

**Application of the  
Earned Income Credit Two-Year Ban  
Could Be More Consistent, Accurate,  
and Clear to Taxpayers**

**December 2004**

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WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Application of the Earned Income Credit  
Two-Year Ban Could Be More Consistent, Accurate, and Clear  
to Taxpayers (Audit # 200340008)

This report presents the results of our review of the Earned Income Credit (EIC) 2-year ban. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively implemented the ban. We determined whether the ban was consistently and correctly applied, the ban indicator was properly set and was properly released when the ban expired, and returns subject to the ban were correctly banned. We also determined whether instructions and notices to taxpayers regarding the ban were clear, complete, and accurate.

To help address EIC abuse, the Congress passed legislation<sup>1</sup> prohibiting taxpayers from receiving the EIC for 2 tax years if the IRS determines that their EIC claim is due to reckless or intentional disregard of rules and regulations. The ban is an important tool to help the IRS combat noncompliance. It not only encourages compliance but also helps to conserve resources because the IRS can deny the EIC during the ban period without conducting an examination. However, in using the ban, the IRS must strike a delicate balance between its compliance goals and protecting the rights of low-income taxpayers who may not understand the law or may not have the ability to document their entitlement to the EIC. During Fiscal Year 2003, the IRS applied the ban to approximately 8,600 taxpayer accounts. As of July 2003, there were approximately 18,000 taxpayer accounts with the ban in effect.

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<sup>1</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

In summary, improvements are needed to ensure the ban is effectively and correctly used. IRS computer programming accurately set the ban indicator on taxpayers' accounts when examinations were closed with improper EIC claims. However, examiners did not always consistently and correctly apply the ban, computer programming did not always prevent the EIC for the appropriate 2 tax years, and IRS communications did not always provide taxpayers with complete ban information.

- Examiners at only three of the seven IRS Compliance sites working EIC Program examinations regularly considered and applied the ban, with the percent of EIC examinations with the ban applied ranging from 0 to 6.3 percent among the Compliance sites. Examiners applying the ban used inconsistent criteria, applied some incorrect bans, and applied some unintended bans. As a result, taxpayers were not treated consistently. Some taxpayers who should have been banned were not, including some who engaged in flagrant EIC abuse. Other taxpayers were banned when it was not warranted. Ban guidelines provided by the IRS National Headquarters office were not clear, complete, or consistent and did not always accurately reflect the law. This created confusion that contributed to these conditions.
- After the ban was set, computer programming did not always prevent the EIC for the correct 2 tax years. As subsequent tax returns were processed for banned taxpayers, some returns had the EIC banned when it should not have been; other tax returns did not have the EIC banned when it should have been. This occurred because the programming did not consider unfiled tax returns when determining which returns were banned and when to release the ban. The programming only counted tax returns that were filed, so if taxpayers did not file returns for tax years that should have been banned, later tax returns were banned in error. In addition, the programming also released the ban after a specified period of time, allowing taxpayers who filed late returns to avoid the ban.
- The ban notice, form instructions, and EIC publication need to provide more complete ban information and help taxpayers avoid the ban. These documents did not clearly inform taxpayers who were trying to recertify their EIC eligibility of their responsibilities and warn them about the ban. This is especially important because, in our case review, approximately one-half of the taxpayers intentionally banned by examiners were trying to recertify. These documents also did not always tell taxpayers which tax years were banned.

We recommended the Commissioner, Wage and Investment (W&I) Division, with input from the Commissioner, Small Business/Self-Employed Division, improve guidelines, consider identifying examination cases with apparent EIC abuse before taxpayers are contacted, and improve oversight for ban training and application. In addition, the Commissioner, W&I Division, should revise ban programming to consider unfiled and late-filed tax returns and improve taxpayer correspondence and instructions. These actions would help ensure the ban is applied more consistently and correctly, the appropriate years are banned, and taxpayers can more easily comply with or avoid the ban.

Management's Response: IRS management agreed with our recommendations and has initiated corrective actions. The IRS revised guidelines to include comprehensive sections explaining the 2-year ban; stressed application of the 2-year ban in various meetings; revised the ban notice and applicable forms, instructions, and publications; and updated annual training to incorporate more examples of suggested paragraphs addressing the deficiencies noted in this review.

In addition, the IRS will select egregious cases for application of the 2-year ban before issuance of an initial contact letter. Lastly, an interactive web-based tool to assist examiners in making proper EIC determinations will include reminders to consider imposing the 2-year ban when taxpayers do not comply with the EIC rules. This tool will also provide links to the revised ban guidance. The IRS will update ban programming to consider nonfiled years when determining the ban period. In addition, a new display field will show the year the ban expires. This field will print on the revised ban notice. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Could Be More Consistent, Accurate, and Clear to Taxpayers**

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## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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### Background

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The Earned Income Credit (EIC) is a refundable tax credit available to low-income, working taxpayers. The amount of the EIC taxpayers qualify for is based on their income level, filing status, and whether (1) they have qualifying children or (2) they have no qualifying children but meet age, dependency, and residency requirements. For Tax Year (TY) 2003, the maximum EIC amount was \$382 for taxpayers without a qualifying child, \$2,547 for taxpayers with 1 qualifying child, and \$4,204 for taxpayers with 2 qualifying children.

Because of concerns about the extent of erroneous EIC claims, the Congress passed legislation<sup>1</sup> that placed restrictions on taxpayers that improperly claim the credit on TY 1997 and subsequent tax returns. Taxpayers denied the EIC as the result of an Internal Revenue Service (IRS) examination must prove their eligibility before they will be allowed the credit on any subsequent tax returns. In addition, taxpayers are prohibited from receiving the EIC for 2 tax years if the examination determines their claim for the EIC is due to reckless or intentional disregard of EIC rules and regulations.

In response to this legislation, the IRS implemented the EIC Recertification Program. The IRS places a recertification indicator on taxpayers' accounts when their EIC has been denied as the result of an examination of their tax return. Different values of this indicator are used to identify taxpayers that are required to prove their EIC eligibility ("recertify") and taxpayers that are subject to the 2-year ban. These indicators are intended to prevent the EIC from being improperly allowed when subsequent tax returns are processed.

The recertification indicators are automatically placed on taxpayers' accounts when EIC examinations are completed. The indicator requiring recertification is set when the EIC is decreased. The ban indicator is set when the EIC is decreased and the accuracy-related penalty is assessed. After their bans expire, taxpayers must recertify their EIC

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<sup>1</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

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eligibility (usually through an examination) to receive the EIC again.

The ban is an important tool to help the IRS combat noncompliance. It not only encourages compliance but also helps to conserve resources because the IRS can deny the EIC during the ban period without conducting an examination. However, in using the ban, the IRS must strike a delicate balance between its compliance goals and protecting the rights of low-income taxpayers who may not understand the law or may not have the ability to document their entitlement to the EIC. During Fiscal Year 2003, the IRS applied bans to approximately 8,600 taxpayer accounts. As of July 2003, there were approximately 18,000 taxpayer accounts with the ban in effect.

This review was performed at the IRS National Headquarters office and at the Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Brookhaven, New York; Fresno, California; Kansas City, Missouri; and Philadelphia, Pennsylvania, Compliance Sites during the period June 2003 through May 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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### Computer Programming Placed the Correct Indicator on Banned Taxpayers' Accounts

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When examiners examine a tax return and determine a ban is warranted, they close the examinations using transactions that should cause IRS computer programming to automatically set the ban indicator on the taxpayers' accounts. This indicator is used to prevent the EIC from being allowed when subsequent tax returns subject to the ban are filed. It also alerts IRS employees to the fact that the taxpayer is subject to the ban.

IRS computer programming accurately set the ban indicator on taxpayers' accounts when examinations were closed with improper EIC claims. We identified approximately 7,500 examinations closed from October 2002 through August 2003 with transactions that should have set the ban indicator.<sup>2</sup> The ban indicator was correctly set on these

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<sup>2</sup> These examinations had a decrease in the EIC and an accuracy-related penalty assessed.

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taxpayers' accounts. Also, a test of taxpayer accounts with the ban indicator showed the accounts properly had a tax return examination closed with transactions that would have set the ban.

Although the IRS properly set the indicator for taxpayers banned by examiners, we identified several problem conditions. Examiners did not always consistently and correctly apply the ban, computer programming did not always prevent the EIC for the appropriate 2 tax years, and IRS communications did not always provide taxpayers with complete ban information.

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### **Examiners Did Not Always Consistently and Correctly Apply the Two-Year Ban**

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Application of the ban was inconsistent among the various IRS Compliance sites and among examiners at the same site. Examiners used different ban criteria, applied some incorrect bans, and applied some unintended bans to the taxpayers they examined. As a result, taxpayers were not treated consistently. Some taxpayers who should have been banned by examiners were not, including some who engaged in flagrant EIC abuse. Other taxpayers were banned by examiners when it was not warranted. Consequently, IRS resources may be wasted examining taxpayers who should have been banned,<sup>3</sup> while other taxpayers may be incorrectly denied the EIC for 2 tax years.

The IRS strives to apply the tax law consistently and fairly to all taxpayers. The ban should be applied when an examiner determines the taxpayer's EIC claim is denied due to reckless or intentional disregard of the rules and regulations. We realize that ban determinations are based on examiners' judgment, but the inconsistencies noted went far beyond any variations we would expect from judgment differences.

### **Examiners at some Compliance sites applied the ban, while those at other sites did not**

We compared the number of bans to EIC examinations closed by the IRS Compliance sites from October 2002 through August 2003. This analysis, in conjunction with

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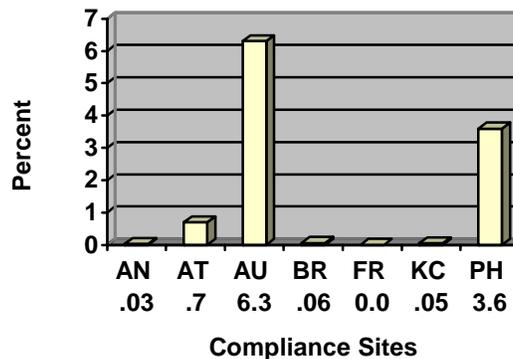
<sup>3</sup> Taxpayers who should have been banned, but were not, would be subject to the EIC recertification process. If they claim the EIC and request recertification, their tax returns would likely be examined.

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our discussions with managers and employees at the sites, showed that examiners at only three of seven IRS Compliance sites examining EIC tax returns were regularly considering the ban and applying it. The percentage of examinations with the ban applied ranged from 0 to 6.3 percent among the sites.

Percentage of EIC Examinations With the 2-Year Ban by Site<sup>4</sup>



Source: The number of bans was determined from our Master File<sup>5</sup> extract. The number of EIC examinations was provided by the IRS.

### **Bans were not applied consistently and were not always correct**

There were significant differences in the criteria examiners used to apply the ban, not only at different IRS Compliance sites but also among examiners at the same site. These differences were evident from both our case reviews and interviews. To illustrate:

*Repeat behavior:* Taxpayers trying to “recertify” their EIC eligibility will typically have their returns examined and be asked to prove their EIC entitlement.<sup>6</sup> National EIC Program guidelines instructed examiners to ban these taxpayers if their EIC was again disallowed because, as in

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<sup>4</sup> The sites included, from left to right, Andover, Atlanta, Austin, Brookhaven, Fresno, Kansas City, and Philadelphia.

<sup>5</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>6</sup> As explained on Page 1, taxpayers whose EIC was denied in a prior examination must prove their eligibility before they will be allowed the credit on a subsequent tax return.

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the prior examination, they could not prove the child was their qualifying child.<sup>7</sup>

Examiners' ban decisions for taxpayers denied the EIC in a prior examination were inconsistent. Some examiners routinely applied the ban in the subsequent examination when, in our opinion, there was no clear indication of "reckless or intentional disregard" of EIC rules. The taxpayers were banned merely because they did not provide enough documentation to support their EIC claim. In contrast, other examiners determined that taxpayers in similar situations should not be banned.

The Government Accountability Office (GAO) reported<sup>8</sup> that low-income taxpayers often have difficulty obtaining EIC documents that IRS examiners will accept, and examiners' assessments of the documents are inconsistent. We do not believe it is appropriate to ban taxpayers whose EIC was previously denied merely because they provide insufficient documentation in a subsequent examination. We believe these taxpayers should be banned only when the examination case facts indicate (1) the taxpayer clearly did not meet legal requirements for claiming the EIC on the subsequent return and (2) the prior examination would have made the taxpayer aware of the legal requirement(s) that was not met.

Examiners applied incorrect bans in 9 (8 percent) of 116 examinations in which taxpayers were banned. Of the nine, examiners banned seven taxpayers with the EIC denied in a prior examination but with no indication of reckless or intentional disregard of EIC rules in the ban year (this included five taxpayers who were unable to provide sufficient documentation to support their EIC and two taxpayers who likely did not know they were not entitled to the EIC).<sup>9</sup>

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<sup>7</sup> See Appendix V for the exact wording of this guideline.

<sup>8</sup> *Earned Income Credit - Opportunities to Make Recertification Program Less Confusing and More Consistent* (GAO-02-449, dated April 2002).

<sup>9</sup> One taxpayer filed the subsequent ban year return long before the prior examination closed; the second taxpayer was not entitled to the EIC for the ban year because the law had changed since the prior examination.

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National EIC Program guidelines showing the example of a taxpayer with the EIC denied in a prior examination were issued when examiners were to start applying the ban in January 2000. Examiners' training material for Calendar Year 2004 included more detailed examples that made it clear there should be indications of abuse by these repeating taxpayers rather than simply a lack of documentation. These revised examples and the associated training should help to reduce the number of incorrect bans.

*Examinations with no response:* The IRS uses an automated system to process most EIC examination cases. While examiners review some cases in which taxpayers have not responded to the examination notices, most cases are reviewed by examiners only if a taxpayer responds to a notice. Cases without a response will often be worked completely by the automated system and never be seen by an examiner.

National EIC Program guidelines varied on applying the ban for examinations with no response but generally instructed examiners to apply the ban only if the taxpayer responded. However, IRS procedures for applying the accuracy-related penalty and other IRS guidance on the ban indicated that examiners could apply the ban without a taxpayer response when case facts and circumstances indicated reckless or intentional disregard of the EIC rules. We believe examiners should apply the ban without a taxpayer response when warranted.

Ban application for examinations with no response was inconsistent. The majority of examiners told us they would not ban taxpayers without a response. Other examiners would ban these taxpayers if available case facts and circumstances supported the ban. In addition, there was no opportunity for examiners to place the ban on cases worked completely by the automated system.

As a result, taxpayers who tried the hardest to prove their EIC eligibility by responding to examination notices were the most likely to be banned; whereas, taxpayers who flagrantly abused the EIC but did not respond to the notices were not always banned. In our review of a sample of

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85 examinations with intentional bans,<sup>10</sup> 56 (66 percent) had taxpayer responses. The remaining 29 (34 percent) had no response from the taxpayer. Examiners at one site banned taxpayers for many of the examinations with no response that involved flagrant EIC abuse with apparent fabricated business income.<sup>11</sup>

This illustrates two ban issues that contributed to inconsistent and/or incorrect bans. See Appendix V for additional ban guideline issues and details.

### **Examiners unintentionally set some bans**

As stated earlier in this report, the ban is automatically set when an examination of a tax return results in a decrease of the EIC and an assessment of the accuracy-related penalty. This combination of transactions may occur even when the examiner has not determined the ban applies.

Examiners unintentionally set bans on taxpayers' accounts in 31 (27 percent)<sup>12</sup> of 116 examinations with bans that we reviewed. This occurred most often when taxpayers' returns were adjusted for unreported income. In some cases, the EIC was examined and decreased; in others, it was decreased only due to the change in income. The examiners had not determined that these taxpayers recklessly or intentionally disregarded the EIC rules but had assessed the accuracy-related penalty due to the unreported income.

There are procedures for removing unwanted bans; however, these examiners were not aware that their examination actions set the ban. Therefore, they did not remove these unintended bans from taxpayers' accounts.

Inadequate management oversight at both the national and local levels led to the above conditions. The following causes also contributed to the conditions.

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<sup>10</sup> Of the 116 examinations with bans that we reviewed, 85 had bans that were intended by the examiners and 31 had bans that were not intended.

<sup>11</sup> Income reported on Profit or Loss From Business (Schedule C). Schedule C income can qualify taxpayers for the EIC.

<sup>12</sup> Due to our sampling method, the cases reviewed had a higher percent of unintended bans than we would expect to find in the overall ban population for the Compliance sites. At two sites that were generally not applying the ban, almost all our sample cases had unintended bans.

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*Inadequate ban guidelines:* The ban guidelines provided by the National Headquarters office for the EIC Program were not clear, complete, and consistent and, in our opinion, did not always accurately reflect the law. This caused confusion that contributed to the ban problems.

The National EIC Program ban guidelines were a combination of written procedures, emails, discussions, and training materials. None of the examiners we interviewed had all the guidelines available for reference. We were often told by examiners and their managers that they needed better procedures and were not comfortable with applying the ban.

Ban guidance included information on taxpayers with the EIC previously denied, examinations with no response, examinations allowing the EIC with no qualifying children, and amended returns. The guidance on some issues changed, was not always distributed to all the Compliance sites, and was not always appropriate. See Appendix V for details.

The ban guidelines and examples did not address many of the most common situations that might warrant the ban. For example, there was no mention of altered documents, taxpayers claiming someone else's children, taxpayers living with their spouse but using Head of Household filing status, or fabricated Schedule C income. Some examiners and their managers told us they would ban only those taxpayers who had the EIC disallowed in a prior year. The limited examples provided in the guidance may have contributed to this approach.

*Inadequate local training, emphasis, and oversight:* Analysts at the Compliance site that applied the most bans told us that applying the ban was a radical change. It was difficult to implement and required significant emphasis by local management to overcome their examiners' reluctance to apply it. All the examiners we interviewed at this site told us they had received ban training, considered the ban in their examination work, and had applied the ban.

In contrast, at a Compliance site that was not applying the ban, it did not receive similar emphasis. Many examiners told us they had not received ban training; others indicated

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that the training received was limited, informal, or not emphasized. Most examiners did not consider the ban in their examination work, and only 1 of 16 interviewed had ever applied a ban. However, an analyst and Operations Manager for these examiners thought the examiners were applying the ban.

*Inadequate ban explanations:* The principal control to ensure bans are correct is that every ban must be approved by the examiner's manager. Examiners' workpaper explanations were often not sufficient to support the ban. Many examiners made general comments about case characteristics or simply stated they were applying the penalty/ban, rather than explaining what the taxpayer did that was considered reckless or intentional disregard of the EIC rules. Inadequate ban explanations in examiners' workpapers make it more difficult for managers to evaluate bans and may have contributed to incorrect bans.

### Recommendations

To help ensure 2-year bans are consistently and correctly applied, the Commissioner, Wage and Investment (W&I) Division, along with the Commissioner, Small Business/Self-Employed Division, should:

1. Revise and distribute written ban guidelines that are clear, complete, consistent with other IRS programs and procedures, and accurately reflect the law. This should include, at a minimum:
  - a. Issuing guidelines that include each of the problem areas identified in this review (see Appendix V), examples of the most common situations warranting the ban, and examples of ban explanations.
  - b. Ensuring written guidelines explaining how the ban is set and how to remove it are distributed and emphasized to examiners for all Compliance function programs, both at the Compliance sites and in the field offices.

*Management's Response:* The IRS revised guidelines to include comprehensive sections explaining the 2-year ban. The IRS also updated annual training to incorporate more

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examples of suggested paragraphs addressing the deficiencies noted in this review.

2. Consider using available data<sup>13</sup> to identify EIC examination cases with apparent abuse before taxpayers are contacted. Examiners could review these cases, which might otherwise be worked completely by the automated system, and propose a ban on the initial examination report when warranted.

Management's Response: The IRS will select egregious cases for application of the 2-year ban before issuance of an initial contact letter. Programming changes will not be available until 2006.

3. Make sure Compliance site management takes appropriate actions to help ensure all EIC examiners receive adequate ban training, consider the ban on each EIC examination they work, and properly apply the ban guidelines.

Management's Response: The IRS has stressed application of the 2-year ban in various meetings. The Decision Support Tool (DST), an interactive web-based tool to assist examiners in making proper EIC determinations, will include reminders to consider imposing the 2-year ban when taxpayers do not comply with the EIC rules. The DST will also provide links to the guidance mentioned in the corrective actions to Recommendation 1.

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**Due to the Design of the  
Computer Programming, the  
Appropriate Tax Years Were  
Not Always Banned**

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When a 2-year ban indicator is placed on a taxpayer's account, the intent is to prevent the EIC for the first 2 tax years, subsequent to the examined tax year, for which the taxpayer has not yet filed a return.<sup>14</sup> For example:

- If TY 2001 was examined, and the TY 2002 tax return had not yet been filed, the ban applies for TYs 2002 and 2003.

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<sup>13</sup> Such as that on the Dependent Database, which is used to select EIC returns for examination.

<sup>14</sup> This is determined when the examination closure posts to the IRS Master File.

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- If TY 2001 was examined, and the TY 2002 tax return had already been filed, the ban applies for TYs 2003 and 2004.

As subsequent tax returns were processed for banned taxpayers, computer programming did not always prevent the EIC for the correct 2 tax years. Some tax returns had the EIC banned when it should not have been; other tax returns did not have the EIC banned when it should have been. From a sample of 241 banned taxpayers, 5 tax returns had the EIC banned in error and an additional 62 tax returns had the potential<sup>15</sup> for the EIC to be banned in error. Also, 3 tax returns did not have the EIC banned when it should have been, and an additional 38 tax returns had the potential<sup>16</sup> for not having the EIC banned when it should be.

The design of the ban programming allowed these problems to occur. The programming relied primarily on counting tax returns to determine which returns were banned and when to release the ban. Although unfiled tax returns should have been considered in determining which tax years were banned, the programming counted only those tax returns that were filed. When taxpayers did not file returns for tax years that should have been banned, later tax returns were banned in error. In addition to the counting process, the programming also released the ban after a specified period of time. This allowed taxpayers who filed late returns to avoid the ban, although they would still be required to recertify their eligibility to receive the EIC.

As a result, some taxpayers had their EIC improperly denied. In other instances, IRS resources may have been wasted examining taxpayers who should have been banned. We reviewed 400 of 3,500 tax returns with the EIC banned during return processing from January through October 2003 and estimate that approximately 380 (11 percent) of the 3,500 were banned in error.

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<sup>15</sup> The potential erroneous bans included returns with no EIC claimed and returns that were not filed at the time of our review.

<sup>16</sup> The potential returns that would not be banned had not been filed at the time of our review.

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### Recommendation

To help ensure the correct tax years are banned, the Commissioner, W&I Division, should:

4. Revise the ban programming to consider unfiled and late-filed tax returns. We believe this could be accomplished, in part, by establishing a computer field that contains the first tax year after the ban expires. This field could be used to determine which tax returns should be banned and which would require recertification. This field could also be used to help prevent actions subsequent to return processing that incorrectly allow the EIC for a banned tax year.<sup>17</sup>

Management's Response: The IRS will update ban programming to consider nonfiled years when determining the ban period. In addition, a new display field will show the year the ban expires. This field will print on the Computer Paragraph (CP) 79A notice.

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### Correspondence and Instructions Related to the Two-Year Ban Need Improvement

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The ban notice, form instructions, and *Earned Income Credit (EIC)* (Publication 596) did not specifically inform taxpayers who were attempting to recertify of their responsibilities and warn them about the ban. These documents also did not always explain which years were banned.

One goal of the IRS Commissioner is to improve service to taxpayers to make it easier for them to understand and comply with the tax laws. Notices, instructions, and publications should clearly inform taxpayers about the ban and clearly explain what they should do to claim the EIC after the ban has expired. These documents should also adequately warn taxpayers about the ban and help them avoid it.

IRS management did not ensure EIC correspondence and instructions included complete ban information, warned taxpayers about the ban, and helped taxpayers avoid the ban.

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<sup>17</sup> For 241 banned taxpayers, approximately \$6,800 of the EIC was allowed after return processing for 4 banned tax years. Because the bans were not removed, these actions appear to be incorrect.

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### **The notice explaining the ban could be improved**

The IRS sends taxpayers a notice about the ban when it is imposed.<sup>18</sup> This notice identifies the tax year examined, explains the ban, and gives examples showing which years are banned. The notice also explains that to claim the EIC after the ban, the taxpayer must file an Information To Claim Earned Income Credit After Disallowance (Form 8862) with the next tax return claiming the EIC.

This notice could better inform and warn taxpayers about claiming the EIC after the ban expires. The notice seems to “invite” taxpayers to claim the EIC again, stating simply, “To claim the EIC after the 2-year ban, you must attach a completed Form 8862 . . . .”

This notice does not emphasize that taxpayers must meet all the current EIC requirements; it does not, as does a related notice,<sup>19</sup> inform taxpayers that they may be asked to document their EIC claim or explain that their EIC will be denied without Form 8862; it does not inform taxpayers that their tax return is likely to be examined; it does not warn them of another possible penalty and/or ban if they again improperly claim the EIC; and it does not accurately reflect the revised Form 8862 requirements for claiming the EIC without a qualifying child. In addition, the notice would be more informative if it specified the first tax year for which the taxpayer may again be able to claim the EIC.

### **Tax form and publication ban information could be improved**

Form 8862 instructions, individual tax return<sup>20</sup> instructions, and Publication 596 all accurately inform taxpayers about the ban. However, these documents could be improved to better educate taxpayers about the recertification process and help them avoid the ban, warn taxpayers about the ban, and make it clear which years are banned.

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<sup>18</sup> Notice CP 79A.

<sup>19</sup> Notice CP 79, issued to taxpayers with the EIC denied in an examination but who are not banned.

<sup>20</sup> This includes U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

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Taxpayers who want to recertify their EIC eligibility must file Form 8862. Form 8862 instructions advise taxpayers to file the form if they “now want to claim the EIC” and also advise banned taxpayers “. . . do not file Form 8862 or take the credit for 2 years if it was determined that your error was due to reckless or intentional disregard of the EIC rules . . . .” These instructions seem to “invite” taxpayers to file Form 8862 by referring to “want to claim the EIC” without emphasizing that they must qualify for the EIC. The instructions do not include a warning about the ban. This is especially important because, in our case review, approximately one-half of the taxpayers intentionally banned by examiners were trying to recertify. In addition, Form 8862 instructions do not explain, or provide a reference to explain, which 2 tax years are banned.

Similarly:

- Individual tax return instructions advise banned taxpayers “do not file Form 8862 or take the credit for 2 years if it was determined that your error was due to reckless or intentional disregard of the EIC rules,” but do not explain, or provide a reference to explain, which 2 tax years are banned.
- Publication 596 includes sections on claiming the EIC after it has been denied and also after it has been banned. Both sections instruct taxpayers to file Form 8862 “if you wish to claim the EIC.” Here again, these instructions seem to “invite” taxpayers to claim the EIC again without emphasizing that they must qualify for it and without warning them about the ban.

Improving this notice and these instructions may help some taxpayers avoid the ban and help banned taxpayers comply with the ban. Taxpayers trying to recertify may not have understood their responsibilities and the potential for being banned. Also, banned taxpayers may not have understood which tax years were banned.

- For Fiscal Year 2003, approximately 8,600 notices<sup>21</sup> were sent to taxpayers to explain the ban. These

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<sup>21</sup> Volume was provided by the IRS.

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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taxpayers may not have understood the requirements for claiming the EIC after their bans expired.

- Of 116 ban examinations reviewed, 50 taxpayers (43 percent) were trying to recertify. Because these taxpayers claimed the EIC again after having it denied in a prior examination and were still unable to verify their EIC eligibility, they may not have understood the requirements to recertify or the potential for the ban.
- From January to October 2003, approximately 3,200 taxpayers filed returns claiming the EIC for a banned tax year. These taxpayers may not have understood which 2 tax years were banned.

### Recommendations

To help taxpayers comply with 2-year ban requirements and help them avoid the ban, the Commissioner, W&I Division, should:

5. Revise the CP 79A notice to emphasize that recertifying taxpayers must meet EIC requirements, warn of the likelihood of an examination and potential for another ban, and reflect the revised Form 8862 requirements when claiming the EIC without qualifying children. The revised notice should also include the first tax year for which the taxpayer may again be able to claim the EIC. If ban programming is revised as suggested in Recommendation 4, this tax year information would be available.

Management's Response: The CP 79A notice was revised to incorporate all of the recommended changes. As discussed in the response to Recommendation 4, the notice will now indicate the tax year in which the taxpayer can again claim the EIC if eligible.

6. Revise Form 8862 instructions and Publication 596 to emphasize that recertifying taxpayers must meet EIC requirements and to warn taxpayers about the ban. Also, the Commissioner, W&I Division, should revise Form 8862 instructions and the individual tax form instructions to explain (or provide a reference that explains) which years are banned.

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Management's Response: The IRS will incorporate the revisions of the Form 8862, its instructions, and Publication 596 into the Tax Year 2004 version of these forms, instructions, and publications.

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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### Appendix I

#### Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively implemented the 2-year ban, also referred to here as “the ban,” for the Earned Income Credit (EIC). We determined whether the ban was consistently and correctly applied, the ban indicator was properly set and was properly released when the ban expired, and returns subject to the ban were correctly banned. We also determined whether instructions and notices to taxpayers regarding the ban were clear, complete, and accurate.

To accomplish our objective, we:

- I. Determined whether bans were correctly and consistently applied.
  - A. Evaluated national guidelines for applying the ban.
  - B. Interviewed analysts, managers, and examiners at Wage and Investment Division and Small Business/Self-Employed Division Compliance sites to determine the criteria used for applying the ban.
  - C. Evaluated a judgmental sample of 116 examinations from 4,170 closed examinations with the ban applied to determine whether the bans were warranted. We obtained an Individual Master File<sup>1</sup> extract of examinations closed with the EIC decreased and an accuracy penalty assessed. We manipulated the extract data and identified the 4,170 examinations closed from September 2002 through August 2003 by the 7 Compliance sites working EIC Program examinations. We selected a judgmental sample because we wanted to include cases from each of these sites, the sample could be analyzed within reasonable time periods, and we did not plan to make projections.
  - D. Compared the volume of bans set to the volume of EIC Program examinations closed by the Compliance sites for the period October 2002 through August 2003. We obtained the ban volume from our Master File extract noted in Step I. C. The IRS provided us with the volume of EIC Program examinations closed by site for this time period.
- II. Determined whether the ban indicator was properly set on taxpayers’ Individual Master File accounts when examinations were closed with transactions that should set the ban.
  - A. Identified 7,535 examinations that should have set the ban from our Master File extract of examination closures from October 2002 through August 2003. From these, we identified 259 without the ban indicator on the account and reviewed a random sample of 100 to determine why there was no indicator. We used a random

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<sup>1</sup> The IRS database that maintains transactions or records of individual tax accounts.

## **Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers**

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- sample to ensure each account had an equal chance of being selected, which provided sufficient evidence to support our results.
- B. Identified all 241 taxpayers' accounts with the ban indicator as of December 2002 from the Treasury Inspector General for Tax Administration's (TIGTA) 1 percent file of accounts on the Individual Master File. We reviewed all 241 accounts to determine whether there was an examination closure that would set the ban indicator.
- III. Determined whether the ban indicator was effective in preventing the EIC from being allowed for the 2 banned tax years.
- A. Analyzed the 241 accounts with the ban indicator described in Step II. B. to determine whether the EIC was banned for the correct tax years and allowed when the bans should have been expired.
  - B. Analyzed a statistically valid sample of 400 tax returns with the EIC banned because we wanted to estimate the number of tax returns incorrectly banned. From the TIGTA's Data Center Warehouse Individual Return Transaction File<sup>2</sup> information, we identified 3,572 tax returns with the EIC denied because of the ban. These returns were posted to the Master File from January through October 2003, and we identified those with a Taxpayer Notice Code indicating the EIC was denied due to the ban. From the 3,572 returns, we reviewed a sample of 400 returns, which reflected a confidence rate of 97 percent, a precision of  $\pm 3$  percent, and the actual error rate of 10.75 percent.
- IV. Determined whether information provided to taxpayers about the ban was clear, complete, and accurate.
- A. Evaluated instructions related to the ban for individual income tax returns,<sup>3</sup> Information To Claim Earned Income Credit After Disallowance (Form 8862), and the *Earned Income Credit (EIC)* publication (Publication 596).
  - B. Evaluated the notice Computer Paragraph 79A sent to taxpayers when an examination closes with the ban.

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<sup>2</sup> TIGTA data extracted from the IRS' Individual Return Transaction File, which contains tax return information input from individual tax returns as they are processed. The TIGTA extract includes income, tax, and credit amounts reported and allowed on the return.

<sup>3</sup> This includes U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

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**Appendix II**

**Major Contributors to This Report**

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Scott A. Macfarlane, Director

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**Appendix III**

**Report Distribution List**

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Deputy Commissioner, Wage and Investment Division SE:W  
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:C&L  
Director, Compliance, Wage and Investment Division SE:W:CP  
Director, Compliance Services Campus Operations, Small Business/Self-Employed Division  
SE:S:CSCO  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Strategy and Finance, Wage and Investment Division SE:W:S  
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI  
Director, Compliance Campus Operations, Brookhaven SE:S:CSCO:CCO:BR  
Director, Compliance Campus Operations, Philadelphia SE:S:SCCO:CCO:PHIL  
Field Director, Compliance Services (Andover) SE:W:CP:CS:AN  
Field Director, Compliance Services (Atlanta) SE:W:CP:CS:AT  
Field Director, Compliance Services (Austin) SE:W:CP:CS:AU  
Field Director, Compliance Services (Fresno) SE:W:CP:CS:F  
Field Director, Compliance Services (Kansas City) SE:W:CP:CS:KC  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Management Controls OS:CFO:AR:M  
Audit Liaisons:  
    Chief, Customer Liaison, Small Business/Self-Employed Division SE:S:COM  
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## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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### Appendix IV

#### Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 384 taxpayers (see page 10).

##### Methodology Used to Measure the Reported Benefit:

From the Treasury Inspector General for Tax Administration's (TIGTA) Data Center Warehouse Individual Return Transaction File,<sup>1</sup> we identified 3,572 tax returns with the Earned Income Credit (EIC) disallowed during return processing because of the 2-year ban, also referred to here as "the ban." We identified those returns posted to the Individual Master File<sup>2</sup> from January through October 2003 with a Taxpayer Notice Code (TPNC) of 658, indicating the EIC was disallowed due to the ban. We selected a statistical sample of 400 returns and evaluated these taxpayer accounts to determine if the EIC for the selected return should have been banned. We identified 43 (10.75 percent) returns that had the EIC banned in error. Based on the actual error rate, a 97 percent confidence level, and a +/- 3 percent precision, we estimate that 384 of the 3,572 returns had the EIC banned in error. All the identified tax returns were for Tax Year 2002, and for different taxpayers, so an estimated 384 taxpayers were affected.

##### Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 8,637 notices (see page 12).

##### Methodology Used to Measure the Reported Benefit:

We reviewed the notice sent to taxpayers about the ban<sup>3</sup> and identified unclear, missing, or inaccurate information that could be confusing to taxpayers. The Internal Revenue Service provided a count of the examinations closed each week of Fiscal Year 2003 with the ban applied, which totaled 8,637.<sup>4</sup> The notice explaining the ban would have been issued for each of these examinations.

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<sup>1</sup> TIGTA data extracted from the Internal Revenue Service's (IRS) Individual Return Transaction File, which contains tax return information input from individual tax returns as they are processed. The TIGTA extract includes income, tax, and credit amounts reported and allowed on the return.

<sup>2</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>3</sup> Notice Computer Paragraph 79A.

<sup>4</sup> This included audit closures posted to the Individual Master File from processing cycle 200240 through cycle 200339 (September 29, 2002, through September 27, 2003).

## **Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers**

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### Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 3,235 taxpayers (see page 12).

### Methodology Used to Measure the Reported Benefit:

We identified 3,572 returns (for 3,572 taxpayers) processed from January through October 2003 with the EIC disallowed because of the ban. Of these, an estimated 384 returns had the EIC banned in error, leaving an estimated 3,188 that were correctly banned. The 3,188 taxpayers filing these returns may not have understood which 2 tax years were banned. Refer to the first Outcome Measure (see page 21), which describes how these returns were identified and how we estimated that 384 were banned in error.

We reviewed 116 examinations closed from September 2002 through August 2003 with the ban applied. We determined whether these taxpayers had a prior examination denial of the EIC at the time they filed the ban year return. Of the 116 bans, 50 taxpayers had had their EIC previously denied and were trying to recertify. Three of these taxpayers were also included in the 3,572 immediately above, leaving 47 additional taxpayers who may not have understood what was required to recertify.

**Application of the Earned Income Credit Two-Year Ban  
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**Appendix V**

**Ban Guideline Issues**

**Taxpayers With the Earned Income Credit (EIC) Denied in a Prior Examination  
(Repeat Behavior)**

*National EIC Program Guidelines:* The guideline examples for this issue changed during our review.

- The example in effect from January 2000 until early 2004 stated, “The taxpayer’s EIC in a prior year was disallowed by audit [examination] because the taxpayer could not demonstrate the child was the taxpayer’s qualifying child. The taxpayer files a subsequent return claiming EIC and again cannot demonstrate that the child was the taxpayer’s qualifying child. You can consider that the taxpayer intentionally disregarded the EIC rules and regulations and impose the 2-year ban.”
- For examiner training in early 2004, examples provided for similar situations made it clear that the child had not lived with the taxpayer for the year in question. Therefore, the child obviously did not meet the EIC residence requirement, and the taxpayer clearly was not entitled to the EIC.

*What Examiners Were Doing:* We interviewed examiners and reviewed examinations with a 2-year ban, also referred to here as “the ban,” closed from September 2002 through August 2003 and determined that application of the ban varied when the EIC was denied in a prior examination. Some examiners routinely applied the ban when taxpayers were unable to provide adequate documentation for their EIC claim, but there was no clear indication that the taxpayer “recklessly or intentionally disregarded” the EIC rules. Other examiners did not apply the ban in similar situations. We also noted instances where taxpayers were banned who may not have known, due to timing of the prior examination or law changes, that they were not entitled to the EIC.

*Treasury Inspector General for Tax Administration (TIGTA) Comments:* We believe taxpayers with the EIC denied in a prior examination should be banned only when case facts indicate (1) the taxpayer clearly did not meet legal requirements for claiming the EIC on the subsequent return and (2) the prior examination would have made the taxpayer aware of the legal requirement(s) that was not met.

*What Is Needed:* The revised examples provided for the 2004 examiner training make it clear there should be indications of abuse by these repeating taxpayers rather than simply a lack of documentation. This should help reduce the number of incorrect bans. Internal Revenue Service (IRS) management needs to emphasize these examples to help ensure examiners implement the revised guidelines. Management should also provide examples of taxpayers with the EIC previously denied who should not be banned because the prior examination would not have made them aware of the legal requirements that were not met in the subsequent examination. For

## **Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers**

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example, when the return being examined was filed long before the prior examination denying the EIC was closed; or when the EIC is disallowed based on a legal issue, and the law regarding that issue changed from the prior examination.

### **Examinations With No Response**

*National EIC Program Guidelines:* The guidelines for examinations with no response varied and were not always distributed to all Compliance sites.

- In early 2000, when the sites began applying the ban, guidelines allowed the ban on cases with no response.
- Approximately 3 months after the sites began applying the ban, the guidelines were changed to apply the ban only if a taxpayer responded.
- In November 2002, a National Headquarters office analyst forwarded IRS guidance to the sites with an introductory analysis stating, “It clearly states that we should NOT impose the ban when a taxpayer has not responded...” However, the guidance simply stated that a taxpayer’s failure to respond was not *by itself* a reason to apply the ban – more facts are required to support the ban.
- In November 2002, one site questioned the analyst’s above analysis. The analyst retracted it, but the retraction was sent only to the site that questioned the analysis.
- Examiners’ training material for 2004 again advised examiners to apply the ban only if the taxpayer responded.

*What Examiners Were Doing:* The majority of examiners we interviewed told us they would not ban a taxpayer who did not respond. However, other examiners told us they would ban these taxpayers if available case facts and circumstances supported the ban. In addition, there was no opportunity to place the ban on cases worked completely by the automated system.

In our sample review of 85 examinations with intentional bans, 56 (66 percent) had taxpayer responses. The remaining 29 (34 percent) had no response from the taxpayers.

*TIGTA Comments:* We believe examiners should apply the ban without a taxpayer response when available case facts and circumstances support the ban. This is consistent with IRS procedures for assessing the accuracy-related penalty and with other IRS guidance regarding the ban. Taxpayers involved in flagrant EIC abuse are likely to not respond to the examination, which would allow examiners to ban these taxpayers.

*What Is Needed:* Clear guidelines should be issued to allow application of the ban without a taxpayer response when available case facts and circumstances support the ban. To help ensure the ban is considered for cases that might otherwise be worked completely by the automated system, management should also consider identifying potentially abusive EIC examination cases before taxpayers are contacted to evaluate whether the ban should be proposed on the initial examination report.

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### **Examinations With Fabricated Business Income**

*National EIC Program Guidelines:* We were unable to locate any EIC Program guidelines regarding the ban when taxpayers could not show their business income, reported on Profit or Loss From Business (Schedule C), existed.

*What Examiners Were Doing:* These examinations were worked primarily by two Small Business/Self-Employed Division Compliance sites. Management at one site informed us that examiners working the day shift were applying the ban to these cases, while examiners on the night shift were not. At the second site, examiners were not applying the ban.

*TIGTA Comments:* Taxpayers who fabricate Schedule C income to improperly qualify for the EIC are some of the most flagrant EIC abusers. We believe that, at a minimum, the ban is warranted on these examinations. This is consistent with IRS guidance on disallowing the EIC when it is determined that the business does not exist.

*What Is Needed:* Guidelines should be revised to include instructions to apply the ban on Schedule C examinations when it is determined that the business does not exist.<sup>1</sup>

### **Examinations With the EIC Allowed to Taxpayers Without a Qualifying Child**

*National EIC Program Guidelines:* The guidelines instructed examiners not to apply the ban if they allowed the taxpayer the EIC without a qualifying child.

*What Examiners Were Doing:* Most examiners were apparently not aware of this guideline. In our interviews, most said they would apply the ban even if they allowed the taxpayer the EIC without a qualifying child.

*TIGTA Comments:* We believe this guideline does not accurately reflect the intent of the ban law. In addition, it is not consistent with the application of the accuracy-related penalty for other issues or in other IRS programs.<sup>2</sup> Using this guideline, taxpayers would be banned or not banned depending on their income levels. The ban should be applied to any taxpayer who recklessly or intentionally disregards the EIC rules, regardless of income level.

*What Is Needed:* Guidelines should be revised to allow application of the ban when taxpayers are allowed the EIC without a qualifying child.

### **Criminal Investigation Function Referrals**

*Background:* The Criminal Investigation (CI) function identifies tax returns with potentially abusive claims for the EIC. These returns may involve fabricated wage or Schedule C income. Some of these returns are referred to the Compliance sites for examination in the EIC Program.

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<sup>1</sup> This would apply to examinations worked by the Compliance sites. A 10-year ban is also available if the IRS determines the EIC claim is due to fraud. At the time of our review, the 10-year ban could not be applied by the Compliance sites.

<sup>2</sup> For example, adjustments for unreported income made in the Underreporter Program or made in field examinations of Schedule C.

## **Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers**

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*National EIC Program Guidelines:* Examiners were instructed to not apply the ban to these examinations. These instructions were apparently based on a November 2001 memorandum regarding CI function referrals that stated not to consider any penalties until a national policy was developed. At the time of our review, we were informed that no national policy had yet been developed.

*What Examiners Were Doing:* Based on our discussions, examiners generally were not applying the ban to these examinations. However, of 116 closed examinations with bans that we reviewed, 4 were CI function referrals.

*TIGTA Comments:* We believe tax returns referred to the EIC Program by the CI function often involve flagrant EIC abuse, which would warrant the ban. Although national Compliance function analysts were concerned that the ban might create problems for the CI function on these taxpayer accounts, national CI function analysts were not aware of any potential problems and felt the ban was warranted. It should also be noted that the regular recertification indicator would be set on these accounts if the EIC were denied with no ban applied. This would have a similar effect on the account, from a CI function perspective, as the ban. Therefore, the Compliance function concerns do not appear to be justified.

*What Is Needed:* A national policy needs to be developed and written guidelines need to be issued with regard to bans on tax returns referred by the CI function to the EIC Program. We believe examiners should be allowed to apply the ban to these examinations when warranted.

### **Claims for Refund**

*Background:* Taxpayers may file a claim for refund<sup>3</sup> of the EIC rather than claiming the EIC when they file their original returns. Taxpayers may do this to intentionally avoid the IRS' automated controls that help prevent erroneous EIC from being allowed as original returns are processed.

*National EIC Program Guidelines:* The guidelines for applying the ban to claims for refund varied. Examiners were at first instructed to consider the ban on claims. Later, training class information from November 2001 indicated that the National Headquarters office was deciding whether to apply the ban to claims and how to process the ban.

*What Examiners Were Doing:* Based on our discussions, examiners would consider applying the ban to claims. However, a few informed us that they were unable to set the ban on some types of claims. One of the transactions needed to automatically set the ban is not used for some claims.<sup>4</sup>

*TIGTA Comments:* For consistent treatment of taxpayers, a taxpayer who files a claim for refund of the EIC should be subject to the ban just as is a taxpayer who claims the EIC on an original return. However, we did not determine if these claims fall under the ban law.

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<sup>3</sup> For example, by filing an Amended U.S. Individual Income Tax Return (Form 1040X).

<sup>4</sup> If no EIC is credited to the taxpayer's account, no EIC will be reversed when an EIC claim is denied. The transaction reversing the EIC is needed to set the ban.

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*What Is Needed:* The National Headquarters office needs to determine if claims for refund fall under the ban law and, if so, establish a process and issue guidelines so examiners are able to apply the ban to any claim for refund when warranted.

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Appendix VI

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

RECEIVED  
NOV 22 2004

NOV 19 2004

MEMORANDUM FOR PAMELA J. GARDINER  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. *Henry O. Lamar, Jr.*  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Application of the Earned Income Credit  
Two-Year Ban Could Be More Consistent, Accurate, and  
Clear to Taxpayers (Audit # 200340008)

I reviewed your report and appreciate your comments and recommendations concerning the Earned Income Credit (EIC) two-year ban process that you brought to our attention. I would like to commend your audit team for the approach they took with the Examination EIC staff during the course of this audit. This positive interaction allowed us to make real-time adjustments to improve the ban program. As a result, we have already implemented most of the recommendations contained in your report. The improvements will result in a more consistent and accurate application of the EIC two-year ban.

Taxpayers are prohibited from receiving the EIC for two tax years if their EIC claims are due to reckless or intentional disregard of the rules and regulations. Currently, almost 20,000 taxpayers are subject to the two-year ban. This year, approximately 1,600 taxpayers claimed EIC while under the ban. We automated our process to identify these taxpayers and notify them of their EIC ineligibility due to the ban. While this is an improvement over our process in previous years, more can be done to improve our application of the ban.

You state in your report that we need to reemphasize the need for examiners to consider the application of the two-year ban during examinations. As you acknowledge, revisions to examiner training material will help to reduce the number of incorrect bans applied. Along with our actions to improve guidelines and training materials, as you have recommended, we initiated a number of systemic improvements which will further strengthen this program. These include both systemically selecting the most egregious cases for application of the ban before the first contact and determining the period of the ban. We revised our Computer Paragraph (CP) 79A notice to improve the explanation of the ban, show the year in which the taxpayer can claim EIC again if eligible, and provide the procedures they

## **Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers**

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should follow. The implemented and planned corrective actions will improve the effectiveness of the ban program and further deter EIC noncompliance.

We concur with your outcome measures. Attached is a detailed response outlining corrective actions that we will take to address your recommendations.

If you have any questions, please call me at (404) 338-7060 or members of your staff may call Jim Grimes, Director, Reporting Compliance at (404) 338-7643.

Attachment

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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Attachment

To help ensure that two-year bans are consistently and correctly applied the Commissioner, Wage and Investment (W&I) Division, along with the Commissioner, Small Business/Self-Employed (SB/SE) Division, should:

### **RECOMMENDATION 1**

Revise and distribute written ban guidelines that are clear, complete, consistent with other IRS programs and procedures, and accurately reflect the law. This should include, at a minimum:

- a. Issuing guidelines that include each of the problem areas identified in this review (see Appendix V), examples of the most common situations warranting the ban, and examples of ban explanations.
- b. Ensuring written guidelines explaining how the ban is set and how to remove it are distributed and emphasized to examiners for all Compliance programs, both at the Compliance sites and in the field offices.

### **CORRECTIVE ACTIONS**

We have revised both the Penalty Handbook Internal Revenue Manual (IRM) (20.1.5.13) and the Service Center Exam IRM (4.19.1.5.1.4.1) to include comprehensive sections on the two-year ban. We updated the Service Center Exam Continuing Professional Education (CPE) for 2005 to incorporate more examples of suggested paragraphs addressing the deficiencies noted by the Treasury Inspector General for Tax Administration (TIGTA). We will deliver this training to all Campuses in 2005. We provided SB/SE Headquarters with revised EIC two-year ban procedures so they can be utilized by the Area Office Examination and Case Processing sites. We provided guidance on the two-year ban to the SB/SE Directors of Campus Reporting Compliance and Exam Policy on October 26, 2004.

### **IMPLEMENTATION DATE**

February 20, 2004 - Completed the Penalty Handbook revisions

October 1, 2004 - Completed IRM 4.19.1.5.1.4.1 revisions

October 15, 2005 - Delivery of all Fiscal Year 2005 CPE lessons

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Chief, Examination EITC will ensure that all Examination Operations tax examiners receive the updated CPE on the two-year ban during Fiscal Year 2005. We will continue to assess proper application of the two-year ban during our annual site reviews.

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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### **RECOMMENDATION 2**

Consider using available data to identify EIC examination cases with apparent abuse before taxpayers are contacted. Examiners could review these cases, which might otherwise be worked completely by the automated system, and propose the ban on the initial examination report when warranted.

### **CORRECTIVE ACTIONS**

Chief Counsel, Headquarters staff, and site representatives discussed using data to identify EIC audit cases with apparent abuse before taxpayer contact. As a result, we will work with the Report Generation System/Correspondence Exam Automation Support Batch Processing and Dependent Database programmers to select egregious cases for application of the two-year ban before issuance of an initial contact letter. In compliance with the IRS Request for Information Services (RIS) cycle, changes will not be available until 2006.

### **IMPLEMENTATION DATE**

February 15, 2006

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

A Placeholder RIS (EXM 50027P00) was submitted by the October 29, 2004, deadline for the 2006 RIS cycle. Periodic discussions will be held with all impacted parties to design the functionality for the final RIS, which is due February 28, 2005. The Chief, Examination EITC will work with MITS to monitor the design, development and testing of functionality to be delivered through this RIS to ensure desired functionality is achieved.

### **RECOMMENDATION 3**

Make sure Compliance site management takes appropriate actions to help ensure that all EIC examiners receive adequate ban training, consider the ban on each EIC examination they work, and properly apply the ban guidelines.

### **CORRECTIVE ACTIONS**

During our Exam Operations Managers' Meeting in late August 2004, we discussed the importance of properly applying the two-year ban. The two-year ban is on the agenda for the Exam Operations EIC Teleconference in November 2004. The Decision Support Tool (DST), an interactive web based tool to assist examiners in making proper EIC determinations, will include reminders to consider imposing the two-year ban when taxpayers do not comply with the EIC rules. The DST will also provide links to the guidance mentioned in our corrective action to your Recommendation #1.

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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### **IMPLEMENTATION DATE**

February 15, 2005 - DST will be integrated with two-year ban material

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

We will continue to assess proper application of the two-year ban during our annual site reviews. The Chief, Examination EIC will monitor the integration of the two-year ban material into the DST.

### **RECOMMENDATION 4**

Revise the ban programming to consider unfiled and late-filed tax returns. We believe this could be accomplished, in part, by establishing a computer field that contains the first tax year after the ban expires. This field could be used to determine which tax returns should be banned and which would require recertification. This field could also be used to help prevent actions subsequent to return processing that incorrectly allow the EIC for a banned tax year.

### **CORRECTIVE ACTIONS**

We submitted RIS # WEX40017 to consider non-filed years when determining the ban period. Masterfile will also contain a new display field showing the year the ban expires. This field will print on the CP 79A notice.

### **IMPLEMENTATION DATE**

February 15, 2005

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

TIGTA, W&I Compliance, and Modernization & Information Technology Services (MITS) reviewed and agreed the RIS # WEX40017 contains the functionality to correct the problems detailed in Recommendation #4. MITS is on target for implementation in 2005.

### **RECOMMENDATION 5**

Revise the CP 79A notice to emphasize that recertifying taxpayers must meet EIC requirements, warn of the likelihood of an examination and potential for another ban, and reflect the revised Form 8862 requirements when claiming the EIC without

## Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers

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qualifying children. The revised notice should also include the first tax year for which the taxpayer may again be able to claim the EIC. If ban programming is revised as suggested in Recommendation #4, this tax year information would be available.

### **CORRECTIVE ACTIONS**

The CP 79A notice was revised to incorporate all of the recommended changes. As discussed in our response to Recommendation #4, the notice will now indicate the tax year in which the taxpayer can again claim EIC if eligible. These changes will simplify the notice.

### **IMPLEMENTATION DATE**

February 15, 2005

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

Drafts of the CP 79A notice incorporate all changes recommended by TIGTA. MITS is on target for implementation in 2005.

### **RECOMMENDATION 6**

Revise Form 8862 instructions and Publication 596 to emphasize that recertifying taxpayers must meet EIC requirements and to warn taxpayers about the ban. Also, the Commissioner, W&I Division, should revise Form 8862 instructions and the individual tax form instructions to explain (or provide a reference that explains) which years are banned.

### **CORRECTIVE ACTIONS**

We will incorporate the revisions of the Form 8862 tax form and instructions and Publication 596 into the Tax Year 2004 version of these forms, instructions, and publications.

### **IMPLEMENTATION DATE**

February 15, 2005

### **RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Chief, Examination EITC will review all revisions of Publication 596 and Form 8862 prior to publication to ensure that the tax forms and publications incorporate the recommendations.