Report to Congress on Strengthening Earned Income Tax Credit Compliance through Data Driven Analysis

U.S. Department of the Treasury

July 5, 2016

House Report 114-194 directed Treasury and IRS to conduct a data-driven analysis to improve Earned Income Tax Credit compliance with an emphasis on enhancing taxpayer understanding of the credit, and further directed Treasury and IRS to submit a report on their progress toward meeting this goal to the Committees on Appropriations in the House and Senate. This report fulfills the latter request by the Committee.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 1, 2016

The Honorable Hal Rogers
Chairman, House Committee on Appropriations
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Rogers,

In House Report 114-194, the House of Representatives' Committee on Appropriations expressed support for efforts by the Department of the Treasury and the Internal Revenue Service to increase compliance with the Earned Income Tax Credit (EITC) program. The Committee directed Treasury's Office of Tax Policy and the IRS Office of Research, Analysis and Statistics to collaborate in conducting data-driven analysis to improve EITC compliance in collaboration with the tax preparation community with an emphasis on enhancing taxpayer understanding of the credit. The House Report further directed Treasury and IRS to submit a report on their progress toward meeting this goal to the Committees on Appropriations in the House and Senate.

Enclosed is our report on the data-driven analysis that Treasury and IRS are currently undertaking to improve EITC compliance.

Treasury and IRS appreciate the support of the Committee for our ongoing efforts to improve EITC compliance. Should you have any additional questions, please contact me or have your staff contact Lisa Pena, Office of Legislative Affairs, at (202) 622-1900.

Sincerely,

TPM

Thomas Patrick Maloney
Senior Advisor, Office of Legislative Affairs

Enclosure

Identical letter sent to:
The Honorable Thad Cochran
The Honorable Barbara Mikulski
The Honorable Nita Lowey

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 1, 2016

The Honorable Barbara Mikulski
Vice Chairwoman, Senate Committee on Appropriations
United States Senate
Washington, DC 20510

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Ranking Member, House Committee on Appropriations
U.S. House of Representatives
Washington, DC 20515

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United States Senate
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I. Introduction

House Report 114-194 expressed support for efforts by the Department of the Treasury and the IRS to increase compliance with the Earned Income Tax Credit (EITC) program. The Committee directed Treasury and IRS to conduct data-driven analysis to improve EITC compliance with an emphasis on enhancing taxpayer understanding of the credit, and further directed Treasury and IRS to submit a report on their progress toward meeting this goal to the Committees on Appropriations in the House and Senate.[1] This report fulfills the latter request by the Committee.

Treasury and IRS appreciate the support of the Committee for our efforts to improve compliance with respect to the EITC. Consistent with the Committee's direction, we have undertaken and continue to undertake a number of studies designed to strengthen compliance as well as improve our understanding of effective methods to do so. This report provides detail regarding four studies currently underway to improve EITC compliance across different methods of tax preparation. These efforts all take the form of tests with a randomized controlled design that tailor treatments to specific areas of concern regarding compliance behavior. They include efforts to promote compliant participation as well as to detect and deter noncompliance. These studies have provided and will continue to provide Treasury and IRS with evidence regarding the effectiveness of various methods for strengthening EITC compliance. This will allow our future compliance strategy to be data driven, as directed by the Committee. Moreover, all of the studies described have an educational component to them, so that taxpayers and preparers alike who are

[1] The specific report language is: *Strengthening EITC Compliance*.—The Committee supports the Department and IRS' [effort] to increase compliance with and the accuracy of the Earned Income Tax Credit (EITC) program. The complexity of the EITC law makes it inherently difficult for families and individuals to avoid errors and inherently easy for criminals to make false claims. The Committee directs the Office of Tax Policy (OTP) and the IRS Office Research, Analysis and Statistics to conduct data-driven analysis to improve EITC compliance in collaboration with the tax preparation community. Successful analysis will identify solutions effective for both paid preparers and self-preparers, [and] ensure ease of taxpayer understanding. The Committee directs OTP and IRS to submit a report to the Committees on Appropriations in the House and Senate not later than six months after enactment of this Act on meeting this goal.

involved in these studies should, as directed by the Committee, gain improved understanding of the eligibility criteria for EITC and of their responsibilities for correctly claiming the credit.

The four studies are discussed in turn. The EITC Return Preparer Study is a multiple-year iterative study of the effectiveness of feedback or other treatments provided to paid return preparers as part of IRS' compliance strategy for paid preparers of EITC returns. The ongoing outreach and enforcement strategy is estimated to have resulted in a total of almost $1.7 billion dollars in revenue protected over the past four years, and data-driven analysis results in improved treatments for preparers in each successive year. The collaborative IRS-Treasury Tax Software Field Experiment is a study underway in partnership with tax preparation software providers that tests ways to improve self-preparers' abilities to assess their own eligibility for the EITC by embedding additional questions in the tax preparation software. This study is in its second year. Two other studies, the Dependent Database (DDb) Soft Notice Pilot Effectiveness Study and the Field Experiment to Reduce Misreporting of EITC Net Self-Employment Income, explore ways to influence taxpayer behavior by sending mailings to relevant groups of taxpayers based on information submitted as part of their prior year EITC claims. The former of these studies focuses on taxpayers whose returns raised a compliance concern, though they were not selected for audit. Taxpayers selected for this study receive a mailing that describes the specific compliance concern on the return; their subsequent tax returns are evaluated for changes in behavior. The latter study focuses on taxpayers who report self-employment income. For this study, the mailing is more educational in nature, and explains certain rules for reporting self-employment income when claiming the EITC, without referring to any specific concerns about the return filed by the taxpayer. Taken together, these four studies cover three important channels for helping taxpayers improve EITC compliance: through tax preparers, through tax software, and through direct communication with the taxpayer. They reflect Treasury and IRS' commitment to continually explore methods for improving EITC compliance, with particular emphasis on research that leads to data driven conclusions, and informs future treatments.

II. EITC Return Preparer Study

Background:

Return preparers are instrumental partners in tax return preparation for many taxpayers, including 54 percent of EITC claimants. The EITC Return Preparer Study is a multi-year research project that is an integral component of the IRS' larger compliance strategy for EITC return preparers. This overall compliance strategy seeks to improve the accuracy of EITC returns by educating preparers about their due diligence requirements in a variety of ways. The strategy also incorporates an array of enforcement techniques for preparers who fail to meet their due diligence requirements and/or who file a large or disproportionate number of tax returns with potentially erroneous EITC claims.[2] The EITC Return Preparer Study uses randomized controlled sample design to quantify the annual revenue protected by various enforcement techniques in order to identify effective treatments and operational improvements.[3]

The EITC Return Preparer Study has been in operation since Fiscal Year (FY) 2012, and each year the precise strategies are changed to reflect lessons learned in prior years as well as newly arising compliance concerns. The discussion that follows will focus on providing details for the current FY 2016 research in progress, but information about prior year sample sizes and major findings is also presented.

Sample of Selected Preparers:

The sample selected for the FY 2016 treatments consists of 25,500 preparers, 22,000 of whom are in the treatment group and 3,500 of whom are in the control group. The preparers selected for the program all prepared at least 25 tax returns, and either had a large number of their

[2] Internal Revenue Code §6695 and related regulations set out the EITC Due Diligence requirements and the penalties for failure to comply with them.

[3] Certain aspects of the EITC return preparer strategy are implemented without regard to measuring potential revenue effects – namely, efforts to provide education and outreach on paid preparer due diligence through numerous public venues. For example, the IRS has developed a Tax Preparer Toolkit and made it available on the EITC Central website at https://www.eitc.irs.gov/Tax-Preparer-Toolkit/main; here, preparers can access many resources including an interactive Due Diligence Training Module, a webinar in English and Spanish, Schedule C training material, and Hot Topics. IRS also presents due diligence seminars annually at the Nationwide Tax Forums.

prepared EITC returns trigger filters in IRS' Dependent Database (DDb) related to qualifying children or Schedule C, or their prepared returns displayed a disproportionate share where the maximum EITC amount was claimed.[4] The type or types of treatment applied to each preparer in the test group further depend on additional criteria or preparer characteristics; these are described along with each treatment in the section below.

The number of preparers selected each year has varied but the criteria for selection has remained similar over time. The table below shows the size of the sample in each of the five years since the inception of the study. With the exception of FY 2012, several test and control groups are present in each fiscal year; the combined numbers of preparers are reported in the table.

	Total number of preparers	Preparers in test group(s)	Preparers in control group(s)
FY2012	2,000	1,500	500
FY2013	17,500	14,500	3,000
FY2014	21,000	18,100	2,900
FY2015	31,100	20,900	10,200
FY2016	25,500	22,000	3,500

As noted above, the treatments in the EITC Return Preparer Study consist of a variety of enforcement techniques. The FY 2016 study includes the following treatments, which differ in their intensity and timing.

Pre-Filing Season Treatments:

[4] The IRS' Dependent Database refers to an IRS process that combines data from IRS and third-party sources such as the Social Security Administration and the Federal Case Registry. When returns are filed, they are compared against these data and scored for the probability of noncompliance. This process incorporates filters for characteristics that are strong indicators of noncompliance.

The following treatments are conducted during the pre-filing season (September to early January). The treatments are listed in order from most to least intense.[5]

Due Diligence Visits (DDVs): These are visits to return preparers conducted by revenue agents to review preparers' compliance with due diligence requirements under Internal Revenue Code (IRC) § 6695(g). Preparers are penalized $500 for each return where due diligence was not met.[6]

Knock and Talk Visits (KTVs): KTVs are visits to return preparers conducted by revenue agents along with a Criminal Investigation (CI) agent. The purpose of the visit is to educate the preparer about EITC due diligence requirements. Although preparers are selected for visits based on the characteristics of the EITC returns they filed, penalties are not issued as a result of the visit. However, preparers that do not improve during the following filing season receive a DDV, which could result in penalties.

Post-Refund Client Audits: Preparers with high volumes of highly suspect EITC returns receive additional client audits in a post-refund environment. This effort provides information to preparers about whether their work is accurate and reinforces the need to prepare correct returns.

Letters: Selected preparers are sent letters indicating that they might have prepared incorrect returns and reminding them about preparer due diligence requirements. There are a number of different letters that may be sent, depending on the characteristics of the preparers and the returns they file. In FY 2016, preparers with a number of expected errors in excess of a threshold are mailed one of three versions of Letter 5025, which specifies the type of potential error(s) present on the tax return (qualifying child errors, Schedule C errors, or both). Letters are initially sent by certified mail and if the preparer does not pick up the letter, another letter is sent as a first class letter. Preparers with a lower number of expected errors are mailed Letter 4833-A, which does

[5] The most intense treatment employed by the return preparer strategy is an EITC Due Diligence Injunction (EDDI), but because this treatment is not randomized it does not provide information from a research standpoint. EDDI investigations are initiated when a preparer was previously penalized yet continues to prepare questionable returns and continues to be noncompliant in meeting due diligence requirements. An injunction prohibits a return preparer from preparing tax returns for others. Fewer than 10 cases are referred annually for EDDIs.
[6] The penalty is increased for inflation.

not specify the type of potential error.[7] Letters are mailed first class. Some pre-filing season letters are returned to the IRS as undeliverable because of an incorrect address. Although preparers are expected to update their address and phone number annually during renewal of their Preparer Tax Identification Numbers (PTIN), this does not always happen. When letters are returned undelivered, the associated preparer is called to deliver the same message that is contained in the letter. The phone calls are completed in early January, just prior to the start of filing season.

Filing Season Treatments:

Preparers are selected for filing season treatments as tax returns are processed and the treatments are conducted rapidly (late January to February). The goal of the quick identification and treatment is to reduce additional erroneous returns from being filed by correcting behavior right away. Treatments below are ordered by intensity. Preparers may receive multiple treatments during the same filing season if less intense treatments, which are usually attempted first, are not successful.

Real Time DDVs: Real Time DDVs are selected daily from returns filed early in the filing season. Within two days of their selection for audit, the preparer is notified face to face, and the audit begins within 10 working days. The goal is to visit the preparer as early in the filing season as possible in order to reduce the volume of erroneous returns prepared by this preparer through better understanding or better adherence to the rules.

Phone Calls: These calls inform the preparer that they are filing potentially erroneous EITC returns.

Letters: Letter 4858 is similar to Letter 5025 and is mailed first class which requires less preparation for mailing than a certified mail letter and results in quicker delivery.[8]

[7] Current versions of all letters may be viewed at the following website: https://www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/reachingout. For FY 2017, L4833-A will not be used, and all letters will refer to specific suspected errors made by the preparer.
[8] The letter may be viewed at https://www.eitc.irs.gov/Tax-Preparer-Toolkit/compliance/reachingout.

Outcome measures:

The EITC Return Preparer Study generates estimates of annual revenue protected to demonstrate the effectiveness of the treatments conducted each year. The estimates are derived from analyzing the subsequent behavior of the treated preparers, as well as the characteristics of their clients' tax returns, and comparing this with the preparers in the control group and their clients' tax returns. More specifically, revenue protected is the difference between the estimated amount of erroneous credit claims on returns prepared by paid preparers in the treatment group and on returns prepared by paid preparers in the control group. The amount of erroneous credit claims is estimated using tax return characteristics, including DDb scores and other criteria that IRS has found to be associated with errors in claiming tax credits.

The FY 2016 study is also evaluating the following questions in an effort to make further operational improvements.

Preparers Filing Large Number of Tax Returns: The study will evaluate the impact of mailing a pre-filing season letter to preparers filing more than 1,500 total returns under a single PTIN, compared to the impact for smaller preparers. It is likely that preparers with extreme volumes are offices where many preparers are preparing returns and one preparer is signing the returns. Mailing letters to preparers with these apparent volumes may not yield results, as they are not actually performing all of the preparation work. Other more costly treatments could be necessary to address noncompliance in this group.

DDVs: Penalties Needed to Influence Preparer Behavior: The study will analyze the number of penalties from DDVs that are required to change a preparer's behavior. For the FY 2016 effort, preparers receiving a pre-filing season DDV were randomly split into two groups. Revenue agents will review up to 75 returns for half of the preparers and up to 150 returns for the other half of preparers.[9] If preparer improvement is the same for both groups and if comparison of return on investment (ROI) supports it, future pre-filing season DDVs for individual preparers will be limited to a maximum of 75 EITC returns. The reduction in returns reviewed would shorten the amount of time needed to complete a DDV and allow scarce resources to be used elsewhere.

Network DDVs: The FY 2016 study will evaluate the impact on preparer networks when one preparer, who is part of a larger network of preparers, receives a DDV.[10] This will address the question of whether it might be operationally feasible to conduct one visit for multiple preparers in the same network, instead of conducting multiple visits. Prior to FY 2016, the compliance program did not consider network associations when assigning treatments. Going forward, the program will attempt to learn how network dynamics influence preparers and how best to treat networks. Depending on the results, this test may allow the IRS to allocate its scarce compliance resources in a more effective manner.

Correspondence DDVs: Currently, due diligence visits are conducted in person. In 2016, up to ten correspondence "visits" are being conducted in a qualitative test to determine if the approach is workable and could be expanded in future years.[11] Correspondence DDVs would allow the IRS to perform DDVs in areas where no revenue agents are available, or where there are more preparers than revenue agents can visit. Also, correspondence DDVs would likely cost less than an in-person visit. However, current resource constraints may prevent the IRS from implementing this treatment as it is time-intensive, and although no travel is involved, examiners are still needed to conduct the audits.

[9] Returns are reviewed in groups of 25. If there is no evidence of noncompliance with the due diligence requirements in the first group of returns, the examiner will end the audit. If noncompliance is found, another 25 returns are reviewed.

[10] A network is a set of preparers that uses a common identifier on the returns they prepare that indicates they work closely with each other in the same office or same preparer community. For example, the common identifier might be an Electronic Filing Identification Number (EFIN), Employer Identification Number (EIN), or preparer phone number.

[11] This treatment will provide qualitative information rather than data-driven analysis, but it will be useful to understand the logistical challenges that arise from attempting to complete DDVs by correspondence rather than in person. DDVs are both effective and costly; reducing the time and cost it takes to do the DDV would add value to the EITC return preparer program.

Filing Season Treatment Expansion to Preparers Not Treated in Pre-Filing Season: This aspect of the FY 2016 study will measure the impact of treating preparers during the filing season that were not selected for treatment during the pre-filing season. Prior to the FY 2016 compliance effort, filing season treatments were limited to preparers where a pre-filing season treatment was attempted. Preparers not identified as part of the pre-filing season effort, but who filed potentially erroneous returns during the current filing season, were not identified until after filing season was completed and not treated until the following fall. In FY 2016, many of these preparers were identified as returns were being filed and were sent Letter 4858. Treating preparers sooner should yield additional savings.

Knock & Talk Visits (KTVs) and Presence of CI Agents: Currently all KTVs are conducted by a revenue agent who is accompanied by a Criminal Investigation (CI) agent. The study will examine whether KTVs conducted without the presence of a CI agent are as effective as a KTV with a CI agent present. If they are as effective, then CI resources could be used elsewhere. The KTV program also could be expanded to locations where CI agents are not available.

Timing of Analysis:

Results from the 2016 filing season will be available in the summer of 2016. These will be used to modify treatments for the 2017 and later filing seasons.

Conclusion:

The EITC Return Preparer Study continues to demonstrate the effectiveness of IRS' return preparer compliance strategy. Below is a brief summary of major findings from prior years of the study, including annual estimates of the revenue protected by the treatments.

FY 2012

- Many new treatments were piloted for the first time and deemed effective. Following are three examples of treatments employed for the first time:
    - Calls to preparers were made during the filing season.

- Preparer-focused, post-refund client audits were conducted prior to filing season.
- Real Time (RT) Due Diligence Visits (DDVs) were completed during the filing season.

- Pre-filing season and real-time monitoring and intervention resulted in reducing the flow of improper filing season EITC claims. Estimated revenue protected from the FY 2012 program was $230M: $180M for EITC and $50M for Child Tax Credit (CTC) & Additional Child Tax Credit (ACTC). The total cost of the FY 2012 program was $2.7M

FY 2013

- All treatment types (letters, calls, and visits) were determined to be effective in reducing erroneous EITC returns.
- In-person visits and client audits were determined to have larger impacts on preparer behavior; however, letters had the highest ROI due to their relative low cost when compared to in-person visits and audits.
- Pre-filing season treatments are more effective than filing season treatments due to the timing of the treatment. As a result, pre-filing season treatments have a higher ROI.
- The general reduction of erroneous EITC returns for preparers that respond to treatments persists into the next filing season.
- No evidence was found that treatments caused taxpayer migration to other preparers.
- The acceleration of preparer risk scoring from a weekly basis to a daily basis allowed for faster interdiction of preparers and improved the value of the program. It also significantly improved the ability to do data-driven analysis that impacts compliance.
- Estimated revenue protected by the FY 2013 program was $557M: $453M for EITC and $104M for CTC/ACTC. The total cost of the FY 2013 program was $12.6M.

FY 2014

- Approximately 200 preparers were delivered a pre-filing season letter electronically, via a secure IRS system, which was determined to be feasible and effective.[12] The cost of

[12] Electronic delivery of compliance letters has not been attempted since FY 2014 as the IRS does not have the infrastructure in place to administer this approach for more than a few hundred preparers. The current infrastructure used by IRS to communicate with preparers may not be used for compliance purposes due to its funding source.

providing letters electronically will be minimal once the needed infrastructure is completed.

- Pre-filing season outbound calls to preparers that did not receive the pre-filing season certified letter were piloted for the first time and deemed to be successful.
- Estimated revenue protected by the FY 2014 program was $428M: $351M for EITC and $77M for CTC/ACTC. The total cost of the FY 2014 program was $12.6M.

FY 2015

- An iterative pre-filing season treatment delivery process was piloted to increase preparer contact rates prior to the beginning of filing season (first a certified letter, then a first class letter and finally a phone call). This approach increased the contact rate from approximately 70% before FY 2015 to over 90% in FY 2015 (for preparers in the pilot).
- Preparers that received 15 additional post-refund client-audits improved, on average, the same as preparers that received 25 additional client audits. Increasing the number of preparer focused, post-refund, client audits past a certain threshold did not appear to produce better results in this instance.
- Pre-refund client audits were limited in success due to work plan constraints and were removed from consideration as a future treatment.
- Letter 5025 series was determined to be more effective, on average, than Letter 4833. As a result, Letter 4833 was not used in FY 2016. Both letters inform preparers of the possibility of errors on the EITC returns they have filed, and remind them of the EITC due diligence requirements and the consequences they face for not following those requirements. The letters also inform them of the consequences their clients may face for filing erroneous returns. However, the Letter 5025 series are issue-specific and therefore provide the preparers with more information about the type of errors they are potentially making.
- To expand coverage to lower-volume preparers who had not been previously treated, Letter 4833-A, a letter similar to Letter 4833, was piloted and determined to be effective.

The IRS is working with its IT division to develop a system that could be used outside of a pilot environment. Long term postage savings would be substantial if electronic delivery was ever available in a production environment.

However, because issue-specific letters are likely to be more effective, this letter will not be used after FY 2016.

- Estimated revenue protected by the FY 2015 program was $465M: $386M for EITC and $79M for CTC/ACTC. The total cost of the FY 2015 program was $13.4M.

The ongoing, multi-year EITC Return Preparer Study contributes crucially to the IRS' compliance strategy for paid return preparers. Its overall goal is to reduce noncompliance associated with EITC and other tax credits. The study has advanced EITC enforcement with its ability to use near real-time information and the randomized controlled study design produces results that can be used to refine and improve treatments. This has yielded evidence of treatments that improve compliance by paid tax return preparers with respect to claims for EITC and the CTC/ACTC.

III. IRS-Treasury Tax Software Field Experiment

Background:

Taxpayers who self-prepare their tax returns must determine their own eligibility for the EITC. This is often facilitated by tax preparation software, used by the vast majority of self-preparers.[13] Tax preparation software typically helps the taxpayer establish eligibility for the EITC (as well as other tax return line items) by requiring the taxpayer to respond to a series of factual questions about their income and family circumstances.

This project is a randomized controlled test that explores whether expanding the set of questions related to EITC eligibility can reduce noncompliance with respect to the EITC, without reducing participation among compliant taxpayers. The additional questions may have several benefits: first, they clarify aspects of the eligibility rules that otherwise may have been confusing to taxpayers; second, they make the eligibility requirements more salient and force taxpayers to

[13] Less than 2 percent of all EITC claimants file on paper without the use of software.

actively affirm certain information is truthful, which the behavioral economics literature has suggested might improve compliance; and finally, to the extent these questions are ultimately incorporated as a form change, the responses to the questions themselves may provide IRS with additional information that could be used to improve IRS enforcement activities in the future. The test currently underway in 2016 focuses on questions that relate to the qualifying child residency requirement, primarily because the failure to meet this test constitutes the largest (dollar value-wise) EITC error.[14,15]

Sample:

IRS and Treasury worked with several online tax preparation companies in the Do-It-Yourself market in the 2016 filing season to incorporate several additional EITC-related questions into their software for a randomly selected set of taxpayers that numbers in the hundreds of thousands. A control group was also selected from taxpayers using the same software products, but the taxpayers in the control group were not exposed to the "treatment" of additional EITC eligibility questions.

Treatment:

Taxpayers in the treatment group used a version of the tax preparation software that includes additional questions related to the residency test: taxpayers were asked to confirm they lived with each child claimed for the EITC for more than half the year and to provide the address at which they lived with these children the longest. The software also provided clear language explaining that the IRS might ask for documentation to substantiate residency, and forced taxpayers to actively certify that the information they provided was correct.

[14] In order for a child to be eligible to be claimed for EITC, the child must reside with the taxpayer in the United States for more than half the year.

[15] A similar experiment was run with one software provider in the 2015 filing season. There was generally almost no difference in the returns filed by taxpayers in the treatment and control groups, suggesting that the questions tested would have at most modest effects. In the current experiment, we have refined the questions, expanded the number of participating software providers, and substantially increased the sample size and resulting statistical power of the analysis.

Outcome Measures:

Key outcome measures for this analysis include the dollar amount, if any, of EITC claimed with qualifying children and the scores generated by IRS DDb filtering algorithms that predict how compliant the return is with respect to the EITC. Whether the taxpayer started the process but failed to finish the return will also be tracked. Comparison of these measures between the treatment and control groups will indicate whether the additional EITC-related questions yield statistically significant differences in terms of the amount of EITC claimed, the likelihood of noncompliance on the return, and rates of tax return completion. If the questions prove to be a success, we would expect to find that the treatment group claimed less EITC, but the subset that did claim the EITC would look more compliant than the subset in the control group who claimed the EITC, such that only non-compliant taxpayers were dissuaded from claiming the EITC.

Timing of Analysis:

Results are expected to be available in the summer of 2016.

IV. DDb Soft Notice Pilot Effectiveness Study

Background:

As noted above, the IRS' Dependent Database refers to an IRS process that combines data from IRS and third-party sources such as the Social Security Administration and the Federal Case Registry. When returns are filed, they are compared against these data and scored for the probability of noncompliance. This process incorporates filters for characteristics that are strong indicators of noncompliance. The DDb has proven to be a highly effective tool used by IRS to score and select EITC cases for audit. However, some segments of the population identified by DDb as making potentially erroneous EITC claims are unable to be examined by IRS due to limited audit resources.

One treatment option that has been employed by the IRS to reach taxpayer populations that fall outside existing audit parameters is the "soft notice." A soft notice is a letter mailed to specific taxpayers, identifying a potential compliance issue and providing instructions for self-correction. Specifically, taxpayers are instructed to file an amended return if they determine an error was made on their filed return and they are reminded how to be compliant in subsequent years. The soft notice differs from a standard notice in that there is no subsequent IRS follow-up to the recipients of the soft notice, such as a correspondence audit or additional notice communication. The soft notice attempts to change behavior through the taxpayer's own self-correction and through voluntary compliance in future tax years.

The DDb Soft Notice Pilot Effectiveness Study is being undertaken by the IRS in order to address whether a soft notice treatment can effectively improve the compliance behavior of certain self-preparers whose returns have indicators of noncompliance but, due to resource constraints, would not be among the returns selected for other enforcement programs.

Sample:

The population of interest for this study consists of tax year (TY) 2014 taxpayers who self-prepared their return and were identified by the DDb process as making a potentially erroneous EITC claim, but their return was not selected for audit. The population is further defined by the amount of EITC claimed and by not having been selected for audit or a soft notice in recent years. During calendar year 2015, there were approximately 1.9 million returns that met the criteria for this population. The population is then further limited to two groups: 1) taxpayers who did not receive the EITC in the previous three years and 2) taxpayers who received the EITC in the past and for whom the DDb indicated that they made a similar type of error (qualifying child or Schedule C income) for the previous two tax years. A sample of 25,600 taxpayers was selected from these two groups, along with a control group of the same size.

Treatment:

Taxpayers in the treatment group were sent soft notice letters in December 2015 based on their TY 2014 filing. The treatment sought to encourage taxpayers to file amended TY 2014 returns and to change the behavior observable on TY 2015 returns. The content of the letter was tailored to the taxpayer based on what DDb identified as the potential compliance problem. For example, Letter 5621 asks the taxpayer to review their prior year return to determine if each of the children claimed met all of the qualifying child rules for the credit. Letter 5621-A asks the taxpayer to determine if all the income and expenses reported from self-employment on Schedule C or Schedule C-EZ were complete and correct.

Outcome Measures:

The study will attempt to measure the effectiveness of these soft notices in encouraging self-correction on amended TY 2014 returns and voluntarily compliant EITC behavior on the soft notice recipient's TY 2015 tax returns. The analysis will consider the extent to which taxpayers in the test and control groups continue to be identified by DDb as filing potentially erroneous EITC claims, as well as other aspects of filing and EITC-claiming behavior. Outcomes will be evaluated separately by whether the taxpayer was a first time EITC claimant or a repeat EITC claimant. The study will also quantify the amount of potential revenue that is protected for TY 2014 and TY 2015 as a result of the soft notice mailings.

Timing of Analysis:

The analysis is expected to be completed by October 2016.

V. Field Experiment to Reduce Misreporting of EITC Net Self-Employment Income

Background:

Prior research indicates that there is more misreporting of self-employment income compared to misreporting of income from sources for which there is more comprehensive third-party information reporting (and withholding) (Slemrod, 2007; Internal Revenue Service, 2016). Furthermore, prior research from IRS audits and analyses of administrative income tax records has indicated that some taxpayers with self-employment income misreport their net self-employment income in order to maximize Earned Income Tax Credit (EITC) benefits while minimizing the self-employment tax that must be paid (Saez, 2010; Chetty, Friedman, Ganong, Leibel, Plumley and Saez, 2012; and Chetty, Friedman and Saez, 2013).[16] Behavioral economic research in tax applications also indicates that reminders of obligations to truthfully report income can prevent errors from occurring (Slemrod, Blumenthal, and Christian, 2001; Kleven, Knudsen, Kreiner, Pedersen and Saez, 2011). Motivated by this prior research, the IRS developed a study using a randomized controlled design to test whether a soft-touch postcard from the IRS could reduce income misreporting and improve EITC compliance for this population.

Sample:

The population for the pilot project consists of taxpayers who filed tax returns for Tax Year 2014, reported self-employment income, and reported total earned income within $1,000 of the lowest income level for which the maximum EITC is allowed. The sample of 200,000 taxpayers subjected to the treatment includes both self-prepared and third-party prepared returns. A similarly defined control group of over 565,000 taxpayers was selected for comparison.

[16] The EITC increases with earned income (including wages and self-employment) up to a threshold, then remains constant as earned income continues to increase, and then is phased out as income continues to rise above a second threshold. Self-employment income in excess of $400 is taxed at a flat 15.3 percent rate. Thus, by reporting self-employment income exactly equal to the first threshold, a taxpayer can receive the maximum amount of EITC for the least amount of self-employment tax.

Treatment:

The treatment in this study is the mailing of a postcard that informs readers of rules for reporting self-employment income when claiming the EITC. In particular, the postcard mentions that all business income must be reported and only allowable business expenses can be deducted. The postcard also reminds taxpayers that it is not permissible to maximize EITC benefits by claiming less than the full amount of eligible business expenses. The text also informs readers of penalties for both taxpayers and tax preparers for intentional errors in claiming EITC benefits. Thus, the content of the postcard is educational and generic; it does not involve any taxpayer identifying information. In this sense, the soft-touch postcard differs from most IRS soft notices, which explicitly highlight a compliance concern that is specific to the taxpayer. These experimental mailings were sent to taxpayers at the start of the 2016 filling season (January 20, 2016) and again on March 1, 2016, before the end of the filing season. This treatment is similar to soft notice treatment in that no further enforcement is planned as part of the study, although taxpayers who were sent these postcards may be selected for audit or document matching by other standard enforcement processes.

Outcome Measures:

The analysis will examine the impacts of the experimental mailings on treated taxpayers' filing and income reporting behaviors, as well as differential impacts between taxpayers using paid tax preparers and those using self-prepared returns. The analysis will also examine network effects through geographic neighbors and taxpayers using the same tax preparers.

Timing of Analysis:

Preliminary results for the pilot project are expected to be available by August 2016 and final results by the end of December 2016.

VI. Conclusion

This report fulfills the request by the House Committee on Appropriations to describe IRS and Treasury progress toward the goal of improving EITC compliance. The studies described in this report have been carefully designed to evaluate how specific changes to aspects of IRS operations can improve taxpayer compliance with respect to claiming the EITC. They reflect just a few of the efforts that Treasury and IRS undertake as part of the broad set of responsibilities and activities necessary for administering the EITC and other refundable credits. While it is harder to evaluate many of these other efforts, we expect they also have direct and indirect effects on EITC compliance.

For example, each year the IRS conducts a multi-lingual outreach campaign that seeks to reach EITC underserved populations and newly eligible taxpayers. The campaign includes messaging about participation and compliance that helps taxpayers correctly claim the credit. The IRS leverages external partnerships to help provide taxpayers with information on qualifications, how to claim the credit, and how to get free help on filing. An example is the coordinated effort of EITC Awareness Day. Partners hold over 200 local media events. Both partners and the IRS use traditional and social media communication channels to lead taxpayers back to irs.gov where the IRS provides important information about the EITC including the EITC Assistant, a tool that allows taxpayers to determine if they qualify for EITC.

The IRS continues to partner with members of key tax software organizations. The goals of this partnership are to identify software improvements that can help individuals file more accurate EITC returns and preparers in meeting their EITC due diligence requirements.

Another activity designed to foster voluntary compliance is the use of soft notices beyond those described in the DDb Soft Notice Pilot Effectiveness Study in this report. As stated earlier, soft notices are sent just prior to each filing season as a reminder to taxpayers to correct possible errors made on their prior year returns related to the claiming of EITC and dependents. These soft notices promote self-correction and voluntary compliance in subsequent filing periods and are a low-cost alternative to conducting audits. About 90,000 soft notices were sent during fiscal year (FY) 2015 to alert taxpayers that a qualifying child for the EITC claimed on their returns had also been claimed by another person.

IRS also prevents or recovers erroneous EITC claims through examinations (including examinations selected due to questionable EITC claims), the Automated Underreporter (AUR) information return matching program, and correction of errors using math error authority (MEA). The direct revenue effect of these enforcement programs was $4.6 billion for FY 2015. In addition, nearly $1.6 billion in EITC payments were prevented from being processed or paid as part of IRS's identity theft and fraud detection filters. It is likely that there are also indirect effects on compliance not captured in these amounts. The first three of these enforcement programs (examination, AUR, and MEA) each serve to educate taxpayers about how to correctly claim the credit in the future. Moreover, some taxpayers may be deterred from making erroneous EITC claims by the expectation or risk of being detected by IRS and subject to these types of enforcement.

As encouraged by the Committee in House Report 114-194, the IRS held an EITC Summit in June 2016 to seek fresh perspectives and ideas on EITC from companies, organizations, associations, and agencies with an interest in the credit. The Committee, Treasury and IRS recognized the powerful impact that partnerships with the tax community can have as a result of last year's Security Summit. That gathering of tax industry professionals and state agencies resulted in new ideas and cooperative efforts to fight identity theft and refund fraud. During the EITC Summit, the IRS captured ideas during discussions on EITC compliance, participation and administration. The IRS will obtain additional ideas through a specially created mailbox and from preparers during its Nationwide Tax Forums this summer. Before the end of the year, the IRS plans to summarize the suggestions received.

The Administration's Fiscal Year 2017 Budget includes a number of proposed legislative changes aimed at improving EITC compliance. Most importantly, the Budget requests adequate funding to enable the IRS to provide service that will help taxpayers correctly meet their filing obligations and conduct enforcement activities to prevent and recover erroneous EITC claims. In addition, the Budget proposes to explicitly provide authority to regulate tax return preparers, which will help reduce erroneous EITC claims and other tax return errors. The Budget would also provide for more flexible correctable error authority to allow the IRS to correct certain taxpayer errors, including erroneous EITC claims, before refunds are paid. The Budget also calls for increasing civil and criminal penalties for tax-related identity theft, including theft related to the EITC. Finally, the Budget provides for simplifying the rules for claiming the EITC for taxpayers who reside with a child that they do not claim as a dependent, which would reduce taxpayer burden as well as improve EITC compliance.

These activities are a non-exhaustive list of the broad set of ongoing efforts led by Treasury and IRS to improve EITC compliance. The four studies described in detail in the body of this report should directly improve EITC compliance and will provide data-driven insights about how to make changes within the larger set of IRS operations to improve EITC compliance in the future.

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