Those Who Know, Those Who Don't, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns

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THOSE WHO KNOW, THOSE WHO DON’T, AND THOSE WHO KNOW BETTER: BALANCING COMPLEXITY, SOPHISTICATION, AND ACCURACY ON TAX RETURNS

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Table of Contents

Introduction ............................................................................................... 116
I. Refundable Credits................................................................................ 119
   A. History and Purpose of Refundable Credits .............................. 120
   B. Refundable Credits and Complexity ...................................... 123
      1. The Earned Income Credit and Child Tax Credit .............. 125
      2. First-Time Homebuyer Credit ....................................... 129
      3. Adoption Tax Credit....................................................... 130
   C. EITC on Further Review: Audit Rates, Outcomes, and
      Accuracy............................................................................... 132
II. Civil Penalties—Why and How the Service Imposes a Penalty on
    Inaccuracy ..................................................................................... 139
   A. Why Does the Code Impose Penalties? ................................. 139
   B. Section 6662: The Accuracy-Related Penalty ....................... 141
      1. Negligence or Disregard of Rules or Regulations .......... 143
      2. Substantial Understatement of Income Tax.................... 144

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C. The Reasonable Cause Defense and Other Legal Challenges to the Accuracy-Related Penalty .......................................................... 146
  1. Section 6664: Reasonable Cause Defense .................. 146
  2. Statutory Interpretation: Can a Negative Income Tax Liability Result in an “Underpayment”? ........................... 152
  3. Frozen Refundable Credits: Has the Service Ceded Ground in This Subset of Audits? ............................................. 158

III. A Fine Line: How to Deter Those Who Know Better While Not Unduly Penalizing Those Who Don’t Know ........................................... 159
  A. The Problem of Fraudulent Overclaims: “Those Who Know Better” ......................................................................................... 160
  B. Refundable Credits Are Social Benefits and Overpayments Should Be Addressed Accordingly ............................................. 163
    1. SNAP ................................................................................. 163
    2. SSI ..................................................................................... 165
  C. Solutions ..................................................................................... 168
    1. Exclude Refundable Credits from the Calculation of Underpayments .................................................................. 169
    2. Increase or Modify the Statutory Computational Threshold for a “Substantial Understatement” .............. 171
    3. Presumptive First-Time Abatement of the Penalty ............ 172
    4. Reduce Complexity to Increase Accuracy ......................... 175

IV. Conclusion ........................................................................................ 176
Refundable credits, particularly the earned income tax credit (EITC) and the child tax credit, serve an important anti-poverty measure for low-income taxpayers. Annually, millions of taxpayers who do not owe any federal income tax must file a tax return in order to claim these credits that are in the nature of social benefits. The eligibility requirements for refundable credits are complex, and these returns are particularly prone to audit: EITC audits comprise one-third of all individual income tax audits. Because of the large dollar amounts at stake, a taxpayer’s mistaken understanding of the eligibility requirements for these refundable credits can often result in a deficiency of several thousand dollars. Though studies indicate that taxpayer error is more commonly inadvertent than intentional, the section 6662 20% accuracy-related penalty applies once the deficiency reaches a statutory “understatement” threshold; it is imposed computationally and without regard to the taxpayer’s intent.

By statute, taxpayers have the right to contest the accuracy-related penalty by demonstrating that there was reasonable cause for the underlying error and the taxpayer acted in good faith. Treasury regulations provide that such a circumstance might include “an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer.” Yet for all of these reasons—lack of experience, lack of knowledge, and relative lack of education—the taxpayer is unlikely to have the knowledge or resources to raise the very defense that is meant to protect an unsophisticated taxpayer.

Drawing comparisons between refundable tax credits and social programs administered by other agencies, this article calls upon the IRS to better differentiate between inadvertent error (“those who don’t know”) and intentional or fraudulent error (“those who know better”). The article argues that the current accuracy-related penalty approach is unduly punitive. It concludes by proposing solutions that the IRS might consider in light of Congress’s desire for the Service to administer these social benefits through the Internal Revenue Code.
INTRODUCTION

Over four million words long and seeming to change unendingly, the Internal Revenue Code (“Code”) has become a complex labyrinth devoid of any coherent meaning to the average individual taxpayer. Once primarily a mechanism to raise revenue, the Code is now also used by Congress to administer social programs and deliver economic incentives. These benefits come in a variety of forms, with the refundable credit serving as a primary tool in recent years.

A refundable credit first offsets any liability due; if the credit exceeds the taxpayer’s liability, it results in a net payment to the taxpayer (hence the term “refundable”). The full cost of a refundable credit to the government is the sum of the reduction in revenue plus the outlay to the taxpayer. As a result of the congressional trend toward using the Code to administer social programs via new refundable credits, the total costs of these credits (calculated as reduction in revenue plus outlays) has soared in the last decade, peaking in tax year 2008 at $238 billion. As new credits have been introduced, dollars are not the only thing to have increased—statutory complexity has also increased. At the same time, with so much money at stake, unscrupulous activity has followed. There are numerous instances of individuals and of return preparers who have been criminally convicted for filing fraudulent returns claiming refundable credits.

Nina Olson, the National Taxpayer Advocate, connects the dots between refundable credits, complexity, and accuracy in an article in which she discusses the need to regulate the tax return preparer industry. After noting that “Congress has enacted numerous refundable tax credits, in lieu of direct spending programs, as a way of delivering social and economic benefits,” she argues for stronger measures to prevent fraudulent returns.

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2 Part I, infra, provides a more nuanced definition of refundable credit.
4 Part I, section B, infra, provides examples and statistics of this complexity.
5 Part III, section A, infra, highlights examples of such schemes.
benefits to taxpayers,” Olson comments that: “The complexity of eligibility requirements and the application process discourages taxpayers from preparing their own returns. Taxpayers who are the beneficiaries of these [refundable] credits are often the least educated and least financially sophisticated in the United States today.”

The Internal Revenue Service (“Service”) is in the unenviable position of enforcing a complex regime that pays out billions of dollars a year. To be sure, the majority of taxpayers correctly report and receive the refundable credits to which they are entitled; this article refers to these taxpayers as “those who know” because they understand the law or rely on a tax return preparer who prepares their claim correctly. On the other hand, refundable credit overclaims can be divided into two primary classifications: 1) inadvertent overclaims made by “those who don’t know,” either because they are unsophisticated and misunderstand the law or because they are preyed upon by an unscrupulous tax return preparer; and 2) fraudulent or intentional overclaims made by “those who know better.” Taxpayers in the latter group know that they are not entitled to the refundable credit, but see an opportunity to obtain a significant sum of money and perceive little risk of being caught. While it is difficult to ascertain whether noncompliance is

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6 Nina E. Olson, More Than a ‘Mere’ Preparer: Loving and Return Preparation, 139 TAX NOTES 767 (2013) [hereinafter Olson, Loving].

7 Id. at 769. Olson wrote this specific passage in the context of the need for return preparer standards to assure competency and professionalism. The preceding sentence noted that the “availability of e-filing and the magnitude and frequency of claims for refundable tax credits have combined to make tax return preparation a lucrative business for many.” With the goal of better understanding the underlying cause of errors on commercially-prepared returns, Leslie Book authored a study on the role of return preparers in facilitating taxpayer compliance; the study was included in the Taxpayer Advocate’s 2007 Annual Report to Congress. Leslie Book, Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws, in 2 NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 44 (2007).

8 While this article uses these two categories, it is important to recognize that incorrect claims arise from a spectrum of behavior that is more nuanced. Social scientists Robert Kidder and Craig McEwen set out a typology of tax noncompliance upon which Leslie Book has built in his scholarship with respect to low-income taxpayers. See Robert Kidder & Craig McEwen, Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance, in 2 TAXPAYER COMPLIANCE: SOCIAL SCIENCE PERSPECTIVES 47 (Jeffrey A. Roth & John T. Scholz eds., 1989); Leslie Book, The Poor and Tax Compliance: One Size Does Not Fit All, 51 KAN. L. REV. 1145 (2003) [hereinafter Book, One Size] (offering a detailed “typology of low income noncompliance”). This typology is helpful in deciding upon ways to prevent noncompliance. For instance, in some cases a credit overclaim may arise inadvertently as a result of an unintentional miscommunication between the
intentional or inadvertent, Service data from a number of studies have been interpreted to suggest that a significant percentage of—and perhaps most—taxpayer noncompliance is inadvertent.9

If the Code is to be used to administer social programs, consideration must be given as to what happens when a taxpayer makes an inadvertent error. In this regard, it is instructive to look at how other federal agencies tasked with administering social programs treat inadvertent and fraudulent overpayments. As currently structured, the Code distinguishes between inadvertent error and fraudulent overclaims. While the Code’s treatment of fraudulent overclaims is consistent with how other agencies respond to fraud, its treatment of inadvertent overclaims is not. In comparison, the Code is punitive toward inadvertent error. When a refundable credit is denied or reversed, the Service may impose the section 6662 accuracy-related penalty, which is a 20% addition to tax.10 If the overclaim exceeds a statutory computational threshold, the accuracy-related penalty is imposed without any consideration of the taxpayer’s intent (or lack thereof). Thus, in addition to having to pay back any refund that was issued, the taxpayer’s mistake is compounded by an extra 20%. In contrast, programs such as the Supplemental Nutrition Assistance Program (SNAP) and Supplemental

9 Nina E. Olson, Minding the Gap: A Ten-Step Program for Better Tax Compliance, 20 STAN. L. & POL’Y REV. 7 (2009); Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What’s Due: Hearing Before the S. Comm. on Finance, 112th Cong. 2–5 (2011) (statement of Nina E. Olson, National Taxpayer Advocate); Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance, 109th Cong. 4 (2006) (statement of Nina E. Olson, National Taxpayer Advocate). These sources discuss noncompliance generally, but similar conclusions have been drawn from studies examining inadvertent vs. intentional noncompliance within the specific context of earned income credit overclaims. See infra note 41.

10 I.R.C. § 6662(a).
Security Income (SSI) are not punitive in their treatment of inadvertent error.

Within the context of social programs and complexity, this Article examines and rethinks the application of the accuracy-related penalty to unsophisticated and low-income taxpayers. Part I provides a historical perspective on refundable credits, then discusses the complexity of these credits and the shortcomings of the highly automated examination process. Part II describes the accuracy-related penalty, its rationale, and the applicable defenses. In light of these, it considers why the availability of a good faith defense is an insufficient solution for the inadvertent errors that are the concern of this article. Part III acknowledges the phenomenon of fraudulent or intentional overclaims and the challenge of distinguishing these from inadvertently erroneous overclaims. It seeks guidance for the Service by analogy in examining how two other large agencies administer social benefits. Concluding that it is not justifiable to penalize a taxpayer’s innocent misunderstanding of a complex statutory regime, the article proposes solutions to more appropriately distinguish between inadvertent error and fraudulent claims.

I. REFUNDABLE CREDITS

This article focuses in particular on penalties that result from erroneously claimed refundable credits because of those credits’ importance to low-income taxpayers and because of the particular function that they serve in our tax system. Refundable credits are sometimes known as “negative income tax” because the taxpayer will receive a refund of the credit to the extent it exceeds the tax due. Unlike a deduction or a nonrefundable credit, a refundable credit functions as a payment to the taxpayer. From a government perspective, the Congressional Budget Office (CBO) treats the amount of the refundable credit that exceeds the tax liability as an outlay, while the portion that reduces the amount tax due is treated as a reduction in revenue.11

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11 CBO REPORT, supra note 3, at 1. The report notes that it was prepared at the request of the Ranking Member of the Senate Committee on Finance.
A. History and Purpose of Refundable Credits

The first refundable credit was a gasoline tax credit enacted in 1965, which was the predecessor to today’s section 34 fuel tax credit.\footnote{Excise Tax Reduction Act of 1965, Pub. L. 89-44, § 809(c), June 21, 1965, 79 Stat. 167 (1965). See I.R.C. § 39 (1965).} The gasoline tax credit had been previously available to farmers on a separate form, and Congress incorporated the credit into the individual income tax form with the intention of increasing administrative efficiency for both farmers and the Service.\footnote{S. REP. NO. 89-324, at 54–55 (1965).}

In 1975, Congress enacted the earned income tax credit (EITC),\footnote{Tax Reduction Act of 1975, Pub. L. 94-12, § 204, 89 Stat. 30 (1975). See I.R.C. § 43 (1975). The EITC is now located at I.R.C. § 32.} which was the only refundable credit for working families until the child tax credit was enacted in 1997.\footnote{Taxpayer Relief Act of 1997, Pub. L. 105-34, § 101(a), 111 Stat. 796 (1997); I.R.C. § 24. The refundable portion of the child tax credit is known as the “additional child tax credit,” but this term does not appear in the Code. See I.R.C. § 24(d). This article does not make a semantic distinction.} The EITC was designed as an anti-poverty measure,\footnote{Lawrence Zelenak, Tax or Welfare? The Administration of the Earned Income Credit, 52 UCLA L. Rev. 1867, 1903 (2005) [hereinafter Zelenak, Welfare].} and together the EITC and child tax credit provide an important safety net to low-income families.\footnote{In calendar year 2009, the EITC “lifted approximately six million individuals, including approximately three million children, out of poverty.” Internal Revenue Serv. Nat’l Taxpayer Advocate, 2011 Annual Report to Congress 296 [hereinafter Nat’l Taxpayer Advocate 2011 Report]. Lawrence Zelenak distinguishes the EITC from other anti-poverty programs because it is predicated on the recipient earning income: “[r]ather than being a pure antipoverty program, the EITC is a wage subsidy, phased in as earned income increases above zero and not phased out until earned income exceeds the annual full-time minimum wage.” Lawrence Zelenak, Tax or Welfare? The Administration of the Earned Income Credit, 52 UCLA L. Rev. 1867, 1903 (2005) [hereinafter Zelenak, Welfare].} Each credit is based on earnings, is adjusted for the number of children in the household, and is phased out at a higher income level.
certain income level. These two refundable credits remain the most significant for low-income taxpayers as well as to the U.S. Treasury. The CBO estimates that the EITC will cost the government $68 billion in 2013, of which $60 billion is the refundable portion that is counted as a budgetary outlay, the child tax credit is estimated to cost $57 billion in the same year.

More recently, Congress has introduced other types of new refundable credits as a method to temporarily incentivize spending towards particular activities that are deemed desirable, including higher education, home ownership, and adoption. These credits are based not on earnings but on expenditures. Notably, Congress created yet another refundable credit in connection with the Affordable Care Act: low- and moderate-income taxpayers who purchase health insurance through an exchange beginning in tax year 2014 will be eligible for a refundable credit to reduce the cost of the health insurance. The CBO estimates that by 2021, the refundable tax credit for health insurance will be the largest refundable tax credit.

Refundable credits, particularly the EITC and the child tax credit, are one way that the government has chosen to deliver benefits to its citizens. The CBO posits that, at least in some respects, “receiving benefits from the

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18 CBO REPORT, supra note 3, at 9–11. For a detailed explanation tracing how each credit has been increased and expanded over time, see id. at 10–11.

19 Id. at 7.

20 Id. at 10 tbl.2. The report does not provide a specific estimate showing how much of this child tax credit figure represents outlays as opposed to reduction in revenue, but the historical charts suggest the outlay percentage is significantly lower for child tax credit than for EITC. See id. at 8 fig.3. As a comparison to these figures, the total cost of the SNAP program was $78 billion in fiscal year 2012. Supplemental Nutrition Assistance Program Participation and Costs, U.S. DEPT. OF AGRICULTURE, http://www.fns.usda.gov/pd/SNAPsummary.htm (last visited Aug. 14, 2013).

21 I.R.C. § 25A.

22 I.R.C. § 36, see infra section B(2).

23 I.R.C. § 36C, see infra section B(3).

24 CBO REPORT, supra note 3, at 12.


26 CBO REPORT, supra note 3, at 8.
[Service] is simpler for people than receiving them through other federal and state agencies.\textsuperscript{27} To the extent that receiving benefits on a tax return is less burdensome, intrusive, or time-consuming than applying for other types of government benefits, there is a higher rate of participation among eligible recipients of refundable credits.\textsuperscript{28} Lawrence Zelenak has described the EITC as “a welfare program that happens to be administered through the tax system”\textsuperscript{29} while noting that self-declaring eligibility for benefits through tax filing is a “sharp contrast” with the process for applying for government benefits through other agencies, which generally require a claimant to establish eligibility to the agency prior to the receipt of any benefits.\textsuperscript{30}

Delivering government through the Code has a downside, as described by Olson, which is that the Service is not as well-equipped as other agencies to administer social benefits: “the skills and training required to administer social benefit programs are very different from the skills and training that employees of an enforcement agency typically possess.”\textsuperscript{31}

These differences, for better and for worse, result in disparate overpayment rates between the Service and other agencies: because other spending programs have more direct contact with their recipients, their overpayment rates are much lower than the Service’s overpayment rate. On the other hand, the costs for administering the benefits are also disparate. The CBO cites the example of SNAP as having a typical overpayment rate of less than 5%, with an administrative cost that is more than 9% of the

\textsuperscript{27} Id. at 17.

\textsuperscript{28} Id., noting that studies of other welfare transfer programs “show that participation declines as the complexity of the application process increases.” See also Anne Alstott, The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform, 108 HARV. L. REV. 533 (1995) (distinguishing tax-based transfer programs from traditional welfare).

\textsuperscript{29} Zelenak, Welfare, supra note 16, at 1869.

\textsuperscript{30} Id. Zelenak includes as examples both welfare programs such as food stamps (now known as SNAP), Temporary Assistance for Needy Families (TANF) and also “benefits to the middle class (such as Social Security, Medicare, and subsidized college loans).” Id. at 1873.

\textsuperscript{31} I NTERNAL REVENUE SERV. NAT’L TAXPAYER ADVOCATE, 2010 ANNUAL REPORT TO CONGRESS 24 [hereinafter NAT’L TAXPAYER ADVOCATE 2010 REPORT].
total cost of the program.\textsuperscript{32} In contrast, the EITC has an estimated overpayment rate of approximately 25%, but the cost to administer the credit is less than 1% of the total cost of the EITC to the government.\textsuperscript{33}

In Part III, this article will return to the comparison between refundable credits and the social benefits programs administered by other agencies. This Part will proceed next with a closer look at refundable credits and the problems faced by the Service in administering the regime.

\textbf{B. Refundable Credits and Complexity}

Olson has addressed the complexity of the Code and the accompanying administrative burdens on taxpayers. In her 2012 Annual Report to Congress, she identified complexity as “the most serious problem facing taxpayers—and the [Service].”\textsuperscript{34} Olson cites data showing that “there have been approximately 4,680 changes to the tax code since 2001, an average of more than one a day.”\textsuperscript{35} Olson’s report further notes: “[i]ndividual taxpayers find return preparation so overwhelming that about 59 percent now pay preparers to do it for them. . . . An additional 30 percent of individual taxpayers use tax software to help them prepare their returns, with leading software packages costing $50 or more.”\textsuperscript{36}

Recognizing that the Code is complex and preparer fees are a burden on low-income taxpayers, the Service has continued to expand its efforts at providing free income tax preparation to low-income taxpayers through its Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. Though these sites are available in many cities

\textsuperscript{32} CBO REPORT, \textit{supra} note 3, at 21, stating that “federal and state governments together spend approximately $7 billion annually to administer the program (which paid out approximately $75 billion in benefits in fiscal year 2011).”

\textsuperscript{33} Id.

\textsuperscript{34} NAT’L TAXPAYER ADVOCATE 2012 REPORT, \textit{supra} note 1, at 3.

\textsuperscript{35} Id. at n.10, citing unpublished Commerce Clearing House (CCH) data provided to TAS as of Dec. 12, 2012: “CCH advised us that its count of tax-law changes is somewhat understated, because multiple changes to a section might be grouped together and counted as a single entry on its finding lists of tax-law changes.”

\textsuperscript{36} Id. at 6.
throughout the United States, only slightly more than 2% of individual returns filed were prepared through a VITA or TCE site in fiscal year 2012. Unfortunately, free assistance may not be the lifeline of accuracy that some are hoping for: TIGTA has reported a disturbingly high error rate of 51% on the returns prepared for its auditors at IRS Volunteer Program Sites.

Studies on error rates reveal that unsophisticated taxpayers face hurdles regardless of whether they choose to self-prepare, seek out free assistance, or pay for tax return preparation. As discussed in section C below, those who do face audit on refundable credit issues discover that the process is highly automated and not very taxpayer friendly.

While it is undoubtedly difficult to measure, studies suggest that the majority of errors made in claiming the EITC are inadvertent rather than intentional, and that these errors are largely due to the complexity of the statute. Complexity has many roots, including a congressional desire to make the benefits more widely available under a variety of circumstances. Complexity is further compounded each time Congress amends the statute, even if the intention is to expand eligibility.

37 In fiscal year 2012, there were 13,143 Volunteer Tax Preparation Assistance sites. INTERNAL REVENUE SERV. 2012 DATA BOOK 47 tbl.19 (2012).

38 3,264,997 were prepared through VITA or TCE, comprising 2.2% of the 146,244,000 individual income tax returns that were filed in fiscal year 2012. Id. at 47 tbl.19; id. at 4 tbl.2.


40 See infra note 55, for a discussion of paid preparers and error rates.

41 “IRS studies have acknowledged that the complexity of EITC rules contributes to the error rates, and analysis of IRS data by Treasury experts as well as studies by outside researchers indicate that a minority of EITC overpayments result from intentional action by tax filers.” ROBERT GREENSTEIN & JOHN WANCHECK, CENTER ON BUDGET AND POLICY PRIORITIES, REDUCING OVERPAYMENTS IN THE EARNED INCOME TAX CREDIT 2 (2013). See also Leslie Book, Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System, 2006 Wis. L. REV. 1103, 1113 (2006) (citing estimates of intentional EITC noncompliance ranging from 30% to 50%); and Book, One Size, supra note 8, at 1166 (“[T]here is little data relating to how much EITC noncompliance is intentional, although there is strong anecdotal evidence that a significant amount of EITC noncompliance is caused by taxpayer ignorance or mistake.”).
For individual taxpayers, four of the most significant refundable credits from a dollar standpoint are the earned income tax credit (EITC), the child tax credit, the first-time homebuyer credit (FTHBC), and the adoption tax credit. The EITC and the child tax credit are based on earnings, have been in effect since 1975 and 1998 respectively, have been amended and expanded repeatedly since their enactment, and remain in the Code as important ongoing relief for families. The FTHBC and the adoption tax credit are based on expenditures rather than earnings, and these credits were introduced more recently only as temporary incentives. The FTHBC was available for tax years 2008, 2009, and 2010. The adoption tax credit was a refundable credit for tax years 2010 and 2011, though it was previously and is still available as a nonrefundable credit. Despite these differences, each of the four shares some common traits: each one is complex, has proven difficult for the Service to administer, and has been subject to a high audit rate. While the article focuses primarily on those low-income taxpayers who inadvertently overclaim EITC and child tax credit because those credits serve as an earnings subsidy for families, the phenomenon of unsophistication and the accuracy-related penalty extends to all four of these refundable credits.

1. The Earned Income Credit and Child Tax Credit

The EITC statute is more than 2,500 words long. The statute contains multiple eligibility requirements, many of which are cross-referenced from other Code sections. As one example, section 32(c)(3)(A) defines “qualifying child” to mean “a qualifying child of the taxpayer (as defined in section 152(c)), determined without regard to paragraph 1(D) thereof and section 152(e)).” 42 Because of the complexity, the Service created detailed instructions, worksheets, and a publication intended to explain the provision in laymen’s terms. However, even these simplified explanations are overwhelming: Publication 596, Earned Income Credit, is 62 pages long. To help taxpayers determine eligibility, the Service website provides an online tool called the “EITC Assistant.” 43

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The determination of eligibility for EITC is fairly straightforward for many taxpayers, such as a married couple with minor children who share one household. However, it quickly becomes more complicated in other cases. If the children split time among more than one household during a given year, the parents must determine the child’s “principal place of abode.” If the parents are divorced, the Code allows the custodial parent to claim the EITC even if he or she releases the dependency exemption to the non-custodial parent, in which case the non-custodial parent may be eligible to claim the child tax credit. In other cases, such as when the children’s parents are unmarried or in households in which multiple generations live together, there may be two or more taxpayers who would be eligible to claim the same qualifying child. The code does not allow this—the child can only be claimed on one return—and provides yet another set of complicated “tiebreaker” rules as to who can claim the child. One problem with these tiebreaker rules is that they presume sharing of information, such as adjusted gross income, among individuals who may not all necessarily communicate with one another about financial matters.

The EITC requirements overlap with, but do not perfectly mirror, the requirements for the three other so-called “family status” provisions in the code: the dependency exemption, head of household filing status, and the

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44 See Zelenak, Welfare, supra note 16, at 1870 (citing IRS studies indicating that “qualifying child errors” were uncommon among parents filing joint returns and single mothers).

45 I.R.C. § 152(c)(1)(B).

46 I.R.C. §§ 152(e), 32(c)(3)(A).

47 I.R.C. § 152(c)(4). For example, if the parents of an individual may claim such individual as a qualifying child but no parent so claims the individual, such individual may be claimed as the qualifying child or another taxpayer but only if the adjusted gross income of such taxpayer is higher than the highest adjusted gross income of any parent of the individual.

I.R.C. § 152(c)(4)(C).

48 For example, the unmarried parents of an infant may live with one of their sets of parents. It is possible that the infant may meet the criteria of “qualifying child” as to several people in that household, but can only be claimed by one taxpayer under the rules provided by § 152(c)(4). Without knowing the adjusted gross income of both parents and whether one of the parents claimed the infant, the grandparents cannot determine their eligibility, even though they may feel “most entitled” to claim the EITC because they pay the household bills (the EITC is not based on level of support for the child).
child tax credit.\textsuperscript{49} This leaves an unsophisticated taxpayer vulnerable to an innocent mistake on multiple fronts for an audit. Together, these provisions intersect; if all are denied, it can result in a deficiency of several thousand dollars. Among many solutions she offers in her report, Olson recommends that Congress consolidate the family status provisions as a measure to simplify the Code.\textsuperscript{50} She notes that these provisions “continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction.”\textsuperscript{51}

In addition to the complexity of the rules, there is evidence that eligibility for EITC shifts significantly from year to year, by as much as one-third of eligible taxpayers.\textsuperscript{52} Thus, it is not the same taxpayers claiming the credit from year to year; rather, “one in three EITC taxpayers each year is in a learning mode.”\textsuperscript{53}

Despite the cost, the majority of low-income taxpayers seek help with tax return preparation: according to Service data from tax year 2009, 66\% of all EITC returns were prepared by a paid preparer.\textsuperscript{54} This means, of course, that roughly one-third of EITC recipients are trying to sort through the complexities on their own. Interestingly, the one-third who self-prepare may be less likely to face an audit: fiscal year 2010 data revealed that 75\% of EITC returns selected for audit were prepared by a paid preparer.\textsuperscript{55} Olson believes this is due in part to the proliferation of unregulated return preparers. Of 79 million individual income tax returns prepared by paid

\textsuperscript{49} I.R.C. §§ 151, 2, 24. The Taxpayer Advocate refers to these Code sections collectively as “family status issues” in her Annual Report, and this article adopts this terminology.

\textsuperscript{50} \textit{1 Nat’l Taxpayer Advocate 2012 Report}, supra note 1, at 17.

\textsuperscript{51} \textit{Id.}


\textsuperscript{54} \textit{Id.} at 300.

\textsuperscript{55} \textit{Id.} at 302 n.44.
preparers in 2011, roughly half were prepared by unregulated preparers.\(^5\) Olson has long advocated for a regime to regulate return preparers and bring them under the ethical standards of Treasury Department Circular 230.\(^5\) She cites limited studies by the Government Accountability Office (GAO) and TIGTA in which auditors posing as taxpayers visiting paid preparers and found an inconsistent level of competency and due diligence procedures.\(^5\) In 2009, the Service conducted a Return Preparer Review and solicited input through the public comment process. Its resulting recommendations were published,\(^5\) and the U.S. Treasury Department (“Treasury Department”) subsequently issued regulations that are referred to collectively as the IRS Tax Return Preparer Initiative (RPI).\(^6\) Olson posited in her 2011 Annual Report that the RPI would “significantly reduce EITC error (and even fraud).”\(^6\) However, the RPI faced a significant setback in 2013 and unknown future. A federal court ruled in favor of return preparers who brought suit alleging that the Treasury Department lacks the authority to regulate return preparers unless directed to do so by Congress.\(^8\) The court enjoined the Service from mandatory enforcement of the RPI regulations, and the case is on appeal to the D.C. Circuit.\(^7\)

Section C, below, will examine the audit process for the EITC in greater detail.

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\(^5\) Olson, Loving, _supra_ note 6, at 769. “Unregulated preparers” are those paid preparers who are not subject to any professional regulation. The definition excludes attorneys, certified acceptance agents, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and state regulated tax preparers. _Id._ at 769 n.14.

\(^6\) _Id._ at 768, noting in n.4 that she had testified to Congress on this issue in 1997 and 1998, prior to her appointment as National Taxpayer Advocate.

\(^7\) _Id._ See also U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-06-563T, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, CHAIN PREPARERS MADE SERIOUS ERRORS (2006); TREASURY INSPECTOR GEN. FOR TAX ADMIN, NO. 2008-40-171, MOST TAX RETURNS PREPARED BY A LIMITED SAMPLE OF UNENROLLED PREPARERS CONTAINED SIGNIFICANT ERRORS (2008).

\(^8\) INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, PUB. 4832, RETURN PREPARER REVIEW (2009).


\(^7\) Loving v. IRS, No. 13-5061 (D.C.C. Appeal filed Mar. 29, 2013).
2. First-Time Homebuyer Credit

Enacted as a measure to stimulate the housing market, the FTHBC is a refundable credit that was narrow in scope and temporary in duration insofar as it is available one time only to a taxpayer who purchased a principal residence on or after April 9, 2008 and before May 1, 2010. The first iteration of the FTHBC was a refundable credit of up to $7,500 with a very significant string attached: the recipient was required to repay the full amount of the credit to the government, typically during a fifteen-year recapture period. Thus, the refundable credit operated as an interest-free loan. The next year, Congress increased the maximum available credit amount to $8,000, twice extended the availability period, and sweetened the incentive significantly relative to the original version: those eligible first-time homebuyers who purchased a house in calendar year 2009 and 2010 were not required to repay the credit.

As with the EITC, the FTHBC statute is long (approximately 2000 words) and complex, riddled with limitations and definitions that are cross-referenced to other code sections. As with the EITC, the FTHBC proved to be both a headache for the Service to administer and a magnet for fraudulent claims. To be sure (again, as with the EITC), some taxpayers

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64 CONGRESSIONAL RESEARCH SERVICE, R40153, THE FIRST-TIME HOMEBUYER CREDIT: AN ECONOMIC ANALYSIS (2009) (noting that the credit was intended to be temporary and was “intended to address two housing market concerns: an excess supply of homes on the market and falling prices of homes.”).


67 By October 2009, the IRS had identified over 160 potential schemes resulting in scores of criminal investigations; moreover, it had selected more than 100,000 returns claiming the FTHBC for examination. Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 2009 WL 3390198 (2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service). For example, the Service identified 580 instances of taxpayers younger than 18 years old claiming the FTHBC; these claims from minors aggregated nearly $4 million. Implausibly, the youngest claim was from a four-year-old taxpayer. Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 2009 WL 3390199 (2009) (statement of J. Russell
who “know better” made fraudulent claims. However, due to the novelty of the credit, the complexity of the statute, and the fact that the statute was amended twice shortly after originally enacted, other errors were certainly inadvertent. The Taxpayer Advocate noted these complexities in a statement to Congress in which she referred to the FTHBC as “perhaps the most significant challenge for the Service and certain taxpayers [in the 2009] filing season”:

There are three different maximum credit amounts, two different eligibility phase-outs based on adjusted gross income, two different eligible statuses (first-time homebuyer and long-time resident) with special rules for military personnel, and three different effective dates with separate eligibility dates for entering into a contract and for completing the sale. There are also age limits, home purchase price limits, and related-party rules.68

As section B of Part II will discuss, inadvertent FTHBC errors can be subject to the section 6662 accuracy-related penalty. However, even if it is determined that section 6662 does not apply, the Service can consider whether to impose the newer “erroneous claim for refund” penalty under section 6676. Part II will explain why this distinction matters to unsophisticated taxpayers.

3. Adoption Tax Credit

Like the FTHBC, the adoption tax credit is an expenditure-based credit created to incentivize behavior: by reducing the cost impediment, it was intended to encourage adoption among low- and middle-income families.69 As originally enacted in 1996, the credit was not refundable.70 An amendment in 2010 made the credit refundable for tax years 2010 and 2011 only.71 Large dollars were at stake: in tax year 2011, the maximum available credit was $ 13,360 per child adopted.
As with the FTHBC, the refundable nature of the adoption credit was novel and complex. It was difficult for taxpayers to navigate and difficult for the Service to administer. Due in large part to these challenges, a stunning 69% of returns claiming the adoption credit were selected for audit in tax year 2012. The majority of those audits were resolved in favor of the taxpayer.

While the Service was understandably concerned that such a large refundable credit would attract fraudulent claims, the Service reported in October 2011 that it “had not found any fraudulent adoption tax credit claims, and there had been no referrals of adoption tax credit claims to its Criminal Investigation unit.” This conclusion would suggest that most (possibly even all) adoption credit overclaims were made erroneously and in good faith.

Though the same concerns of unsophistication, complexity, and accuracy apply to the adoption tax credit, Part II will not include a discussion of the adoption tax credit. It does not lend itself to a good case study because the rate of imposition of the accuracy-related penalty on adoption credit overclaims is not publicly disclosed and at the time of writing the author did not locate any U.S. Tax Court opinions involving an overclaim of the refundable adoption tax credit. There is, however, reason to believe that taxpayers who did not prevail in full on audit were subjected to the accuracy-related penalty in cases in which the overclaim exceeded

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72 The rules differed depending on whether the adoption was domestic or foreign, whether the child had special needs, and the timing of the process. “Qualifying expenses” were not exhaustively defined, leaving ambiguity as to whether certain expenses should be covered. See, e.g., INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, 2011 INSTRUCTIONS TO FORM 8839 (2011), http://www.irs.gov/pub/irs-prior/i8839--2011.pdf.

73 See generally INTERNAL REVENUE SERV. NAT’L TAXPAYER ADVOCATE, MSP #7, THE IRS’S COMPLIANCE STRATEGY FOR THE EXPANDED ADOPTION CREDIT HAS SIGNIFICANTLY AND UNNECESSARILY HARMED VULNERABLE TAXPAYERS, HAS INCREASED COSTS FOR THE IRS, AND DOES NOT BODE WELL FOR FUTURE CREDIT ADMINISTRATION (2013); NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 111–33.

74 NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 111.

75 Id.

$5,000.\textsuperscript{77} Therefore, it is important to mention the adoption tax credit as an additional example of a social benefit that was administered through the Code yet treated punitively if claimed erroneously.

\textbf{C. EITC on Further Review: Audit Rates, Outcomes, and Accuracy}

In a research study of refundable credits and noncompliance, Olson critiques the design of the tax system and identifies a number of ways in which the Service currently is not well-suited to administer social benefit programs.\textsuperscript{78} She concludes that “noncompliance is not necessarily more prevalent in refundable credits than any other type of tax incentive.”\textsuperscript{79} She further concludes that “in addressing noncompliance, the traditional [Service] approach to audits and collection can undermine the very policy goals the program was designed to achieve.”\textsuperscript{80}

This section will reveal in greater detail why refundable credits, particularly the EITC and the child tax credit, are an imperfect way to deliver social benefits. These benefits are intended to assist low-income taxpayers who are, as Olson observed, “often the least educated and least financially sophisticated” taxpayers.\textsuperscript{81} The credits are complex and there are compelling reasons for the Service to regulate these programs carefully. Unfortunately the correspondence audit process used to oversee the EITC program is also imperfect and, in important respects, unsophisticated in its own right. It is highly automated, making it inefficient: for instance, the taxpayer lacks the opportunity to exchange information directly with one designated representative throughout the process. It can be painstakingly

\textsuperscript{77} Part II, infra, explains how the “substantial understatement” definition is met by a computational threshold. While anecdotal, there is evidence on adoption websites and blogs that the IRS imposed the accuracy-related penalty on adoption tax credit audits. See, e.g., http://www.nacac.org/taxcredit/faqs.html.

\textsuperscript{78} Olson names five design elements that “contribute to the level of noncompliance in refundable credit programs: (1) fact-based eligibility requirements, (2) the lack of pre-certification procedures, (3) characteristics of the target population, (4) the large size of the benefit amounts, and (5) the role of return preparers in claiming the benefit.” 2 NAT’L TAXPAYER ADVOCATE, 2009 ANNUAL REPORT TO CONGRESS 83 (2009) [hereinafter NAT’L TAXPAYER ADVOCATE 2009 REPORT VOL. 2].

\textsuperscript{79} Id.

\textsuperscript{80} Id.

\textsuperscript{81} Olson, Loving, supra note 6, at 769.
slow, with taxpayers who appeal the outcome in Tax Court and prevail typically waiting nearly a year and a half to receive a refund that might represent more than a quarter of the taxpayer’s adjusted gross income. Most troubling of all, an audit determination disallowing the family status provisions is not conclusively indicative of ineligibility and, in a significant percentage of cases, a disallowance was later determined to be incorrect upon administrative appeal.

EITC audits comprise approximately one-third of all individual taxpayer audits, with the Service examining more than half a million EITC returns annually. Taxpayers claiming the EITC are “almost twice as likely to be examined as other individual filers.” What is at stake in these audits? For many taxpayers, the proposed deficiency is several thousand dollars. In tax year 2013 the maximum EITC amount for a taxpayer with three or more qualifying children will be $6,044. If the Service is simultaneously challenging one or more of the family status provisions, this further increases the amount at stake. The child tax credit is a maximum refundable credit of $1,000 per child and each dependency exemption is a $3,900 deduction.

As will be discussed in Part II, if the understatement of tax is greater than $5,000, the Service proposes an accuracy-related penalty of 20% based on a computational formula and generally without inquiry into the taxpayer’s intent. Due to the size of the refundable credits coupled with dependency exemptions, it is not at all uncommon for a family status audit

82 NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 86.
83 See infra text accompanying notes 101, 113.
84 NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 75; NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 296, 300. See also INTERNAL REVENUE SERV. 2012 DATA BOOK, supra note 37, at tbl.9a (2012). The 2012 data show an audit rate of approximately 2% for returns with EITC, compared to a 1% rate overall. In 2012, 558,531 returns with EITC were examined, comprising 37.7% of the 1,481,966 total individual income tax returns examined. Id. at col. 2.
85 NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 300.
88 I.R.M. 20.1.5.8.3.
to result in an understatement in excess of this $5,000 computational threshold. Thus, if the Service upholds its determination, the taxpayer will owe not just the deficiency, but an additional 20% penalty and interest accrued on both amounts. The taxpayer who makes an inadvertent error is, in effect, penalized for his or her lack of sophistication in the face of a system riddled with complexity.

While the high audit rate on EITC claims is striking, it is not without reason: the Service estimated that its EITC error rate for fiscal year 2011 was between 21 and 26%, resulting in improper payments of somewhere between $13.7 and $16.7 billion. The Improper Payment Information Act of 2002 requires federal agencies to estimate the amount of improper payments made annually. The EITC program is the only program the Service has defined as “high-risk.” The Service has made little progress in reducing improper payments of EITC since it began estimating and reporting these amounts; since 2003, improper payment rates have decreased slightly (down from a high estimate of 25–30% improper payments), but the overall dollar value of the improper payments has steadily increased over time.

However, the data underlying these improper EITC payments are controversial: Olson has highlighted studies suggesting that these Service estimates “may be flawed and [are] most likely significantly overstated” in that they are based on audit results including the 70% of taxpayers who

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91 TIGTA Report 2012, supra note 89, at 1.

92 Id. at 2.

93 Id. at 5 fig.2, “EITC Improper Payments for Fiscal Years 2003 to 2011.”

do not respond to the automated correspondence audit letter.\textsuperscript{95} Olson has written and testified extensively on the flaws of the audit process, which stem in part from the highly factual nature of the credit’s requirements and the unsophistication of the taxpayers, and has pointed out that an EITC denial in many cases means that the taxpayer could not prove eligibility rather than that the taxpayer was ineligible.\textsuperscript{96}

Much has been written about the increased automation of tax administration.\textsuperscript{97} Automation affords the Service greater efficiency in a political reality defined by limited resources. But it does so at a cost to individual taxpayers, particularly the low-income taxpayer population, and one of the best examples is the EITC audit process. Almost always conducted by correspondence, the EITC audit process is highly automated.\textsuperscript{98} The Automated Correspondence Examination software processes cases “with minimal to no tax examiner involvement until a

\textsuperscript{95} NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 298 n.18 (citing fiscal year 2010 figures from the IRS Automated Information Management System).

\textsuperscript{96} See, e.g., Hearing on Improper Payments in the Admin. of Refundable Tax Credits Before the Subcomm. on Oversight, Comm. on Ways and Means, U.S. House of Representatives, 2011 WL 2036007 (2011) (Written Statement of Nina Olson):

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. 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.

\textit{Id.} at 14.


\textsuperscript{98} “In fiscal year (FY) 2010, 86 percent of individual audits were conducted by correspondence, and 42 percent concluded with no personal contact with the IRS whatsoever.” NAT’L TAXPAYER ADVOCATE 2011 REPORT VOL. 2, supra note 97, at 300. Davis-Nozemack, supra note 94, at n.178, cites the 2010 IRS Data Book tbl.9a, which shows nearly 97% of audited EITC returns were correspondence audits.
taxpayer reply is received."\textsuperscript{99} The Taxpayer Advocate has criticized this approach as “particularly inappropriate for low income workers who face literacy challenges and are often transient."\textsuperscript{100} She has also argued that the automated process “sometimes leads [the Service] to deny taxpayers the credit Congress intended them to have.” A study suggested that when the automation is revisited and the Service takes a “second look” at denied EITC claims, the taxpayer often prevails in full or in part.\textsuperscript{101}

The Taxpayer Advocate Service conducted a research study of “audit barriers” to better understand EITC audit outcomes.\textsuperscript{102} Among the interesting findings, the study revealed that the letters used in correspondence audits were not clear to the recipients: more than 25% of the EITC taxpayers it surveyed “did not understand the [Service] was auditing their return”; 39% “did not understand what the [Service] was questioning about their EITC claim”; and only 50% “felt they knew what they needed to do in response to the audit letter.”\textsuperscript{103}

Many taxpayers are unrepresented on audit,\textsuperscript{104} which compounds these audit barriers. The Taxpayer Advocate raised lack of representation as a concern based on a 2004 study showing that “taxpayers who used a representative during the audit process were nearly twice as likely to be determined EITC eligible when compared to taxpayers without representation.”\textsuperscript{105}

\begin{itemize}
\item \textsuperscript{99} NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 301 n.38.
\item \textsuperscript{100} Id. at 301. In a more recent speech, Olson characterized correspondence audits of low-income taxpayers as an approach that “den[ies] the basic humanity of the taxpayer.” Olson, Brave New World, supra note 97, at 1192.
\item \textsuperscript{101} NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 75.
\item \textsuperscript{102} 2 NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 103 (2007) [hereinafter NAT’L TAXPAYER ADVOCATE 2007 REPORT VOL. 2].
\item \textsuperscript{103} Id. at 103–04.
\item \textsuperscript{104} Davis-Nozemack, supra note 94, notes a study in which 98% of taxpayers were unrepresented during EITC examinations (citing NAT’L TAXPAYER ADVOCATE 2007 REPORT VOL. 2, supra note 102, at 102).
\item \textsuperscript{105} NAT’L TAXPAYER ADVOCATE 2007 REPORT VOL. 2, supra note 102, at 108.
\end{itemize}
Unlike field and office audits, which are conducted by Revenue Agents, correspondence audits are conducted by Tax Examiners. A Revenue Agent is required to have a four-year degree with an emphasis in accounting, while a Tax Examiner is an entry-level position that requires only a high school diploma or GED and no accounting background. Tax Examiners are trained to consult Service publications rather than the Code, regulations, or case law. They are not afforded the training to appreciate the nuances of the EITC or the discretion to accept substantiation that supports EITC eligibility yet falls outside their specified list of allowable documentation.

In most cases, the taxpayer does not contest the audit outcome and the tax is assessed against the taxpayer. Many of these taxpayers simply give up in frustration or do not understand their rights of appeal. Many do not ever reply to the notice, even though studies show that some people who do not reply are actually entitled to the credit. According to a TIGTA report, 60% of EITC audits are conducted by correspondence before the credit is paid. Of these taxpayers, nearly 70% do not respond to the audit inquiry letter, resulting in an EITC denial. A Taxpayer Advocate Service research study of audit reconsideration requests in EITC cases found that of these cases closed because there was “no response” from the taxpayer,

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106 NAT’L TAXPAYER ADVOCATE 2011 REPORT Vol. 2, supra note 97, at 76.

107 Id.

108 Id. at 77.

109 Id. at 77–78.


111 NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 82 (citing TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2011-40-023, REDUCTION TARGETS AND STRATEGIES HAVE NOT BEEN ESTABLISHED TO REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME CREDITS EACH YEAR 29 (2011)).

approximately 43% of taxpayers prevailed at audit reconsideration and had some or all of the EITC restored.\textsuperscript{113}

The small percentage of taxpayers who are savvy or persistent enough to petition the Tax Court are likely to settle their case rather than proceed to trial. To better understand why, the Taxpayer Advocate Service studied a sample of 256 Tax Court cases in which the Service conceded that the taxpayer was entitled to the EITC (though had been denied such at the audit level).\textsuperscript{114} Several interesting findings support the notion that EITC audits are inefficient and inaccurate. For instance, taxpayers often have the documentation necessary to substantiate the EITC claim, but are not successful in doing so during the automated audit process.\textsuperscript{115} In approximately 20% of the cases studied, an Appeals Officer or Chief Counsel attorney accepted documents that the Tax Examiner had rejected.\textsuperscript{116} A primary reason for this is that Tax Examiners lack the training and/or the discretion to accept the substantiation provided because the document was not specifically listed in the Internal Revenue Manual.\textsuperscript{117} In 5% of the cases studied, the Service conceded after concluding that the Tax Examiner misapplied the law\textsuperscript{118}—a significant error rate, considering the high stakes for these taxpayers.

Unfortunately, the majority of unsophisticated and unrepresented taxpayers navigate these correspondence audits without fully appreciating their rights or the availability of free counsel through the Low-Income Taxpayer Grant program. Not having read the Taxpayer Advocate reports on this subject, these taxpayers are not aware that contesting their claim in Tax Court will allow them to work with a better trained adversary who is afforded broader discretion in accepting documents to substantiate the claim. Frustrated by the process and overwhelmed at responding to a

\begin{itemize}
\item[113] \textit{Id.} at 83 (citing a study from 2004). The taxpayers who prevailed upon audit reconsideration “received on average about 96 percent of what they had originally claimed on their returns.” \textit{Id.} (citing 2 Nat’l Taxpayer Advocate, 2004 Annual Report to Congress 9 (2004)).
\item[115] \textit{Id.} at 77.
\item[116] \textit{Id.} at 89.
\item[117] \textit{Id.} at 79–80.
\item[118] \textit{Id.} at 90.
\end{itemize}
faceless bureaucracy, many taxpayers do not understand how the numbers are calculated, and many do not even realize that the Service has assessed a 20% accuracy-related penalty in addition to denying the claim. Ironically, it is this same lack of sophistication that could form a basis for requesting an abatement of that 20% penalty—if only the taxpayers knew such a defense existed.

II. CIVIL PENALTIES—WHY AND HOW THE SERVICE IMPOSES A PENALTY ON INACCURACY

Part I explored the rationales of refundable credits as social benefits and the complexity of several statutory provisions. The Service determines by audit whether it believes that the payment of a refundable credit is or was improper. As Part II will explain in detail, the Service may demand more than mere repayment of the improperly claimed credit. Upon audit, the Service often invokes section 6662 to impose a 20% accuracy-related penalty in addition to the deficiency. For refundable credits other than the EITC, if the section 6662 penalty does not apply, it is possible that a 20% “erroneous claim for refund” penalty may be imposed under the newer and less-commonly used section 6676. While this article focuses primarily on section 6662 and its defenses, it will also consider the role that section 6676 might play in non-EITC cases.

In order to gauge the appropriateness of the Service imposing the section 6662 accuracy-related penalty in the context of refundable credits, it is helpful first to understand why the penalty and its defense exist. What is the penalty meant to accomplish? When is it appropriate to impose the penalty? When is it appropriate to abate the penalty? Moreover, what does the government hope to accomplish through the imposition of penalties generally? This section will examine the Service policy statements on penalties, as well as the accuracy-related penalty and its reasonable cause defense.

A. Why Does the Code Impose Penalties?

The Service has an official policy statement on penalties. The current version is Policy Statement 20-1, which was approved on June 29, 2004. The primary thrust of the policy statement is that “penalties are used to enhance voluntary compliance by: a) demonstrating the fairness of the tax system to compliant taxpayers; and b) increasing the cost of
noncompliance.” The policy statement also states that “in order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.”

The Internal Revenue Manual notes that penalties “also serve to bring additional revenues into the Treasury and indirectly fund enforcement costs. However, these results are not reasons for creating or imposing penalties.”

The policy statement helps us to understand the Service’s view of penalties, but what about the taxpayer’s perspective? Must a taxpayer be aware of the existence of a penalty in order for it to be effective? If a taxpayer lacks a meaningful understanding of the penalty or a fair opportunity to respond, is the Service achieving the intended effect by imposing a penalty? Or is the taxpayer merely being penalized with a larger assessment without any coherent connection to the rationale for imposing a penalty? Olson expressed this concern in her 2008 Annual Report to Congress, stating that “[p]enalties cannot promote voluntary compliance if taxpayers do not understand them.”

In the correspondence exam unit, which includes almost all EITC exams, the accuracy-related penalty proposal is highly automated. The letter used to propose the penalty does not include contact information for the examiner, the examiner does not call the taxpayer to solicit any explanation for the taxpayer’s position, and the penalty is assessed automatically in cases in which the taxpayer cannot be located. This level of automation is not consistent with the Service’s own policy statement, which states:

In order to effectively use penalties to encourage compliant conduct, examiners and their managers must consider the applicability of penalties in each case, and

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119 I.R.M. 1.2.20.1.1(3).
120 I.R.M. 1.2.20.1.1(2).
121 I.R.M. 20.1.1.2.1(4).
123 NAT’L TAXPAYER ADVOCATE 2012 REPORT VOL. 2, supra note 110, at 155.
fully develop the penalty issue when the initial consideration indicates that penalties should apply. That is, examiners and their managers must consider the elements of each potentially applicable penalty and then fully develop the facts to support the application of the penalty, or to establish that the penalty does not apply, when the initial consideration indicates that penalties should apply. Full development of the penalty issue is important for Appeals to sustain a penalty and for Counsel to successfully defend that penalty in litigation.¹²⁴

This problem is compounded by the fact that low-income taxpayers do not always fully understand the correspondence audit process,¹²⁵ and because of automation they lack an opportunity to work with a designated individual throughout the process. While the audit process does afford taxpayers an opportunity to respond to a penalty, that may not be clear to an unsophisticated taxpayer. The automation of the audit process, including the process for imposition of penalties, may frustrate the purposes that penalties are intended to serve.

As section C of Part II will explore, there are various ways to challenge the imposition of the accuracy-related penalty. However, the current process is not an effective way to encourage voluntary compliance. To the extent that it penalizes unsophisticated taxpayers who error in good faith, the current process may in fact undermine perceptions of fairness. Olson has expressed concern that “undeserved penalty assessments are probably more likely to discourage taxpayers from complying by communicating that the system is unfair and that they may be penalized even if they try to comply.”¹²⁶

B. Section 6662: The Accuracy-Related Penalty

Section 6662, the modern-day “accuracy-related penalty,” was enacted in 1989 as a consolidation of several separate pre-existing penalties.¹²⁷ Prior

¹²⁴ I.R.M., supra note 119.
¹²⁵ See discussion of audit barriers, supra notes 102–03.
to its enactment, the Code provided separate civil penalties relating to accuracy, including negligence, substantial understatement, and misvaluation; however, the penalty rates varied and there was no statutory prohibition on stacking.\textsuperscript{128} The current incarnation of the accuracy-related penalty provides: “if this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.”\textsuperscript{129} Underpayment is defined in section 6664(a)\textsuperscript{30} and is expressed in Treasury Department Regulation 1.6664-2 as the algebraic formula:

\[ \text{Underpayment} = W - (X+Y - Z) \]

where

\[ W \] = the amount of income tax imposed;
\[ X \] = the amount shown as the tax by the taxpayer on his return;
\[ Y \] = amounts not so shown previously assessed (or collected without assessment); and
\[ Z \] = the amount of rebates made.

Section 6662(b) provides the list of seven instances to which a portion of an underpayment might apply.\textsuperscript{131} In fiscal year 2012, the Service subject to a 25% penalty. The accompanying House Report stated the committee’s belief “that the number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties by the IRS.” H.R. REP. NO. 101-247, at 1388.

\textsuperscript{128} H.R. REP. NO. 101-247, at 952, reprinted in 1989 U.S.C.C.A.N. 1906, at 2423. The prohibition on stacking is found in I.R.C. § 6662(b), which provides that the penalty applies to “1 or more” of the specific reasons for underpayment and further provides that § 6662 “shall not apply” when a penalty is imposed under § 6663 (relating to fraud) or § 6662A (relating to reportable transactions). See also Treas. Reg. § 1.6662-2(c) (2003).

\textsuperscript{129} I.R.C. § 6662(a).

\textsuperscript{130} I.R.C. § 6664(a) provides that an underpayment is:

the amount by which any tax imposed by this title exceeds the excess of—

(1) the sum of—

(A) the amount shown as the tax by the taxpayer on his return, plus
(B) amounts not so shown previously assessed (or collected without assessment), over

(2) the amount of rebates made.

For purposes of paragraph (2), the term “rebate” means so much of an abatement, credit, refund, or other repayment, as was made on the ground that tax imposed was less than the excess of the amount specified in paragraph (1) over the rebates previously made.

\textsuperscript{131} I.R.C. § 6662(b) provides, in relevant part:
assessed an accuracy-related penalty on more than 600,000 returns, for a total dollar amount of more than $1.38 billion. While the accuracy-related penalty is broad in its application, this article is concerned with two specific bases for imposition of the accuracy-related penalty: 1) “negligence or disregard of rules or regulations” and 2) “any substantial understatement of income tax.” The former is based on a statutory definition, while the latter is a statutory computational threshold. Thus, unlike the negligence basis, the substantial understatement basis can be justified by the Service based solely on a number, without factual development.

1. Negligence or Disregard of Rules or Regulations

Negligence is defined as including “any failure to make a reasonable attempt to comply with the provisions of this title.” “Disregard” is defined to include “any careless, reckless, or intentional disregard.” The Internal Revenue Manual defines these terms as follows:

Disregard of rules or regulations are: “Careless” if the taxpayer does not exercise reasonable care to determine the correctness of a tax return. “Reckless” if the taxpayer makes little or no effort to determine if a rule or regulation exists, under circumstances demonstrating a substantial deviation from a reasonable standard.

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:
(1) Negligence or disregard of rules or regulations.
(2) Any substantial understatement of income tax.
(3) Any substantial valuation misstatement under chapter 1.
(4) Any substantial overstatement of pension liabilities.
(5) Any substantial estate or gift tax valuation understatement.
(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.
(7) Any undisclosed foreign financial asset understatement.

132 INTERNAL REVENUE SERV. 2012 DATA BOOK, supra note 37, at 42 tbl.17.
133 I.R.C. § 6662(b)(1).
134 I.R.C. § 6662(b)(2).
135 I.R.C. § 6662(c).
136 Id.
of conduct. “Intentional” if the taxpayer knows of a rule or regulation and ignores that rule or regulation.137

The Treasury Department Regulations elaborate further on the definition of negligence and provide an exception for adequate disclosure.138 Notable to the topic of low-income taxpayers, the regulations provide that “[n]egligence is strongly indicated where . . . a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be ‘too good to be true’ under the circumstances.”139

2. Substantial Understatement of Income Tax

An understatement is “substantial” according to the following computation: “if the amount of the understatement for the taxable year exceeds the greater of—(i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) $5,000.”140 Understatement is also expressed in Treasury Department Regulation 1.6662-4(b)(2) as the algebraic formula:

$$\text{Understatement} = X - (Y - Z),$$

where

$X =$ the amount of the tax required to be shown on the return;
$Y =$ the amount of the tax imposed which is shown on the return; and
$Z =$ any rebate.

These are the two bases for the accuracy-related penalty that a low-income taxpayer is most likely to encounter. When the Service proposes the accuracy-related penalty on exam, it does not specify the particular paragraph of subsection 6662(b) that is the basis for the penalty. In other words, the taxpayer (and his or her counsel, if represented) will not know from the exam report whether the penalty is proposed for negligence or for substantial understatement.

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137 I.R.M. 20.1.5.7.2(3).

138 Treas. Reg. § 1.6662-3(b)-(c) (2003). The focus of this article is on unsophisticated taxpayers who self-prepare returns; the adequate disclosure exception is not typically implicated in these situations.


140 I.R.C. § 6662(d)(1)(A). An understatement is defined in § 6662(d)(2) to mean “the excess of—(i) the amount of the tax required to be shown on the return for the taxable year, over (ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of § 6211(b)(2)).”
Irrespective of the particular basis under 6662(b) for the imposition of the accuracy-related penalty, section 6664(c) provides a defense that taxpayers may raise once the penalty has been proposed. This so-called “reasonable cause” defense is examined in section C, below. But before turning to the defense and other legal challenges, it is useful to review the Service procedures for proposing the accuracy-related penalty.

The Internal Revenue Manual directs examiners to consider the application of penalties during the examination process, noting that the accuracy-related penalty and other penalties are “important deterrents to non-compliance.”

Some of the Code’s penalties, including the accuracy-related penalty in certain cases, can be automatically assessed; outside of these exceptions the Code provides that the examiner’s initial determination of a penalty assessment must be approved in writing by his or her immediate supervisor. In either case, the taxpayer can raise a defense during the examination process. If the underlying tax is subject to deficiency procedures, the taxpayer can also challenge an accuracy-related penalty assessment in Tax Court.

As will be discussed further in section C, the Tax Court is an impartial forum in which to contest the accuracy-related penalty. However, the burden is on the taxpayer to raise a defense to the penalty. Unfortunately, the opportunities and methods by which to challenge the accuracy-related penalty are unknown to the very people who are most likely to succeed in raising them: the unsophisticated taxpayer.

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141 I.R.M. 20.1.5.1(5). I.R.M. 20.1.5.1.5(3) also includes the fraud penalty and the erroneous claims for refund or credit penalty in its list of penalties that are “important deterrents to non-compliance.” See also I.R.M. 20.1.5.3(2).

142 I.R.C. § 6751(b)(1). Certain penalties, including those automatically calculated through electronic means, are excluded from this requirement. § 6751(b)(2). For example, if a taxpayer fails to report W2 income on his or her return, the Automated Underreporter (AUR) program will assess the accuracy-related penalty electronically. In such a case, a taxpayer still will have the opportunity to respond to the proposed penalty and raise a defense. I.R.M. 20.1.5.1.6(9).

143 See I.R.C. § 6213; I.R.M. 20.1.5.2(11).
C. The Reasonable Cause Defense and Other Legal Challenges to the Accuracy-Related Penalty

1. Section 6664: Reasonable Cause Defense

Section 6664(c)(1) provides an exception to the accuracy-related penalty, stating that “no penalty shall be imposed under section 6662” if the taxpayer shows that there was “reasonable cause” for the underpayment and that the taxpayer acted in “good faith.” In fiscal year 2012, the Service abated 58,661 accuracy-related penalties.144 According to the Treasury Department Regulations:

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer.145

The Internal Revenue Manual also specifically mentions sophistication as a factor, stating:

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. The taxpayer’s mental and physical condition, as well as sophistication with respect to the tax laws at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause. If the taxpayer is misguided and unsophisticated in tax law, but acts in good faith, a penalty is not warranted.146

This instruction in the manual presumes that an examiner is thoughtfully considering the imposition of the penalty. However, the automated nature of the correspondence audit process does not lend itself naturally to an evaluation of whether a taxpayer is “misguided and

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144 INTERNAL REVENUE SERV. 2012 DATA BOOK, supra note 37, at 42 tbl.17. Note that this figure includes not just § 6662, but also § 6662A (understatement of reportable transactions) and § 6653 (underpayment of stamp tax).
146 I.R.M. 20.1.5.6.3. (emphasis added).
unsophisticated in tax law” but “acts in good faith.” To the extent that the imposition of the accuracy-related penalty is based strictly on a computational threshold, the onus is entirely on the unsophisticated taxpayer to recognize the significance of the penalty and raise the defense.

In its 2013 report on refundable credits, the CBO cited census data in noting a correlation between refundable credits, complexity, and lack of sophistication:

The challenges arising from complexity are probably exacerbated by certain characteristics of the population toward whom refundable credits are targeted. Relative to the rest of the filing population, a higher proportion of low-income filers are likely to be high school dropouts or to be from countries in which English is not the main language.147

This concern is especially pronounced for unrepresented and unsophisticated taxpayers who face the “audit barriers” discussed in Part I148 or who do not have any personal contact with the Service during the audit.149 Thus, the reasonable cause defense presents a conundrum for the very taxpayers it is meant to benefit: if one is inexperienced, has little to no knowledge of tax law, and has relatively little formal education, how would that person know to invoke the reasonable cause defense?

In Tax Court, the burden of production is on the Commissioner to show evidence in support of its imposition of the accuracy-related penalty.150 It is, however, the taxpayer who bears the burden of proof with respect to the reasonable cause defense.151 Among other factors, the Tax Court has held that the taxpayer’s sophistication with respect to the tax laws at the time the return was filed is relevant in deciding whether the taxpayer acted with reasonable cause; if the taxpayer is unsophisticated in tax law and acts in good faith, a penalty is not warranted.152 Studies of cases

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147 CBO REPORT, supra note 3, at 18.
148 See NAT’L TAXPAYER ADVOCATE 2007 REPORT VOL. 2, supra note 102, at 103–04.
149 See NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 300.
150 I.R.C. § 7491(c).
152 See, e.g., Kees v. Comm’r, 77 T.C.M. (CCH) 1374, 1999 T.C.M. (RIA) ¶ 99,041 (1999); Collins v. Comm’r, 857 F.2d 1383 (9th Cir. 1988).
spanning all issues for which the accuracy-related penalty is imposed (not just refundable credits) and including both individual and business taxpayers (not just unsophisticated taxpayers) reveal that the Service prevails more often than not when taxpayers raise the good faith and reasonable cause defense.\(^{153}\)

How frequently does the Service assert the accuracy-related penalty in the refundable credit context? It is not known, but Olson reported that in tax year 2000 the Service “issued approximately 17,300 EITC deficiency notices involving accuracy-related penalties.”\(^{154}\)

As noted in Part I, relatively few taxpayers dispute their audit outcome in Tax Court; among those who do, the vast majority of cases are settled rather than tried and decided.\(^{155}\) For this reason, there is not a very extensive body of case law on refundable credits and the accuracy-related penalty.\(^{156}\) This article considered a small sample of cases in which: 1) the

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\(^{153}\) The Code requires the Taxpayer Advocate to identify in her annual report the ten tax issues most litigated in federal court. I.R.C. § 7803(c)(2)(B)(ii)(X). Accuracy-related penalties appear on the “most litigated” list every year, and the annual reports provide an analysis of the outcome of all identified published cases. The following figures are the percentage of cases, as reported by the Taxpayer Advocate Reports, in which the IRS prevailed in full on a 6662(b)(1) or (b)(2) claim in the fiscal year preceding the report: 2005: 68% (\textit{1 NAT’L TAXPAYER ADVOCATE, 2005 ANNUAL REPORT TO CONGRESS} 516 [hereinafter \textit{NAT’L TAXPAYER ADVOCATE 2005 REPORT}]); 2006: 68% (\textit{1 NAT’L TAXPAYER ADVOCATE, 2006 ANNUAL REPORT TO CONGRESS} 589 [hereinafter \textit{NAT’L TAXPAYER ADVOCATE 2006 REPORT}]); 2007: 65% (\textit{1 NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS} 621); 2008: 70% (\textit{1 NAT’L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS}; 2009: 82% (\textit{1 NAT’L TAXPAYER ADVOCATE, 2009 ANNUAL REPORT TO CONGRESS} 454); 2010: 69% (\textit{NAT’L TAXPAYER ADVOCATE 2010 REPORT}, supra note 31, at 452); 2011: 65% (\textit{NAT’L TAXPAYER ADVOCATE 2011 REPORT}, supra note 16, at 646); 2012: 66% (\textit{NAT’L TAXPAYER ADVOCATE 2012 REPORT}, supra note 1, at 589).

\(^{154}\) \textit{1 NAT’L TAXPAYER ADVOCATE, 2001 ANNUAL REPORT TO CONGRESS} 90. See also Carlton M. Smith, \textit{IRS Wrongly Ignores the 20 Percent Excessive Refund Penalty,} 138 TAX NOTES 973, 975–76 (2013). Extrapolating a “guesstimate” from the figure cited by Olson for tax year 2000, Smith estimates that the IRS has sought “perhaps as much as $300 million in penalties” on refundable credit disallowances since 1989 under an erroneous interpretation of the word “underpayment” in section 6664(a). \textit{Id.} at 973. Smith’s interpretation of “underpayment” is discussed in section 2 of Part II, infra.

\(^{155}\) \textit{NAT’L TAXPAYER ADVOCATE 2012 REPORT} VOL. 2, supra note 110, at 181–83.

\(^{156}\) For the period 2006–2010, “family status issues” were included in the Taxpayer Advocate’s “most litigated” list every year, with the number of family status decisions identified by TAS ranging from 34 in the lowest year to 48 in the highest year. \textit{NAT’L TAXPAYER ADVOCATE 2010 REPORT}, supra note 31, at 495. Many family status issues do not include an EITC claim. Family status issues did not appear on the top ten list in the 2011 or 2012 annual report. Instead, the 2012 report included a study of a sample of 256 Tax Court cases in which the EITC claim was conceded in full by the IRS without trial. \textit{See NAT’L TAXPAYER ADVOCATE 2012 REPORT} VOL. 2, supra notes 114–18.
primary issues were family status issues including the EITC (rather than the primary issues being unreported income or unsubstantiated business deductions); 2) the accuracy-related penalty was proposed upon exam; and 3) the court considered the reasonable cause and good faith defense. The outcomes in this sample of cases were fairly evenly mixed.

In some instances, IRS Counsel disputed the taxpayer’s eligibility for EITC and/or other family status issues at trial while conceding that the accuracy-related penalty should not apply.\(^\text{157}\)

In other cases, the taxpayer lost on his or her EITC and/or other family status claims, but the court held that the accuracy-related penalty should not apply.\(^\text{158}\) Where the record allowed for it, the Court examined the taxpayer’s intentions and efforts. For example, in \textit{Burton v. Commissioner} the court sympathetically noted that the taxpayer “cared for the children and provided financial support in a multitude of ways” while failing to meet the statutory requirements: “The law does not always reward commendable acts such as petitioner’s.”\(^\text{159}\) While the court upheld the deficiency, it did not sustain the imposition of the accuracy-related penalty. It found that taxpayer satisfied the reasonable cause exception because he “made a reasonable and good-faith attempt to comply with the technical elements of law regarding qualifying children and qualifying relatives.”\(^\text{160}\)


\(^{159}\) \textit{Burton}, 2012 WL 2000339, at *1.

\(^{160}\) \textit{Id}. at *4. In support of its finding that the accuracy-related penalty should not apply, the opinion also noted that petitioner sought help with his return; completed the applicable forms in full; and that no other taxpayer claimed the children for tax purposes.
In a number of other cases, the taxpayer lost on the EITC and/or family-status issues and the court also upheld the imposition of the accuracy-related penalty due to unfavorable facts in the record and/or the taxpayers’ failure to present evidence of good faith at trial.\textsuperscript{161}

Reliance on a tax professional can also constitute reasonable cause and good faith.\textsuperscript{162} However, tax preparation is expensive and not all taxpayers choose to use a paid preparer.\textsuperscript{163} Many low-income individuals self-prepare using free file, tax software, and/or the help of a well-meaning but equally unsophisticated friend. As noted in Part I, roughly one-third of taxpayers claiming EITC do so without the assistance of a paid preparer.\textsuperscript{164}

In a number of recent Tax Court cases, taxpayers have raised the argument that they relied on Turbo Tax software as a defense to the imposition of the accuracy-related penalty. With one notable exception, the so-called “Turbo Tax defense” has been rejected by the Tax Court.\textsuperscript{165} One of the cases in which the court rejected the defense, \textit{Morales v. Commissioner},\textsuperscript{166} involved an erroneously claimed refundable credit. The

\begin{itemize}
\item \textsuperscript{162} Treas. Reg. § 1.6664-4(b)(2) (2003) provides examples illustrating this and other examples. For an example outside the refundable credit context, see Furnish v. Comm’r, 82 T.C.M. (CCH) 821, 2001 T.C.M. (RIA) ¶ 2001-286 (2001) (“It is clear from the record that petitioner is an unsophisticated taxpayer who relied reasonably and in good faith on his accountant. Consequently, we conclude that for the years in issue petitioner had reasonable cause and acted in good faith as to any underpayment resulting from the deductions in issue.”).
\item \textsuperscript{163} Of electronically filed returns in fiscal year 2012, 63% (75,139,489 of 118,401,243 total returns) were classified as practitioner filed. \textit{Internal Revenue Serv. 2012 Data Book, supra} note 37, at 9–10 tbl.4.
\item \textsuperscript{164} \textit{Nat’l Taxpayer Advocate 2011 Report, supra} note 16.
\item \textsuperscript{165} The notable exception is Olsen v. Comm’r, T.C. Summ. Op. 2011-131, 2011 WL 5885082 (2011) (finding that taxpayer who made a data entry error acted in good faith and with reasonable cause because he “reviewed the information he entered using his tax preparation software upon completion of the software’s interview process. Despite his best efforts, however, petitioner failed to discover that the amount of the interest income did not appear on the final version of his tax return that was filed.”).
\item \textsuperscript{166} Morales v. Comm’r, 104 T.C.M. (CCH) 741, 2012 T.C.M. (RIA) ¶ 2012-341 (2012).
\end{itemize}
taxpayers claimed the FTHBC, resulting in an $8,000 credit, the maximum available amount. For purposes of the credit, a “first-time homebuyer” was defined as “any individual if such individual (and if married, such individual’s spouse) had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence to which this section applies.” The taxpayers had sold a previous residence thirty-four months prior to the purchase of their new property; as the sale was in the three-year window, the taxpayers were not eligible for the credit and the court upheld the Service’s denial. The court next considered the Service’s imposition of the accuracy-related penalty for negligence or disregard of rules or regulations, noting that this was the first case in which the Service imposed the accuracy-related penalty in the context of the FTHBC. The taxpayers raised the reasonable cause and good faith defense; they contended that they used Turbo Tax to prepare the return and the software was “responsible for them improperly claiming the first-time homebuyer credit.” Citing precedent, the court noted that “tax preparation software is only as good as the information the taxpayer puts into it” and that “the misuse of tax preparation software, even if unintentional or accidental, is no defense to penalties under section 6662.”

The reasonable cause and good faith defense is generally the one raised to challenge a section 6662 accuracy-related penalty in court. However, in the refundable credit context, challenges also have been raised on statutory interpretation grounds.

167 I.R.C. § 36(c)(1).
169 Id.
170 Id. at *6.
171 Id. (citing Bunney v. Comm’r, 114 T.C. 259, 266–67 (2000); Anyika v. Comm’r of Internal Revenue, 101 T.C.M. (CCH) 1322, 2011 T.C.M. (RIA) ¶ 2011-069 (2011); and Lam v. Comm’r, 99 T.C.M. (CCH) 1346, 2010 T.C.M. (RIA) ¶ 2010-082 (2010)). The *Morales* decision noted that the petitioners did not introduce evidence regarding the TurboTax instructions and the information they entered into the software; the decision remarked in a footnote: “We leave for another day whether reliance on tax preparation software such as TurboTax is sufficient to avoid the accuracy-related penalty where the taxpayer has provided evidence demonstrating a programming flaw or an instructional error.” *Morales*, 104 T.C.M. at *7 n.2.
2. Statutory Interpretation: Can a Negative Income Tax Liability Result in an “Underpayment”?

In three instances interpreting section 6662, the Tax Court has held that an overstated refundable credit should not be taken into account in the computation of “understatement”\(^{172}\) or “underpayment.”\(^{173}\) The result in these cases was that the court found there was no accuracy-related penalty because an underpayment did not result. The *Akhter* case drew a distinction between an overclaim that created a negative tax liability and an overclaim that merely reduced a precredit income tax liability.\(^{174}\) However, none of the three cases has precedential value because in each instance the taxpayer had elected the small case procedures.\(^{175}\)

The Service has not adopted this interpretation. The Internal Revenue Manual provides definitions in its penalty handbook stating that adjustments to refundable credits are to be included in calculating the amount of tax imposed and the amount of the underpayment.\(^{176}\) The Office of Chief Counsel adopted the same position, which it reaffirmed in 2009 in a memorandum to the service program managers:

> Because [Treasury Dept. Reg. § 1.6664-2(b) and (c)(1)] state that the calculations are to be made “without regard” to the section 31 and 33 credits, estimated payments and other payments, the “amount of tax imposed” and the “amount shown as the tax by the taxpayer on his return” should be computed


\(^{173}\) Solomon v. Comm’r, T.C. Summ. Op. 2008-95, 2008 WL 2945344 (2008) (drawing a distinction between computation of deficiency under I.R.C. § 6211(b)(4) and calculation of underpayment under § 6664(a), the court held that a refundable fuel tax credit disallowance should be included in the former but not the latter); *Akhter* v. Comm’r, T.C. Summ. Op. 2001-20, 2001 WL 1922060, at *3 (2001) (holding that the accuracy-related penalty does not apply because “there can be no underpayments . . . because for each year in issue the tax imposed by the Internal Revenue Code was zero and did not exceed the amount of tax shown on the return.” As authority, n.3 of the *Akhter* opinion states, “Compare the definition of an underpayment in sec. 6664(a) with the definition of a deficiency in sec. 6211(a). While the definitions are substantially similar, the latter—in contrast to the former—treats the excess of the earned income credit claimed (or allowed) over the tax shown (or imposed) as a negative amount of tax. See sec. 6211(b)(4).”), Id.

\(^{174}\) Akhter, 2001 WL 1922060, at *3. See also Zelenak, Welfare, supra note 16, at 1894 n.113 (phrasing the distinction as two different types of overclaims).

\(^{175}\) See I.R.C. § 7463(b).

\(^{176}\) I.R.M. 20.1.5.2.4(8).
with regard to other refundable credits, such as the FTHBC or EIC, when determining if there is an underpayment amount.\textsuperscript{177}

The same memorandum further notes that “refundable credits can be seen as payments or negative tax because these are paid to the taxpayer to the extent they exceed the taxpayer’s liability for the year.”\textsuperscript{178} It justifies its conclusions with the rationale that the accuracy-related penalty “should apply equally” to those taxpayers claiming credits to which they are not entitled regardless of whether they report positive taxable income or report $0 taxable income and $0 tax for the year.\textsuperscript{179}

For more than a decade, Chief Counsel guidance held this position both in cases in which the claim was denied pre-refund and those in which it was denied post-refund.\textsuperscript{180} As the next section will discuss, in 2012 the Office of Chief Counsel reconsidered its pre-refund (or “frozen refund”) position; this development may indeed be very significant for low-income taxpayers.

In the post-refund context, there is a test case currently pending in the Tax Court, \textit{Rand v. Commissioner},\textsuperscript{181} in which this statutory interpretation question was briefed. The taxpayers in \textit{Rand}, which is a regular case not subject to the small case procedures, claimed the EITC, child tax credit, and recovery rebate credit. After issuing the refund, the Service audited the return and determined that the taxpayers were not entitled to the amounts claimed. The taxpayers argued that section 6662 cannot be imposed on

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\bibitem{note179} \textit{Id.}

\bibitem{note180} “[F]or purposes of calculating an underpayment when there is a EITC disallowed, the underpayment amount should be the same whether the refund was issued or frozen.” I.R.S. Chief Couns. Mem. 200113028, \textit{supra} note 177, at 5.

\bibitem{note181} Rand v. Comm’r, No. 2633-11 (T.C. filed Feb. 7, 2011). As this article was going to publication, the Tax Court issued a court-reviewed opinion in \textit{Rand}; the majority position adopted Smith’s argument that the refundable credits “reduce the amount shown as the tax by the taxpayer on his return, but not below zero.” Rand v. Comm’r, 141 T.C. No. 12, 2013 WL 6063566, at *12. At this time it is not yet known whether the Service will appeal to the Seventh Circuit.

\end{thebibliography}
refundable credit disallowances. Should the taxpayer prevail on this issue, the appeal would lie in the 7th Circuit.

Carlton Smith filed an amicus brief detailing his interpretation of the applicable statutes. Both the petitioners and Smith agree that the amount of tax shown on a return cannot be a negative number. The petitioners go further than Smith, arguing that “tax” as used in section 6664(a) should not be interpreted to include account reductions for credits.

Smith disagrees. He asserts that a credit can reduce the tax to zero, but that it cannot reduce the tax to a negative number. In other words, a refundable credit is potentially comprised of two distinct portions: 1) the portion offsetting a tax due, and 2) a refundable portion that exceeds the tax. Smith’s position is that the Service cannot impose the accuracy-related penalty on the refundable portion of a credit.

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182 Brief for Cardozo Tax Clinic, Carlton Smith as Amicus Curiae Supporting Petitioners, Rand v. Comm’r, No. 2633-11 (T.C. filed Feb. 7, 2011) [hereinafter Smith Amicus Brief]. Smith, a tax law scholar, was director of the Cardozo Tax Clinic at the time of filing but has since returned to private practice.


184 Smith Amicus Brief, supra note 182, at 5–6.

185 Zelenak refers to these as the portion reducing a positive precredit income tax liability and the portion in excess of the taxpayer’s precredit income tax liability. Zelenak, Welfare, supra note 16, at 1894 n.113.

186 In coming to this conclusion, Smith relies on the doctrine of in pari materia, arguing that I.R.C. § 6664(a) should be given the same interpretation as that given to similar phrases in § 6211(a). Smith Amicus Brief, supra note 182, at 4. Smith believes the applicable precedent is the Martz case, which held that a credit shall be considered in computing a deficiency under § 6211(a). Martz v. Comm’r, 77 T.C. 749, 751–53 (1981). Smith notes that § 6211(b)(4), added to the Code in 1988, does contemplate a negative tax when the amount of the EITC exceeds the tax liability. However, he cautions that “the point of the amendment . . . was not to make refundable credits for the first time part of the deficiency calculation,” but to make the refundable portion of the credit subject to the Tax Court’s deficiency jurisdiction. Smith Amicus Brief, supra note 182, at 16–17. Absent that amendment, the Service would be able to assess a refundable credit overpayment without the taxpayer having the right to contest the assessment in Tax Court. Id. at 14. Smith notes that § 6664(a) (defining underpayment) was enacted in 1989; as this was only one year after the enactment of § 6211(b)(4), Congress could have chosen to explicitly include “negative amounts of tax” in the 6664 definition of underpayment, but it did not do so. Id. at 18. Smith interprets this failure to do so as a deliberate omission, with the result being that the Service lacks the statutory authority to impose the accuracy-related penalty on the refundable portion of a credit. Id. at 17–20. He also notes that the Treasury Department Regulation under § 6664 “says nothing about [credit overpayment amounts being treated as] negative amounts of [income] tax.” Id at 20.
In its answering brief, the Service emphasizes its position that a taxpayer should be penalized for an improperly claimed refundable credit:

If the Court adopts the interpretation of the section 6664 underpayment advocated by amicus, a taxpayer could negligently or intentionally claim a refundable tax credit in any amount (in this case, $7,471) when he is in fact ineligible for that credit, yet still only be liable for a nominal penalty that is not tied in any fashion to the amount of the improper credit.\textsuperscript{187}

This call for a penalty (in addition to repayment of the improperly claimed portion) goes to the heart of Zelenak’s observations about the EITC as a program with “self-declared eligibility”\textsuperscript{188} while other social benefit programs require an agency determination in advance of payment, refundable credits are available to anyone who claims them and must be policed by limited audit enforcement. The stated concern about a taxpayer who could “intentionally” claim a credit for which he is ineligible is misplaced hyperbole, as it blatantly disregards section 32(k), which allows the Service to impose a two-year ban on claiming the EITC when it is determined that a taxpayer recklessly or intentionally disregarded the EITC rules.\textsuperscript{189} A two-year ban for someone who may be otherwise eligible for the EITC would constitute a “penalty” of several thousand dollars—far from nominal.

The Service in \textit{Rand} further argues that an accuracy-related penalty in such a case is necessary “to properly reflect the tax harm of the wrongfully-claimed credits.”\textsuperscript{190} Recall the Service’s policy statement on penalties, which states that “penalties encourage compliance by: 1) demonstrating the fairness of the tax system to compliant taxpayers; and 2) increasing the cost of noncompliance.”\textsuperscript{191} The “tax harm” argument advanced in \textit{Rand} seems to go beyond enhancing voluntary compliance, suggesting rather that the penalty can or should serve an expressive rationale.

\textsuperscript{187} Respondent’s Answering Brief to Brief for Amicus Curiae Cardozo Tax Clinic at 5, Rand v. Comm’r, No. 2633-11 (T.C. filed Feb. 7, 2011) [hereinafter Respondent’s Answering Brief].


\textsuperscript{190} Respondent’s Answering Brief, supra note 187, at 8.

\textsuperscript{191} I.R.M. 1.2.20.1.1.(3).
In his legal scholarship, Smith wonders why the Service seems to be ignoring a newer penalty section, enacted in 2007: the section 6676 “erroneous claim for refund or credit” penalty. Smith believes the Service may view section 6676 as “unnecessary because it thinks it can already get a 20 percent accuracy-related penalty in nearly every income tax case in which it could get the section 6676 penalty.”

The Treasury Department has not yet promulgated regulations on section 6676, but the Office of Chief Counsel has provided its interpretation as to how the newer penalty intersects with section 6662 in the FTHBC context. The guidance notes that “[t]he key to identifying which of the penalties applies to a taxpayer erroneously claiming a refund or credit is to first determine if his reporting creates an underpayment on his return.” In its examples, the Service includes the refundable credits in its calculation of

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192 Smith, supra note 154. I.R.C. § 6676 provides, in relevant part:

(a) Civil Penalty.—If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a penalty in an amount equal to 20 percent of the excessive amount . . .

(b) . . . the term “excessive amount” means . . . the amount by which the claim for refund or credit for any taxable year exceeds the amount of such claim allowable . . .

(c) Coordination with Other Penalties.—This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.

193 Smith, supra note 154, at 973. Smith points to the fact that Congress carved the EITC out from § 6676 as support for his statutory interpretation of “underpayment” in § 6664(a), arguing that Congress “did not want a 20 percent penalty imposed on EITC disallowances—under § 6662, 6663, or 6676—on top of the money that was erroneously paid to the taxpayer and must be reimbursed.” Id. at 978. Smith continues: “Congress apparently decided that the sanction it imposed at § 32(k) on people who incorrectly claim the EITC is a better sanction than simply adding on a 20 percent penalty against a low-income taxpayer who is probably unlikely to pay back the improper EITC or any penalty.” Though it is not clear that Congress was so intentional in its thinking, Part III of the article concludes that § 32(k) should be the sole and appropriate sanction for “those who know better.”

194 Program Manager Tech Adv. Mem. 2011-003 (Aug. 27, 2010). The guidance was subsequently revisited in Program Manager Tech. Adv. Mem. 2012-16, which revised its examples to the extent they involved frozen refunds. However, the 2010 guidance presumably would still apply to non-frozen (post-refund) credits.

the underpayment. It advises that if an underpayment exists, the examiner must first determine whether the section 6662 accuracy-related penalty applies on a theory of negligence or disregard or substantial understatement. If so, section 6676 cannot apply; if, however, there is no basis for imposing the section 6662 penalty, the examiner should consider whether section 6676 may apply. 196

Olson has criticized section 6676 as “overbroad” and noted that its “reasonable basis” exception is not the same as the “reasonable cause” defense permitted in section 6662. Olson has recommended that Congress should amend section 6676 to add such a “reasonable cause” defense for taxpayers who make an inadvertent error when claiming a non-EITC refundable credit. 197 Olson’s concern stems in part from the fact that—unlike section 6662, which is an addition to tax—section 6676 is an assessable penalty, meaning a taxpayer does not have recourse in Tax Court through a deficiency proceeding. 198

In the event that the taxpayers prevail in Rand and the Tax Court agrees that an “underpayment” should not include the refundable portion of a credit, this will be great precedent for future litigants challenging the imposition of the penalty, especially in EITC cases. But the average taxpayer will not know about Rand. Unsophisticated taxpayers will benefit only if the Service acquiesces and changes its policy at the examination level or, alternatively, if Congress clarifies the definition by amending the statute. Meanwhile, however, even if it is determined that a denied refundable credit does not constitute an “underpayment,” those credits other than the EITC will remain vulnerable to the imposition of a 20% penalty under section 6676.

196 Id. at 9–10.
198 NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 547 (citing I.R.C. § 6671 and I.R.M. 8.11.1.2). However, a taxpayer would be able to pursue prepayment review of a section 6676 penalty in Tax Court within the context of a collection due process hearing.
3. Frozen Refundable Credits: Has the Service Ceded Ground in This Subset of Audits?

To help prevent improper payments, the Service will commonly hold or “freeze” the EITC portion of a refund, meaning the taxpayer is selected for audit and the refund is not paid out unless and until the taxpayer substantiates entitlement for the credit. These are referred to by the Service as “pre-refund examinations.” As noted in Part I, frozen refunds are more common than not in the EITC context. Until recently, the Service took the position that the accuracy-related penalty applied in the refundable credit context even when the Service froze the refund. Thus even though the taxpayer never received the credit at the heart of the deficiency, the Service nonetheless imposed the 20% accuracy-related penalty.

In 2012, the Chief Counsel’s Office reconsidered its position and recommended that the Service “treat a FTHBC, EI[T]C or other refundable credit which has not been refunded or credited to the taxpayer, i.e. a frozen refund, as an ‘amount not so shown previously assessed (or collected without assessment)’(variable Y).” The guidance further states:

If the Service has not refunded or allowed a credit to the taxpayer for the erroneously or fraudulently claimed FTHBC or EI[T]C, absent additional circumstances, the amount of such credit is added to Y because it is a sum collected without assessment. For most taxpayers the net result will be that X and Y cancel each other out and consequently no “underpayment” exists.

This advice is particularly significant for EITC claims that are denied. However, the guidance notes in its non-EITC examples that while the application of this formula may not result in an “underpayment”

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200 A TIGTA study found that 60% of EITC exams are audits that occur by correspondence before the refund is paid. See NAT’L TAXPAYER ADVOCATE 2011 REPORT VOL. 2, supra note 97, at 82.
202 The Internal Revenue Manual has been updated in at least one place to reflect this guidance. See I.R.M. 25.1.14.5. However, the definition of underpayment in the Penalty Handbook section of the Internal Revenue Manual has not yet been updated at the time of writing, at least not publicly. I.R.M. 20.1.5.2.4(8).
for section 6662 purposes, “the Service may wish to consider applying the penalty of 6676 to [a taxpayer who makes] an excessive refund claim.”

The 2012 Chief Counsel guidance notes the pending Rand case and distinguishes it as a post-refund case. The guidance applies only to frozen refund cases and is therefore not applicable to Rand and the significant percentage of claims that are audited after a refund is issued.

While it is interesting to examine the case law on the reasonable cause defense and the challenges to the definition of “underpayment,” it is important to keep in mind that most examinations are not resolved by trial. Many taxpayers concede or do not contest the examination of the underlying credit or respond to the subsequent Notice of Deficiency, so the cases do not go to IRS Counsel for trial. Among those unsophisticated taxpayers who are unrepresented, it is possible that many do not understand that the accuracy-related penalty has been imposed, let alone know about the possible defenses. For these reasons, Part III proposes solutions that are both statutory and administrative-based.

III. A FINE LINE: HOW TO DETER THOSE WHO KNOW BETTER WHILE NOT UNDULY PENALIZING THOSE WHO DON’T KNOW

To be sure, the availability of refundable credits attracts fraud. There are many documented cases of individuals who clearly “knew better” than to claim a credit that was subsequently disallowed. The Service should and does scrutinize claims in order to minimize improper payments. But in doing so, it should be careful not to unduly penalize those taxpayers who “don’t know” simply because they do not understand the complexities or appreciate the nuances of the Code. Congress already has provided the Service with statutory tools to address both reckless disregard and fraudulent behavior. By drawing a clearer line between inadvertent error

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204 Id. at 9.
205 Olson notes in a research study entitled Running Social Programs Through the Tax Code: “[T]he data do not necessarily support the position that the refundability component actually attracts or influences noncompliance more than any other type of tax incentive. The amount of the benefit and the relative ease with which it can be obtained appear to be more significant factors.” NAT’L TAXPAYER ADVOCATE 2009 REPORT VOL. 2, supra note 78, at 82.
and intentional wrongdoing, the Service can accomplish the policies underlying the penalty regime without undermining faith or trust in the revenue system. This Part will look at existing tools for combating fraudulent claims, draw comparisons with other social benefit programs, and propose new solutions for protecting the unsophisticated taxpayers.

A. The Problem of Fraudulent Overclaims: “Those Who Know Better”

TIGTA notes that “the [Service] has found that refundable credits of significant amounts attract fraud and fraudulent preparers.” Schemes are hatched. Individuals claim children who do not exist. Clearly, these claimants know that they are not entitled to the benefits, but are looking for easy money. In the most egregious cases, criminal charges are brought. For example, a California man was sentenced to 54 months in prison and ordered to pay restitution to the Service for his participation in a scheme in which he filed more than 1,000 false returns seeking $1.3 million in EITC refunds. If criminal charges are not warranted, the Service might consider pursuing civil fraud penalties via section 6663 of the Code, which is a 75% rather than a 20% penalty. The burden of proof is significantly higher for the Service to prevail on a fraud penalty than on the accuracy-related penalty.

Section 32(k) provides other tools for the Service to address those taxpayers who “should know better.” Section 32(k)(1) permits a 2-year

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209 “The Commissioner must prove by clear and convincing evidence that the taxpayer intentionally engaged in wrongdoing with the specific intent to avoid a tax that he knew to be owing.” Id. at 5, citing Akland v. Comm’r, 767 F.2d 618, 621 (9th Cir. 1985), aff’g 46 T.C.M. (CCH) 51.

210 Section 32(k), enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1085(a)(1), 111 Stat. 788 (1997), provides the following addition to the earned income credit section:
EITC ban if the Service determines that the claim was due to reckless or intentional disregard of rules and regulations, or a 10-year ban if it is determined that the claim was due to fraud. The bans track the criteria for negligence under 6662 (the 2-year ban) and civil fraud under 6663 (the 10-year ban), though either ban can be imposed in the absence of (or in addition to) the penalties. Unlike the section 6662 accuracy-related penalty, these bans require the Service to develop a factual record in support of its action. The Internal Revenue Manual provides detailed guidance as to how to develop these cases and decide on whether the 2 or 10-year ban might be appropriate. For instance, the Internal Revenue Manual provides an “if . . . then” chart with non-inclusive examples of when to impose the 2-year ban. The chart includes these examples, among others:

If this is the first year EITC audit for the taxpayer, then a ban usually is not imposed for the first year UNLESS the taxpayer establishes

(k) Restrictions on taxpayers who improperly claimed credit in prior year.

(1) Taxpayers making prior fraudulent or reckless claims.

(A) In general. No credit shall be allowed under this section for any taxable year in the disallowance period.

(B) Disallowance period. For purposes of paragraph (1), the disallowance period is—

(i) the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer’s claim of credit under this section was due to fraud, and

(ii) the period of 2 taxable years after the most recent taxable year for which there was a final determination that the taxpayer’s claim of credit under this section was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

(2) Taxpayers making improper prior claims. In the case of a taxpayer who is denied credit under this section for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no credit shall be allowed under this section for any subsequent taxable year unless the taxpayer provides such information as the Secretary may require to demonstrate eligibility for such credit.

211 I.R.M. 20.1.5.2.1.

blatant disregard for the rules and regulations. Example: During a conversation, the taxpayer admits he/she knew they did not meet the eligibility requirements but decided to “try it anyway.” In this instance, the ban would be justified because the taxpayer intentionally disregarded the rules and regulations.

If a decedent’s SSN is used for a qualifying child and the person died before the year under examination, then based on facts and circumstances presented apply the two-year ban.

If the technician can determine the taxpayer’s claim was due to reckless or intentional disregard rather than misunderstanding or confusion of the rules, then the two-year ban should be imposed.

The taxpayer is claiming different qualifying children each year and, when asked to identify the qualifying children, the taxpayer does not know who they are claiming, then the two-year ban should be imposed.213

Interestingly, all of these examples require the examiner to delve into the facts surrounding the claim and show bad faith before imposing the negligence/disregard ban. In these examples, the Service is developing facts to demonstrate that the taxpayer “knew better.”214 While a 2-year ban is a harsh outcome for a claimant, such a penalty is arguably warranted if the taxpayer is acting in bad faith. Importantly, the onus is on the Service to show the bad faith before imposing a ban. Contrast this to the section 6662 20% accuracy-related penalty, which can be imposed on a taxpayer by a statutory calculation without any showing of bad faith; in those cases, the onus is on the taxpayer to prove good faith, but due to automation and other audit barriers, it is commonly the case that the taxpayer’s story will not be heard.

Statutory tools exist for the Service to penalize those who know better. It should use them. It is important, however, to distinguish and protect those taxpayers who make inadvertent errors. This is particularly true in the

213 Id.
214 The manual also provides detailed guidance on when to impose the 10-year ban, including examples of fraud indicators in EITC cases. Id. at (8). As noted, development of a 10-year ban case more closely parallels the § 6663 civil fraud penalty.
context of refundable credits because these taxpayers are trying to access social benefits that Congress chose to make available in the Code.

B. Refundable Credits Are Social Benefits and Overpayments Should Be Addressed Accordingly

Olson has analogized refundable credits to claims for other federal benefits, stating that for those taxpayers, filing a Form 1040 “is no different from an advance application for veterans’ benefits or food stamps.” So how do other agencies that distribute social benefits address overclaims?

Like the Service, other agencies are very concerned with identifying fraudulent overpayments. In some contexts, fraud results in the suspension of benefits, similar to the 2- and 10-year EITC ban, or even termination in benefits after repeated offenses. As with refundable credits, fraud can sometimes result in criminal charges including imprisonment.

More instructive for purposes of this article is the way other agencies treat inadvertent error. This part will draw comparisons among refundable credits and two other federal social programs: the Supplemental Nutrition Assistance Program (SNAP) and Supplemental Security Income (SSI). In all three contexts, a recipient may be required to repay amounts that were overpaid due to inadvertent error of the recipient. Hardship exceptions may apply: the rules vary depending on the type of benefit. But in comparison to the other two programs, the Internal Revenue Code is far more punitive with regard to inadvertent error.

1. SNAP

The program formerly known as food stamps, SNAP is operated by the states but funded federally and overseen by the United States Department of

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215 Olson, Loving, supra note 6. See also Zelenak, Welfare, supra note 16.

216 In comparing the EITC 2- and 10-year sanctions with the civil sanctions imposed for the Temporary Assistance for Needy Families (TANF) and food stamps (now known as SNAP) programs, Lawrence Zelenak concluded: “The EITC [2- and 10-year ban] sanctions much more closely resemble sanctions for misbehavior in connection with welfare programs (TANF and Food Stamps) than they resemble generally applicable income tax penalties.” He noted, however, that the EITC ban sanctions “have been applied very sparingly” as compared to the welfare civil sanctions. Zelenak, Welfare, supra note 16, at 1893–96.
Agriculture (USDA). The Food and Nutrition Service (FNS) is charged with overseeing accuracy, and it monitors the states’ implementation for quality control.217 Under federal regulation, FNS delegates administration to the states, including “the authority to determine the amount of, and settle, adjust, compromise or deny all or party of any claim which results from fraudulent or nonfraudulent overissuances to participating households.”218 Overissuances are categorized in one of three ways: 1) Intentional Program Violation (IPV); 2) Inadvertent Household Error (IHE); or 3) Agency Error (AE).219

An IPV includes a knowledge element; it is defined as when a recipient has “intentionally made a false or misleading statement, or misrepresented, concealed or withheld facts.”220 IPVs can result in disqualification from the program, but the recipient is first entitled to an investigation, notice, and hearing.221 The intentional wrongdoing must be established by clear and convincing evidence.222

On the other hand, an IHE is defined as a “claim for an overpayment resulting from a misunderstanding or unintended error on the part of the household.”223 After finding an IHE or an AE (an overpayment caused by the state’s action or failure to take action), the state agency must pursue repayment but is limited to collecting “the greater of $10 per month or 10 percent of the household’s monthly allotment, unless the household agrees to a higher amount.”224

To draw the analogy to refundable tax credits, an IPV would be committed by “those who know better” whereas an IHE would be an erroneous claim made by an unsophisticated taxpayer. Like fraudulent

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218 7 C.F.R. § 271.4(b) (2013).
219 Id. at § 273.18(b).
220 Id. at § 273.16(c).
221 Id. at § 273.16.
222 Id. at § 273.16(e)(6).
223 Id. at § 273.18(b).
224 Id. at § 273.18(g).
EITC claims, an IPV can result in program disqualification. A recipient shown to have committed an IPV is disqualified from the program for 12 months for a first violation, for 24 months for a second violation, and permanently for a third violation.\(^{225}\)

Like inadvertently erroneous refundable credit claims, the agency will require repayment of an overissuance due to an IHE. It will not, however, impose any additional penalty for the error.

2. SSI

SSI is the “nation’s largest cash assistance program for the poor.”\(^{226}\) Administered by the Social Security Administration, the SSI program provides monthly benefits to people with limited income and resources who are disabled, blind, or age 65 or older.\(^{227}\) Unlike Social Security benefits, SSI eligibility is not based on work history and is not funded by social security (FICA and SECA) taxes.\(^{228}\) In 2011, the program paid $46 billion to 9 million recipients.\(^{229}\)

As with EITC eligibility, eligibility for SSI is determined by complex and changing factors such as income levels and living arrangements.\(^{230}\) As with the EITC and other social benefit programs, overpayments are a concern.\(^{231}\) The statute and regulations governing SSI distinguish between

\(^{225}\) Id. at § 273.16(b). Penalties are increased if certain aggravating conditions are present, such as controlled substances, firearms, or trafficking.

\(^{226}\) U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-02-849, PROGRESS MADE IN DETECTING AND RECOVERING OVERPAYMENTS, BUT MANAGEMENT ATTENTION SHOULD CONTINUE 1 (2002) [hereinafter GAO 02-849].

\(^{227}\) SOCIAL SEC. ADMIN., NO. 05-11000, SUPPLEMENTAL SECURITY INCOME (SSI) 4 (2012).


\(^{230}\) Id.

\(^{231}\) GAO 02-849, supra note 226, at 4. “Since its inception, the SSI program has been difficult and costly to administer because even small changes in monthly income, available resources, or living arrangements can affect benefit amounts and eligibility…. SSA must constantly monitor these situations to ensure benefit amounts are paid accurately.”
fraudulent and nonfraudulent causes of overpayment. For purposes of an analogy with the accuracy-related penalty, this discussion will focus solely on nonfraudulent overpayments.  

Nonfraudulent overpayments occur when there is a change in circumstance that affects the recipient’s payment level or eligibility. The recipient may be required to fully repay the overpayments through adjustment to future benefits, in which case monthly limitations may apply to the adjustment. There are also exceptions in which the agency will waive repayment of the overpayment; in fiscal year 2011, approximately 76% of the 276,226 SSI overpayment waivers requested by recipients were approved by SSA.

To help prevent overpayments from occurring, SSI recipients are required to report certain events or changes in circumstance affecting eligibility within 10 calendar days after the end of the month in which the change occurred. If the failure to make a required report in a timely manner results in an overpayment, a penalty applies. According to the GAO, these penalties “are meant to encourage recipients to file accurate and timely reports of information so that SSA can adjust its records to correctly pay benefits.” This penalty can be analogized to an accuracy-

232 SSI fraud is determined under a “knowing and willful” standard, can be criminally prosecuted, and can be punished by imprisonment of up to 5 years. 42 U.S.C. § 1383(a)(a) (2013). The regulations provide civil sanctions for making false or misleading statements or withholding information, including suspension of benefits. 20 C.F.R. § 416.1340 (2013). This regulation includes a “know or should know” standard, which can be interpreted as more than an inadvertent error but less than fraudulent intent. Because it involves an affirmative misstatement or material nondisclosure, this could perhaps be analogized to the reckless disregard grounds for the 2-year EITC ban.


234 42 U.S.C. § 1383(b)(1)(B)(i) (2013); 20 C.F.R. § 416.550 (2013). For example, adjustment or waiver may be granted upon a finding that the recipient is “without fault [in the receipt of the overpayment] and adjustment or recovery of the overpayment would defeat the purpose of the supplemental security income program.” 20 C.F.R. § 416.553 (2013).

235 GAO 13-109, supra note 229, at 14.

236 42 U.S.C. § 1383(e)(1)(B)(i)(2) (2013). See also 20 C.F.R. § 416.708 (2013). The regulations provide a list of 14 different reportable events or changes. Like the EITC requirements, some of the changes hinge on factually intensive situations that for some households are fluid. For example, a recipient must report "any change in the make-up of your household. That is, any person who comes to live in your household and any person who moves out of your household.” § 416.708(b).


238 GAO 02-849, supra note 226, at 13.
related penalty in the sense that recipients may inadvertently fail to report a change due to a misunderstanding of the rules. However, there are two important distinctions to note in making this analogy: 1) the dollar amount of the applicable penalties is far less severe; and 2) as with section 6662, there is a “good cause” exception for the failure to timely report a change.

With the EITC and other refundable tax credits, the accuracy-related penalty is 20% of the underpayment of tax.\textsuperscript{239} Because of the large dollar amounts at stake with these refundable credits, the dollar amount of the penalty will exceed $1,000 in many cases. In contrast with this figure, the penalty for failure to timely report events or changes in circumstances affecting SSI eligibility is stunningly modest: $25 for the first penalty period; $50 in the second penalty period; and $100 for the third and any following penalty period.\textsuperscript{240}

The statute and regulations further provide that there will be no penalty deduction from SSI if the agency finds the recipient had “good cause for failure to report timely.”\textsuperscript{241} “Good cause” includes a finding that the recipient is “without fault” or that the failure or delay in reporting was “not willful.”\textsuperscript{242} The regulations provide: “In determining whether you have good cause for failure to report timely, we will take into account any physical, mental, educational, or linguistic limitations (including any lack of facility with the English language) you may have.”\textsuperscript{243}

Drawing analogies between the Code’s treatment of inadvertent error and the ways in which other programs and agencies treat error is enlightening. Important distinctions persist, and the comparison should not be overstated. While the EITC is a safety net designed to help lift working persons out of poverty, SSI and SNAP are designed as a safety net for basic subsistence. Thus, it is quite arguably more appropriate for the agencies administering those benefits to error on the side of leniency.

\textsuperscript{239} I.R.C. § 6662(a).
\textsuperscript{240} 20 C.F.R. § 416.724 (2013).
\textsuperscript{241} Id. at § 416.732.
\textsuperscript{242} Id. at § 416.732(a).
\textsuperscript{243} Id. at § 416.732(b).
Another obvious distinction is the method of obtaining the social benefits. As discussed in section A of Part I, taxpayers claiming a refundable credit self-declare their eligibility, whereas other forms of social benefits are distributed only after a more thorough application and evaluation process. Though the costs of administering the EITC are very low relative to other social programs, the trade-off of this low administrative cost appears to be a higher overpayment rate for EITC.

With this shift in costs and benefits comes another trade-off: taxpayers are left to figure out eligibility on their own. They do not benefit from government workers reviewing their documents, asking questions, and determining eligibility in advance of the determination. If Nina Olson is correct in her observation that “Congress views refundable tax credits as a favored means of delivering social benefits and implementing policy,” then these taxpayers should not be penalized for making an innocent and inadvertent error. They should not be penalized with an addition to tax simply because they did not understand correctly how a complex and lengthy statutory rule applied to their situation. Just as other agencies do not issue punitive sanctions for overpayments absent a finding of fraudulent behavior, the Service should reconsider the role of section 6662 in refundable credits.

With this goal in mind, the final section examines a variety of solutions, both administrative and legislative.

C. Solutions

The analogies drawn in section B of this Part show that the Service is more punitive than other agencies in its imposition of penalties on taxpayers who make inadvertent errors. Regardless of the design differences in the delivery of benefits, recipients should not be penalized for mistakenly claiming social benefits. In the current system, the penalty is

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244 See supra text accompanying notes 27–33.
245 See supra text accompanying notes 32–33.
246 Nat’l Taxpayer Advocate 2009 Report Vol. 2, supra note 78, at 78 (Olson cites “The passage of the American Recovery and Reinvestment Tax Act of 2009 (ARRA) and the Worker, Homeownership, and Business Assistance Act of 2009 (WHBA)” in support of her observation.). See also supra note 66 (these bills amended and expanded the FTHBC).
often imposed in an automated fashion because it is prompted statutorily by the dollar figure of the erroneous credit.

The penalty would function more appropriately as a deterrent if it were imposed more thoughtfully. A more thoughtful process would better demonstrate the fairness of the system, consistent with the Service’s policy statement on penalties. Ideally, the Service would delve into the taxpayer’s motives and carefully weigh the circumstances in deciding whether to impose a penalty. One positive change would be for the Service to interpret section 6664(c) in a more taxpayer-friendly manner, such as presuming that a taxpayer acted in good faith unless the Service can show factors indicating otherwise.

By no means intended as an exhaustive list of solutions, this section will consider a few alternative ways in which the Service or Congress might reexamine the treatment of inadvertent errors.

1. Exclude Refundable Credits from the Calculation of Underpayments

One alternative is for the Service to disregard refundable credits when calculating the amount of tax imposed and the amount of the underpayment. This would be consistent with its recent legal advice on frozen refunds and with the taxpayers’ primary position in the *Rand* litigation. If the Service adopted this interpretation, an improperly claimed refundable credit (whether inadvertently or intentionally claimed) would no longer result in an “underpayment”; the effect of this would be that the refundable credit portion is excluded from the calculation of any section 6662 penalty. This would be true for both the negligence or reckless disregard basis and the substantial understatement of income tax basis.

If this approach were adopted, there are two things to keep in mind. First, the Service would still be able to sanction improper EITC claims by use of the section 32(k) 2- and 10-year bans. These are important tools and are necessary to penalize those who “know better” but choose to engage in fraud. Ideally, the Service would be vigilant in developing the facts before imposing an EITC ban and would not do so unless the evidence clearly

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247 See supra text accompanying note 119.
indicated that the taxpayer knew he or she was not eligible but claimed it anyway.

The second thing to keep in mind is that refundable credits other than the EITC would be subject to the section 6676 “erroneous claim for refund or credit” penalty. However, section 6676 poses a different challenge and could be a trap for the unwary. The statute provides that a 20% penalty is imposed on the excess amount of the credit “unless it is shown that the claim for such excessive amount has a reasonable basis.”248 The Treasury Department has not promulgated regulations under section 6676, though the Service has issued internal guidance.249 The Internal Revenue Manual states that for purposes of section 6676, the definition of reasonable basis is provided in Treasury Department Regulation 1.6662-3(b)(3).250 Without the benefit of further guidance from the Service, it is difficult to know how this standard would be applied. Though section 6676 imports this definition from a regulation issued under section 6662’s accuracy-related penalty, the “reasonable basis” concept is distinct from “reasonable cause.” Reasonable basis relates to a standard of tax reporting for return positions and does not, on its face, provide a good faith exception.251

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248 I.R.C. § 6676(a).
250 I.R.M. 20.1.5.16.2(13).
251 Treas. Reg. § 1.6662-3(b)(3) (2013) provides:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2). (See § 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in § 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.
It seems that for all refundable credits the Service is relying on section 6662 to impose the accuracy-related penalty because it can do so under its current definition of underpayment. If the Service were to adopt this recommendation and exclude refundable credits from the calculation of an underpayment, it should consider carefully whether it is appropriate to impose section 6676 in cases of inadvertent error.

Until the Service issues guidance on section 6676 or Congress clarifies by statute, there is no indication that the Service would refrain from imposing the 20% penalty even if a taxpayer could show good faith. As noted previously, Olson has recommended that Congress amend section 6676 to include a reasonable cause and good faith exception. 252 In the absence of such a process to distinguish the taxpayer’s motivation, a penalty is too punitive and this solution falls short of addressing the concerns of this article.

2. Increase or Modify the Statutory Computational Threshold for a “Substantial Understatement”

An alternative and simple legislative solution would be for Congress to increase or modify the statutory computational threshold for a “substantial understatement.” As noted in Part II, currently an understatement is “substantial” if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. 253 If Congress were to increase this latter figure to $10,000, that threshold would be sufficiently high so as not to capture refundable credit overclaims. This would effectively eliminate one basis for imposition of section 6662. The Service still would be able to pursue the accuracy-related penalty on the basis of “negligence or disregard of rules or regulations.” 254 Increasing the statutory threshold figure has advantages and disadvantages.

252. See supra text accompanying notes 197–98. In making this legislative recommendation, Olson argued that “allowing a taxpayer to present reasonable cause for an error would be consistent with the purpose of refundable credits, which generally are economic incentives, designed to encourage certain behaviors, and structured as special tax breaks.” NAT’L TAXPAYER ADVOCATE 2011 REPORT, supra note 16, at 547.


The major advantage is that removing the statutory computational threshold would remove a trap for the unwary. The statutory computation is black and white: a taxpayer’s claim exceeds it or it does not, leaving no room for nuance or explanation. If this solution were adopted, the Service should closely and thoughtfully follow its internal procedures for considering the penalty under the negligence basis. The Internal Revenue Manual lists audit indicators for imposing a section 6662 penalty based on negligence. Some of these include: a history of noncompliance; similar, prior audits results; overstated deductions or credits, including claiming clearly improper or exaggerated amounts that are unsubstantiated by facts or documentation; and failure to explain items questioned by the Service.255

Before increasing the threshold, careful consideration should be given to the entire world of audits and not just to those taxpayers erroneously claiming refundable credits. For example, the computational threshold catches many taxpayers who underreport income or fail to report a specific item of income. Would there be unintended disadvantages to increasing the threshold to $10,000, or could these underreporter cases be effectively addressed using the negligence basis for the penalty?

A related but alternative solution would be to retain the $5,000 threshold figure, but bifurcate the calculation as to refundable credits. This could be done by applying a different threshold to refundable credits or by excluding refundable credit overclaims from the threshold calculation.

As with excluding refundable credits from the calculation of “underpayment,” raising or modifying the statutory threshold for “substantial understatement” will protect well-meaning EITC claimants, but carries a risk that the Service may end up falling back on section 6676 to penalize all other types of erroneously-claimed refundable credits. Thus, this solution does not fully address the article’s concerns unless there is also a legislative fix to section 6676.

3. Presumptive First-Time Abatement of the Penalty

A third alternative solution is for the Service to continue to impose the accuracy-related penalty on erroneous claims as it has been doing, but to create a process for a presumptive first-time abatement. This is one way to

255 I.R.M. 4.10.6.2.1.
shift the burden of showing good faith: if presumptive, it would require the Service to document reasons for not granting the abatement. Given the sophistication levels of most taxpayers, this is an appropriate burden shift and addresses the concerns stated herein without removing the Service’s ability to impose the penalty (or EITC ban) upon a showing of bad faith or fraud.

The presumptive element would correct what this article identifies as the major flaw in the current accuracy-related penalty structure, which is that that relief is actually available, but the very grounds that make one qualify (lack of sophistication) are the same that would prevent one from being aware of its availability.

The idea for a first-time abatement for the accuracy-related penalty arises from an existing Service administrative waiver that is very taxpayer friendly, yet little known and thus infrequently requested: the first-time abatement (FTA) penalty waiver for the failure-to-file (FTF), failure-to-pay (FTP), or failure-to-deposit (FTD) penalty.256 The FTA is a discretionary administrative waiver by which the Service can grant relief to taxpayers who receive these automated penalties but have a compliant tax history for the prior three years.257 The FTA waiver applies only to a single tax year.258 It is not available for the accuracy-related penalty. Noting that “[t]axpayers are not considered for FTF or FTP penalty relief under FTA criteria unless they request their penalties be abated,” TIGTA recently criticized the Service for not publicizing to taxpayers the availability of or opportunity to request the FTA waiver.259 TIGTA recommended that the Service should “better use the FTA waiver as a compliance tool by ensuring taxpayers are

256 I.R.M. 20.1.1.3.6.1.
257 Id. at (5).
258 Id. at (3).
259 TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2012-40-113, PENALTY ABATEMENT PROCEDURES SHOULD BE APPLIED CONSISTENTLY TO ALL TAXPAYERS AND SHOULD ENCOURAGE VOLUNTARY COMPLIANCE 3 (2012). The report examined tax year 2010 figures of these penalties: “From a statistically valid sample of 500 of these accounts—250 assessed FTF penalties and 250 assessed FTP penalties—we found 225 (90 percent) and 231 (92 percent) of the taxpayers qualified for penalty relief under FTA criteria but were not granted waivers.”
aware of their potential to receive an FTA waiver based on their past compliance history.**260

Along similar lines as TIGTA, the Taxpayer Advocate has recommended that the Service make the FTA waiver automatic, so that it would be waived without requiring taxpayers to request it.261 In making this recommendation, Olson suggested “[b]y waiving penalties before assessment and following up with a ‘soft notice’ that explains the reason for the waiver, the Service can reduce the cost of administering [reasonable cause] related penalty requests, while educating taxpayers and encouraging voluntary compliance.”262

This proposed solution follows a similar logic. A first-time abatement should be just that—it should be available one time only—but it can serve important expressive goals. Rather than being punitive, it would serve to put the taxpayer on notice about the inaccuracy. It would educate the unsophisticated taxpayer about the way in which he or she misapplied the tax law on the return, or would help the taxpayer to understand the types of substantiation that are required so that he or she can keep better records in future tax years.

If the Service adopted this solution, it could set particular guidelines for which actions constitute presumptive “good faith” on the part of a taxpayer. For example, the Service could presumptively abate the penalty in any case in which the taxpayer responded to the audit with any responsive documentation, even if the documentation is not deemed sufficient to prove eligibility. As discussed in Part I, many audits are decided against the taxpayer because of lack of sufficient documentation.263 This only means that the Service was not satisfied; it does not mean that the taxpayer was not eligible for the credit. Responding to an audit with documentation is itself an act of good faith and should be recognized as such. Taxpayers who know that they incorrectly claimed credits and get caught doing so would be unlikely to respond to the audit with any documentation. Recall that the

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260 Id. at 4.


262 Id. at 203.

263 See supra discussion, at notes 101 & 115.
majority of taxpayers do not respond to a correspondence audit.\textsuperscript{264} If the audit correspondence described the availability of a first-time penalty abatement for taxpayers who submit responsive documentation, this might incentivize a greater response rate.

4. Reduce Complexity to Increase Accuracy

This article criticizes complexity as a fundamental cause of inadvertent overclaims. It argues that if it were easier for taxpayers to understand and apply the law, there would be fewer inadvertent errors. This can be addressed through a reduction in complexity, or a simplification of the Code.

Identifying complexity as “[t]he most serious problem facing taxpayers—and the [Service],” Nina Olson has made numerous recommendations for simplifying the Code, including specifically the family status provisions.\textsuperscript{265} She notes that “the tax code’s family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction.”\textsuperscript{266} Olson’s proposed solution is for Congress to consolidate the existing family status provisions into two refundable credits: a “Family Credit” and a “Worker Credit.”\textsuperscript{267} Olson’s idea to bifurcate the credits into two separate functions could help to reduce complexity, but one should note that the Code provisions are complex precisely because Congress intended to cast a wide net of eligibility and support. If the eligibility rules were oversimplified without careful consideration, the EITC might not reach some of these taxpayers who Congress intends to assist.

Though a desirable goal, simplification should not be an end in itself. Rather, it should be undertaken with specific policy goals in mind. For example, simplified rules might be strategically crafted in an effort to

\textsuperscript{264} See supra text accompanying note 95.


\textsuperscript{266} NAT’L TAXPAYER ADVOCATE 2012 REPORT, supra note 1, at 17.

\textsuperscript{267} Id. at 18.
reduce noncompliance. In the EITC context, Leslie Book has identified certain structural situations in which he has determined that taxpayers are likely to claim the credit even though they know they are not entitled to do so. He argued that taxpayers in these certain situations become frustrated with the eligibility rules, which can result in “intentional non-compliance that taxpayers commit to address perceived injustices in the system.”

Based on these observations, Book made several interesting policy recommendations that he believed would reduce the “systemic temptations to cheat.” He noted that a consolidation of the Code’s family status provisions into one unified refundable credit “might also limit the opportunity or lessen the motive for individuals to game the system.” To the extent that changing the Code can reduce the rate of intentional errors, it may also make it easier for the Service to sort out a taxpayer’s motivations and respond appropriately.

While simplification is an attractive solution to a problem created by complexity, it is perhaps the least realistic alternative because it would require Congress to accomplish comprehensive and thoughtful tax reform.

IV. CONCLUSION

To the extent penalties are intended to deter erroneous claims, this intention presumes that the taxpayer understands that he or she is making the error. Thus, the existence of an accuracy-related penalty will not in itself deter an inadvertent error. Rather than imposing ex post punitive measures, it makes more sense to influence taxpayer behavior by investing resources ex ante in pre-filing education, pre-certification, and/or pre-filing assistance.

Penalties are also intended to show compliant taxpayers that the Service does not tolerate improper claims. However, there are a number of provisions already in place to show that. First, a taxpayer claiming EITC is twice as likely to face audit as other individual taxpayers. This signals to all


269 *Id.* at 1178.

270 *Id.* at 1179.
taxpayers that these claims are carefully scrutinized. Second, when a claim is paid and subsequently disallowed on audit, the government assesses a deficiency that must be repaid to the government, with applicable interest charged. This signals that for those who are caught, there is no economic benefit to an improper claim, even if the error was inadvertent. Third, the Code has civil and criminal fraud provisions to penalize those who claim credits to which they know they are not entitled. The Service should enforce these existing provisions, but do so on a carefully documented record rather than on an automated or reflexive basis.

Most compliant taxpayers sympathize with the notion that taxes are complex and people make mistakes. A system that is overly punitive towards mistakes can undermine rather than assure the public’s confidence. The audit process is already highly automated. The Service should not allow its penalty process to follow suit. Unsophisticated taxpayers are being penalized for Congress’s decision to administer social benefits at a low cost. This is not a sound policy choice. A better choice is to meaningfully penalize those who knowingly abuse the system while giving well-meaning taxpayers the benefit of the doubt absent evidence of bad faith.