WRITTEN STATEMENT OF

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SUBCOMMITTEE ON OVERSIGHT

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Chairman Boustany, Ranking Member Lewis, and distinguished Members of this Subcommittee:

Thank you for inviting me to testify today about improper payments in the administration of refundable tax credits.[1] In my testimony today, I will make the following points:

1. Federal tax law allows individuals, as well as businesses, refundable credits that are not necessarily associated with improper payments.

2. The earned income tax credit (EITC) is a refundable credit, enacted as a work incentive in the Tax Reduction Act of 1975 signed by President Ford, that has become the government's largest means-tested anti-poverty program.[2]

3. The optimal design of a social benefit program maximizes both participation and compliance levels.[3]

4. There is a complex overstatement problem in the EITC that cannot be characterized simply as fraud or ineligibility.

5. Estimates of improper EITC payments contain uncertainties as to the amount and rate of overstatement.

6. EITC overstatement statistics should be evaluated in light of Taxpayer Advocate Service (TAS) research findings.

7. TAS has made numerous recommendations to improve the administration of the EITC and reduce improper payments, and I will describe our most significant recommendations below.

8. Additional legislative action could help reduce improper payments – notably, limiting public access to the database of decedents' Social Security numbers (SSNs) and other personal information and authorizing the use of math error authority for provisions that cap either the lifetime amount of a credit or the number of years for which a credit may be claimed.

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[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget (OMB) for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

[2] *See* Pub. L. No. 94-12, 89 Stat. 26 (1975).

[3] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 103 (Research Study: *Running Social Programs Through the Tax System*).

9. Although there are additional steps the IRS can take to improve its administration of the EITC, some proposals that have been advanced could undermine effective tax administration.

At the outset, I should note that my perspective on refundable credits, particularly the EITC, is based not only on my experience as the National Taxpayer Advocate but also on my prior experience of almost three decades preparing taxes for individuals and small businesses and representing them before the IRS; founding and serving as Executive Director of The Community Tax Law Project, the first independent low income taxpayer clinic in the country; and successfully representing hundreds of low income taxpayers on EITC issues in audits before the IRS and in litigation before the United States Tax Court.

I. Federal Tax Law Allows Individuals, as Well as Businesses, Refundable Credits That Are Not Necessarily Associated with Improper Payments.

Most tax credits merely reduce the amount of tax a taxpayer owes, but in the case of *refundable* tax credits, the IRS may end up paying a taxpayer more than the taxpayer paid in tax, resulting in a "negative" tax. Refundable credits may have become familiar as a benefit to low income taxpayers and therefore may be viewed as a form of "welfare." Nevertheless, these credits are no longer limited to this population. To the contrary, refundable credits are now available to middle-income taxpayers as well as businesses.

In addition, economic incentives may be designed as non-refundable credits for large and small businesses. Recently, the Hiring Incentives to Restore Employment (HIRE) Act provided an incentive for employers to hire previously unemployed workers via a 6.2-percent payroll tax incentive, effectively exempting them from the employer's share of Social Security tax on wages paid.[4] The incentive also allowed an employer an income tax credit up to $1,000 for retaining a worker under certain circumstances.[5] Under the Patient Protection and Affordable Care Act of 2010, a small business may receive a credit of up to 50 percent of premiums for health insurance on low and moderate-income employees.[6]

To provide context for our discussion of improper payments, significant examples of refundable credits are briefly described below.

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[4] *See* IRC § 3111(d).

[5] *See* Pub. L. No. 111-147, § 102,124 Stat. 71, 75 (2010).

[6] *See* Pub. L. No. 111-148 § 10105(e)(1), 124 Stat. 119, 906 (2010), adding IRC § 45R. The credit for small tax-exempt employers is limited to 35 percent.

- The earned income tax credit (EITC) may be described as a wage supplement, with a $5,666 maximum, administered by the IRS to low income workers.[7]

- The additional child tax credit (ACTC) refers to the portion, dependent on earnings, of the $1,000 per child tax credit for low and moderate-income taxpayers that the IRS may refund even in excess of tax owed.[8]

- The First-Time Homebuyer tax credit (FTHBC), enacted in 2008 and subsequently modified, provides the lesser of $8,000 or ten percent of the purchase price to certain low and moderate-income first-time or long-time homeowners.[9]

- The adoption credit allows low and moderate-income parents to claim a credit of up to $13,170 for the expenses of adopting a child.[10]

- The American Opportunity Tax Credit is a partially refundable credit to low and moderate-income taxpayers of up to $2,500 for college tuition, fees, and course materials.[11]

- The fuel tax credit to purchasers of gasoline used on farms or local buses or of fuels for certain other purposes generally is 18.3 cents per gallon.[12]

All of these credits are refundable and may give rise to improper payments, yet data do not necessarily connect refundable credits with more noncompliance than any other tax provision. On the contrary, certain understatements of business income may create more of a tax gap than do overstatements of tax credits.[13]

Generally, the tax gap is a measure of noncompliance that refers to the difference between what taxpayers owe and what they pay voluntarily and timely – an estimated

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[7] *See* IRC § 32(f); IRS Pub. 596, *Earned Income Credit* 45 (2010).

[8] *See* IRC § 24.

[9] *See* IRC § 36; *see also* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 100-103 (discussing administrability problems specific to the First-Time Homebuyer Credit).

[10] *See* IRC § 36C.

[11] *See* IRC § 25A(i).

[12] *See* IRC §§ 34, 4081(a)(2)(A)(i), 6420, 6421, 6427.

[13] *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 82 ("National Research Program (NRP) data for tax year 2001 suggest that approximately 55 percent ($109 billion) of the individual underreporting gap (totaling approximately $197 billion) came from understated net business income, such as unreported receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent ($17 billion) came from overstated tax credits. * * * Based on these data, the National Taxpayer Advocate believes that noncompliance is not *necessarily* more prevalent in refundable credits than any other type of tax incentive.").

$345 billion.[14] This gross tax gap consists of three types of noncompliance, namely failure to report all income ($285 billion), file a tax return ($27 billion), and pay all tax due ($33 billion).[15] Of the $285 billion gross underreporting gap, the largest single segment is business income underreported by individuals ($109 billion or 38 percent).[16] These individuals include those who should report business income as sole proprietors on Schedule C (Profit or Loss from Business) or as farmers on Schedule F (Profit or Loss from Farming).

In context, EITC noncompliance may be a relatively small portion of the tax gap.[17] Nonetheless, the discussion below focuses primarily on the EITC because it is the refundable credit identified under applicable law as an "improper payment."[18]

II. The EITC Is a Refundable Credit, Enacted as a Work Incentive in the Tax Reduction Act of 1975 Signed by President Ford, That Has Become the Government's Largest Means-Tested Anti-Poverty Program.

A. Legislative Background

Generally, the amount of the EITC increases with earned income, creating an incentive to work.[19] The EITC amount also increases if a worker has one, two, or three qualifying children, but is disallowed if the worker has more than $3,100 of investment income.[20] The EITC phases out at an income ceiling of $48,362 (for a married couple filing jointly

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[14] *See* IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007), Fig. 1 at 10 (containing an IRS estimate for TY 2001).

[15] *See id.*

[16] *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 11 (Research Study: *A Comprehensive Strategy For Addressing The Cash Economy*).

[17] *See* IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007), Fig. 4 at 13 (reflecting $17 billion in credits out of $197 billion in individual income tax underreporting for TY 2001); GAO, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges* (Apr. 15, 2011) (reporting $16.9 billion in improper EITC payments in FY 2010).

[18] *See* GAO, *Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments*, No. GAO-09-628T (Apr. 22, 2009) App. I, at 20 (identifying EITC as the Treasury improper payment).

[19] *See* Stacy Dickert, Scott Houser & John Karl Scholz, *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation,* Tax Policy and the Economy, vol. 9, ed. James M. Poterba (MIT Press, 1995); Janet Holtzblatt, *Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits* (Dept. of the Treasury, 2004) 13 (citing Dickert, Houser & Scholz among academic economists who "estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work").

[20] *See* IRC § 32(b) (increasing EITC amount based on number of children), (i) (denying EITC to workers who have excessive income-producing investment assets).

with three or more qualifying children), while detailed requirements govern eligibility and computation.[21]

The Tax Reform Act of 1986, signed by President Reagan, significantly expanded the EITC, raising the maximum credit from $550 to $800 and the phase-out ceiling from $11,000 to $13,500, while indexing the EITC for inflation.[22] The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, signed by President Clinton, substantially reformed traditional welfare programs. As a central component of welfare reform, the EITC was expanded with respect to the amount of work incentive and modified with respect to immigration and work status in the U.S.[23] The Taxpayer Relief Act of 1997, also signed by President Clinton, denied the EITC for two or ten years to a taxpayer who had made a claim that was reckless (*i.e*. due to intentional disregard of rules and regulations) or fraudulent, respectively.[24] The Education, Jobs, and Medicaid Assistance Act of 2010, signed by President Obama, eliminated the advance EITC, which had allowed periodic payments through reduced payroll withholding but had been associated with noncompliance as well as low participation.[25]

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[21] A 2009 House committee report provided the following description:

> Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.
>
> The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.
>
> An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,100 (for 2009). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

H.R. Rept. No. 111-16, at 519 (2009).

[22] *See* Pub. L. No. 99-514, § 111, 100 Stat. 2085 (1986).

[23] *See* Pub. L. No. 104-193, § 451, 110 Stat. 2105, 2276 (1996).

[24] *See* IRC § 32(k).

[25] *See* Pub. L. No. 111-226, § 219, 124 Stat. 2389, 2403 (2010), repealing IRC § 3507.

B. Compliance History

For tax year (TY) 1999, an IRS study estimated that 27.0 to 31.7 percent of EITC claims should not have been paid.[26] For fiscal year (FY) 2009, the IRS estimate of EITC improper payments was 23 to 28 percent.[27] Assuming *arguendo* that these IRS estimates are comparable, *the compliance rate would appear to have increased by four percentage points.*[28] *Taking a 27 percent noncompliance rate down by four points to 23 percent would have reduced the gap by almost 15 percent*. A comparable compliance rate increase in many other tax gap areas would be overwhelming. As discussed below, however, significant statistical questions about the IRS estimates remain.

Over the past decade, the IRS has pursued EITC compliance through a strategy comprising a disproportionately high audit rate of EITC returns, enforcement of rules for paid tax return preparers, and outreach and education directed toward low income taxpayers.

The audit rate for returns with EITC claims is approximately twice the rate at which the IRS audits individual taxpayers in general.[29] This doubled audit rate is counterintuitive when the additional tax recommended after audits averages significantly less for the EITC than for individual returns in general.[30] The following chart shows that EITC audits constitute about a third of all audits, yet they yield on average only about a third as much tax per exam and an even smaller proportion of tax from individual audits overall:[31]

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[26] *See* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002) 3 ("Of the estimated $31.3 billion in Earned Income Tax Credit (EITC) claims made by taxpayers who filed returns in 2000 for tax year 1999, it is estimated that between $8.5 and $9.9 billion (27.0 percent to 31.7 percent) should not have been paid.").

[27] *See* Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* (Feb. 7, 2011) (hereinafter *Reduction Targets*), at 1 ("The FY 2009 EITC improper payment rate is estimated to be between 23 percent to 28 percent or $11 billion to $13 billion in EITC improper payments each year.").

[28] A FY 2010 Improper Payment study shows the EITC noncompliance rate at 23.9 percent to 28.7 percent based on tax year 2006 IRS National Research Program (NRP) data. This noncompliance rate is slightly higher than in the FY 2009 study; however, since the FY 2010 study used methodology not directly comparable to the 1999 EITC study, we have used the 2009 study, which permits a better comparison.

[29] *See* IRS Pub. 55-B, *Data Book* (2010), Table 9a at 22.

[30] *See id.* at 23.

[31] IRS Data Book, 2006 - 2010, Table 9a; EITC Program Office response to TAS information request (May 18, 2011).

FY	All Individual Returns			Returns with EITC			EITC Compared to All Individual Returns		
	Exams	Rec'md add'l tax ($) (in billions)	$ per Exam	Exams	Rec'md add'l tax ($) (in billions)	$ per Exam	Percent of Exams	Percent of Rec'md add'l tax ($)	Percent of $ per Exam
2006	1,283,950	13.05	10,160	517,617	1.49	2,872	40.3%	11.4%	28.3%
2007	1,384,563	15.71	11,343	503,267	1.49	2,969	36.3%	9.5%	26.2%
2008	1,391,581	12.46	8,956	503,755	1.99	3,958	36.2%	16.0%	44.2%
2009	1,425,888	14.94	10,478	508,180	2.15	4,232	35.6%	14.4%	40.4%
2010	1,581,394	15.07	9,527	473,999	1.97	4,162	30.0%	13.1%	43.7%
Average	1,413,475	14.24	10,077	501,364	1.82	3,639	35.5%	12.8%	36.1%

As this chart indicates, the IRS takes its mandate to reduce EITC overclaims seriously. Given the IRS's limited resources, however, the large amount of effort the IRS devotes to relatively low-yield EITC audits means that the agency is probably collecting less overall revenue than a strategy of pursuing higher-yield audits would produce.

A specific EITC compliance mechanism is the recertification requirement imposed after a two- or ten-year denial due to a reckless or fraudulent claim.[32] To claim an EITC again, the taxpayer must file Form 8862 (Information to Claim Earned Income Credit After Disallowance) to enable the IRS to better verify eligibility. Another compliance mechanism is so-called math error authority, or summary assessment, in which the IRS first assesses additional tax, and in order to gain access to the United States Tax Court, the taxpayer must timely challenge the assessment administratively.[33] As the term "math error" suggests, the IRS may use this streamlined authority to correct arithmetic or clerical errors. In addition, the tax law extends this authority in the case of the EITC to such errors as omission of a Social Security number.[34]

With respect to tax return preparers, the IRS has used due diligence audits, visits by revenue and Criminal Investigation agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to improve the accuracy of the EITC returns they file.[35]

At the same time, the IRS has conducted campaigns to educate low income workers about the availability and requirements of the EITC. For example, the IRS sends notices to taxpayers who appear to qualify based on previously filed tax returns to

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[32] *See* Treas. Reg. § 1.32-3.

[33] *See generally* IRC §§ 6213(b) and 6213(g). In general, the United States Tax Court is the only judicial forum in which taxpayers may challenge their tax liabilities before paying the liability in full.

[34] *See* IRC § 6213(b); IRM 21.6.3.4.2.7.13.2 (May 4, 2007).

[35] *See* Dept. of the Treasury, *Performance and Accountability Rept. FY 2010,* at 280 (Nov. 15, 2010).

encourage them to claim the EITC if eligible.[36] Moreover, IRS staff working at Taxpayer Assistance Centers prepared approximately 53,000 EITC returns in TY 2009.[37]

Beyond its own staff, the IRS partners with organizations that serve the low income community to educate taxpayers about the EITC. In particular, the IRS trains volunteers and supports Volunteer Income Tax Assistance (VITA) programs, which offer free return preparation to low income taxpayers and taxpayers who are elderly, disabled, or have limited English proficiency. For TY 2009, VITA prepared approximately three million EITC returns.[38] Another exemplary partnership is led by the National Disability Institute (NDI), which conducts an annual campaign known as the Real Economic Impact Tour to assist disabled workers in preparing their EITC claims. Through this effort, the NDI, other organizations, TAS, and the Stakeholder Partnerships, Education and Communication (SPEC) function of the IRS Wage and Investment division have worked together in 100 cities to provide free return preparation to low income taxpayers with disabilities.[39]

Annually, the IRS has sponsored an EITC Awareness Day. This year on January 28, the IRS held news conferences and produced news releases, e-mail blasts, newsletters, and letters to editors; provided key messages to supplement partners' outreach efforts through their use of Facebook, blogs, Twitter, and other social media; supported events involving mayors of major cities; hosted IRS and other officials along with Members of Congress at events around the country; and provided assistance in local IRS offices to over 15,000 taxpayers on two Saturdays following EITC Awareness Day.[40] TAS assists the IRS with EITC Awareness Day, attending 96 events this year and reaching an estimated 6,000 taxpayers, including veterans, low income taxpayers, immigrants, and those speaking English as a second language. In January 2011, TAS also issued tweets and Facebook status updates focusing on EITC Awareness Day.

In short, the IRS has invested considerable resources in administering the EITC as Congress directed. The EITC has lifted millions of people out of poverty while requiring them to work, yet its design almost certainly yields higher rates of improper payments than traditional benefits programs.

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[36] *See, e.g.,* IRS, *Earned Income Tax Credit Program Effectiveness and Program Management FY 2002-FY 2003* (Aug. 8, 2003).

[37] TAS Research on IRS data (May 19, 2011).

[38] TAS Research on IRS data (May 19, 2011). In 2008, VITA prepared 0.9 percent of all federal income tax returns and 1.9 percent of returns claiming the EITC. *See* Steve Holt, *Ten Years of the EITC Movement: Making Work Pay Then and Now* 9 (Brookings Institution, Apr. 2011).

[39] *See* http://www.realeconomicimpact.org/REI-TOUR.aspx.

[40] *See* http://www.eitc.irs.gov/central/main.

III. The Optimal Design of a Social Benefit Program Maximizes Participation and Compliance Levels.

Given the social policy of support for low income workers that the EITC brings into the tax law, the question arises whether there is a way to achieve better results than the IRS has achieved in implementing such a policy. Traditionally, social benefit programs such as food stamps or the Section 8 Housing Choice Voucher Program have screened out ineligible claimants on the front end at a high administrative cost with relatively low participation rates.[41] Of course, screening processes are not infallible, resulting in some improper payments.

On the other hand, refundable tax credits have low administrative cost and relatively high participation rates but a higher risk of payments to ineligible claimants.[42] Generally, the IRS relies on voluntary assessment through the filing of tax returns. Using tax returns as the "application" for EITC benefits rather than a traditional screening process results in low cost with high participation as well as the risk of improper payment. The IRS has pointed out that for the EITC:

> Current administration costs are less than 1% of benefits delivered. This is quite different from other non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures.[43]

For TY 2009, the IRS reports that it paid $55 billion in EITC claims.[44] If this amount had been paid by another agency that spent 20 percent of program expenditures verifying eligibility, the administration costs to the government would have been $11 billion – nearly 100 percent of the amount of improper payments that the IRS estimates were made.

As part of its ongoing efforts to reduce improper payments, the IRS several years ago piloted a pre-certification program that required EITC claimants either to pre-certify their eligibility or to submit documentation of eligibility with their tax returns. However, the

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[41] *See* Housing Act of 1937 § 8, 42 U.S.C. § 1437f; 24 C.F.R. pt. 982; David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 Yale L.J. 955, 1001 (2004) (observing that integration of provisions such as Food Stamps and the EITC into the tax system can enhance "administrative efficiency by reducing bureaucratic costs").

[42] *See* Weisbach & Nussim, 113 Yale L.J. at 1010 ("The EITC has a high participation rate but also a high overpayment rate. These facts are likely due to the lack of a precertification process."); Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform,* 108 Harv. L. Rev. 560, 564-65, 589 (1995) (observing that "the EITC and other tax-based transfers can enhance administrative efficiency by reducing bureaucratic cost" and identifying "the potential for noncompliance inherent in a tax-based program").

[43] *Reduction Targets* 23 (IRS response).

[44] *See Reduction Targets* 1. Overall EITC claims for TY 2009 exceeded $60 billion, which consisted of about $55 billion in refundable benefits and $5 billion in offsets to other taxes. IRS Pub. 55-B, *Data Book* (2010), Table 1.

IRS ultimately concluded that pre-certification should not be pursued because the "results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers."[45]

While tax administration generally carries a risk of payment to ineligible claimants, a significant criterion for determining EITC eligibility is income, and the IRS has unique expertise in examining income. Thus, it is unclear whether another mechanism for providing a work incentive and paying a wage supplement to low income workers would cost the government less.

IV. The EITC Presents a Complex Overstatement Problem that Cannot Be Characterized Simply as Fraud or Ineligibility.

Improper payments of EITC generally result from overstatement of claims by low income taxpayers. While the IRS has expertise in examining claimed income amounts, examining claims to determine whether a child meets other requirements has presented challenges. In 2004, acting on National Taxpayer Advocate and Treasury proposals, Congress simplified the definition of a qualifying child, generally eliminating the need to prove the cost of supporting a child, as long as he or she is of a prescribed age, relationship, and residence.[46] The IRS can systematically verify age with federal databases (such as the Social Security Numident database). However, relationship and residence are factual circumstances that often require intrusive inquiries into taxpayers' personal circumstances and are hence more difficult to establish. As a result, the most frequent reason for the IRS's rejecting EITC claims is the taxpayer's failure to establish relationship or residency to the IRS's satisfaction.[47]

Over the years, based on experience administering the EITC, the IRS has developed a fairly sophisticated set of business rules to identify EITC returns that have a relatively high risk of overstatement. For example, the IRS can use databases derived from Social Security and other federal data to help identify cases in which the relationship and residence requirements may not be met. While external data may be a helpful indicator, they also may be misleading in some cases. As discussed below, a child's relationship and residence with respect to a low income taxpayer are highly circumstantial facts to be validated on a case-by-case basis.

Under the relationship requirement, the taxpayer generally may claim the EITC with respect to a child who is his or her son, daughter, stepchild, foster child, or a descendant of any of them (*e.g.*, a grandchild), or a child who is a sibling, stepsibling, or

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[45] IRS, *Earned Income Tax Credit Initiative: Final Report to Congress* (Oct. 2005).

[46] *See* National Taxpayer Advocate 2001 Annual Report to Congress 76 (Legislative Recommendation: *Family Status Issues*); Dept. of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004).

[47] *See* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns, at 13* (Feb. 28, 2002).

half-sibling of the taxpayer, or a descendant of any of them (*e.g.,* a nephew or grandnephew).[48]

Under the residence requirement, a taxpayer generally may claim the EITC only with respect to a child who lives with the taxpayer for more than half the calendar year (*i.e.*, six months plus one day).[49]

As a practical matter, low income taxpayers have considerable difficulty documenting relationship and residence.[50] They have difficulty because of lack of clarity from the IRS as well as their own personal circumstances. In the past, TAS has reported that the "two main problems are inconsistency as to which documents the IRS will accept (a document is accepted in one office, but not in another) and inflexibility in accepting proof (failure to accept other types of documents where the taxpayer cannot provide the standard documentation)."[51] On the low income taxpayers' part, one of the biggest issues is "their tendency to be transient or even temporarily homeless" coupled with literacy challenges.[52] This combination of byzantine requirements with lack of a home

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[48] *See* IRC § 152(c)(2).

[49] *See* IRC § 152(c)(1)(B).

[50] *See* Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, Tax Notes (June 23, 2003) 1821; Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), *at* http://works.bepress.com/leslie_book/8; National Taxpayer Advocate 2002 Annual Report to Congress 50 (Most Serious Problem: *EITC Eligibility Determinations Can Be Made Less Burdensome*).

[51] National Taxpayer Advocate 2005 Annual Report to Congress 106-07 (Most Serious Problem: *Earned Income Tax Credit Exam Issues)*.

[52] Leslie Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net,* 81 Ore. L. Rev. 351, 393 (2002).

in which to store documents, not to mention skills with which to read them, frequently results in a lack of documentation.[53]

In the context of low income taxpayers, the question of noncompliance takes on a complexity of its own. Generally, noncompliance is best described as a continuum of behavior from inadvertent error to negligence to recklessness (in disregard of the law) to fraud at civil or criminal levels.[54] Similarly, social scientists have classified noncompliance of different types, such as procedural, lazy, unknowing, asocial, brokered, symbolic, social, or habitual.[55] Compliance may be influenced by factors such as demographic affiliations, personal morals, social norms, deterrence probabilities, trust in government, complexity and convenience, as well as preparers and other third parties.[56]

Reports of improper EITC payments may create concern about fraud. As noted earlier, a refundable feature *per se* does not account for improper payments. Nor is there any

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[53] As previously presented to this Subcommittee, another description of the circumstances of low income taxpayers is excerpted below:

> Whether English speaking or not, taxpayers working near or at minimum wage levels tend to have limited education and literacy skills, and minimal understanding of financial matters. Often these taxpayers work unusual hours (such as less desirable shift work) and many work two or more jobs, which they get to by public transportation. Housing and food expense are often a reach, and these taxpayers commonly qualify for some form of public assistance. Many of our clients share living space in apartments or houses among several generations and/or collateral relatives and friends, and they often take in boarders to help defray their expensive rent, especially in major cities. Having a phone is often a luxury, and their phones are often disconnected for lack of payment. Job tenure is often short, and many float from job to job. These taxpayers do not own their own homes and do not have retirement plans, brokerage accounts, or other accumulated assets. Most live paycheck to paycheck. * * * * *
>
> Adding to the difficulty of the statutory complexity is the fact that a large number of EITC audits are conducted long distance, through EITC centers. Long distance audits are, by their very nature, difficult for the low income taxpayer community to handle. In the case of a long distance EITC audit, for example, taxpayers seeking our services often bring in IRS form requests for documents they have received, such as for birth certificates, school records, and medical records of their children. In many of these cases, the taxpayer has carefully collected the information and sent off a timely response to the IRS to the best of his or her ability. But it is often the case that 'substantiation' of the existence of the child and/or his or her residence is only one of the issues in the audit that the IRS is concerned about, which may also include double claiming of the credit, or the application of the tiebreaker rule.

Statement of Janet Spragens (Prof. & Dir., Fed. Tax Clinic, Washington College of Law, Amer. Univ.), *Hearing on the Taxpayer Advocate Report and Low-Income* Taxpayer *Clinic Program*, Hearing Before the Subcomm. on Oversight, Comm. on Ways & Means, 107th Cong. 55-56 (Jul. 12, 2001).

[54] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 81 (Research Study: *Running Social Programs Through the Tax System)*.

[55] *See* Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 Taxpayer Compliance 57, 56-62 (1989).

[56] *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 87 (Research Study: *Running Social Programs Through the Tax System)*.

reason to believe that low income workers are particularly fraudulent.[57] Instead, it is frequently the case that the IRS denies proper claims because of lack of documentation.[58] Consider the following examples.

Relationship Example

> Assume Granduncle claims the EITC with respect to Grandnephew. Assume further that the IRS questions the claim based on the relationship requirement. To document his relationship to the qualifying child, Granduncle may be required to produce his own birth certificate, a birth certificate for his sibling showing common parents, a birth certificate for his niece showing that Granduncle's sibling was the niece's parent, and a birth certificate for Grandnephew showing that the niece was Grandnephew's mother. That is four birth certificates in all. Depending on the states in which these four individuals were born and the restrictions those states impose on who may obtain birth certificates, it may be extremely time-consuming or even impossible for Granduncle to obtain the requisite substantiation. As a result, the IRS may deny the claim even though it was legitimate.[59]

Residence Example

> Assume Child lived with Taxpayer for more than half of calendar year 2010, and Taxpayer files a proper EITC claim. Assume further that the IRS questions the claim based on the residence requirement. To prove residence, Taxpayer may request a transcript from Child's school showing that Child lived at Taxpayer's address for the 2009-2010 school year. However, the IRS may not accept the transcript as sufficient because a September through mid-June school year transcript shows residence for four months of 2009 and five-and-a-half months of 2010. The transcript does not prove that Child lived with Taxpayer for more than six months in 2010. Alternatively, Taxpayer may obtain transcripts for both 2009 and 2010 but then discover that the school does not include Child's address on those transcripts. Particularly if Taxpayer has trouble understanding the IRS's EITC notice or lacks the time, knowledge, or diligence to obtain documentation

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[57] *See* John Karl Scholz, *The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness*, Inst. for Research on Poverty Discussion Paper No. 1020-93, Univ. of Wisc.—Madison, published in 47 Nat'l Tax J. 63 (1994) (suggesting that taxpayers who claim the EITC but are not eligible for it tend to live in low income households).

[58] *See* National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at 20 (*EITC Audit Reconsideration Study*) ("Documentation difficulties or deficiencies within the original audit acted as the audit reconsideration trigger in 45% of the cases").

[59] In a case where a low income worker and child are asylees or refugees legally admitted to the U.S. from a country that is war-torn or experiencing civil unrest, they may not be able to produce a birth certificate. *Cf*. IRM 3.21.263.5.3.4.2, 3.21.263.6.1.5 (Jan 1, 2011) (in the case of an application for an Individual Taxpayer Identification Number, which does not require legal admission to the U.S., excepting applicants from countries experiencing civil unrest from a birth certificate requirement).

that the IRS will accept, Taxpayer may just give up. As a result, the IRS would deny the claim even though it was legitimate.

These examples are not merely theoretical. These circumstances take place every day. Two Taxpayer Advocate Service studies have demonstrated that the denial of an EITC claim proves merely that the IRS did not accept it, not necessarily that the taxpayer was not eligible for the EITC.[60] As with all taxpayers who claim deductions and credits under the Internal Revenue Code, EITC taxpayers must substantiate their claims for the credit. In many cases, however, the IRS's narrow and rigid internal rules and training about what documentation its auditors will accept as proof of residency and relationship lead to improperly denied claims. In fact, in recognition of this problem, the IRS is currently working with TAS on a research initiative to expand the scope of documentation it will accept from EITC taxpayers, as discussed below.[61] (A list of alternate sources of documentation, used for training employees as part of this research project, is provided in the Appendix.)

V. Estimates of Improper EITC Payments Raise Uncertainties as to the Amount and Rate of Overstatement.

In addition to the complexity of documenting compliance with the tax law, legislative, economic, and statistical factors contribute to the reported EITC improper payment rate. Last month, the Government Accountability Office (GAO) reported that improper EITC payments had jumped to $16.9 billion in 2010 from approximately $12 billion in 2009, without reporting a corresponding increase in the noncompliance rate.[62] However, as Tables 1 and 2 demonstrate, the number and amount of EITC claims have steadily increased each year, for reasons unrelated to noncompliance. Two factors may contribute to the recent reported increase in the dollar amount of EITC noncompliance. The American Recovery and Reinvestment Act of 2009 expanded the EITC to remedy a marriage penalty and allow a higher rate for taxpayers with three children.[63] At the same time, the economic recession may have increased the population of low income workers eligible for the EITC. Over a decade, inflation was also a factor.

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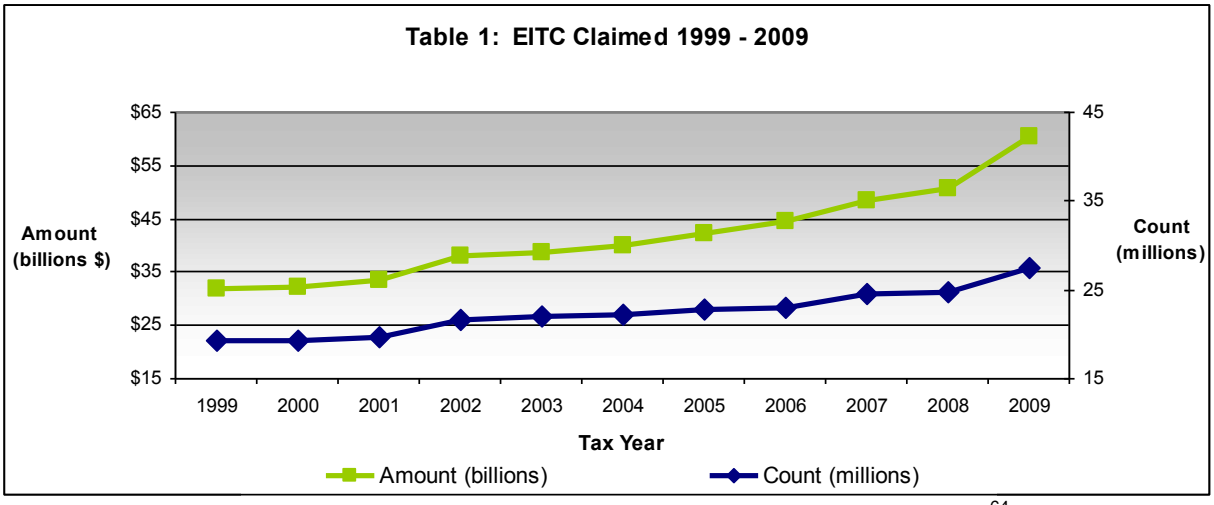
[60] *See* National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at i (*EITC Audit Reconsideration Study*) ("The study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration")*;* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 95 (*The IRS EIC Audit Process – A Challenge for Taxpayers)* ("More than half of EIC audited taxpayers reported difficulties obtaining the documents requested by the IRS, and almost half of the taxpayers did not understand why the documents were requested by the IRS").

[61] Even if we assume that a taxpayer does not meet the statutory criteria if he or she cannot substantiate eligibility, both Congress and the IRS would want to know that there is a significant pool of taxpayers who meet requirements but cannot document them, as that would indicate that the design of the program is preventing benefits from reaching the intended beneficiaries.

[62] *See* GAO, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges* (Apr. 15, 2011), Table 1 at 4.

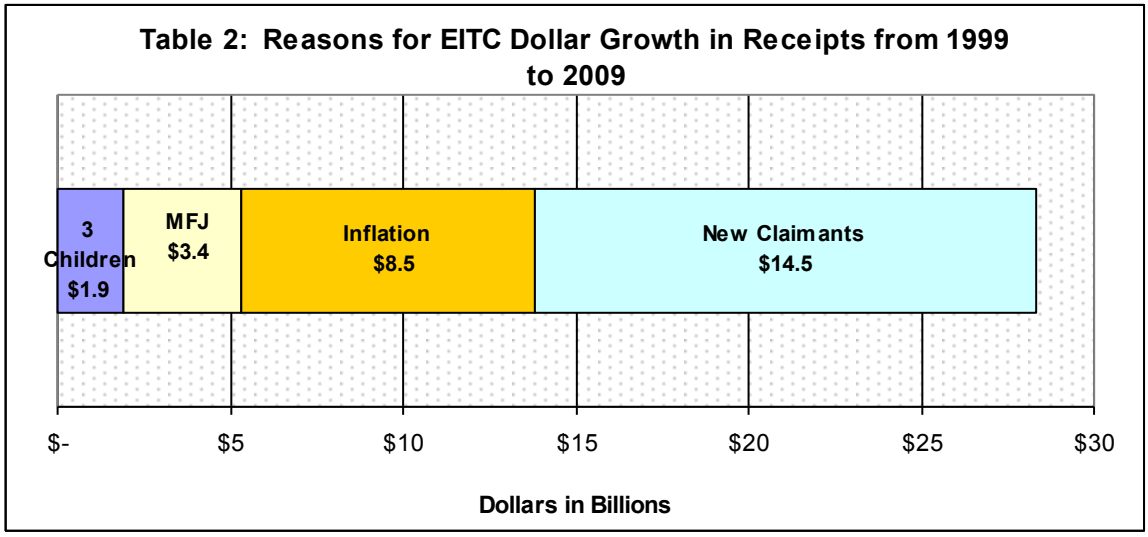
[63] *See* Pub. L. No. 111-5, Div. B, § 1002, 123 Stat. 115, 312 (2009).



Source: IRS, Statistics of Income Division, http://www.irs.gov/pub/irs-sol/histab1.xls.[64]

[64] The following chart shows the growth in the EITC program, with claim amounts nearly doubling since FY 1999:

Tax Year	Count (millions)	Amount (billions)
1999	19.3	$31.9
2000	19.3	$32.3
2001	19.6	$33.4
2002	21.7	$38.2
2003	22.0	$38.7
2004	22.3	$40.0
2005	22.8	$42.4
2006	23.0	$44.4
2007	24.6	$48.5
2008	24.8	$50.7
2009	27.4	$60.4



Sources: Compliance Data Warehouse, Individual Returns Transaction File, TY 2009; New Receipts are based on the amount of new receipts actually awarded, computed as new recipients times the average 2009 EITC claim with provisions relating to MFJ and three children factored in. Inflation is based on the Bureau of Labor Statistics calculator, http://www.bls.gov/data/inflation_calculator.htm.

Moreover, estimates of improper EITC payments, including the recent $16.9 billion estimate, have an uncertain statistical basis to the extent that they are based on previous IRS studies. The IRS study that generated the 31.7 percent estimate of improper EITC payment for TY 1999 had assumed that all taxpayers who failed to document their claims were not eligible, but since then, TAS research has demonstrated that this assumption is not valid.[65] Similarly, the TY 1999 study does "not reflect the fact that some eligible taxpayers may not have claimed the credit to which they were entitled."[66] As previously reported to Congress:

> [T]he National Taxpayer Advocate believes that the study overstates the overclaim rate because it relied exclusively on the outcome of EITC audits. TAS

[65] *See* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002) 3 ("assuming that taxpayers who do not appear for audits are not eligible for any credit"). A 2004 Taxpayer Advocate Service study of a representative sample of the EITC Audit Reconsideration population found that 43 percent of taxpayers who in the original audit did not respond to IRS contacts or whose response was received after the IRS deadline and thus was not considered in the audit had favorable outcomes from the audit reconsideration process (meaning that they received more EITC from the audit reconsideration process than from the initial audit itself). This percentage is about the same as the favorable outcome rate for *all* taxpayers in the audit reconsideration sample. Moreover, the non- and late-responders received about 96 percent of the total EITC claimed on the original return. "*This suggests that taxpayers who fail to respond to the audit, or who have a late response, may in fact be eligible for the EITC.*" (Emphasis in original.) *See* National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at 29 (Earned Income Tax Credit (EITC) Audit Reconsideration Study).

[66] *See* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3 (Feb. 28, 2002).

> data suggests that audit outcomes are frequently incorrect and that a significant number of entitled taxpayers are being denied the credit in error.[67]

After the TY 1999 estimate, an IRS National Research Program (NRP) has studied audit results from 2001 and later years to estimate taxpayer compliance. The IRS estimates of improper EITC payment based on the NRP may not be comparable to the TY 1999 estimate due to methodological differences. In particular, a 2001 IRS estimate of improper EITC payment has not been released for review by TAS or outside statisticians, apparently because it is not comparable to the TY 1999 study. Likewise, the IRS has not released studies for subsequent years to TAS or the public.

At the same time, it is unclear whether the NRP estimate of compliance based on determinations by IRS auditors accounts not only for overstatements but also for understatements due, for example, to lack of knowledge or documents on the part of low income taxpayers, as discussed above. If not, this estimate may exaggerate the amount of improper payments. Although this $16.9 billion amount is public, the underlying data and assumptions are not. I would be very concerned about basing policy decisions on limited studies that have not been released for rigorous professional or peer review in an area as complex as EITC overclaims.

Furthermore, focusing on "improper payments" may be disproportionate when other provisions generate significant concern. As money is fungible, overstatement of a refundable credit is economically equivalent to underpayment of tax for any other reason.[68] Either way, the IRS ends up asserting a deficiency in tax. For instance, a court case in the public record reveals that the IRS has asserted a multi-million dollar deficiency against a single large-business taxpayer for overstatement of the research credit (designed as an incentive for increasing expenditures for research and experimentation).[69] As a practical matter, IRS resources allocated to EITC are resources not allocated to potentially more productive cases, possibly leading to reduced revenue levels and customer service, as the IRS is stretched thin.

VI. EITC Overstatement Statistics Should Be Evaluated in Light of Important TAS Research Findings.

A. Previous Research

As mentioned above, TAS reported in 2004 on a study of taxpayers who had their audit results reconsidered by the IRS, concluding that

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[67] National Taxpayer Advocate FY 2004 Objectives Report to Congress 21.

[68] *See* Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit,* 52 UCLA L. Rev. 1867 (2005).

[69] *See Union Carbide v. Comm'r*, T.C. Memo. 2009-50.

> the manner in which the IRS conducts its audits of low income taxpayers impacts the audit outcomes. One can infer from the study that in many cases – 43 percent of 67,000 FY 2002 audit reconsiderations, or over 28,000 cases – taxpayers were entitled to virtually all of the EITC they claimed. That is, their original audit results did not accurately reflect their eligibility for the EITC. Rather, the audits merely show that the taxpayer flunked the IRS audit process.[70]

The IRS had assumed erroneously that certain taxpayers were not eligible for the EITC. Instead, those low income taxpayers had been confused by IRS audit procedures, notices, and documentation requirements. When TAS staff explained the requirements, reported eligibility increased. Notably, the percentage of taxpayers who received EITC increased in direct proportion to the number of telephone contacts that TAS initiated.[71]

In almost all EITC cases, the IRS conducts audits by long distance through so-called automated correspondence exams (ACE), which the IRS describes as a

> multifunctional software application that fully automates the initiation, Aging and Closing of certain Earned Income Tax Credit (EITC) and non-EITC cases. Using the ACE, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice and closing, tax examiner involvement is eliminated entirely on no-reply cases.[72]

In other words, the IRS offers no human contact with a taxpayer unless the taxpayer initiates it by calling the IRS. This approach is particularly inapt for low income workers who face literacy challenges and are often transient.[73] Moreover, correspondence is not a reliable means of communication when, for example, a recent TIGTA audit estimated that during FY 2009, approximately 19.3 million pieces of mail, or almost ten percent of all correspondence for the year, were returned to the IRS.[74]

In 2007, TAS reported on another study confirming the discrepancy between actual ineligibility and flunking an IRS audit. The study concluded:

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[70] National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, i & 9 (based on study reviewing a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003).

[71] *Id*. at 10.

[72] IRM 4.19.20.1 (01-01-2011).

[73] *See* National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low income Taxpayers Are Not Being Adequately Met*).

[74] *See* National Taxpayer Advocate 2010 Annual Report to Congress 221 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*), citing TIGTA, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail,* No. 2010-40-055, at 2 (May 14, 2010).

> Overall, more than one-quarter of taxpayers receiving an [EITC] audit notice did not understand that the IRS was auditing their return. An even larger percentage, almost 40 percent, of the respondents did not understand what the IRS was questioning about their [EITC] claim. Similarly, only about half of the respondents felt that they knew what they needed to do in response to the audit letter.[75]

The inscrutability of the IRS audit process places low income workers at a serious disadvantage, unless they are represented by an attorney, certified public accountant, enrolled agent, or other tax professional. When TAS reviewed the *entire* EITC audit population for TY 2004, it found that taxpayers who used representatives were nearly twice as likely to be found eligible for the EITC, compared with taxpayers who were not represented during the audit process. Over 40 percent of all taxpayers with representatives emerged from their audit with their full EITC intact, whereas less than one in four taxpayers without a representative kept their full EITC."[76]

B. Pilot Programs

In light of these studies, TAS and the IRS currently are conducting a pilot program to increase EITC compliance by improving communication and certain other protocols during audits. Even as the IRS generally conducts certain examinations by correspondence, the pilot program includes outbound telephone calls from IRS auditors to explain the process to taxpayers.

The pilot program involves a representative sample of taxpayers in EITC correspondence audits conducted by IRS examiners who have undergone training by, among others, the National Taxpayer Advocate and Low Income Taxpayer Clinic directors, who shared their experiences working with low income taxpayers. In a first phase, these IRS correspondence examiners are initiating telephone calls to taxpayers in the test group at two points during the examination process – about ten days after sending the initial contact letter and, for taxpayers who have not responded, just prior to issuing a statutory notice of deficiency (assessing tax due to an insufficient EITC claim).[77] During the calls, the IRS examiners explain the examination process to the taxpayers, answering their questions. To answer questions about documentary evidence, TAS has developed a list of 50 ways to prove eligibility, ranging from divorce decrees, to Section 8 Housing applications, to baptismal certificates and eviction notices.[78] TAS researchers will collect data on audit outcomes to determine whether this revision to IRS examination procedures has helped taxpayers overcome communication barriers they may be experiencing during the examination process.

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[75] National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 100, 103-104 (relating to a survey sample designed to achieve an overall accuracy of plus or minus five percent at the 95 percent confidence level).

[76] *Id*. at 96.

[77] *See* IRC § 6212.

[78] See Appendix.

During a second phase, taxpayers who did not retain all of their EITC and who did not agree to their audit outcomes will be referred to TAS. Case advocates will then attempt to contact these taxpayers to help them through the process of proving eligibility for EITC. TAS researchers will analyze the final audit outcomes after this phase to determine whether TAS assistance impacted the audit results.

Another pilot program tests the use of affidavits to establish qualifying child status. Currently, IRS audit procedures allow either official records or letters on official letterhead to document the residence requirement.[79] A proposal would allow a third-party affidavit as a documentary option. That is, third parties with knowledge of the child's residence during specific time intervals could fill out a standardized affidavit rather than write a letter.

This proposal originated in a TY 2003 IRS initiative to use affidavits to document residency of qualifying children of low income taxpayers who participated in a test of a proposed EITC pre-certification process. At that time, the IRS concluded that affidavits would be acceptable as well as convenient documentation:

> Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. *The results show that affidavits had a higher acceptance rate than the other two types of documents. In each of the tests, about one-half of the records and statements or letters were accepted compared to approximately three-quarters of the affidavits*.[80] (Emphasis added.)

The current pilot program, involving a large sample population, is designed to show the extent to which the use of affidavits reduces understatement or increases overstatement; the percentage of taxpayers who opt for affidavits to document residence; and the effect of affidavits on the efficiency of the audit process.

VII. TAS Has Proposed Improvements to the EITC and Refundable Credits.

TAS has made numerous regulatory and legislative recommendations to improve the administration of refundable credits, particularly the EITC, and to reduce improper payments without unduly burdening taxpayer rights. Of the following TAS proposals,

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[79] Form 886-H-EIC-2010 (Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child or Children) requires "photocopies of school (no report cards), medical, childcare provider (provider can't be a relative) or social service records" or "a letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of your child's parent or guardian, your child's address and the dates that they lived with you."

[80] *See* IRS, *Earned Income Tax Credit Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests,* at 14 (2008).

the first two are being addressed through ongoing regulatory action and the remaining ones merit further consideration.

A. Regulate Paid Tax Return Preparers.

Paid tax return preparers wield significant influence over EITC returns. In the past, TAS has proposed regulation of preparers through registration, competence testing, continuing education, due diligence, and enhanced enforcement.[81] In 2010, the Commissioner of Internal Revenue announced a return preparer initiative.[82] This initiative should have substantial impact on EITC compliance with preparer-prepared returns, since about two-thirds of tax returns claiming EITC benefits are completed by preparers rather than by the taxpayers themselves.[83] Moreover, the IRS has indicated that the new testing and continuing education regime would include a focus on the EITC as well as ethics in tax preparation.

B. Regulate Refund Anticipation Loans (RALs).

A refund anticipation loan (RALs) is a financial product that has developed largely in the EITC preparation market and effectively enables low income taxpayers to accelerate receipt of their tax refund at what frequently turn out to be usurious charges taken off the top by the lender when the refund arrives.[84] In the past, TAS has proposed regulation of RALs,[85] which have been statistically associated with noncompliance.[86] In 2010, the Commissioner announced curtailment of RALs by terminating dissemination of an IRS "debt indicator" that shows whether a claimed tax refund will be offset due to a debt of the taxpayer.[87]

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[81] *See* National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation*: The Time Has Come to Regulate Federal Tax Return Preparers)*.

[82] *See* IRS Pub. 4832, *Return Preparer Review* (Dec. 2009).

[83] EITC Preparer Office, *EITC Summary of Vital Statistics* (May 2011).

[84] A RAL is money borrowed by a taxpayer from a financial institution based on the taxpayer's anticipated federal income tax refund. The loan is made pursuant to a written agreement between the taxpayer and the financial institution. To apply for a RAL, the taxpayer must sign an application acknowledging that a RAL is a loan and that the loan must be repaid even if the anticipated refund is not received from the IRS. If the taxpayer's application is approved, a temporary bank account is opened in the taxpayer's name by the financial institution, and the IRS is directed to remit the taxpayer's tax refund directly to the taxpayer's account. The financial institution transfers the loan proceeds to the taxpayer. When the IRS subsequently processes the taxpayer's refund, the IRS deposits the taxpayer's refund into the temporary bank account at the financial institution. The taxpayer authorizes the financial institution to withdraw sufficient funds from the temporary bank account to pay off the outstanding RAL and any tax return preparation fees. The taxpayer grants the financial institution a security interest in his or her refund and agrees to be liable for any amounts remaining unpaid.

[85] *See* National Taxpayer Advocate 2005 Annual Report to Congress 468 (Legislative Recommendation*: Debt Collection Techniques on EITC Benefits by Refund Anticipation Loan Industry)*.

[86] *See* Karen Masken, Mark Mazur, Joanne Meikle & Roy Nord, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?* (IRS Office of Research, Analysis and Statistics, 2009).

[87] IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010).

C. Revise EITC Penalties.

In conjunction with enhanced oversight of preparers, we have recommended that penalties for facilitating EITC overclaims be increased.[88] In particular, a preparer would have to sign under penalty of perjury Form 8867 (Paid Preparer's Earned Income Credit Checklist), attaching it to the taxpayer's return to confirm compliance with certain due diligence requirements designed to ascertain eligibility. The due diligence requirements set forth in regulations are minimal and do not address the largest areas of EITC noncompliance. We have recommended that these regulations be updated to require preparers to certify, under penalties of perjury, that they have specifically inquired of the taxpayer about certain designated EITC eligibility requirements and, in some circumstances, asked to see specific documentation. We understand that the IRS is considering requiring preparers to file the existing Form 8867 with taxpayers' income tax returns and has committed to reviewing the existing due diligence requirements. We commend the IRS for these actions and look forward to working with it on the revisions.

In addition, we have recommended that Congress replace the $100 penalty for failure to comply with EITC due diligence requirements with a tiered penalty structure that increases over time with accumulated failures.

Finally, we have recommended that Congress authorize the IRS to assess a penalty on a preparer for joint and several liability (with the taxpayer) in the amount of EITC overclaim that is attributable to the preparer's intentional misstatement, misrepresentation, fraud, or deceit or any unlawful act that causes a taxpayer to incur a tax liability attributable to the EITC.

Because about two-thirds of EITC claims are prepared by tax preparers, I believe that requiring preparers to comply with enhanced due diligence requirements and imposing increased penalties on those who do not live up to their responsibilities is an efficient and effective way to reduce improper claims.

D. Accelerate the Use of Third-Party Information Reports.

Third-party information reports, such as Form W-2 (Wage and Tax Statement), are a principal tool for IRS verification of claimed income amounts. The IRS has identified "income reporting errors" as the type of error resulting in the third largest amount of EITC overstatements (after relationship and residence errors).[89] To reduce improper EITC payments, we have recommended that steps be taken to enable the IRS to

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[88] *See* National Taxpayer Advocate 2003 Annual Report to Congress 272-73 (Legislative Recommendation*: Federal Tax Return Preparers: Oversight and Compliance*).

[89] *See* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3 (Feb. 28, 2002).

receive and process information returns before it issues refunds.[90] I am very pleased that Commissioner Shulman recently embraced this vision in his annual speech at the National Press Club, and I look forward to working with the IRS to move it ahead.

E. Revise the IRS Mission Statement to Encompass Social Benefits.

We have recommended that the IRS revise its mission statement to explicitly acknowledge that its traditional role as the tax collector has expanded in recent years so that it is now both (i) collecting taxes and (ii) administering social and economic benefit programs.[91] To be clear, the IRS's role in administering benefits programs extends far beyond the EITC. Today's hearing addresses a wide range of refundable credits, and there are other benefits programs as well, including stimulus payments the IRS was directed to make in 2008[92] and the Hiring Incentives to Restore Employment (HIRE) Act, enacted in 2010, which provides incentives for small businesses to hire additional workers.[93]

There are significant differences between benefits agencies and enforcement agencies like the IRS in terms of culture, mindset, and the skill sets and training of their employees, and if the IRS is to perform both roles effectively, it must have the right mix of staffing. A dual mission statement would serve as an organizing principle toward that end, and would also make clear that the IRS will require sufficient funding to do both jobs well. Absent adequate funding, the IRS will be forced simultaneously to rob Peter to pay Paul and to rob Paul to pay Peter, and little good will come of that situation.

F. Separate Work and Family Credits.

We have recommended separating the worker portion of the EITC from the portion of the EITC attributable to family size, and then consolidating all family-related benefits. If implemented properly, this simplification initiative should reduce the incentives for fraud and simplify the substantiation process for taxpayers claiming the worker credit. As discussed above, the IRS is the best examiner of income to the extent that the EITC is based on wages, but the IRS is challenged by verification of qualifying children, who also figure in a complex web of family provisions comprising filing status, dependency exemptions, the child tax credit, and the child care credit. Under our proposal, a simplified and consolidated family credit would be separated from a work credit, reducing the high stakes currently generated by the EITC.

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[90] *See* National Taxpayer Advocate 2009 Annual Report to Congress 338 (Legislative Recommendation*: Direct the Treasury Department to Develop a Plan to Reserve the "Pay Refund First, Verify Eligibility Later" Approach to Tax Return Processing)*.

[91] *See* National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs)*.

[92] Economic Stimulus Act, Pub. L. No. 110-185, 122 Stat. 613 (2008).

[93] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

The earnings component of a credit can be easily verified through income reporting, leaving the more difficult family status eligibility verification to an isolated family credit.[94] This refundable family credit would be available to all taxpayers, not just low income ones, thereby eliminating the relatively discriminatory audit focus on low income taxpayers that exists today. Additional legislative action could help reduce improper payments, including limiting public access to the database of decedents' Social Security numbers and other personal information and authorizing use of math error authority for provisions that cap either the lifetime amount of a credit or the number of years for which a credit may be claimed.

VIII. Additional Steps Can Be Taken to Reduce Improper Payments.

A. Public Release of the Social Security Administration's Death Master File Provides Significant Opportunities for Identity Thieves to Commit to Tax Fraud and Must Be Limited.

As a form of identity theft, the IRS has identified schemes to misuse deceased taxpayers' SSNs to obtain fraudulent refunds, including the EITC. Approximately 2.4 million people die every year.[95] Thus far in 2011, the IRS has received more than 660,000 decedent returns.[96] Effective April 17, 2011, the IRS instituted business rules to filter out some of these "decedent scheme" returns. Within one month, it stopped 42,441 decedent-related returns claiming questionable refunds estimated at $194 million.[97] The IRS estimates that an additional 221,000 returns claiming $700 million in refunds would have been stopped had the business rules been in place at the beginning of the filing season.[98]

In 1980, the Social Security Administration (SSA) created a Death Master File (DMF) as a result of a consent judgment reached in a Freedom of Information Act lawsuit brought by a private citizen. In essence, the individual had argued that SSN files are government records and that a deceased individual does not retain a privacy interest in his SSN and related information.

The SSA now makes public significant personal information upon a person's death, including the decedent's full name; SSN; date of birth; date of death; and the county, state, and zip code of the last address on record. This information is now regularly

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[94] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 90 (Research Study: *Running Social Programs Through the Tax System*).

[95] U.S. Census Bureau, *The 2011 Statistical Abstract*, Table 78, Live Births, Deaths, Marriages and Divorces 1960 to 2007.

[96] TAS notes from IRS conference call on decedent schemes (Apr. 25, 2011).

[97] TAS notes from IRS conference call on decedent schemes (May 12, 2011).

[98] *Id.*

obtained and used by government agencies, credit reporting agencies, financial firms, and genealogists. Unfortunately, it is also used by identity thieves to commit tax fraud.

For tax filing purposes, the SSN of an individual may be used even after his or her death. For example, the surviving spouse of an individual who died in January of 2011 generally may file a joint return for 2011, which would require the decedent's SSN. The due date for the 2011 return, with extension, would be October 15, 2012 – 20 months after the death occurred. For that reason, the IRS cannot immediately block the use of the decedent's SSN. In the interim, however, identity thieves may troll the DMF for recent deaths and file fraudulent returns claiming refunds.

A similar type of tax fraud arises with respect to dependency claims for minor children. In one recent TAS case that the taxpayers authorized me to discuss publicly, a couple had a child who died of sudden infant death syndrome (SIDS) in 2009.[99] By law, the couple was entitled to claim the child as a dependent on their 2009 tax return. But by the time they filed their 2009 tax return in 2010, an identity thief had already filed a return claiming their child, so their claim was initially denied.

While I understand the competing policy concerns, the government's provision of all of this information in unredacted form aids and abets identity theft and tax fraud, and it is frankly appalling. It provides identity thieves with the opportunity to steal potentially billions of dollars of federal funds through fraud. It also has the effect of imposing untold burden on the innocent victims of identity theft, who often must spend hundreds of hours to prove who they are and straighten out their finances. Not insignificantly, there is also a compelling personal and emotional consequence to all this. One can only imagine how a taxpayer must feel first to lose a spouse or a child and then find out that his sense of privacy was violated by routine government release of information that allowed someone else to profit from the death and requires him to prove to an initially skeptical government agency that his spouse or child was indeed his relative and not the identity thief's.

I urge Congress and the SSA to address this problem immediately. The most comprehensive solution would be for Congress to pass legislation for the SSA similar to IRC § 6103, which prohibits the IRS from releasing taxpayer return information (including SSNs and addresses), absent explicit statutory exceptions or taxpayer consent. (If Congress proceeds along these lines, I recommend that it create a statutory exception for sharing the DMF with the IRS, so the IRS may screen for and ultimately "retire" SSNs of deceased taxpayers from its own databases.) A less comprehensive but quicker solution is for the SSA simply to truncate SSNs in the DMF and make public only the last four digits of the number. If that requires the SSA to ask the court to modify its 1980 consent judgment, it should do so.

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[99] Consent to Disclosure of Tax Return Information (signed May 20, 2011).

B. Limited Additional Use of Math Error Authority Could Reduce Both Inadvertent and Fraudulent Claims.

As noted earlier, IRC §§ 6213(b) and (g) authorize the IRS, in specific instances, to use its math error authority to summarily assess tax without first providing the taxpayer with access to the pre-payment forum of the U.S. Tax Court.

The legislative history to the early authorizations of summary assessments for mathematical or clerical errors makes very clear that this deviation from the protections of deficiency procedures was intended to be limited in scope. Math error authority was to be used only in those instances where errors were apparent on the face of the return or from information that was provided on the return.[100]

Over the years, Congress has expanded math error authority to apply where comparison of tax return entries to information contained in non-IRS governmental databases makes apparent an error on the return. One example of this expanded authority is the use of the SSA's Numident database, described above.

Use of external data, a traditional audit indicator, is not justified for summary denial when an inherently qualitative judgment is required.[101] For this reason, TAS previously recommended repealing the use of the Federal Case Registry of Child Support Orders (FCR) under math error authority for summary assessment because this database does not accurately verify a child's residence. This reasoning would apply equally to proposals to use certain state databases to determine eligibility, especially with respect to a qualifying child.[102] Applying data collected for other purposes to an EITC claim is akin to verifying addresses with a telephone directory to deny a home mortgage interest deduction. Even if virtually all of the entries in a directory were accurate, they were compiled for a different purpose, do not disprove eligibility under the tax law, were compiled at a prior date and may not be current, and should not deprive a taxpayer of a due process right to present his or her own facts.

However, there are instances where additional math error authority would help reduce both inadvertent and fraudulent claims. For example, the American Opportunity Tax Credit provides for a maximum annual credit of $2,500 for qualified post-secondary education expenditures.[103] Up to 40 percent of the credit is refundable. Because the

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[100] *See* National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*).

[101] *See id*. at 185.

[102] *See* TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 13-14 (Dec. 31, 2008) (recommending that the IRS consider "Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return"), referenced in *Reduction Targets* 9; *see also* Dept. of the Treasury, *Performance and Accountability Rept. FY 2010,* at 280 (Nov. 15, 2010).

[103] See IRC § 25A(i).

credit is available only for the first four years of a student's post-secondary education and because the number of years claimed for each student is information that is readily available from the face of the return, additional math error authority would enable the IRS to stop the improper payment of capped claims with minimal resources. We believe that a close review of recently enacted refundable and nonrefundable tax expenditures might identify additional candidates for math error authority that would protect both the taxpayer and the public fisc from improper payments without eroding vital taxpayer rights.

IX. Although There Are Additional Steps the IRS Can Take To Improve its Administration of the EITC, Some Proposals That Have Been Advanced Would Undermine Effective Tax Administration.

The EITC and other tax expenditures with refundable components tend to have complex eligibility requirements that present administrative challenges to both taxpayers and the IRS. While TAS has advanced past and pending proposals as described above, certain other recommendations for refundable credit compliance could undermine the IRS's effective administration of the tax laws.

- Removal of tolerance levels, which reflect the IRS's determination of how it can most efficiently utilize its limited enforcement resources, would likely impair the IRS's ability to maximize the collection of taxes. Because lowering or eliminating tolerances would generate a significant number of new cases for which the IRS is unlikely to receive additional funding, the IRS would have to reassign personnel from much more productive programs and leave whole areas of the tax gap unaddressed, thereby increasing the tax gap and reducing overall compliance.

- Freezing questionable refunds has been a practice predicated on the assumption that the IRS can accurately determine fraud unilaterally, but that assumption has proved to be inaccurate.[104] Based on data from 2005, the IRS Criminal Investigation division had frozen hundreds of thousands of refund claims on a suspicion of taxpayer fraud, without notifying the taxpayers involved of its suspicion of criminality or giving the taxpayers an opportunity to provide documentation to support their refund claims.[105] In FY 2005 alone, TAS received more than 28,000 such cases. The TAS Research function analyzed a statistically representative sample of those cases and found that

[104] *See* TIGTA, Ref. No. 2010-40-062, *Better Use of Available Third-Party Data Could Identify and Prevent More Than One Billion Dollars in Potentially Erroneous Refunds* 2 (Jul. 13, 2010) (recommending that the IRS "freeze refunds while contacting those taxpayers with potentially invalid EITC claims or questionable information on their tax returns"), referenced in *Reduction Targets* 9.

[105] National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem*: Criminal Investigation Refund Freezes*).

TAS ultimately persuaded the IRS that the taxpayer was entitled to all or a portion of the claimed refund 80 percent of the time.

In an EITC case, the complex requirements discussed above could generate circumstances in which a legitimate claim appears to be questionable. With respect to reported fraud by prisoners, who may claim the EITC or other tax refunds, TAS' prior review raises questions about what the IRS may assume is fraudulent. For example, a prisoner may undergo partial-year incarceration, maintaining a marriage or earning wages for months subject to required tax return reporting. These circumstances require a specific factual judgment of fraud, but the IRS relies in large part on computer programs.[106]

Moreover, fraud may be an instance of "brokered" non-compliance in which an unscrupulous preparer, perhaps spurred by expectation of RAL charges, coaches a low income taxpayer to overstate an EITC claim.[107] As Treasury economists have observed, the IRS EITC compliance study (relating to the published TY 1999 study) "does not distinguish taxpayer confusion from intentional misreporting."[108]

- Requiring a Social Security number for the ACTC would be contrary to current law, and therefore a suggestion that the IRS paid billions of dollars in refundable credits on ACTC claims that were noncompliant is inaccurate.[109] Under a 1996 amendment designed to ensure proper immigration status of EITC claimants, the tax law specifically requires reporting of SSNs for both an EITC claimant and his or her qualifying child.[110] By contrast, the child tax credit statute requires a Taxpayer Identification Number (TIN),[111] which may be an SSN or an Individual TIN or Adoption TIN assigned by the IRS.[112] Substantive amendments of the child tax credit statute enacted as recently as the American Recovery and Reinvestment Act of 2009 have left the TIN requirement intact, effectively reaffirming this requirement.[113] Congress may

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[106] *See* TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist with Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (Dec. 29, 2010) 6 ("Tax returns with a prisoner indicator are then evaluated for fraud based on predefined criteria specific to prisoner fraud").

[107] *See* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), *at* http://works.bepress.com/leslie_book/8.

[108] Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, The Crisis in Tax Administration, ed. Henry Aaron & Joel Slemrod (Brookings Inst. Press, 2002) 169.

[109] See TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* 14 (Mar. 31, 2009) ("Billions of dollars in tax credits are provided to ITIN filers without verification of eligibility").

[110] *See* IRC § 32(m).

[111] *See* IRC § 24(e); *see also* IRC § 151(e) (requiring a TIN for the dependency exemption).

[112] *See* Treas. Reg. § 301.6109-1(a)(1)(i).

[113] *See* Pub. L. No. 111-5, Div. B, § 1003, 123 Stat. 115, 313 (2009).

have had a rational basis for reaffirmation. As then-Commissioner of Internal Revenue Mark Everson (who previously had served as Deputy Commissioner of the Immigration and Naturalization Service) testified to the Committee on Ways and Means in 2006: "ITINs are issued regardless of immigration status because non-citizens may have U.S. tax return and payment responsibilities under the Internal Revenue Code."[114]

X. Conclusion

Refundable credits are unlike traditional benefits programs. The administrative costs of refundable credits are substantially lower and the percentage of the eligible population receiving benefits is substantially higher than in traditional benefits programs, yet refundable credits carry a heightened risk of improper payments. As the administrator of refundable credits, the IRS has taken and continues to take steps to minimize improper payments. I believe there are additional steps the IRS and others can take, and I have described our most significant proposals in this testimony. However, I also believe that the challenge of improper payments must be viewed in context. The estimated amount of EITC improper payments, while significant, is relatively low as compared with other components of the tax gap that the IRS is also responsible for addressing. Thus, with limited resources, the IRS must make prudent resource-allocation decisions. Lastly, based on TAS research studies, I am concerned that the EITC claims of many taxpayers are denied simply because they cannot substantiate the residence and relationship requirements of the EITC, even where those taxpayers meet the requirements. For that reason, I believe a significant portion of the improper payment estimate is attributable to taxpayers who are the intended beneficiaries of the program. That suggests the requirements should be simplified and that the IRS should be more flexible in working with taxpayers to ensure that the correct result is reached.

[114] *See* Hon. Mark W. Everson, *Testimony Before the House Committee on Ways and Means* (Jul. 26, 2006).

APPENDIX

Earned Income Tax Credit Alternative Documentation

1. Birth certificate (relationship)
2. Marriage certificate (relationship)
3. Divorce decree, separation agreement, or decree of separate maintenance (relationship)
4. Letter from an authorized adoption agency (relationship)
5. Letter from the authorized placement agency or applicable court document (relationship)
6. Custody order (relationship)
7. School records (may require 2 years since school years overlap tax years) (relationship, residency)
8. Medical records (relationship)
9. Social service records (relationship)
10. Section 8 housing applications (residency)
11. Immigration paperwork (relationship, citizenship)
12. Green card (citizenship)
13. Citizenship papers (relationship, citizenship)
14. Child care provider records (relationship, support)
15. Baptismal certificate (relationship)
16. Court document (relationship)
17. Letter on official letterhead from a school, medical provider, social service agency, placement agency official, Indian tribal official, landlord or property manager, or place of worship that shows names, common address and dates (relationship, residency)
18. Statement from any government agency verifying the amount and type of benefits you and/or your dependent received for the year (relationship)
19. Rental agreement or statement showing the fair rental value of your residence (residency, support)
20. Property tax bills (residency)
21. Mortgage receipts (residency)
22. Official mail (residency)
23. Earnings statement (residency)
24. Social Security card (citizenship)
25. Library card (residency, citizenship)
26. Utility and repair bills (proof of household expenses) with canceled checks or receipts (residency, support)
27. Clothing bills (proof of child's support) with canceled checks or receipts (residency, support)
28. Driver's license (residency, citizenship)
29. Automobile registration (residency)
30. Automobile insurance bill (residency)
31. Club memberships (residency)
32. Copies of cancelled checks for mortgage payments, rent, utilities insurance (residency)
33. Credit card statements (residency)

34. Bank statements (residency)
35. Military records (relationship)
36. Statement or records from homeless shelter (residency)
37. Eviction notices (residency)
38. Paperwork to obtain a Post Office box
39. Parole Office files (residency, relationship, citizenship)
40. Accurint (residency, relationship)
41. Magazine subscriptions (residency)
42. DDBKD (relationship, citizenship)
43. Obituary (relationship)
44. Census records (relationship)
45. Voter registration card (residency)
46. Homeowners/Renters Insurance Policy (residency)
47. Passport (relationship, citizenship)
48. Ancestry.com (relationship)
49. DNA test (relationship)
50. Alumni yearbooks (relationship)