeeded in lowering its overpayment rate to 6 percent — encourages use of neighbors as third-party contacts. For many taxpayers, neighbors may be the only individuals who know personally that the taxpayer and child have lived together during a particular period of the year. They should be permitted to sign an affidavit.

The point is made forcefully in comments prepared by members of the American Bar Association's Section on Taxation, Committee on Low Income Taxpayers and submitted on July 10 by the Chair of the ABA Section on Taxation. The comment letter states: "We applaud the Service's willingness to allow a third-party affidavit as verification. However, we disagree with the apparent assumption reflected in the form that only certain categories of third parties are reliable enough to verify residence. In the experience of many LITCs [low income tax clinics],

there are many other types of third parties who have more personal knowledge than those in the categories listed on the form. For example, school bus drivers, neighbors, public librarians, attorneys who handle custody or divorce matters for a taxpayer, and co-tenants (roommates) who are unrelated to the taxpayer are examples of reliable third parties who have more knowledge of where a child lives than a medical doctor who may see the child once or twice a year."

Restrictions on Child Care Providers

Furthermore, while child care providers generally are permitted to sign the affidavit, neighbors or relatives of the EITC claimant are disqualified from signing the affidavit, unless the child care provider is a licensed or regulated provider. Child care providers are unreasonably singled out in this manner. A minister may sign an affidavit. The minister is not disqualified if he or she is a neighbor. But a child care provider *is* disqualified if the provider is a neighbor or relative of the filer. This disqualification is arbitrary and unreasonable and almost certain to lead to denial of significant numbers of eligible filers. Low-income workers are much more likely than higher-income parents to rely upon neighbors and relatives for child care.

There are many reasons why low-income families may use neighbors on relatives for child care, including the fact that it may be the only type of care that is affordable to them. Licensed care tends to be more expensive, and many low-income workers cannot afford it. In addition, some low-income workers must work nights or weekends, and they may find that neighbors or relatives are the only available or affordable source of "off-hours" care. Furthermore, some low-income non-English speaking families may want to place their children with neighbors or relatives who speak their native language.

Federal Child Care and Development Fund regulations recognize these realities; they emphasize "choice" by parents and guardians in selecting the type of care most appropriate for their children, including unlicensed relative and neighbor care. Accordingly, significant amounts of federal and state child care funds are provided to child care providers who are not licensed or regulated and who are neighbors or relative of children placed in their care. Similarly, tax filers who claim the Child and Dependent Care Credit or use child care tax preferences associated with cafeteria plans are permitted to use child care providers who are not licensed or regulated and who are neighbors or relatives, so long as the tax filer supplies the provider's Social Security or Employer Identification Number.

One additional factor that underscores the necessity of the approach that both federal and state child care programs and the child care provisions of the tax code take is that many states simply do not license or regulate family day care providers. Studies indicate that 75 percent to 80 percent of family day care providers in the nation are not licensed.

As a result, the IRS rule that would bar child care providers who are neighbors or relatives from completing the EITC pre-certification affidavit is unduly restrictive, as well as flatly inconsistent with other parts of the Internal Revenue Code and other federal programs. This heavy-handed restriction would prohibit some of the individuals most likely to have first-hand knowledge that the worker and child lived together from filling out the affidavit and would likely lead to loss of the EITC by substantial numbers of eligible families.

This restriction also means that a worker whose neighbor provides child care every day in her home next door or down the block may *not* have her child care provider sign the affidavit,

while a worker who must get on the bus every morning while it is still dark to take a child to a child care provider miles away across town would be able to have that provider complete the affidavit, even though that provider has less immediate information regarding the worker's living circumstances.

Exacerbating this problem, the IRS form and instructions provide no definition or clarity on what a "neighbor" is. Is a neighbor someone who lives next door, on the same street, or "in the neighborhood?" What is a "neighborhood?" What constitutes a neighbor if you live in a rural area?

The GAO has noted in reviewing other IRS procedures relating to the EITC that IRS' refusal to accept statements from relatives who provide child care creates difficulties for low-income taxpayers who cannot afford commercial child care and have little alternative but to use relatives. "Refusing to accept child care statements from relatives can pose a hardship for low-income taxpayers who use relatives for child care," the GAO said. The GAO cited a Census Bureau report on child care arrangements that found that preschoolers in poor families were 50 percent more likely to be cared for by grandparents or other relatives than preschoolers in non-poor families."[4]

The form should be changed to allow any day care provider over age 18, who is not a spouse or dependent of the taxpayer, to sign the affidavit.

"Property Managers"

The instructions for the affidavit permit a "landlord or property manager" to complete an affidavit. Many filers, however, are likely to be unfamiliar with the term "property manager." IRS presumably intends to include a building superintendent or concierge, or a rental agent, but many filers may not know that and may mistakenly assume that a building superintendent or concierge doesn't qualify. In addition, comparable officials such as housing authority officials should be permitted to fill out an affidavit. It would not make sense to allow a private rental agent or property manager to fill out the form but to disallow a comparable public official. The instructions to Form 8836 thus should expand the term and the definition of "property manager" to include these types of individuals.

In addition, homeowners should be able to have a bank official or insurance agent with personal knowledge of a child's residency sign the affidavit. Otherwise, the IRS rules risk discriminating against homeowners and would be biased against the rural working poor. Census data show that 55 percent of rural working families with children that have incomes in the EITC income range (below twice the poverty line) are homeowners.

[4] General Accounting Office, (GAO-02-449), pp. 15-19.