

# U.S. REFUNDABLE CREDITS: THE TAXING REALITIES OF BEING POOR<sup>1</sup>

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## Abstract

This paper looks at the American experience in using tax law to deliver benefits to low and moderate-wage workers. First examining two recent cases in which individuals improperly claimed the earned income tax credit, this paper explores some of the challenges to both taxpayers and tax administrators associated with using the tax system to deliver benefits that are dependent on levels of attachment to children and the presence of earned income. The paper then explores two approaches to improve compliance. One approach is a proposal in a recent Heritage Foundation policy briefing recommending that only parents with legal custody of their children should be entitled to receive the earned income tax credit. The state of California initially excluded self-employment income from its definition of earned income in its state earned income tax credit. Both measures fail to reflect characteristics of the lives of the working poor, including a growing reliance on multi-generational living arrangements and shared care of children, a surge in nontraditional employment associated with the gig economy, and a reliance on third parties such as return preparers and tax software providers. Despite the problems with the proposals, they reflect genuine compliance concerns. This paper concludes with recommendations to address those compliance concerns that will likely serve the goal of improving integrity, while also ensuring the law and administration of the law reflects the lives of lower-income Americans who increasingly rely on the tax system to meet basic needs and support their families. As the American tax system is increasingly a key component of the safety net, this paper is especially timely and can assist policymakers who wish to balance improvements in program integrity with a respect for taxpayer rights and achievement of other program goals.

## Key Terms

Tax compliance; earned income tax credit; tax credits; self-employment income; return preparers.

## INTRODUCTION

It has been over twenty years since the last significant procedural and administrative reform of the IRS, the 1998 IRS Restructuring and Reform Act. Since that time, the Internal Revenue Code has

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grown increasingly complex.<sup>3</sup> Part of that complexity stems from Congress expanding the use of the Internal Revenue Code to deliver benefits in the form of tax expenditures, that is, preferential tax rates, deductions, exclusions and credits (Hickman, 2015; Office of Tax Policy, 2016).<sup>4</sup>

Key legislative and executive branch proposals share a desire to simplify the Code, especially for individuals; major American tax legislation enacted in 2017 failed to achieve meaningful simplification and, in fact, has added new layers of complexity (August, 2018).<sup>5</sup>

One of the key voices in the American tax reform process is Nina Olson, the National Taxpayer Advocate (NTA), who, in a series of annual reports to Congress, has repeatedly emphasized the need to simplify the American tax law. In her 2016 Annual Report to Congress, Olson emphasized that reducing the use of the Code as a vehicle for delivering social benefits would simplify tax administration and alleviate taxpayer burden (National Taxpayer Advocate, 2016a, p. 305-07). Despite the call to curtail tax expenditures, the NTA acknowledged the trade-offs that accompany using the tax system to achieve a variety of social objectives (National Taxpayer Advocate, 2016a, p. 306-07). To that end, the NTA suggests that in considering tax reform, Congress should explicitly consider the rights of taxpayers, the burden on taxpayers and on the IRS's ability to administer any provision (National Taxpayer Advocate, 2016a, p. 306-07).

As part of that directive to more explicitly consider administrative issues, the NTA proffers a series of core principles that should guide the tax reform process (National Taxpayer Advocate, 2016a, p. 319-20). The first core principle is that tax law should not “entrap” individuals (National Taxpayer Advocate, 2016a, p. 319-20). This paper explores how one part of tax law, the earned income tax credit (EITC), violates this foundational principle. This paper reveals that the EITC entraps individuals, contributing to greater distrust of the tax system. To illustrate this point, this paper will use as a platform two recent court cases, a case from the United States Tax Court, *Smyth v Commissioner* (2017), and case from the Court of Federal Claims, *Foxx v U.S.* (2017). Both cases involve taxpayers who improperly claimed EITC. In *Smyth*, the taxpayer was a grandmother who worked as a nursing assistant and lived with and cared for her grandchildren. In *Foxx*, the taxpayer, in filing her return claiming an EITC, relied on a tax return preparer with years of experience preparing individual tax returns and who referred to himself as the “Tax Doctor”. Yet, in both cases, the taxpayers were not entitled to receive the EITC. The cases reflect the two most common sources of taxpayer error with the EITC: errors associated with qualifying child eligibility and errors pertaining to income misreporting. In addition, they provide a window into the lives of the working families that claim the EITC: multi-generational living arrangements and tax return preparers who instead of helping individuals comply with the tax laws actually facilitate the filing of tax returns that are incorrect. This paper argues that the *Smyth* and *Foxx* cases provide a window

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<sup>3</sup> Internal Revenue Code of 1986, as amended (herein “Code”). The National Taxpayer Advocate noted that since 2001, Congress has made over 5,900 changes to the Internal Revenue Code, contributing to complexity and compliance costs that lead to individuals and businesses spending approximately 6 billion hours per year complying with filing requirements (National Taxpayer Advocate, 2016a, p. 305-07). This does not include time spent responding to correspondence or other post-filing burdens.

<sup>4</sup> Treasury estimates that for FY 2016 total U.S. tax expenditures amounted to \$1.42 trillion; as a point of comparison U.S. individual income tax revenues in the same period were \$1.63 trillion (Office of Management and Budget, 2015, Table 2.1).

<sup>5</sup> See Cohn, G. (2017, April 26), for a discussion on the importance of simplifying the tax code, noting taxpayers spend roughly 7 billion hours per year complying with the tax code.

into ways that policymakers should consider reform of the EITC to reduce program overpayments and ensure that individuals do not end up worse off by claiming the EITC.

In considering specific proposals to improve program integrity, Congress and the IRS should anticipate the largest areas of noncompliance, minimize opportunities for noncompliance and consider the lives and circumstances of EITC claimants. Using these criteria and insights into the lives of the working poor as reflected in the *Smyth* and *Foxx* cases, this paper critically examines two recent efforts to reform the EITC that are intended to reduce taxpayer qualifying child and income reporting errors. These measures are inadequate because they fail to reflect the lives and circumstances of the EITC, including that taxpayers increasingly care for children with the assistance of multiple family members and often live with multiple generations of family members, earn money as part of the growing platform economy that allows for work without traditional employment arrangements, and rely on tax return preparers who may promise refunds at the expense of complying with the tax laws. Proposals that fail to address the reality of the lives of claimants themselves are likely to backfire and will contribute to greater distrust in the IRS and perhaps have the unintended consequence of contributing to increased noncompliance (Gangl, Hofmann, Pollai, & Kirchler, 2012; Olson, 2015).

Before proceeding, it is important to briefly describe the EITC, provide some general figures on U.S. tax compliance and to define what “entrap” means. As with many countries, the U.S. tax agency is charged with administering credits that taxpayers can claim on a tax return and receive as a refund in excess of any individual tax liability. The EITC is the most important refundable credit in terms of dollar amount claimed and impact (Nichols & Rothstein, 2015). Based primarily on the presence of earned income and the residence of qualifying children who satisfy age, residency and relationship tests, in 2015 over 27 million taxpayers received approximately \$67 billion in EITC benefits, with \$2,455 as the average amount claimed (Earned Income Tax Credit & Other Refundable Credits, 2017). It has become one of the largest federally administered means-based anti-poverty programs and a major part of the way U.S. creates incentives for low-wage work.<sup>6</sup> In 2013, nearly one in five taxpayers filing individual tax returns claimed the EITC and approximately 44 percent of all filers with children received the EITC (Hoynes & Rothstein, 2017). The number of taxpayers claiming the EITC and the amount those taxpayers claim has grown significantly over the years since the EITC’s inception as a temporary provision in 1975.<sup>7</sup>

The voluntary compliance rate for the EITC (looking at lower and upper bound overclaim percentage prior to enforcement) is estimated at between 60.9 percent and 71.5 percent (Marcuss, Dubois, Risler, & Leibel, 2014). This compares to an overall voluntary compliance rate of 81.7 percent, though that figure is somewhat misleading, as the voluntary compliance rate for items that are not subject to information reporting falls significantly (Internal Revenue Service, 2017). Key factors that drive EITC eligibility – residency and relationship of children to claimant, as well as much of the income that sole proprietors earn – are not subject to third-party reporting.

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<sup>6</sup> Under U.S. law, the EITC cannot be counted as income in determining eligibility, or the amount of benefit, for any federally funded public benefit program, such as Supplemental Nutrition Assistance, federal housing benefits, and Temporary Assistance to Needy Families (Falk, p. 13).

<sup>7</sup> See Book (2016), for growth in EITC since its inception. There are many excellent discussions of the EITC’s history and its current place as one of the main federal policies to address poverty and incentivize work. See Ventry (2001), for a historical discussion. See Nichols & Rothstein (2015), for a discussion and compilation of current research of the EITC’s impact on addressing poverty and incentivizing work.

Approximately 20 percent of all individual income tax returns include the EITC, but total EITC overclaims comprise 3 to 4.2 percent of the total tax gap, 4.3 to 6.6 percent of the gross tax gap for individual income and 5.3 to 7.3 percent of the underreporting tax gap for individual income.<sup>8</sup> Despite contributing to a relatively small share of the overall or individual tax gap, EITC audits account for approximately 39 percent of all IRS income tax examinations (Crandall-Hollick, 2015, p. 3-4; United States Government Accountability Office, 2016, p. 33).<sup>9</sup>

A dictionary definition of “entrapped” includes “to lure into a compromising statement or act” (Entrap, n.d.) or “to lure into danger, difficulty, or a compromising situation” (Entrap, 2014). This article does not make the claim that either Congress, in drafting the law, or the IRS, in administering the law, acts with intent to trick or deceive individuals. Yet, entrap is an apt word to describe the EITC’s impact for at least two reasons. First, many individuals find themselves worse off than if they had not filed a tax return claiming the EITC. In addition to potentially owing money back to the IRS as a result of compliance actions the IRS takes, the claimants may have incurred return preparation fees and spent time both in preparing the return and in responding to IRS correspondence. Second, due to a variety of factors, such as the legal complexity of the EITC itself, individual characteristics of the claimants and the role of third party return preparers, a significant number of individuals who may claim a credit to which they are not entitled are likely to act without intent to cheat or misstate eligibility.<sup>10</sup> Many taxpayers have a good faith but erroneous belief that they are entitled to the credit they claim on the tax return even when they are not eligible to claim the credit at all or at times are only entitled to a lesser amount.

Individuals who mistakenly claim the EITC come to the tax system expecting to receive a refund or credit based on their earnings and family situation. Yet, these individuals often come away worse off for the experience, facing thousands of dollars in assessed liabilities, or for the lucky ones who are audited prior to receiving a refund, just the experience of having to try to respond to the IRS requests to verify information via correspondence. Those assessed liabilities and additional costs often strike the most vulnerable; that is, those taxpayers who are least likely to be able to afford the costs and who may suffer economic hardship when they expected that their filing a claim for an EITC would lead to a sizeable refund.

This article proceeds in two main parts. The first part discusses those two recent cases and illustrates how they reveal the traps facing taxpayers who claim the EITC. In the second part, this article briefly describes an overview of the EITC compliance problem and critically evaluates proposals to reform the EITC, using the *Smyth* and *Foxx* cases as illustrations.

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<sup>8</sup> I compute this using the lower and upper range EITC overclaim amounts as a numerator and the 2008-10 gross tax gap and gross income tax gap figures as denominators (Internal Revenue Service, 2016, April, p. 2). The share of the tax gap attributable to all credits is 9 percent.

<sup>9</sup> In FY 2013, the IRS estimated that of approximately \$37.1 billion of additional tax owed as a result of examinations about \$2.5 billion, or 6.9% of all additional estimated tax owed, was due to examinations of returns that had an EITC claim (Crandall-Hollick, 2015, p. 6).

<sup>10</sup> While the EITC may be one of the most robustly studied provisions in the tax code in terms of compliance, there is no consensus on the amount of error that is unintentional relative to intentional misconduct. See Holt (2016, p. 5-6), for a discussion of evidence of good faith versus intentional errors.

## CASE STUDIES

### The Sad Tale of Grisel Smyth

The living arrangement in *Smyth* is relatively straightforward and not uncommon among many American families where multiple generations live together, often with a grandparent or older adult relative providing the main financial support for the household (Maag, Peters, & Edelstein, 2016). As the opinion discusses, Grisel Smyth worked as a nursing assistant in El Paso and maintained a home with her modest earnings (*Smyth v. Commissioner*, 2017). Her adult son, his wife and their two young children, ages 2 and 4, lived in her home. (*Smyth v. Commissioner*, 2017). The opinion discussed how Grisel provided all the financial support for the household, noting that Grisel's son "did not work, and he was into dealing drugs" while his wife "stayed home and took care of the babies" (*Smyth v. Commissioner*, 2017, at \*1).

Grisel's tax problem arose after she filed a 2012 tax return claiming her grandchildren as dependents and qualifying children for the EITC (*Smyth v. Commissioner*, 2017). She expected a refund of \$5,300; of that amount about \$2,900 was attributable to an EITC that she claimed using her grandchildren as qualifying children (*Smyth v. Commissioner*, 2017). She claimed the grandchildren after her son told her he was not going to claim them and that she should use the refund to recover some of the money she spent supporting the family (*Smyth v. Commissioner*, 2017). Grisel's son lied to his mother; rather than not filing, he raced to file a tax return before she did, and the son claimed the EITC and treated his kids (Grisel's grandchildren) as his and wife's qualifying children, and, as the opinion notes, took the refund and spent it on drugs (*Smyth v. Commissioner*, 2017).

The opinion discusses how Grisel credibly testified that she had no knowledge her son claimed her grandchildren on his tax return and she would never have claimed the kids had she known her son and daughter-in-law filed their own tax return using the children as their qualifying children (*Smyth v. Commissioner*, 2017).

Why did it matter for Grisel that her son and daughter-in-law filed a return claiming the children? The U.S. tax code allows for the possibility that multiple adults could theoretically be in a position to claim a child as a "qualifying child."<sup>11</sup> When one of those adults is the child's parent and the other adult is not, generally the parent is the one entitled to claim the child as a qualifying child. It does not matter if the other adult claiming the child is the primary caregiver; it does not matter if the parent agreed that she or he would not claim the child but in fact did; it may not even matter if the parent files an amended return after the fact disclaiming the earlier position he took on the return (though the Tax Court in *Smyth* and other cases have demurred on that issue; see below). On the other hand, if the child's parents do not claim the child, then another adult who is otherwise eligible can treat the child as a qualifying child so long as the other adult has a higher adjusted gross income than either parent. In sum, if either of the child's parents (or both if the parents are filing a joint return) claim the child, then the other adult is out of luck, no matter that adult's connection to or financial support of the child, or the agreement or understanding the parents may have reached.

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<sup>11</sup> The Code's tiebreaking rules for qualifying children are found in 26 USC § 152(c)(4).

Bringing this back to Grisel, it is easy to see the difficulties Grisel faced. Instead of filing a tax return and getting a sizeable refund, she received a letter from the IRS notifying her that someone else claimed the children and challenging her right to claim her grandchildren as dependents and qualifying children for the EITC (*Smyth v. Commissioner*, 2017).<sup>12</sup> The letter froze her refund and proposed to assess a \$1,000 civil penalty for good measure (*Smyth v. Commissioner*, 2017).

The situation Grisel found herself in was not unique; IRS processes are set to automatically reject returns like Grisel's when another person, especially a parent, claims a child. The reason why the IRS selected her return for examination, as the opinion states, is that "Smyth's unemployed son had already claimed the children on his tax return, gotten a check from the government, and cashed it to spend on drugs" (*Smyth v. Commissioner*, 2017, at \*1).<sup>13</sup> Grisel testified that she could not understand how another had claimed her grandchildren (*Smyth v. Commissioner*, 2017). She thought that the dual claim was due to identity theft (*Smyth v. Commissioner*, 2017); that was not an unrealistic assumption as the IRS and innocent taxpayers have struggled with sorting between real taxpayers and imposters who essentially steal another person's identity and access the tax system to receive improper credit-driven refunds (Treasury Inspector General, 2017).

Grisel, on her own, (and probably after spending a considerable amount of time, and perhaps a \$60 filing fee)<sup>14</sup> filed a petition to U.S. Tax Court asking the Tax Court to allow her to treat the grandchildren she supported and lived with as qualifying children (*Smyth v. Commissioner*, 2017). After she filed the suit and feeling guilty about lying to his mother, Grisel's son offered to write an affidavit describing his mother's role in supporting the children (*Smyth v. Commissioner*, 2017). He then (with the assistance of a return preparer) prepared an amended return disclaiming treating his children as dependents and qualifying children during the pendency of his mother's case (*Smyth v. Commissioner*, 2017).

After Grisel filed the petition to Tax Court, the court scheduled a trial to consider the evidence and applied the law to Grisel's circumstances (*Smyth v. Commissioner*, 2017). Presumably Grisel took time off from work to testify; luckily for her, a volunteer attorney was at the Tax Court calendar call (*Smyth v. Commissioner*, 2017).<sup>15</sup> The opinion notes that "[h]e was moved by Ms. Smyth's testimony and entered an appearance after trial[,] presumably to assist in preparing and submitting a post-trial brief (*Smyth v. Commissioner*, 2017, at \*5, footnote 1). After trial, the Tax Court issued an opinion (*Smyth v. Commissioner*, 2017). To the Tax Court, the legal issue was clear: given the children's parents also claimed the children, under the tie-breaker rule, Grisel was not entitled to treat the children as qualifying children, and thus, not able to receive the refund she claimed on her tax return (*Smyth v. Commissioner*, 2017).<sup>16</sup> In addition, the son's submission of an amended return failed to meet the technical requirements because he did not mail it to the appropriate IRS office or hand-deliver it to an IRS employee that had authority to accept an amended return (*Smyth*

<sup>12</sup> The IRS examination proposed an approximate \$5,000 deficiency; in addition, the IRS proposed a 20% civil penalty, which it later conceded.

<sup>13</sup> The opinion does not discuss the amount of the refund her son received nor whether the IRS had examined his return.

<sup>14</sup> See US Tax Court Rule 20(d), establishing a \$60 fee unless the petitioner establishes the inability to pay the fee.

<sup>15</sup> See Panuthos (2015), for a discussion of the efforts of hundreds of volunteer attorneys who volunteer to assist unrepresented taxpayers such as Grisel Smyth.

<sup>16</sup> There is a small EITC available for childless workers between the ages of 25 and 65; the cap in 2012 for receipt of an EITC for a childless worker was \$13,980 and Grisel's income exceeded that limit (*Smyth v. Commissioner*, 2017).

*v. Commissioner*, 2017).<sup>17</sup> Even if the son and his wife had properly filed the amended return, no case has held that a taxpayer can by way of amended return disclaim a previously claimed child as a dependent or qualifying child (*Smyth v. Commissioner*, 2017).<sup>18</sup>

Despite the relatively straightforward application of the law, Judge Mark Holmes, the judge who wrote the opinion, was struck by the case's injustice (*Smyth v. Commissioner*, 2017). His concluding comments in the opinion reflect the unease he felt in finding for the government.

We are sympathetic to Smyth's position. She provided all of the financial support for [her grandchildren], had been told by her son that she should claim the children as her dependents, and is now stuck with a hefty tax bill. It is difficult for us to explain to a hardworking taxpayer like Smyth why this should be so, except to say that we are bound by the law. And it is impossible for us to convince ourselves that the result we reach today--that the IRS was right to send money meant to help those who care for small children to someone who spent it on drugs instead--is in any way just. Except for the theory of justice that requires a judge to follow the law as it is but explain his decision in writing so that those responsible for changing it might notice (*Smyth v. Commissioner*, 2017, at \*4).

### **The Tax Doctor: Doctor Foxx and Doing His Clients Harm**

George Foxx came to the attention of the IRS after the IRS audited the 2007 federal income tax return of Shakeena Bryant (*Foxx v. U.S.*, 2017). For the 2007 year, Bryant claimed an EITC of \$2,577. Foxx held himself out as a tax doctor and referred to himself as Dr. Foxx,<sup>19</sup> and claimed to have 37 years of tax return preparation experience. Bryant went to the tax doctor with a friend of hers, Herman James (*Foxx v. U.S.*, 2017). She brought with her a W-2 income statement showing \$15.51 from brief employment at an amusement park in Florida (*Foxx v. U.S.*, 2017). According to an affidavit of both Bryant and James, Foxx told her that she could receive a refund if she reported income from a business (*Foxx v. U.S.*, 2017). According to Bryant and James, on

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<sup>17</sup> The son arranged for the purported amended return to be delivered by a return preparer to IRS counsel in his mother's Tax Court case (*Smyth v. Commissioner*, 2017). *Smyth* (2017) referred to *Quarterman* (2004), where the hand delivery of a tax return to an IRS attorney did not constitute a filing. The opinion does not state how much the return preparer charged and whether Grisel or her son paid that fee (*Smyth v. Commissioner*, 2017).

<sup>18</sup> The Tax Court has not resolved whether a parent or other adult can disclaim a prior claimed dependent or qualifying child, though *Smyth* notes that prior cases have suggested that in certain circumstances it might be willing to treat an amended return as a valid disclaimer. (*Smyth v. Commissioner*, 2017). *Smyth* (2017) referred to *Brooks* (2013) that suggested perhaps a daughter's amending of a return prior to the IRS auditing her mother might have been sufficient; and *McBride* (2015) that suggested that a grandfather might be entitled to a dependency exemption if the mother filed an amended return before the statute of limitations would have barred the IRS from determining a deficiency against the mother.

<sup>19</sup> A separate issue in the case involved the government's seeking discovery from the University where Foxx claimed to have received a doctorate; Foxx filed a request for sanctions claiming the government's discovery was irrelevant and an attempt to harm him (*Foxx v. U.S.*, 2017). The court found the government's discovery efforts were appropriate as it was "reasonably calculated to assist the trier of fact in assessing Dr. Foxx's education and credibility" (*Foxx v. U.S.*, 2017, at \*421).

direction from Foxx, Bryant left the office, applied for and received a Florida business license for automobile detailing (*Foxx v. U.S.*, 2017).<sup>20</sup>

Bryant returned the same day with the license, and filed a tax return showing \$18,288 in business income (*Foxx v. U.S.*, 2017). The presence of the income generated a \$2,577 refund (*Foxx v. U.S.*, 2017). The existence of income created a positive tax result that is attributable to the credit exceeding Bryant's income and employment tax liability, a common situation for many lower income claimants, whose taxable income is often low due to deductions attributable to claimed dependents and the standard deduction.<sup>21</sup> This places the IRS in the awkward position of disproving that a claimant has earned income (or trying to demonstrate that a claimant has expenses that should have been deducted but were not).<sup>22</sup> Bryant also paid Foxx a \$169 return preparation fee (*Foxx v. U.S.*, 2017), which is also a common situation for claimants, who annually pay billions of dollars in fees for the preparation of returns and ancillary services related to claiming the EITC (Wu & Hernandez, 2016).

On audit of Bryant's return, the IRS disallowed the credit (*Foxx v. U.S.*, 2017). During the audit, Bryant agreed she did not have the income necessary to justify her claiming the credit, and the IRS presumably sought to recover from Bryant the refund she received (*Foxx v. U.S.*, 2017). In correspondence, Bryant claimed she was instructed by Foxx to report the income to justify the refund (*Foxx v. U.S.*, 2017).

The IRS then examined Dr. Foxx and assessed a \$5,000 civil penalty under Section 6694 for his willful or reckless conduct in preparing the return (*Foxx v. U.S.*, 2017). After an administrative appeal of his penalty, the IRS reduced it to \$2,500. Foxx paid and sued for refund in the Court of Federal Claims (*Foxx v. U.S.*, 2017).

The case on the surface turned on whether the preparer George Foxx 1) facilitated the improper claiming of the credit by instructing the taxpayer how to claim the credit and to make it look legitimate by applying for a business license even in the absence of the actual business or 2) prepared the return based on what Bryant told him about her business (*Foxx v. U.S.*, 2017).

A bad fact for the Tax Doctor in this case was that Bryant's friend James on deposition supported Bryant's version of the facts. Both Bryant and James stated that she obtained a business license the same day the return was prepared pursuant to Dr. Foxx's instruction (*Foxx v. U.S.*, 2017). James also stated that "Dr. Foxx explained that such a license would allow him to obtain more money for Ms. Bryant, and Dr. Foxx, not Ms. Bryant, created the false business income that appeared on Ms. Bryant's tax return" (*Foxx v. U.S.*, 2017, at \*419).

According to the opinion, Foxx claimed that in preparing the return he relied upon Bryant's business license which she on her own received and two pages of his notes that outlined expenses associated with the business (*Foxx v. U.S.*, 2017).

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<sup>20</sup> Florida requires that small businesses register for licenses to do business (Small Business Advice, n.d.).

<sup>21</sup> See Crandall-Hollick (2015, p. 11), for a discussion on how income misreporting includes both under and overreporting.

<sup>22</sup> See Order, *Kalokoh v Commissioner* (2015), where a self-employed hairstylist claimed EITC and proved at trial she had receipts from her business that generated sufficient earned income for a claimed EITC.



Both parties filed motions for summary judgment; generally, a summary judgment motion is inappropriate for resolving disputes when the parties differ on the facts (*Foxx v. U.S.*, 2017). Yet, despite the presence of a dispute as to which version was accurate, the Court of Federal Claims resolved the case on the motion, essentially concluding that even if Foxx were telling the truth, he was reckless in disregarding his due diligence obligations under Section 6695, which require preparers to “make reasonable inquiries if the information furnished to, or known by, [the preparer] appear[ed] to be incorrect, inconsistent, or incomplete” (*Foxx v. U.S.*, 2017, at \*419). Even if Bryant did tell the preparer about her income, the court concluded Foxx had an affirmative obligation under the specific EITC due diligence regulations to dig deeper:

Dr. Foxx argued before the IRS that his reliance on Ms. Bryant's alleged statements regarding her business was reasonable because Ms. Bryant otherwise would have only earned approximately \$15 in 2007 based on the W-2 she provided to Dr. Foxx. Such an argument is misplaced; Ms. Bryant's financial situation did not relieve Dr. Foxx of his obligation to make reasonable inquiries into any auto detailing business purportedly conducted by Ms. Bryant after she did not provide adequate documentation. His failure to do so was an intentional or reckless disregard of relevant Treasury Regulations [referring to the due diligence regulations under Section 6695]. (*Foxx v. U.S.*, 2017, at \*419-20).

## **LESSONS LEARNED: THE COMPETING NARRATIVES AND PROPOSALS FOR REFORM**

### **The Competing Narratives of the EITC**

As with many countries, in the U.S. the tax agency is charged with administering credits that taxpayers can claim on a tax return and receive as a refund in excess of any individual tax liability. As mentioned above, the EITC is the most important. It has become one of the largest federally administered means-based anti-poverty programs and a major part of the way the U.S. supplements wages and provides incentives for low-wage work.

The IRS estimates that anywhere from 28.5 percent to 39.1 percent of the EITC is overclaimed, and that approximately 24 percent of all EITC payments are improper. The IRS also estimates that anywhere from 43 to 50 percent of all EITC returns are incorrect, with most of those errors going in favor of the claimants, not the government. Despite there being little understanding (and in fact often heated partisan debate) about whether the EITC errors are the source of willful misconduct or innocent mistake,<sup>23</sup> the IRS has been a target for its inability to reduce the overclaim or improper payment rate over the better part of the last 15 years. While the EITC has generally received bipartisan support (Holt, 2016),<sup>24</sup> proposals to expand the EITC often return to the issue of compliance,<sup>25</sup> with opponents keying in on errors as likely due to fraud, while proponents generally

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<sup>23</sup> See Holt (2016, p. 5), for a discussion stating the true extent and nature of the problem are subjects of stalemated debate between program skeptics and advocates.

<sup>24</sup> See Adamson (2016), for a discussion of current bipartisan support around expanding EITC.

<sup>25</sup> For example, in the Protecting Americans from Tax Hikes Act of 2015 (PATH) legislation that made permanent some aspects of the child tax credit and the EITC that were set to expire in 2016 (such as an increased credit for

look to program complexity as a main driver of error (Drumbl, 2017; Holt, 2016).<sup>26</sup> The compliance problem exists despite the IRS and Congress having taken a variety of efforts to combat errors, including approximately 450,000 annual correspondence examinations requiring claimants to verify eligibility to the IRS by sending in documents proving eligibility after the filing of a tax return, expanded civil penalties giving the IRS power to punish both claimants and preparers, and the IRS authority to make changes to certain EITC-claiming returns without giving claimants the full-blown pre-assessment court review that other taxpayers enjoy (Olson, 2015).

There are two main and at times competing narratives when thinking about the IRS's administration of refundable credits. I will call them Narrative A and Narrative B. In Narrative A, as the U.S. has de-emphasized much of the federal safety net outside the tax system, the IRS has become a steward and key deliverer of one of the nation's most important means-tested anti-poverty programs, the earned income tax credit.<sup>27</sup> The EITC is a major aspect of American social policy that has generally received bi-partisan support. The IRS has been a remarkably efficient deliverer of these benefits. Working with the private sector commercial return preparer industry and software providers to ensure high take up rates, the IRS has helped push many low and middle-income taxpayers into the 21<sup>st</sup> century of online tax return filing and away from the stigmatizing receipt of benefits associated with other means-based programs. Narrative A highlights the IRS role in lifting millions of children out of poverty, encouraging a return or entry into the labor force for many workers, especially single mothers, and generating benefits that millions of lower-income workers rely and depend on to meet essential consumer purchases and at times special purchases that are facilitated by the lump sum nature of the annual tax refund.

Narrative B focuses on the negative.<sup>28</sup> It goes like this: the attributes that make Narrative A so compelling have also contributed to the EITC being plagued with fraud, errors and overpayments that generally exceed the reported rates in other non means-based benefits, like food stamps and traditional welfare programs. In relying on the U.S. tax system's self-attesting process that does not have intrusive and costly case workers screening eligibility, and by tethering eligibility to items (such as relationship of family, residence of children or the presence of income) that may not be known to the IRS at the time an individual files her application for the credit in the form of an annual tax return, the IRS has major challenges in maintaining program integrity. Individuals, some on their own and others in concert with illicit tax return preparers (like Dr. Foxx) or complicit friends and relatives, can exploit the tax system's self-attesting method of claiming benefits and limited capacity for ex post compliance measures. With annual estimates of the EITC improper payment rate at about 24 percent (which accounts for an estimated \$15.6 billion in improper payments), this places the IRS at the top or near the top of agencies that (as the narrative frames it) squander precious federal resources on ineligible recipients.

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families with three or more children and increased phase-out range for married couples filing jointly), Congress added additional compliance measures directed at refundable credit integrity (Book, 2015, December 18). The additional PATH compliance provisions are "part of the quid pro quo associated with extensions and sweeteners to refundable credits that largely benefit lower-income and more moderate-income taxpayers" (Book, 2015, December 18, para 4).

<sup>26</sup> See Rubin (2016), for an article that can be placed among other scholarship attempting to unpack the rhetoric surrounding the EITC compliance problem.

<sup>27</sup> See Marr, Huang, Sherman, & Debot (2015), for a representative perspective reflecting this narrative.

<sup>28</sup> See Rector & Hall (2016), for a representative perspective reflecting this narrative.

## ***Smyth* and Limiting EITC Eligibility to Only Parents**

The compliance issues presented in *Smyth* relate to a broader class of issues concerning who are the appropriate adults to be entitled to claim a child for purposes of generating a tax refund based on the EITC. One way to explain the compliance challenges associated with the EITC is in the way the eligibility criteria allows for differing classes of family members to claim the EITC. While parents essentially are the default eligible taxpayers to claim a child who meets age and residency requirements, other family members, such as grandparents, aunts and uncles and siblings, can also claim a child for these purposes. One approach that could minimize compliance challenges for the IRS would be to limit the EITC to adults who are the children's biological parents or other adults who have a legal relationship with the children.

Consider a recent paper by Robert Rector and Jamie Hall at the Heritage Foundation (2016), which proposes to limit the EITC along these lines. In a 2016 report called "Reforming the Earned Income Tax Credit and Additional Child Tax Credit to End Waste, Fraud, and Abuse and Strengthen Marriage[.]" Mr. Rector and Mr. Hall make some broad assertions about the EITC and related benefits' programs, essentially taking a Narrative B type approach to the issue, claiming the program's errors are best explained by claimant fraud rather than by other reasons such as misunderstanding of the EITC's complex eligibility requirements, inability to verify eligibility or actions of third parties like preparers like Dr. Foxx. Rector and Hall make the common-sense claim that it is impossible to expect the IRS to check for eligibility for all the variants of eligibility (2016). The solution they propose (in part) is to scale back who is eligible for the credit, enhance the IRS's verification and substantiation of income requirements prior to the IRS issuing a refund, and to increase claimant penalties for noncompliance (Rector & Hall, 2016).

The proposals merit consideration though, as discussed below, reflect an approach that disregards the circumstances of millions of lower income Americans who depend on the EITC to help meet basic needs and will cause significant harm to children who are major beneficiaries of the EITC. Consider one of the main points concerning the compliance challenges the IRS faces relating to the claiming of children. Rector and Hall note that "[r]oughly one in 10 EITC claims, or some 2.8 million claims per year, are based on false claims of residence by absent parents or relatives" (Rector & Hall, 2016, p. 7). It is a substantial and costly aspect of the EITC compliance challenge (Rector & Hall, 2016). Mr. Rector and Mr. Hall assert it is a reasonable assumption "that most residency fraud involves claims by noncustodial unmarried parents (generally absent fathers) and adult relatives who do not actually reside with the child" (Rector & Hall, 2016, p. 11).<sup>29</sup>

Their solution is to remove millions of potentially eligible claimants by limiting claimants to parents who have a legal relationship with their child, and if no biological parent has legal custody,

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<sup>29</sup> As discussed above, there is substantial disagreement as to whether and to what extent errors are attributable to claimant fraud rather than mistake. That under the US tax code noncustodial parents may be allowed to claim children as qualifying children for purposes of dependency exemption (but not for purposes of EITC) suggests the possibility that taxpayer confusion is the reason for error (IRC § 152(e)(2)). The difficulty associated with identifying an error as due to fraud or some other reason is not unique to tax. The Stanford Center on Longevity, in conjunction with the Finra Financial Education Foundation, conducted one of the largest US surveys on the extent of financial fraud in the US suggests that measuring fraud is inherently difficult due to the challenges in determining "intent to deceive" (DeLiema, Mottola, & Deevy, 2017, p. 26).

then only an adoptive parent, legal guardian or foster parent could claim the child (Rector & Hall, 2016, p. 11).

### ***Foxx* and Phantom Income: The California Approach to Income for Purposes of the EITC**

California, like many states, supplements the federal EITC with a state EITC that is modeled in large part on the federal program (Center on Budget and Policy Priorities, 2016), but when it initially enacted its EITC, it featured one key difference: self-employed taxpayers were generally not permitted to treat their self-employment income as earned income for purposes of the State EITC.<sup>30</sup> As indicated above, the presence of earned income is a necessary element to claim the EITC. The EITC creates special challenges for many self-employed taxpayers because the IRS may, as with the *Foxx* case, find itself investigating whether in fact the taxpayer truly has the earned income she claims on the tax return. In addition, the IRS may find itself examining a taxpayer to ensure that in fact the taxpayer claims all deductions to which she might be entitled, as the amount of the credit may exceed by thousands of dollars the amount of any income or employment tax liability. The inability to seamlessly determine whether a taxpayer's self-reported self-employment income is accurate has led California to change the definition of earned income for these purposes.

The IRS ability to verify earnings claimed on an EITC tax return is one that has attracted Congressional attention. While not as costly as qualifying child errors, income misreporting is the most common error on EITC returns; in fact, approximately 51 percent of returns with an EITC overclaim had an income misreporting error as its sole error (Marcuss, Dubois, Risler, & Leibel, 2014, p. 10). Recent studies indicate between \$3.7 billion to \$4.5 billion in overclaims were attributable to incorrectly reporting earned income, of which between \$3.2 billion and \$3.8 billion was associated with self-employment income misreporting (Marcuss, Dubois, Risler, & Leibel, 2014, p. 16). Congress has recently acted to address the issue. The PATH Act accelerates to January 31 for the filing of third-party information returns, including the form that covers nonemployee compensation (Form 1099-MISC). It also delays payment of a refund attributable to an EITC and certain other credits until February 15. The purpose of the delay is to give the IRS more time to identify incorrect or fraudulent claims prior to making payments by requiring employers to report to the IRS and Social Security Administration wages paid earlier than under prior law, which required third parties to file information returns by March 31 (February 28<sup>th</sup> if by paper) and penalized IRS for not releasing refunds within 45 days of processing a refund by imposing an interest obligation IRS on refunds not issued within that time frame.

In the 2017 filing season the IRS implemented these provisions and had considerable success in using the new rules to prevent the payment of improper claims (National Taxpayer Advocate, 2017). The NTA reports that the PATH changes allowed the IRS to have a material impact on its ability to freeze refunds on returns that may otherwise have reflected income misreporting, with a projected 2.1 percent decrease in improper payments as compared to the immediately preceding

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<sup>30</sup> Adopted in 2015 for the 2016 year, California is the 26<sup>th</sup> state to add a state-level EITC. Unlike most other states, which give individuals a fixed percentage of the federal EITC, California concentrates its credit on lower-income individuals by phasing out the credit at a much lower-income threshold than under federal law (Montialoux, C. & Rothstein, J., 2015). Under legislation enacted in 2017, however, California increased the amount of income that recipients could earn before phasing out its benefits (State of California Franchise Tax Board, 2017b, p. 4).

filing year when the PATH changes were not yet effective (National Taxpayer Advocate, 2017, p. 64-65). The IRS and Congress have high expectations these measures will reduce the opportunities for incorrect claims and increase the ability for the IRS to prevent payment on returns that reflect income that is not reported by third parties.<sup>31</sup>

Yet, while PATH makes considerable inroads in allowing IRS to associate third party income reports prior to having to decide whether to release a refund, it does little to address income that is earned by millions of sole proprietors who are part of the cash economy or the sharing economy and whose income is often not subject to third party reporting.<sup>32</sup> Many of those sole proprietors receive income that is not reported to the IRS; even among the sole proprietors whose income is reported to the IRS (and who are thereby subject to the PATH changes), it is often the case that the information returns are insufficient for the IRS to associate those information returns with the EITC claims. This is because the EITC claim is based on net income; the Forms 1099 are generated based on gross payments.<sup>33</sup>

In contrast with Congress' approach in PATH to give the IRS additional tools to detect and prevent improper payments, California, in initially adopting a state earned income tax credit, took a different approach (California Earned Income Tax Credit, 2017). California avoided the problem of putting the California Franchise Tax Board (the state equivalent of the IRS) in the position of having to prove the amount or existence of a sole proprietor's income by carving out from the definition of earned income any income from self-employment (California Earned Income Tax Credit, 2017).<sup>34</sup> Under the original law, unless the income was received in the capacity as an employee and subject to California withholding, the amount could not be used to generate a state-level EITC (California Earned Income Tax Credited, 2017; State of California Franchise Tax Board, 2017a). To be sure, in 2017, California expanded its EITC to self-employment income, though in doing so it recognized that self-employed taxpayers present challenging compliance problems for tax administrators (State of California Franchise Tax Board, 2017b).<sup>35</sup> Despite

<sup>31</sup> See U.S. House of Representatives Oversight Subcommittee Hearing (2017), for a discussion on this point from the Chair of the Oversight Subcommittee in his introduction statement and from IRS executive Kirsten Wielobob in her testimony.

<sup>32</sup> See Oei and Ring (2016), for a discussion of the sharing economy, where individuals can obtain goods and services from peers via the internet, and how that has exacerbated tax administration problems for sole proprietors.

<sup>33</sup> See Lederman (2010, p. 1740), for a discussion on the conditions where information reporting will likely reduce noncompliance. The article notes information reporting is most effective when it provides the government with complete information necessary to match what is reported on a person's tax return (Lederman, 2010, p. 1740).

<sup>34</sup> See Montialoux & Rothstein (2015, p. 9), who speculated that the reason for the rule was a concern with compliance.

<sup>35</sup> The California EITC is premised each year on the State legislature authorizing and appropriating funds to allow the State taxing authority the resources to "oversee and audit returns associated with the credit" (State of California Franchise Tax Board, 2017b, p. 2). When California initially enacted its EITC, the legislature directed the Franchise Tax Board to explore ways "to allow self-employment income to be included as earned income while protecting against improper payments" (State of California Franchise Tax Board, April 27, 2016, p. 1). The FTB identified a number of ways to enhance compliance among self-employed taxpayers, including imposing additional verification and documentation associated with self-employment income and additional audits of taxpayers whose returns reflect self-employment income. The FTB noted that it surveyed other states' experiences and met with representatives from New York State, which has a vigorous and resource-intensive effort to address improper State EITC claims. According to the FTB, New York representatives told the California FTB that "self-employment income was one of the primary reasons for improper EITC payments" and that "[l]imiting the EITC to wage only-earned income would be an effective method of reducing improper payments due to the ability to reliably match taxpayer-reported wage income against employer-provided wage data" (State of California Franchise Tax Board, 2016, April 27, p. 4).

California now allowing its self-employed taxpayers to potentially benefit from the EITC, its approach to the issue shows how it is possible for a legislature, in the interest of program integrity, to overreact and sacrifice other key policy goals associated with the delivery of refundable credits. California is a cautionary tale showing how the EITC compliance problem can contribute to unfairly punishing taxpayers in an economy that they do not have much power over, instead of thinking through the difficult task of compliance and establishing compliance norms.

### **Proposals That Anticipate Noncompliance But Also Reflect The Lives of the Working Poor**

#### *First Proposal: Allow for Greater Flexibility in Establishing Eligibility Criteria*

In the previous section, I discussed two reform proposals designed to address the types of compliance issues associated with in *Smyth* and *Foxx*. *Smyth* implicates qualified child errors, the costliest type of EITC error. *Foxx* implicates income-misreporting errors, the most common EITC error associated. The proposals address different aspects of the EITC compliance problem but share a common theme: reduce opportunities for noncompliance by removing from the eligibility criteria sources that are difficult for the IRS to verify. The Rector and Hall proposal simplifies the IRS task by only allowing biological parents with formal legal custody, foster parents and legal guardians to treat children as qualifying children for purposes of the EITC (Rector and Hall, 2016). California's initial approach would simplify the agency's task by only allowing earned income that is reported by employers on W-2s or otherwise subject to state withholding to be treated as earned income for purposes of credit eligibility (California Earned Income Tax Credit, 2017).

Both measures, if adopted at the federal level, would have a significant impact on overclaims. Consider Rector and Hall's proposal first. It addresses two different, but related, EITC compliance problems relating to qualifying children: residency and multi-generational household errors of the kind in *Smyth* (Rector & Hall, 2016). First, they note that most qualifying child error issues relate to residency (2016). By some estimates, approximately 2.8 million claims are based on false residency claims by noncustodial parents or other adult relatives; in other words, the claimant does not live in the same household with the claimed child for more than half the year (2016, p. 14). Second, Rector and Hall note that, among multi-generational households, another approximately 500,000 erroneous claims relate to custodial parents "permitting" other related adults to claim the child to maximize EITC benefits (2016, p. 7, footnote 39). In those multi-generational households, Rector and Hall argue, families engage in active "benefit gaming" by sharing children among relatives to maximize household EITC receipt (2016, p. 11).

The Rector and Hall proposal directly addresses multi-generational households by eliminating non-parental claimants even if those relatives live with and support minor children (2016). The proposal indirectly addresses residency issues by limiting opportunities for sharing children among nonparental family members who do not reside in the same household.<sup>36</sup>

<sup>36</sup> Rector and Hall discuss the indirect impact and his assumptions:

A demographic breakout of false residence claims is not available, but it is reasonable to assume that relatively few single biological parents with legal custody fail to reside with their children but still claim the EITC. Similarly, it is unlikely that large numbers of married couples claim the EITC when neither parent resides with the child. A reasonable assumption, therefore, is that most residency fraud involves claims by noncustodial unmarried parents (generally absent fathers) and adult relatives who do not actually reside with the child (2016, p. 11).

Despite little evidence that supports the claim, and considerable evidence that suggests to the contrary (National Taxpayer Advocate, 2015c, p. 330), Rector and Hall assert that the IRS has access to federal databases that will allow it to easily verify the legal relationship of claimants to children; the implication is that under this approach IRS could use summary powers to reject an EITC claim when the claimant is not a biological parent with legal custody or foster parent (2016). This aspect of his proposal is important, as IRS resources are strained,<sup>37</sup> and to be able to reject claims using summary math or clerical error powers is significantly less costly than under traditional correspondence-based examinations that cost hundreds of dollars per examination and often take months to resolve.<sup>38</sup>

To be sure, the proposal reflects and is consistent with the idea that the government should anticipate the largest areas of noncompliance and minimize opportunities for that noncompliance. Limiting the class of adults to essentially biological parents with legal custody would have a major impact on overclaim rates. Assuming accuracy of database information (which is not a reasonable assumption), the IRS at little cost to it could reject erroneous claims without the need for costly and time-consuming correspondence.

Even assuming that IRS could seamlessly have access to accurate information about the residency and relationship of claimed children, the Rector and Hall proposal has a significant shortcoming: it does not reflect the circumstances of the working poor. A core aspect of the proposal is that the EITC is meant to encourage parental work, which in his view is “at the philosophical heart of the program” (2016, p. 11). To be sure, encouraging parental work is a key aspect of the EITC but its origins stem from reducing welfare rolls and incentivizing entry into the labor force, and not promoting any one idea of traditional family arrangements.<sup>39</sup> The lives of the working poor are often characterized by situations present in *Smyth*: adult family members other than parents who live with and support minor children. By eliminating the possibility that the EITC provides a benefit to those families, Rector’s proposal results in denying benefits to responsible adults who, like the grandmother in *Smyth*, worked hard to keep and maintain a home for her grandchildren. By extension, the proposal may have a significant negative impact on the lives of children, especially like the grandchildren of Grisel Smyth who benefit from the care and support of family members who act as surrogate parents when biological parents either cannot or are unwilling to provide the support that the children need. As Judge Holmes notes in *Smyth*, it does not in any way “seem just” to deny a benefit meant to reward a low-wage worker who supports and lives with minor children (*Smyth v. Commissioner*, 2017, at \*4).

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<sup>37</sup> See Debot, Horton, & Marr (2017), for a discussion of the reductions in the IRS’s budget since 2010 and the overall decline in the agency’s employees.

<sup>38</sup> The IRS estimates that each correspondence examination costs IRS \$410.74 and imposes significant burdens on taxpayers in terms of time needed to respond to correspondence (United States Government Accountability Office, 2016). The United States Government Accountability Office also noted that the burden of correspondence examinations on taxpayers is not evenly distributed and that it takes taxpayers approximately 30 hours to fully participate in correspondence examinations (2016). To summarize assess using math error procedures costs significantly less, at least in up front measurable agency costs. The NTA has argued that summary assessment powers are actually much costlier when considering downstream agency and taxpayer costs (National Taxpayer Advocate, 2014, p. 171; National Taxpayer Advocate, 2015c, p. 330).

<sup>39</sup> See Crandall-Hollick (2018) for a summary of the legislative history of the EITC, including its origins as a means to reduce dependence on traditional welfare and encourage entrance in the labor force.

Simply eliminating the ability to claim the credit for the millions of adults who play by the rules and work and care for children is at least in some metrics a way to increase compliance. It will reduce the IRS's challenges in the short-term, and it likely would have not resulted in Grisel Smyth improperly claiming the EITC if there were a bright line "parent with legal custody only" test. A simple rule along the lines Rector and Hall propose is easy for individuals to understand. But it has other effects as well, including creating a structural mismatch between the reality of people's lives and the eligibility for benefits, a situation that can contribute to individuals' increased willingness to engage in noncompliant behavior.<sup>40</sup> If the EITC is principally intended to reward low-wage work, offset the regressive impact of payroll taxes and provide needed benefits to offset poverty for low-wage workers who care for children, should a family member like Grisel Smyth who maintains a household and works a full-time low wage job as a nursing assistant not be able to claim the credit because she, rather than her son, is the main family breadwinner? Inherent in the proposal is a yearning for a time when tax rules generally benefited more "traditional" households, headed by a married couple living solely with their biological children. That period does not exist, was not a stated policy goal of the EITC at the time of enactment or as part of post-enactment legislative expansions, and is unlikely to return notwithstanding any federal incentives.<sup>41</sup>

The basic facts in *Smyth* reflect an increasing reality of American family life. Households consisting of two biological parents and their children are declining, especially for lower-income Americans. A study by the Council on Contemporary Studies and a paper by the Tax Policy Center discuss the decline of traditional two-parent households, with both indicating that changes in family households are more pronounced among lower-income families. In the 1960's about 90 percent of children lived in two parent households; by 2014 just under 68 percent of children were living with both parents (Cavanagh, 2015). American households are increasingly characterized by a shared parenting approach, with younger adult Americans often living with other adults who help financially and with the nonfinancial aspects of child rearing. The Tax Policy paper also discusses the greater fluidity of living arrangements, that is, changes in locations within a year and changes of composition within households (National Taxpayer Advocate, 2016b, p. 336). Underlying census data also shows that, as of 2013, approximately 7.3 million custodial parents of the nation's 13.4 million parents living with children under age 21 did not have any type of legal arrangement outlining custody. About half of the 6.5 million custodial parents who had some arrangement with noncustodial parents provided for visitation privileges for children but did not provide for shared legal or physical custody (Grall, 2016, p.8). These changes are more pronounced among lower and moderate-income families (National Taxpayer Advocate, 2016b, p. 336).

These changes create challenges for the IRS. As the National Taxpayer Advocate has noted, current U.S. tax law, and the EITC in particular, assigns benefits to only one person (or in the case

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<sup>40</sup> Sociologists Robert Kidder and Craig McEwen have persuasively discussed how individuals may engage in "symbolic noncompliance" as a way to combat perceived unfairness or inequities in the law (1989, p. 59).

<sup>41</sup> For a summary of the legislative history of the EITC from origin to the present, see Crandall-Hollick (2018), Many reasons have contributed to the changing family make up of American households, including the cost of housing and the opioid epidemic that has afflicted many young adults, often resulting in other family members stepping in and taking informal custody of children. See Desmond (2015), for a discussion of housing costs and its impact on lower-income families. See Whalen (2016), for a recent article discussing the impact of the opioid crisis on children and caregiving.



of a married couple, two people) (National Taxpayer Advocate, 2016b, p. 325). Yet, multiple adults other than parents or legal guardians often have responsibility for and support minor children; many parents are deeply involved in their children's lives, but for many reasons the parents may not have formal legal custody of their children. Limiting the EITC solely to parents with legal custody is inconsistent with the fundamental ways in which lower and moderate-income individuals raise children. As lower-income families often take a shared approach to child-raising (due in part to factors such as high costs of housing and child care), a proposal that limits the class of eligible adults smacks of attempting to shoehorn policy into an idealized image of family life rather than the reality that many lower-income individuals experience.

Is there a different approach that could perhaps better reflect the changing reality of American family life? If some of the noncompliant claimants (like Smyth) are truly engaged in the lives of minor children, then perhaps the solution is to expand rather than contract the class of adults who can qualify to claim children as qualifying children.<sup>42</sup> To better reflect the ways in which many Americans actually live and care for children, Congress could amend U.S. law to allow an adult to treat a child as a qualifying child if that adult provides significant care for a child during the course of a 12-month period. This is similar to what Australia does with its Family Tax Benefit credit, which provides a refundable credit for a child who is in a parent or grandparent's care for at least 35 percent of the time (Australian Department of Human Services, 2017). There would be many details to be worked out in such a system, including the possibility that multiple adults could potentially qualify as a primary carer (and perhaps share the credit, as is possible in Australia), the process for establishing that an adult is a primary carer, and how to define care in a way that perhaps includes but is not limited to residency.<sup>43</sup>

Despite the considerable details that would need to be resolved, the virtue of this approach is that it allows for and considers the greater reality that many adults have connections to children that may justify support from the state, unlike the Rector and Hall proposal, which attempts to limit overclaims by narrowing the class of individuals who would be eligible to claim the EITC. It would have the virtue of redefining previously noncompliant behavior as compliant,<sup>44</sup> an especially attractive option if one views the noncompliant behavior as consistent with the EITC's broader policy goals of rewarding low-wage workers who care for children.

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<sup>42</sup> A more far-reaching proposal would be to bifurcate the work and child aspects of the EITC into two separate credits (National Taxpayer Advocate, 2016b, p. 328). Under this proposal, individuals would be eligible for the Family Credit to all taxpayers regardless of income; the EITC would be awarded on a per worker basis, which by definition would include more generous benefits for childless workers. Under this proposal, adults who live with and care for children (even perhaps with children not related to the adult) would be eligible for the Family Credit. By not limiting the Family Credit to households based on income levels, the proposal significantly reduces incentives to improperly share children to maximize credits; by unifying the definition of child it would also minimize taxpayer mistake as a source of error.

<sup>43</sup> In Australia, caring includes factors that are broader than residency. Australia looks to who is the "primary carer" or who in fact has the greater responsibility for the child, including things like who has daily responsibility for the child, who is responsible for transportation to and from school, and who is the child's primary emergency contact (Australian Department of Human Services, 2017).

<sup>44</sup> Congress has done this before with the Economic Growth and Tax Relief Reconciliation Act of 2001 in which the tiebreaker rules were amended and relaxed to "allow[] eligible taxpayers with the same qualifying child to decide amongst themselves who would claim the child" (Marcuss, Dubois, Risler, & Leibel, 2014, p. 2).

*Second Proposal: Waive Repayment or Reversal Where to Do So Would be Inequitable*

Congress may be unwilling to expand the definition in the way I suggest above. Another more limited proposal that may provide for relief for individuals like Grisel Smyth would be to give the IRS or, on review, a court the option to waive repayment or reversal of an erroneously claimed EITC if repayment or a reversal would be inequitable. This option exists in a number of nontax federal statutes when the government must decide whether it should recover erroneously disbursed funds<sup>45</sup> and shares the objective of giving the IRS additional discretion to compromise an agreed-upon liability when compelling public policy or equity considerations warrant a compromise.<sup>46</sup> The statutes give federal agencies the power to allow for the waiver of repayment when to do so would be “against equity and good conscience” (*Trimmer v. Commissioner*, 2017, at 45-46). While the standard differs according to context, the underlying theme when thinking about equity is whether a waiver would promote the “spirit and habit of fairness and justice” (*Groseclose v. Bowen*, 1987, at 505). The term conscience means “the sense of right or wrong \* \* \* together with a feeling of obligation to do or be that which is recognized as good” (*Groseclose v. Bowen*, 1987, at 505).<sup>47</sup> Often, considerable discretion is left to the agency to consider an individual’s facts and circumstances, though in application the courts have looked to the underlying program purpose and have attempted to identify factors to guide the process.

In the context of the EITC, a number of factors could assist the IRS and courts in this determination, including whether it was reasonable for the claimant to conclude she was able to claim the child as a qualifying child, the good faith reliance on a tax return preparer who was given all information about the claimant’s circumstances, the degree to which the claimant can establish that she spent a considerable amount of her earnings on support of the household and child, and the hardship that would result from repayment of the erroneous amount. While there would be considerable details to consider in such a proposal (including the mechanism for establishing relief and whether the benefit could extend to individuals who claimed but did not receive the credit following an IRS pre-refund examination), the proposal reflects the possibility that good-faith mistakes may in fact contribute to inequities and that allowing for limited exceptions to the application of eligibility criteria may in fact contribute to more just administration of the laws.<sup>48</sup>

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<sup>45</sup> See *Trimmer v Commissioner* (2017, at 45), where the court listed a number of statutes “where the Government must decide whether a recovery of erroneously disbursed funds should be attempted[.]” including Railroad Retirement Act of 1974, Pub. L. No. 93-445, §10(c), 88 Stat. at 1344, codified as amended at 45 U.S.C. §231i(c) (2012); Railroad Unemployment Insurance Act Amendments, Ch. 842, §. 11, 54 Stat. at 1096, codified as amended at 45 U.S.C. §352(d) (2012 & Supp. I 2013); 5 U.S.C. §§5584(a), 8346(b), 8470(b) (2012); 10 U.S.C. §§1442, 1453(b)(2) (2012); 37 U.S.C. §§303a(e), 373(b) (2012); 38 U.S.C. §§5302(a) and (b) (2012); Intelligence Authorization Act for Fiscal Year 1993, Pub. L. No. 102-496, §265, 106 Stat. at 3237-3238, codified at 50 U.S.C. §2095 (2012); Social Security Amendments of 1967, Pub. L. No. 90-248, §152(b), 81 Stat. at 861, codified as amended at 42 U.S.C. §404(b) (2012 & Supp. III 2015); Social Security Amendments of 1965, Pub. L. No. 89-97, §1870(c), 79 Stat. at 331, codified as amended at 42 U.S.C. §1395gg(c) (2012 & Supp. I 2013).

<sup>46</sup> These are so-called effective tax administration offers in compromise (Compromises, 2002). See Freund (2014), for a discussion and critique of the IRS’s ineffective administration of ETA offers.

<sup>47</sup> See also *Quinlivan v. Sullivan* (1990, at 526-27), where the Ninth Circuit concluded that in using the phrase “against equity and good conscience[.]” with respect to waivers of overpayments of disability benefits, “Congress intended a broad concept of fairness to apply to waiver requests, one that reflects the ordinary meaning of the statutory language and takes into account the facts and circumstances of each case.”

<sup>48</sup> See Book (2015, May 10), for a particularly unfair application of current EITC rules.

### *Third Proposal: Require Additional Upfront Eligibility Requirements for Some Self-Employed Claimants*

The prior two proposals are directed more at the qualifying child errors raised in the *Smyth* case. The California approach to reducing errors in its initial enactment of the EITC is based on income misreporting errors and reflects the somewhat unusual aspect of the EITC as compared to other means-tested benefits programs. While the EITC is designed in part to promote work, the EITC can also promote taxpayers claiming that they did work when they did not, leading to claims based on unverified or perhaps nonexistent earnings or earnings that are reported without any offsetting deductions.<sup>49</sup> This leads individuals to invent fictitious businesses or inflate income (or omit deductions) associated with real businesses.<sup>50</sup>

It is useful to think of this activity in context. In the context of the EITC, there are general issues relating to the IRS's inability to verify taxpayers' earned income. Recent legislation addressed part of this problem. The legislation accelerates the due date when employers and other service recipients are to file Form W-2 and Form 1099 to January 31 and delays issuing EITC-based refunds until February 15<sup>th</sup>. The idea behind the changes is to ensure the IRS can verify income that claimants report on EITC claims, and allow the IRS to contact taxpayers where those information returns do not match reported income on the tax returns (Protecting Americans from Tax Hikes Act of 2015).

The PATH legislation partially addressed EITC income misreporting issues of self-employed individuals. Self-employed individuals account for approximately two-thirds of income misreporting overclaims (Marcuss, Dubois, Risler, & Leibel, 2014). It is noteworthy that self-employed individuals present the greatest challenges in terms of individual income tax compliance,<sup>51</sup> and the EITC is only a small subset of issues that pertain to this class of taxpayers. Due in large part to the absence of meaningful third-party reporting and withholding, the underreporting of income associated with self-employed individuals accounts for a majority of the overall individual tax gap (Internal Revenue Service Research, Analysis and Statistics, 2016; Tax Policy Center, n.d.). While there have been legislative and administrative proposals to address that issue, it stubbornly persists.<sup>52</sup>

California's initial approach to address this issue in the context of EITC was simple: rather than require the California Franchise Board to verify whether a sole proprietor truly had the income she reports, California removed income that is self-employment income from the definition of earned

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<sup>49</sup> Deductions associated with a trade or business that would potentially generate income to support a claimed EITC are not permissible; in other words, a taxpayer is required to claim deductions that are attributable to the taxpayer's trade or business (See e.g., Order, *Kalokoh v Commissioner*, 2015).

<sup>50</sup> It is possible as well that an EITC claimant in the phase-out range of the EITC could take the more traditional approach to noncompliance and understate income or overstate deductions.

<sup>51</sup> See DeLaney Thomas (2013), for a discussion of recent compliance data and noting that self-employed individuals have an overall compliance rate of less than 50%. Delaney Thomas, looking at IRS data, notes that among individuals in cash businesses sole proprietors report "a staggeringly low 19% of their income" (2013, p. 112).

<sup>52</sup> See Beers, LoPresti, & San Juan (2012) and Beers, Wilson, Nestor, Ibbotson, Saldana, & LoPresti (2013), for thoughtful studies on factors that might encourage sole proprietors to comply, including the importance of increasing trust in the government and tax system). See Bankman, Nass, & Slemrod (2015), for suggestions on ways to use behavioral economics principles to prompt greater compliance among self-employed taxpayers.

income. The California approach takes as a starting point the goal of minimizing the opportunity for noncompliance. Like the Rector and Hall proposal, however, it shares a disconnect from the lives of the working poor. Over the past decade, there has been a significant increase in the number of workers who work as sole proprietors, with the norm of steady employment by one employer shrinking.<sup>53</sup> By removing the possibility that self-employment income can generate an EITC, the proposal sacrifices other program goals. It raises equity concerns as people are treated differently depending on whether income is classified as wages or as self-employment income. Given that worker misclassification is a serious problem in the United States (and employers have incentives to treat workers as contractors rather than employees) the California's initial approach if adopted elsewhere would likely cause significant hardships to workers.<sup>54</sup>

Is there a way to minimize opportunity for noncompliance among the self-employed but still reflect the importance of this type of work? Rector and Hall propose that individuals either provide a Form 1099 showing the income that is earned or submit proof of a business' existence by furnishing information about State or local registration or licensing. In addition, Rector and Hall propose that all self-employed individuals submitting EITC claims would be required to submit invoices identifying goods or services sold and also prove that in fact they have paid self-employment tax regularly during the year.<sup>55</sup>

Rector and Hall's proposal that self-employed individuals be required to submit invoices and other proof of existence is far too burdensome on taxpayers, who would likely be unable to e-file returns with such requirements. In addition, it would impose significant costs on the IRS. Imposing additional burdens on self-employed taxpayers who claim the EITC raises fairness and potential due process concerns,<sup>56</sup> as it is inconsistent with what the tax law generally requires of other self-

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<sup>53</sup> U.S. labor is increasing the number of sole proprietors and the number of sole proprietors who rely on independent contractors (Beesley, 2013; King, 2014). In 2013, over 70% of businesses were "owned and operated by sole proprietors or sole traders" (Beesley, 2013). According to King (2015), in 2013, there were 24 million sole proprietors who generated \$1.34 trillion in revenue, compared to 2012, where there were 23.5 million sole proprietors who generated \$1.30 trillion in revenue. Similarly, in 2014, nonfarm sole proprietorship activity reported "approximately 24.6 million individual income tax returns [ , which represents a] 2.3-percent increase from 2013 (Dungan, 2016, p. 2). Further, in 2014, profits for nonfarm sole proprietorships totaled \$317.1 billion, which represented an increase of 4.9 percent from 2013 (Dungan, 2016, p. 2). Additionally, between 2010 and 2013, there was a 38 percent "growth in the dollar amount of sole proprietor's use [of] contract labor" (King, 2015). According to Worstall (2016), job growth over the past decade, from 2005 to 2015, is contributed to a significant rise in contractor and temp jobs. For instance, the study shows that from 2005 to 2015, alternative work arrangements, such a temp jobs, on-call workers, and contract works, "rose from 10.1 percent in February 2005 to 15.8 percent in late 2015" (Worstall, 2016). "The percentage of workers hired out through contract companies showed the sharpest rise increasing from 0.6 percent in 2005 to 3.1 percent in 2015" (Worstall, 2016).

<sup>54</sup> Worker misclassification "presents one of the most serious problems facing affected workers, employers and the entire economy" (United States Department of Labor). The U.S. Department of Labor has, in partnership with many states, undertaken a major initiative to combat misclassification but the problem persists and is often disproportionately affects lower-income workers with less bargaining power (Department for Professional Employees, 2016).

<sup>55</sup> Rector proposes all individuals claiming an EITC based on self-employment income must provide a Form 1099 documenting the income or be a registered or licensed small business under state law (Rector, 2016, p. 14). In addition, all individuals must provide invoices of payments that identify customers and the service provided and must have paid self-employment taxes regularly during the year (Rector, 2016, p. 14).

<sup>56</sup> See Tahk (2017), for a discussion of how rights-based claims, including procedural due process, may extend to EITC claimants.

employed taxpayers, despite high levels of noncompliance associated with self-employed taxpayers in areas outside the EITC.

Despite the obvious flaws in the specifics of the proposal requiring submission of invoices, the notion of varying EITC-filing requirements among differing taxpayers has appeal. In other words, current rules essentially default to a one-size-fits all approach to upfront filing requirements for the EITC. Perhaps some classes of claimants should have additional requirements that perhaps can be satisfied with submission of some sample documents or an affidavit of eligibility that explicitly identifies and describes the goods or services that the claimant provided. For example, sole proprietors whose income is not subject to Form 1099 reporting (and thus not addressed in the recent PATH legislative changes) might be a prime target for additional self-disclosure requirements.

While the Rector and Hall proposal in its full form is a likely nonstarter in light of fairness concerns and taxpayer and IRS burden, the principle that some claims may necessitate additional upfront eligibility requirements warrants further consideration. There are considerable details that would need to be addressed in any approach that would vary the upfront eligibility requirements associated with self-employed workers. Some of those details include what documents would suffice, which taxpayers were subject to the requirements, whether third parties could assist the IRS in reviewing documents and whether the payment of self-employment tax should be a necessary requirement, since so many EITC claimants have no positive self-employment tax liabilities when taking into account the EITC. To reflect the reality that not all individuals with self-employment income have a structural incentive to misreport income, perhaps the additional documentation requirements should only be targeted to self-employed individuals who have self-employment income that generates an EITC that is greater than would exist in the absence of the reported self-employment income.<sup>57</sup> In addition, if IRS were to consider varying the requirements for some claimants it would benefit from the input of small business taxpayers and their advisors as well as a careful review of the impact of the benefits and costs of the requirement, including their impact on eligible claimants who may decide to opt out of claiming the EITC in light of the additional compliance costs.

#### *Fourth Proposal: Further Encourage the Use of Certain Tax Return Preparers*

A final proposal bridges the issues implicated in both *Smyth* and *Foxx*. Both cases are typical in many EITC claims because the taxpayer relied on and paid for the services of a tax-return preparer and *Foxx* was subject to IRS attention after it had discovered that many returns he prepared reflected income that was non-existent or overstated. Tax-return preparers play an important role in the tax system in general and with respect to the EITC in particular. While there has been a steady growth in individual use of tax software to prepare tax returns and EITC claims without the use of a preparer, approximately half of all EITC returns are prepared by tax return preparers.<sup>58</sup>

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<sup>57</sup> Consider an example where an individual has W-2 income that places the EITC recipient in the plateau or phase-out range of the EITC. That individual who properly reports her self-employment income would actually receive a lower EITC as a result of reporting the self-employment income. Imposing additional compliance responsibilities on that person would be unwise as it would increase taxpayer burden at no potential benefit to the fisc.

<sup>58</sup> “Fifty-five percent of returns claiming EITC were prepared by paid return preparers in tax year (TY) 2013” (National Taxpayer Advocate, 2015a, p. 261).

Apart from a few states, the U.S. tax system allows for any individual to prepare tax returns for compensation, without requiring individuals to possess minimum or continuing education requirements or to pass a test demonstrating competence in basic tax knowledge.<sup>59</sup> The IRS unsuccessfully sought to regulate unenrolled return preparers with the Court of Appeals for the District of Columbia in *Loving*, holding that the IRS acted outside its authority in mandating continuing education and competency testing for unenrolled tax return preparers (*Loving v. IRS*, 2014). Unenrolled preparers play a significant role in preparing and submitting EITC claims, accounting for approximately three-fourths of all prepared EITC returns (National Taxpayer Advocate, 2015b, p. 71). A 2014 IRS study, released after the D.C. Circuit decided *Loving*, showed that unenrolled return preparers had the highest frequency and percentage of EITC overclaims, with almost half of those EITC returns having an overclaim, and overclaims constituting roughly one-third of the total EITC claimed on those returns (Marcuss, Dubois, Risler, & Leibel, 2014).<sup>60</sup>

Following the IRS defeat in *Loving*, it instituted a voluntary program known as the Annual Filing Season Program.<sup>61</sup> The program allows unenrolled preparers to voluntarily elect to take continuing education classes, pass a competency examination and agree to be bound by professional responsibility standards. In exchange, the IRS lists the preparers in a national searchable database and allows those preparers to interact with IRS examination employees if the return that the preparer submits is selected for examination or if the IRS has questions regarding the processing of the returns. The NTA, among others, has repeatedly called for legislation that would explicitly give the IRS the authority to regulate and require a mandatory return preparer regulatory program (National Taxpayer Advocate, 2002, p. 216; National Taxpayer Advocate, 2013).<sup>62</sup> The idea behind the proposals is that the error rates among unenrolled preparers suggest that significant numbers of preparers either lack the tax law knowledge to competently advise taxpayers or seek to exploit taxpayers. They may exploit taxpayers by facilitating noncompliance by recommending ways to generate an improper refund or by turning a blind eye to due diligence requirements that are specifically targeted to return preparers submitting tax returns with certain refundable credits, including the EITC.

While regulation of return preparers alone cannot control for all program errors, the increased accountability and visibility of preparers would likely serve to encourage additional compliance (Book, 2008, p. 90-91), and increasing the skills of preparers would likely contribute to fewer returns reflecting unintentional errors. This would be especially likely if the IRS embarked on a sustained public education campaign regarding the role of tax return preparers and the IRS further paired a program with a compliance and education campaign directed specifically toward encouraging the use of competent and ethical return preparers.<sup>63</sup>

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<sup>59</sup> One exception is for return preparers under various IRS sanctioned volunteer programs (Internal Revenue Service, 2016). Those preparers are required to pass a competency examination and to sign volunteer standards of conduct certification (Internal Revenue Service, 2016).

<sup>60</sup> See Marcuss, Dubois, Risler, & Leibel (2014, p. 36, Table 9), for a comparison of other preparers as comparison.

<sup>61</sup> The program started in 2014 (Internal Revenue Service) and has been updated annually (Internal Revenue Service, n.d.).

<sup>62</sup> See Soled & Delaney Thomas (2016), for a proposal to regulate both tax return preparers and tax preparation software providers.

<sup>63</sup> See National Taxpayer Advocate (2013, p. 70), for specific ideas around such an awareness campaign. See also Kornahuser (2007), suggesting that tax morale can influence compliance and suggesting that the IRS should better use media campaigns and education to influence compliance. The theory behind such an approach recognizes that not all

When unenrolled tax return preparers, such as Dr. Foxx, facilitate noncompliance either by directly advising individuals how to file erroneous claims or failing to exercise their specific due diligence obligations, taxpayers like Shakeena Bryant are often left with the consequences, including a possible tax liability to the IRS and no way to recoup the preparation and ancillary costs associated with submitting the tax return.

In the absence of legislation, the IRS does not have the authority to require all preparers to consent to testing and education requirements. There are possible ways the IRS could further encourage individuals who do use tax return preparers to use certain preparers that opt in to the IRS voluntary program. For example, the IRS could expedite the issuance of refunds for returns submitted by preparers who opt in to the annual filing season program, on the ground that the relatively high error rates associated with unenrolled preparers justifies additional scrutiny of those returns.<sup>64</sup> In addition, the IRS could publicize that it would subject returns from preparers who do not opt in to the IRS program to greater risk of audit. Aversion to IRS scrutiny might encourage taxpayers to visit preparers who have demonstrated a commitment to education in the tax law and have explicitly agreed to be covered by Treasury rules meant to regulate the conduct of those who appear before the IRS.

There are additional costs associated with additional requirements imposed on preparers and taxpayers, including the possibility that preparers will pass on additional compliance costs to the taxpayers. In addition, there is always a risk that taxpayers and preparers wishing to avoid the scrutiny of the IRS may collude to ensure that the preparer does not identify him or herself on the tax return, a phenomenon known as ghost preparing. Ghost preparers (anecdotally at least) seem to be on the rise and may explain the recent decline in paid preparer usage on EITC returns.<sup>65</sup> Yet, the relationship between preparers and taxpayers is dynamic and is a fertile area for additional research. Prior studies have identified at least seven different reasons why a preparer may submit an erroneous EITC claim, and not all errors associated with preparer-submitted returns are attributable to preparer misconduct or incompetence.<sup>66</sup> The IRS itself has warned it is difficult to

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regulated parties will need to have intrusive actions to comply; some may comply as a result of education and service that the agency can provide. These insights have come under the broad heading of responsive regulation. Responsive regulation sets forth a regulatory pyramid with a “series of options that a tax authority might use to win compliance, sequenced from the least intrusive at the bottom to the most intrusive at the top” (Braithwaite, 2007). See National Taxpayer Advocate, 2015a, p. 266 for specific suggestions that adopt the responsive regulatory framework in the context of ways the IRS can improve the oversight of tax return preparers submitting EITC claims.

<sup>64</sup> See Drumbl (2017, p. 284), for a similar idea, suggesting a “Fast-track EITC” along the lines that airport passengers can opt in to avoid security lines.

<sup>65</sup> The IRS itself identifies these preparers as ghost preparers (Internal Revenue Service, 2011).

<sup>66</sup> The seven different reasons why a preparer may submit an erroneous EITC claim include the following:

1. Ignorance or misunderstanding of the law – poor training, inadequate attention to changes in the law, or complexity of the law;
2. Misunderstanding or failure to understand or learn the facts – due to language or cultural barriers – can also be related to ignorance or understanding of the law, as the practitioner may not know what information is relevant;
3. Inability or unwillingness to detect false or incorrect information, though the inability or unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;

draw conclusions from the compliance research that shows a higher overclaim rate among unenrolled preparers, as the higher rate may be attributable to selection bias of the taxpayers themselves (Internal Revenue Service, 2014), an issue the *Foxx* opinion raises in light of Dr. Foxx's claims that he was essentially preparing the erroneous return based on the information that Ms. Bryant provided to him. Yet, even assuming that selection bias accounts for some of the differences, preparers who comply with due diligence obligations or otherwise signal compliance norms may influence taxpayers, especially taxpayers who are not committed to gaming the tax system or taxpayers who may in fact be influenced by preparers who wish to prepare and submit accurate tax returns.<sup>67</sup> Taxpayers who may be on the fence or subject to the influence of preparers who facilitate or broker noncompliance would benefit from a system that encouraged the use of preparers who are more visible and accountable.

## CONCLUSION

The EITC presents significant challenges for taxpayers and the IRS. American tax reform is likely to include a review of the IRS role in administering benefits that that benefit working families. While the EITC has enjoyed bipartisan support, critics have pointed to high error rates and have suggested proposals to limit eligibility as part of an effort to improve program integrity. In designing any benefits' program targeting lower-income working families, there are differing ways to minimize opportunities for taxpayer noncompliance and facilitate greater systemic detection and prevention of error. This paper reviews two recent tax cases, *Smyth* and *Foxx*, and explores aspects of key compliance issues that those cases typify. After reviewing those cases and suggesting that they represent ways in which the current law can entrap individuals to misstate EITC eligibility, this paper considers a recent Heritage Foundation proposal and the initial California state EITC legislation meant to address compliance concerns implicated in the *Smyth* and *Foxx* cases. This paper reveals how the Heritage Foundation proposal and the initial California rule reduce compliance risk but fail to reflect the ways Americans live and work. While tax agencies can often efficiently deliver benefits, given increasing family complexity and fluidity, and a work force that often has earnings that are not subject to information reporting, limiting EITC eligibility to parents with legal custody and eliminating from the definition of earned income self-employment income raises equity concerns. Proposals that restrict the ability for families to claim the EITC may improve program integrity but if the proposals do not reflect the lives and experiences of the claimants themselves, they will likely be counterproductive. Despite the challenges in crafting measures to address integrity that do not impose unfair taxpayer burden,

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6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to otherwise generate IRS attention; and

7. Directed noncompliance – working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds. (Book, 2008, p. 6)

<sup>67</sup> Morse suggests the IRS could better utilize gatekeepers, like tax return preparers, to encourage taxpayer compliance, especially if the IRS tied such reliance to greater publicity and education (2009, p. 499-500). In addition, Boll looked to Danish efforts to nudge consumers to purchase services from tax compliant businesses; as with incentives to use certain preparers, the idea behind the Danish approach is to rely on external stakeholders to achieve regulatory goals (2016). Lederman suggests that normative beliefs about honesty play an important role in tax compliance, with the IRS capable of using targeted enforcement to establish a critical mass of compliance norms among subgroups that may have stubborn norms of noncompliance (2003). Oats and Onu review research on social norms on tax compliance, sharing insights from other disciplines (2015).



there are ways to improve compliance that also reflect the reality that many lower-income Americans face.

Ultimately, no single approach is likely to be effective given that there are many differing causes for EITC noncompliance. With recent legislation accelerating the filing of information returns and mandating a delay in payment of credit-based refunds, Congress provided an approach that allows the IRS to have better information before it decides to release refunds to claimants. This paper offers other proposals that can contribute to greater program integrity while also reflecting the reality and complexities of lower-income lives.

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