

## TAS Research and Related Studies

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# Study of Two-Year Bans on the Earned Income Tax Credit, Child Tax Credit, and American Opportunity Tax Credit

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## EXECUTIVE SUMMARY

The Internal Revenue Code (IRC) authorizes the IRS to ban taxpayers from claiming certain refundable credits (the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), or the American Opportunity Tax Credit (AOTC)) for two years if it determines that the taxpayer claimed the credit recklessly or with intentional disregard of rules and regulations.<sup>1</sup> A review of a representative sample of cases in which the bans were imposed as a result of audits of tax year 2016 returns shows the IRS often did not follow its own procedures:

- In 53 percent of the cases, required managerial approval for imposing the ban was not secured;
- In 82 percent of the cases, the IRS did not adequately explain to the taxpayer why the ban was imposed as required;
- In 61 percent of the cases in which the auditor was required to speak to the taxpayer before imposing the ban, no such conversation took place; and
- In 54 percent of the cases in which taxpayers submitted documents, it appeared from the documents submitted that the taxpayer believed he or she qualified for the credit.

These improper bans deprived taxpayers, if they were otherwise eligible for a credit in the ensuing two years, of significant tax benefits. For example, taxpayers who were banned from claiming EITC lost almost \$5,000 on average.<sup>2</sup>

Moreover, the IRS may exercise its summary assessment authority to disallow credits that taxpayers claim while a ban on that credit is in effect.<sup>3</sup> Thus, affected taxpayers may not receive a notice of deficiency that would permit them to file a petition with the Tax Court for review of the disallowance. In other situations, taxpayers may be required to petition the Tax Court multiple times to remove the effect of an erroneously imposed ban.<sup>4</sup>

## INTRODUCTION

The EITC, enacted in 1975, is a tax credit targeted at low-income workers (primarily workers with children).<sup>5</sup> It has become one of the government's largest means-tested anti-poverty programs.<sup>6</sup> During 2018, 25 million eligible workers and families received about \$63 billion in EITC.<sup>7</sup> The CTC, enacted

1 IRC §§ 32(k)(1)(B)(ii) (relating to the EITC); 24(g)(1)(B)(ii) (relating to the CTC); and 25(A)(b)(4)(a)(ii)(II) (relating to the AOTC). The statistical information in this research study was not provided or reviewed by the Secretary under IRC § 6108(d). See IRC § 7803(c)(2)(B)(ii)(XII).

2 IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File (IRTF), average EITC for returns receiving this credit in tax years 2017 and 2018 as of cycles 201839 and 201939, respectively.

3 See Protecting Americans from Tax Hikes (PATH Act) of 2015, Pub. L. No. 114-113, div. Q, title 2, § 208, 129 Stat. 2242, 3084, amending IRC § 6213(g)(2)(K) and adding subparagraphs (P) and (Q), applicable to tax years beginning after Dec. 31, 2015. See also Consolidated Appropriations Act, 2018, Pub. L. 115-141, Div. U, Title I, § 101(l)(18), Title IV § 401(a)(277), (278) (2018), making technical corrections to IRC § 6213(g)(2)(P) and (Q) retroactive to enactment of the PATH Act.

4 IRC § 6214(b), relating to the Tax Court's jurisdiction, discussed below.

5 Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975).

6 Congressional Budget Office, *Federal Means-Tested Programs and Tax Credits – Infographic* (Feb. 11, 2013), <https://www.cbo.gov/publication/43935>.

7 IRS, About EITC (Mar. 2019), <https://www.eitc.irs.gov/eitc-central/about-eitc/about-eitc>.

in 1997, is also a means-tested tax credit available to working families.<sup>8</sup> Together, the EITC and CTC lift millions of people out of poverty.<sup>9</sup>

The AOTC, enacted in 2009, is a means-tested tax credit for those who incur qualified education expenses.<sup>10</sup> The credit is available with respect to a student enrolled at least half-time in a college, university, or other accredited post-secondary educational institution, and pursuing a degree or education credential.<sup>11</sup>

If the IRS determines that a taxpayer improperly claimed the EITC, CTC, or AOTC “due to reckless or intentional disregard of rules and regulations,” then the IRS may ban the taxpayer from claiming the credit for two years.<sup>12</sup> Audits of tax year 2016 returns resulted in two-year bans being imposed on 3,831 taxpayers, sometimes with respect to more than one credit.

## BACKGROUND

The IRS has had the authority to ban taxpayers from claiming the EITC since 1997.<sup>13</sup> It acquired the same authority with respect to CTC and AOTC in 2016.<sup>14</sup> In 2013, the National Taxpayer Advocate raised concerns about the IRS’s practices and procedures for imposing the two-year ban on claiming the EITC.<sup>15</sup> The concerns were based on IRS data showing that the IRS frequently — almost 40 percent of the time — imposed the ban without making the statutorily required determination about the taxpayer’s state of mind, discussed below.<sup>16</sup> Moreover, a 2013 TAS study of a representative sample of two-year ban cases found, among other things:

- The IRS frequently — 19 percent of the time — imposed the ban solely because the EITC had been disallowed in the previous year;
- The IRS often — 69 percent of the time — did not obtain managerial approval before imposing the ban, as required by its own procedures; and

8 Pub. L. 105–34, title I, § 101(a), 111 Stat. 796 (1997).

9 Chuck Marr, Chye-Ching Huang, Arloc Sherman and Brandon DeBot, *CBPP-EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children’s Development, Research Finds* (Oct. 1, 2015), <https://www.cbpp.org/research/federal-tax/eitc-and-child-tax-credit-promote-work-reduce-poverty-and-support-childrens> (reporting that together, the EITC and CTC lifted 9.4 million people out of poverty in 2013).

10 Pub. L. 111-5, div. B, title 1, § 1004, 123 Stat. 313 (2009).

11 IRC § 25A(b).

12 IRC §§ 32(k)(1)(B)(ii); 24(g)(1)(B)(ii); and 25(A)(b)(4)(a)(ii)(I). The IRS is authorized to impose a ten-year ban on taxpayers who fraudulently claim the EITC, CTC, or AOTC. IRC §§ 32(k)(1)(B)(i); 24(g)(1)(B)(i); and 25(A)(b)(4)(a)(ii)(I).

13 See IRC § 32(k), enacted by the Tax Reform Act of 1997, Pub. L. No. 105-34, § 1085(a)(1), 111 Stat. 788, 956 (applicable to taxable years beginning after Dec. 31, 1996).

14 See PATH Act of 2015, Pub. L. No. 114-113, div. Q, title 2, § 208, 129 Stat. 2242, 3083-3084, enacting IRC §§ 24(g) and 25(A) (applicable to taxable years beginning after Dec. 31, 2015).

15 National Taxpayer Advocate 2013 Annual Report to Congress 103-115 (Most Serious Problem: *Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*).

16 *Id.* (noting, among other things, that of the taxpayers on whom the IRS imposed the ban in 2011, the accounts of 39 percent were designated on IRS records as “no show/no response” or carried the notation that mail sent to them was returned as undelivered). IRS, CDW, IRTF (Tax Year 2011).

- Almost 90 percent of the time, neither IRS work papers nor communications to the taxpayer contained an adequate explanation of why the ban was being imposed.<sup>17</sup>

### The Rules for Claiming the Earned Income Tax Credit, Child Tax Credit, and American Opportunity Tax Credit Are Complex, Differ From Each Other, and Were Easily Confused With the Rules for Claiming a Dependency Exemption<sup>18</sup>

The amount of allowable EITC and CTC is a function of a taxpayer's earned income or "modified adjusted gross income" and the number of "qualifying children" in the household.<sup>19</sup> A "qualifying child" is a person who, among other things, meets age requirements, bears a specified relationship to the taxpayer, and has the same principal residence as the taxpayer for more than half the year.<sup>20</sup>

The EITC and CTC age requirements differ, and disabled dependents may meet the definition of a qualifying child for purposes of the dependency exemption and the EITC, but not for purposes of the CTC.<sup>21</sup> Moreover, the dependency exemption was available not only with respect to a "qualifying child" but also with respect to a "qualifying relative."<sup>22</sup>

The amount of allowable AOTC, like the CTC, is a function of "modified adjusted gross income" and, like the CTC but unlike the EITC, is only partially refundable.<sup>23</sup>

### A Taxpayer's Recklessness or Intentional Disregard of Rules and Regulations, Rather Than Mere Negligence, Is Required to Trigger a Ban

The IRC authorizes the IRS to impose two-year bans following "a *final determination* that the taxpayer's claim of credit was due to *reckless or intentional disregard of rules and regulations*."<sup>24</sup> Neither the IRC nor Treasury regulations defines the terms "reckless or intentional disregard" for purposes of imposing the

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- 17 National Taxpayer Advocate 2013 Annual Report to Congress 103-115 (Most Serious Problem: *Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*). The National Taxpayer Advocate renewed her concerns in 2019. See National Taxpayer Advocate Fiscal Year 2020 Objectives Report to Congress, vol. 3, at 44-48 (Special Report: *Earned Income Tax Credit: Making the EITC Work for Taxpayers and the Government, Improving Administration and Protecting Taxpayer Rights*).
- 18 The Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97 §§ 11022 and 11041 (2017), added a new credit for other dependents under IRC § 24 for a dependent who is not a qualifying child for purposes of the CTC, significantly increased the CTC, and suspended dependency exemptions. These changes to the tax law are effective for tax years 2018-2025. Thus, for all the taxpayers described in this study, the applicable rules were those in effect prior to passage of the TCJA.
- 19 See IRC §§ 32(c)(1) and 24(a) relating to eligibility to claim the credit, and IRC §§ 32(b) and 24(b) for the calculation of the amount of allowable credit.
- 20 IRC §§ 32(c)(3); 24(c); 152(c) (providing that a qualifying child is an individual who is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (e.g., a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them).
- 21 See IRC § 24(c)(1), requiring a qualifying child to not have attained the age of 17, and IRC § 152(c)(3)(B), providing an exception to the general age requirements, for purposes of IRC § 152(c)(3)(A), but not for purposes of IRC § 24, for individuals who are permanently and totally disabled. For the National Taxpayer Advocate's recommendation that this inconsistency be removed, see National Taxpayer Advocate 2018 Annual Report to Congress 421-424 (Legislative Recommendation: *Child Tax Credit: Amend Internal Revenue Code § 24(c)(1) to Conform With § 152(c)(3)(B) for Permanently and Totally Disabled Individuals Age 17 and Older*).
- 22 See IRC § 152(a)(2) and (d). A qualifying relative includes, for example, the taxpayer's sibling, father, and mother.
- 23 See IRC §§ 25A(i), 24(d).
- 24 IRC §§ 32(k)(1)(B)(ii); 24(g)(1)(B)(ii); and 25(A)(b)(4)(a)(ii)(II) (emphasis added). Under IRC §§ 32(k)(1)(B)(i); 24(g)(1)(B)(i); and 25(A)(b)(4)(a)(ii)(I), the IRS is also authorized to impose a ten-year ban on taxpayers who fraudulently claim these credits, but it imposes the ten-year ban infrequently (for example, audits of 2016 returns resulted in the imposition of ten-year bans on 162 taxpayers - IRS, CDW Individual Master File (IMF)).

ban, and there is no judicial interpretation of those terms in the context of two-year bans.<sup>25</sup> However, IRS Chief Counsel guidance provides that a “taxpayer’s failure to respond (or failure to provide an adequate response) to a request for substantiation and verification of EITC does not, in and of itself, constitute reckless or intentional disregard of the rules and regulations.”<sup>26</sup>

**According to IRS Procedures, Auditors’ Work Papers Must Contain a Detailed Explanation for Imposing a Ban, Managers Must Approve Bans, Auditors Must Speak to Taxpayers Who Are Being Audited for the First Time Before Imposing a Ban, and the IRS Must Explain to the Taxpayer Why It Is Imposing a Ban**

Following the publication of TAS’s research findings from the 2013 study on two-year EITC bans, the IRS revised the Internal Revenue Manual (IRM) to provide additional guidance to auditors about when to impose bans.<sup>27</sup> Both the current version of the IRM and the 2013 version require auditors who propose the two-year ban to note in their work papers, with more than just a cursory explanation, the reason for the decision.<sup>28</sup> However, the IRM now explicitly directs auditors to review the documentation submitted by the taxpayer and to determine whether to impose a ban based on applicable law; the taxpayer’s documentation; contact with the taxpayer; and research on IRS databases, including work papers for the prior year.<sup>29</sup>

Both the current version of the IRM and the 2013 version also require the auditor’s manager to approve the imposition of a ban.<sup>30</sup> However, the IRM now explicitly directs managers to review the entire case file and ensure that the workpapers properly document the decision and reason to impose or not impose a ban.<sup>31</sup> Managers are now also required to ensure that the decision to assert the ban is warranted and to record approval of the ban on the IRS Correspondence Examination Automation Support (CEAS) database.<sup>32</sup>

One current IRM provision that was not part of the 2013 IRM requires the auditor to speak with the taxpayer before imposing the ban if the taxpayer is being audited with respect to the disallowed credit

25 Neither the statutes nor the regulations thereunder cross reference any other Code section (such as IRC § 6662) or regulations that contain similar language. Under IRC § 6662(b)(1), an accuracy-related penalty may be imposed on certain underpayments due to “negligence or disregard of rules or regulations.” IRC § 6662(c) provides: “For purposes of this section, the term ‘negligence’ includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.” Treas. Reg. § 1.6662-3(b)(2) provides: “A disregard is ‘reckless’ if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is ‘intentional’ if the taxpayer knows of the rule or regulation that is disregarded.”

26 IRS Service Center Advice (SCA) 2002-45051 (Nov. 8, 2002).

27 The applicable provision in 2013, captioned EITC 2/10 Year Ban - Correspondence Guidelines for Examination Technicians (CET), was IRM 4.19.14.6.1. That IRM is now numbered as 4.19.14.7.1.

28 IRM 4.19.14.7.1(2), 2/10 Year Ban - Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018) provides “**Note:** Do not use standard statements such as 2-year ban is applicable because taxpayer showed intentional disregard of the rules and regulations for EIC/ACTC/AOTC. Proper workpaper documentation should clearly outline the audit steps taken and fully explains the decision to assert or not assert the 2-year ban.” (emphasis in original).

29 IRM 4.19.14.7.1(2), 2/10 Year Ban - Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018).

30 *Id.*

31 *Id.*

32 *Id.*

for the first time and has responded to the audit.<sup>33</sup> Another current IRM provision that was not part of the 2013 IRM requires auditors to “[w]rite an 886-A explanation to the taxpayer clearly explaining the reason for the assertion of the 2-year ban.”<sup>34</sup> Form 886-A, Explanation of Items, is used as a schedule or exhibit to audit reports.

At the conclusion of the audit, a taxpayer may agree to the proposed additional assessment and ban. If he or she does not agree and does not seek a conference with IRS Appeals (or does not prevail in an Appeals conference), the IRS issues a statutory notice of deficiency to which it may attach the Form 886-A that was sent to the taxpayer. At this point, the taxpayer may seek Tax Court review of the IRS’s determination to impose additional tax. As discussed below, however, the Tax Court may not have jurisdiction to consider whether the ban was properly imposed.

Once the ban has been imposed, the IRS sends the taxpayer Notice CP 79A, We Denied One or More of the Credits Claimed on Your Tax Return and Applied a Two-Year Ban, reciting that it denied one or more of the credits claimed on the return and applied a two-year ban.<sup>35</sup> Notice CP 79A advises the taxpayer “you don’t need to take any action at this time,” but also refers the taxpayer to an IRS web page for additional information. At that web page, the answer to “What do I need to do if I disagree with the 2-year ban?” is “You may request a reconsideration of the audit. In your request, send us proof you are entitled to the credits for the audited year, or proof your claim for the credits wasn’t due to reckless or intentional disregard of rules and regulations.”<sup>36</sup>

### **The IRS May Disallow Claimed Credits Pursuant to Its Summary Assessment Authority While a Ban Is in Effect**

When a taxpayer claims a credit while subject to a ban, the IRS is authorized, pursuant to its summary assessment authority, to assess additional tax (which includes reducing the amount of refund due) that arises from disallowing the credit, without issuing a statutory notice of deficiency.<sup>37</sup> However, if the taxpayer responds to the IRS’s notice of such an assessment within 60 days, the IRS must reverse the summary adjustment and issue a notice of deficiency before assessing additional tax.<sup>38</sup> The taxpayer may then petition the Tax Court for a redetermination of the tax for that year. As noted above, in order to seek relief from the ban administratively, according to IRS procedures, the taxpayer must request audit

33 IRM 4.19.14.7.1(7), 2/10 Year Ban - Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018), provides that “IF this is the first year EITC, CTC/ACTC, or AOTC was audited; AND the TP has responded, you must speak with the taxpayer before you recommend assertion of the ban. Based on the information received and your conversation with the taxpayer, the taxpayer shows they had prior knowledge of the rules and regulations for claiming one or more of the credits, but chose to take it anyway; THEN Assert the ban on each of the credits to which it applies and include the specific details that showed the taxpayer had prior knowledge of the rules and regulations.” The IRM does not define what constitutes a first-time audit.

34 IRM 4.19.14.7.1(4), 2/10 Year Ban – Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018).

35 IRM 4.19.14.7.1(5), 2/10 Year Ban – Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018) (providing that “[w]hen the case closes Master File will mail CP 79A to the taxpayer explaining that the 2-year ban was applied and what they need to do in the future”).

36 IRS, Understanding Your CP79A Notice (Oct. 29, 2019), [www.irs.gov/cp79a](http://www.irs.gov/cp79a).

37 IRC § 6213(g)(2)(K), (P), and (Q); IRM 4.19.14.7.1.1, Project Codes 0697 and 0698 - EITC Claimed Under the 2/10 Year Ban (Nov. 2, 2017). If the taxpayer did not participate in the audit that triggered the ban (perhaps because mail to the taxpayer was undeliverable, as discussed below) this disallowance may be the first time the taxpayer realizes the ban was imposed.

38 See IRC § 6213(a), (b)(2).



reconsideration (not abatement of the tax).<sup>39</sup> The IRS's summary assessment notice does not inform taxpayers of this avenue for seeking removal of the ban.<sup>40</sup>

### The IRS Automatically Imposes Two-Year Bans in Some Recertification Cases

A taxpayer whose claimed EITC, CTC, or AOTC for a particular tax year is disallowed is required to demonstrate eligibility for the credit before claiming it in subsequent years.<sup>41</sup> The IRS places an indicator on the taxpayer's account and if the taxpayer claims the same credit in a later year, the IRS requests the taxpayer to recertify eligibility for the credit.<sup>42</sup> If EITC recertification is required but is not submitted and the case is selected for audit, the case is assigned one of two project codes:

- Project Code 27 - Full scope EITC with two-year ban proposed; or
- Project Code 28 - Schedule C and full scope EITC with two-year ban proposed.<sup>43</sup>

If a case is assigned project code 27 or 28, the IRS will request documentation from the taxpayer to prove he or she is entitled to claim the EITC. If the taxpayer does not respond, the two-year EITC ban is automatically, or systemically, imposed. If the taxpayer replies to the request for documentation, an auditor evaluates the taxpayer's response.

These procedures not only circumvent the statutory requirement that the IRS ascertain whether the taxpayer acted recklessly or with intentional disregard of rules and regulations, they also place the burden on the taxpayer to show that the ban should *not* be imposed, rather than requiring the IRS to show that the ban should apply.

If the auditor proposes a ban, then the same procedures applicable to other proposed ban cases apply: managerial approval is required, and a detailed explanation for imposing the ban must be provided to the taxpayer.<sup>44</sup>

39 IRM 4.13.3.17, Audit Reconsiderations EITC 2/10 Year Ban (Dec. 17, 2015).

40 The summary assessment notice sent in the year following the ban, for example, advises the taxpayer "We disallowed the amount claimed as earned income credit on your tax return. Our records indicate that we've banned you from claiming earned income credit for two tax years. (Form 1040/A)." A letter with similar language is sent in the second year of the ban, and similar letters are sent with respect to summarily disallowed CTC and AOTC. IRM Exhibit 3.12.3-2, Taxpayer Notice Codes (Feb. 6, 2018), taxpayer notice codes 814, 815, 819-824.

41 IRC §§ 32(k)(2), 24(g)(2) and 25A(b)(4)(B) all provide that "[i]n the case of a taxpayer who is denied [the credit under this section] for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no [credit] shall be allowed under this section for any subsequent taxable year unless the taxpayer provides such information as the Secretary may require to demonstrate eligibility for such credit."

42 IRM 4.19.14.7, Recertification (Apr. 11, 2018).

43 IRM 4.19.14.7.1.5, Project Codes 0027 and 0028 – EITC Recertification with a Proposed 2 Year EITC Ban (Nov. 2, 2017).

44 IRM 4.19.14.7.1.5 (2), Project Codes 0027 and 0028 – EITC Recertification with a Proposed 2 Year EITC Ban (Nov. 2, 2017).



In 2013, the National Taxpayer Advocate pointed out the inappropriateness of automatically imposing bans under these procedures and recommended the IRS immediately suspend the automatic imposition of the two-year EITC ban.<sup>45</sup> In response to this recommendation, the IRS noted that it “is working with the Office of Chief Counsel [OCC] to ensure we are applying the EITC ban in appropriate circumstances.”<sup>46</sup> In April 2014, the IRS received advice from OCC that attempted to describe the circumstances in which automatic imposition of a ban could be permissible under the statute. OCC shared the advice with TAS, but in May 2014, OCC notified the IRS that it was withdrawing the advice.

### Taxpayers May Be Required to Petition the Tax Court Multiple Times to Remove the Effect of an Erroneously Imposed Ban

Under IRC § 6214, the Tax Court’s jurisdiction is restricted to determining the amount of tax owed in the tax year(s) before it. Thus, if a taxpayer files a Tax Court petition in response to a statutory notice of deficiency issued with respect to Year 1, the court may not have jurisdiction to determine whether a ban included in that statutory notice of deficiency should apply to future years (Years 2 and 3) that are not included in the statutory notice of deficiency and are thus not before it.<sup>47</sup>

If the Tax Court does not consider whether a ban was properly imposed in Year 1 and the ban is left intact, then if the taxpayer claims the banned credit in Year 2 or 3, the IRS will disallow the claim pursuant to its summary assessment procedures. The taxpayer would be required to dispute the summary assessment and again seek Tax Court review to determine whether the credit was properly claimed once the IRS issues a statutory notice of deficiency for that year. Consequently, to alleviate the effects of a two-year ban that was improperly imposed, a taxpayer may be required to request Tax Court review multiple times.

Moreover, the Tax Court has not held that it has jurisdiction, in a deficiency proceeding in which Year 2 or 3 is at issue, to determine whether the ban was properly imposed in Year 1 (and if it lacks that jurisdiction, it may not have the authority to allow the credit in Year 2 or 3). Thus, it is unclear whether and at what point the Tax Court has jurisdiction to review a ban determination.<sup>48</sup>

45 See National Taxpayer Advocate 2013 Annual Report to Congress 103, 107 (Most Serious Problem: *Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*), noting that under these procedures, “[t]here is no attempt to ascertain whether the reason for the previous disallowance is different from the reason for the current year’s disallowance (e.g., whether the same children were claimed as qualifying children), or whether there was ever any contact with the taxpayer from which to surmise he or she understood the reason for either disallowance. According to this [IRM] provision, if these taxpayers do respond to audit notifications, it is their burden to show that two-year ban should not apply, rather than the IRS’s burden to show that it does apply.”

46 National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress vol. 2, 42-43 (*IRS Responses and National Taxpayer Advocate’s Comments*).

47 *Compare Garcia v. Comm’r*, T.C. Summ. Op. 2013-28 (Apr. 3, 2013), <https://ustaxcourt.gov/UsTclnOp/OpinionViewer.aspx?ID=10538>, a nonprecedential case in which the Tax Court held a ban did not apply *with Ballard v. Comm’r*, No. 3843-15 (Feb. 12, 2016), <https://www.ustaxcourt.gov/UsTcDockInq/DocumentViewer.aspx?IndexID=6783516>, an Order in which the Tax Court declined to rule on the application of IRC § 32(k), noting that the application of the ban had no consequence to the taxpayer’s federal income tax liability for the year before it.

48 The National Taxpayer Advocate recommends clarifying that the Tax Court has jurisdiction to review bans. See National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 30-32 (*Require Independent Managerial Review and Written Approval Before the IRS May Assert Multi-Year Bans Barring Taxpayers From Receiving Certain Tax Credits and Clarify That the Tax Court Has Jurisdiction to Review the Assertion of Multi-Year Bans*).

## RESEARCH QUESTIONS

A 2013 TAS study demonstrated that the IRS often imposes EITC bans in error, and the IRS made some adjustments to its procedures in the light of that study. A primary objective of this year's study is to determine the extent to which erroneous bans continue. Thus, we posed the following questions:

1. Overall, how often does the IRS impose two-year bans?
2. Overall, how often did the IRS impose bans even though the taxpayer did not participate in the audit or mail to the taxpayer was undeliverable?
3. What are the income characteristics of taxpayers who are subjected to bans?
4. How often is the required managerial approval obtained before the ban is imposed?
5. How often is there an adequate explanation on Form 886-A of why the ban is being imposed as required by IRS procedures?
6. How often does the IRS speak to taxpayers who are being audited for the first time before imposing the ban, as required by IRS procedures?
7. How often does it appear from documents taxpayers submit that they believe they are qualified for the credit?
8. How many bans are systemically imposed?
9. How often do taxpayers seek audit reconsideration of the ban?
10. How often does the IRS use its summary assessment authority with respect to taxpayers subject to a ban?

## METHODOLOGY

In past reports, including our 2013 study, we calculated the number of two-year bans according to when the ban appeared on IRS databases.<sup>49</sup> Updates in IRS databases allow us to identify the tax year at issue in audits that triggered a two-year ban.

In this study, we provide data about the population of taxpayers on whom a two-year ban was imposed. In addition, to learn more about how the IRS imposes two-year bans, TAS Research extracted a random, statistically valid sample of 289 cases in which the IRS imposed one or more two-year bans on a given taxpayer as a result of an audit of the taxpayer's 2016 return (the most recent year for which data is available).<sup>50</sup> Using a Data Collection Instrument (DCI) that was substantially similar to the DCI that

49 See, e.g., National Taxpayer Advocate 2018 Annual Report to Congress 91-104 (Most Serious Problem: *Improper Earned Income Tax Credit Payments: Measures the IRS Takes to Reduce Improper Earned Income Tax Credit Payments Are Not Sufficiently Proactive and May Unnecessarily Burden Taxpayers*); National Taxpayer Advocate 2013 Annual Report to Congress 103-115 (Most Serious Problem: *Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*).

50 As discussed below, some taxpayers were subjected to a ban with respect to more than one credit.

was used in the 2013 TAS study, the TAS team reviewed and analyzed records stored on IRS databases.<sup>51</sup> Unless otherwise indicated, the sample findings can be projected to the entire population and are statistically valid at the 95 percent confidence level with a margin of error of +/- 5.6 percent.

## FINDINGS

### 1. Overall, the IRS imposes fewer two-year bans than in the past, but the number is rising.

The IRS imposed two-year bans on 3,534 taxpayers as a result of audits of tax year 2014 returns; on 4,613 taxpayers as a result of audits of tax year 2015 returns; and 3,831 taxpayers as a result of audits of tax year 2016 returns.<sup>52</sup> Thus, the number of overall bans in recent tax years appears to have declined compared to the number of bans that appeared in IRS databases in 2011. However, the number of bans imposed as a result of audits of 2015 and 2016 returns was higher than the number of bans imposed as a result of audits of 2014 returns.

### 2. In 19 percent of the cases in which the IRS imposed bans, the taxpayer did not participate in the audit or mail to the taxpayer was returned as undeliverable.

IRS records may designate an account as “no show/no response” to indicate that the taxpayer did not participate in an audit, or the account may carry the notation that mail sent to the taxpayer was returned as undelivered.<sup>53</sup> As noted above, a taxpayer’s failure to respond to a request for substantiation and verification of EITC does not, in and of itself, constitute reckless or intentional disregard of the rules and regulation.<sup>54</sup>

Nevertheless, of the 3,831 taxpayers overall on whom a two-year ban was imposed following an audit of their 2016 returns, 714 cases were designated as “no show/no response” or mail was undeliverable, a rate of 19 percent. However, this rate represents a significant improvement over the 39 percent rate at which bans were imposed in 2011, as we found in our 2013 study.

Figure 4.2.1 shows, for the most recent data available, the percent of two-year bans imposed on taxpayers whose accounts were designated as no show/no response or carried the notation that mail was returned to the taxpayer as undelivered.<sup>55</sup>

51 Among other databases, the TAS team consulted the IRS CEAS database that includes copies of the auditor’s work papers and correspondence with taxpayers. There were four cases originally selected for inclusion in the sample for which CEAS records could not be found. Those cases were excluded from the final sample. In some other cases, information was not available to allow the reviewer to respond to all DCI questions. In these instances, the margin of error for the 95 percent confidence level is shown for the smaller sample sizes. Three of the four reviewers also participated as reviewers in the 2013 TAS study.

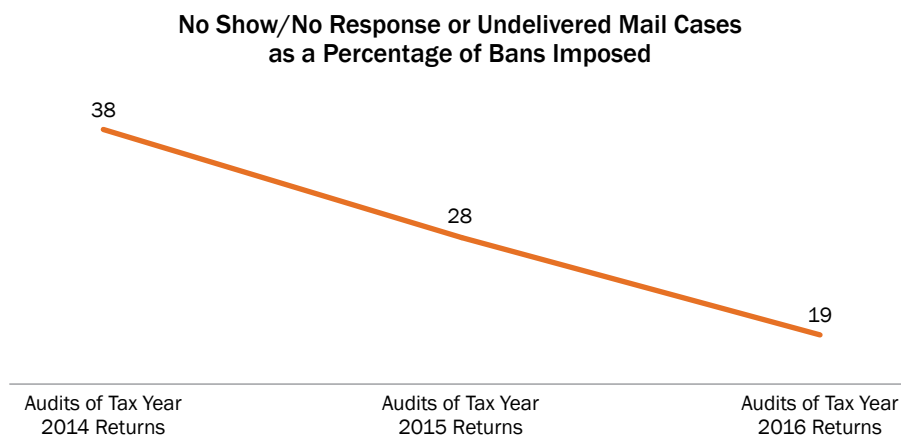
52 National Taxpayer Advocate 2013 Annual Report to Congress 103, 105 (Most Serious Problem: *Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*) (reporting that 4,030 two-year bans appeared on IRS databases in 2009; 4,071 in 2010; and 5,438 in 2011).

53 IRS, CDW Individual Master File and Audit Information Management System.

54 IRS SCA 2002-45051 (Nov. 8, 2002).

55 IRS, CDW, IRTF (Tax Years 2014, 2015, and 2016), showing the number of two-year ban cases that were closed as no show/no response or undeliverable mail was 1,358 out of 3,534 (38 percent); 1,299 out of 4,613 (28 percent); and 714 out of 3,831 (19 percent) for tax years 2014, 2015, and 2016, respectively.

FIGURE 4.2.1



### 3. For taxpayers in the sample, disallowed EITC was 23 percent of adjusted gross income.

For almost all of the taxpayers in our sample (276 out of 289, or 96 percent), a ban was imposed with respect to the EITC. In some cases, a ban was imposed with respect to more than one credit.<sup>56</sup>

The immediate effect of disallowing EITC was to deprive the taxpayer of a significant tax benefit. The average adjusted gross income of taxpayers in the sample who claimed EITC was \$17,268.<sup>57</sup> The average amount of denied EITC was \$4,004, or 23 percent of EITC claimants' adjusted gross income.<sup>58</sup>

However, imposing a ban affects two years following the audited tax year. The average amount of the EITC for eligible taxpayers was \$2,476 in 2017 and \$2,491 in 2018.<sup>59</sup> The combined average was \$4,967. Thus, a taxpayer whose audit of his or her 2016 return triggered the EITC ban and who (but for the ban) was eligible for the credit in the following two years was deprived of a tax benefit that averaged almost \$5,000 for the two years combined.

### 4. Required managerial approval of the bans was often lacking.

In 155 cases out of the 289 cases in our sample, or more than half the time, the ban was imposed without the required managerial approval.<sup>60</sup> As discussed above, the required managerial approval consists of indicating on the CEAS database that the manager has reviewed the file and agrees with the auditor's proposal to impose the ban.<sup>61</sup> Yet, despite improvement in the percentage of cases that

56 There were 248 cases in which the ban applied only to the EITC; no cases in which the ban applied only to the CTC; and 11 cases in which the ban applied only to the AOTC. Where the same taxpayer was subjected to bans with respect to more than one credit (30 cases), the bans usually applied to the EITC and CTC (26 cases), followed by EITC and AOTC (two cases) and CTC and AOTC (two cases). There were no cases in which the ban was imposed with respect to all three credits.

57 TAS Research, IRS, CDW, IRTF (Tax Years 2014, 2015, and 2016).

58 *Id.*

59 TAS Research, IRS, CDW, IRTF, as of cycle 39 for tax years 2017 and 2018.

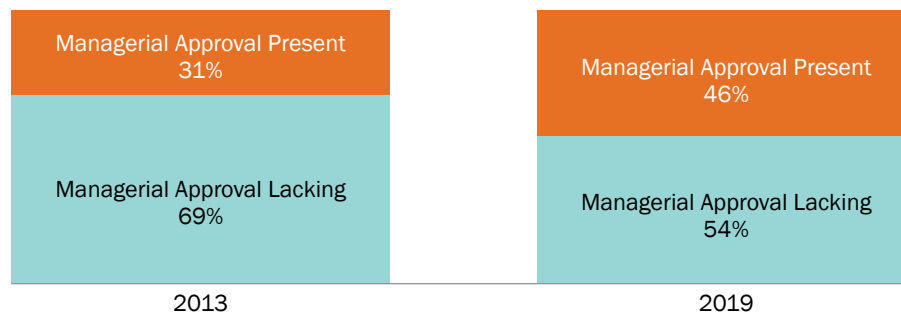
60 155 out of 289 is 54 percent.

61 IRM 4.19.14.7.1(3), 2/10 Year Ban - Correspondence Guidelines for Examination Technicians (CET) (May 8, 2018) provides: "The manager must review the entire case file and ensure the following: the workpapers are documented according to 4.19.13.6 including the decision and reason to impose or not impose the 2-year ban; the decision to assert the 2-year ban is warranted. The manager must input a CEAS non-action note to approve the assertion on the 2-year ban."

contained managerial approval, this crucial step was frequently lacking.<sup>62</sup> Figure 4.2.2 shows the rate at which two-year bans were imposed with and without the required managerial approval, according to this year's study and our 2013 study.

**FIGURE 4.2.2**

**Rate of Managerial Approval of Two-Year Bans**



**5. Form 886-A, Explanation of Items, often did not contain an adequate explanation of why the ban was imposed, as required by IRS procedures.**

Of the 289 taxpayers in the sample, 282 were sent Form 886-A. Out of these 282 cases, the explanation to the taxpayer on Form 886-A clearly explained why the ban was imposed in 44 cases — 16 percent of the time.<sup>63</sup> For example, one explanation was:

A two-year ban of earned income tax credit (EITC), per Internal Revenue Code (IRC) section 32(k), was asserted. Our records show you had a 2014 audit and claimed the same person as for this audit, [name of a relative with a relationship to the taxpayer that is not listed in IRC § 32(c)(3) as someone who can be a qualifying child]. Our phone records from [date] regarding your 2014 audit show you stated that you claimed [that person] and you were advised [that person] did not qualify for earned income tax credit. Evidence suggests you have shown reckless disregard of tax laws, rules and regulations since you aware [that person] was not eligible for the earned income tax credit [in 2014] but you claimed [that person] again for the earned income tax credit on your 2016 tax return.

In 236 of the 282 cases, or 84 percent of the time, the explanation provided to the taxpayer on Form 886-A was inadequate.<sup>64</sup> We consulted auditors' workpapers in these cases for a better understanding of why the ban was imposed. In 73 of these 236 cases, or 31 percent of the time, the auditors' workpapers

62 The National Taxpayer Advocate recommends amending IRC § 6751 to require managerial approval before imposing a ban. See National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 30-32 (*Require Independent Managerial Review and Written Approval Before the IRS May Assert Multi-Year Bans Barring Taxpayers From Receiving Certain Tax Credits and Clarify That the Tax Court Has Jurisdiction to Review the Assertion of Multi-Year Bans*).

63 The DCI question was: "Does Form 886-A clearly explain the reason for the assertion of the 2-year ban?"

64 For one case, we were unable to locate Form 886-A.

demonstrated the ban was imposed solely because the same credit had been disallowed in a previous year.<sup>65</sup> A typical explanation provided to the taxpayer in these cases was:

As you have been previously audited more than once and not been able to prove the return, you should be aware of the rules and regulations to claim the earned income tax credit. We propose that ban of two years to claim the earned income tax credit from the time the examination is closed be imposed. We also propose a penalty of 20 percent for negligence under IRC 6662, as you continue to claim dependents to which you are not entitled.

According to this explanation, the auditors imposed the ban simply because, according to the auditor, the taxpayer “should be aware of the rules and regulations.” The auditors did not even profess to have determined what the taxpayer’s state of mind was.

Moreover, the explanation provided to the taxpayer on Form 886-A sometimes appeared to be based on a form or template. For example, in multiple cases we found the following explanation, or very similar versions of it:

Your [prior year] tax return was examined for the same issue and you did not establish that the child you were claiming qualified for the EIC. You were previously informed of the requirements and the specific rules and regulations pertaining to the EIC and still have not sent in proper documents that verify that you qualify for this credit. Based on the information we have available, we are proposing an accuracy penalty and a 2-year ban on the Earned Income Credit (EIC) due to reckless or intentional disregard of the rules and regulations regarding the EIC. If we receive the proper documents that verify that you qualify for this credit, we will consider removing the penalty and ban.

From this explanation, the taxpayer could infer that the ban is being imposed because the previous year’s credit was disallowed. The explanation does not say *why* the child claimed in the previous year was not a qualifying child (*e.g.*, whether it was the age, relationship, or residency test that was not met), whether the same error was made on the audit year return, or even whether the person being claimed as a qualifying child in the audit year is the same as the person who was not a qualifying child in the prior year. The explanation recites that the taxpayer “was informed of the requirements and the specific rules and regulations” but does not indicate what specific rules appear not to have been followed.<sup>66</sup>

The situation with respect to taxpayers who did not participate in the audit requires additional analysis. As noted above, a taxpayer’s failure to respond to a request for substantiation and verification of EITC does not, in and of itself, constitute reckless or intentional disregard of the rules and regulation.<sup>67</sup> Out of the 289 cases in the sample, the IRS requested additional documentation from the taxpayer in 280 cases. Of these 280 cases, 48 were no show/no response cases, or mail to the taxpayer was returned as undelivered.

65 At the 95 percent confidence level, the margin of error is +/- 5.7 percent.

66 Confusingly, the letter includes the accuracy-related penalty, which applies to negligent conduct, in the discussion. Incorrectly, the letter states that if the taxpayer demonstrates eligibility for the credit, the IRS will only “consider” removing the penalty and ban.

67 IRS SCA 2002-45051 (Nov. 8, 2002).

In only five of the 48 no show/no response cases did the IRS provide an adequate explanation for imposing the ban to the taxpayer on Form 886-A.<sup>68</sup> In only ten of the 48 cases (including the five cases in which the Form 886-A explanation was adequate) did the auditor's workpapers contain an adequate explanation for imposing the ban, as required by IRS procedures.<sup>69</sup> For the remaining cases in which an adequate explanation for the ban was not found, the inference arises that the IRS imposed the ban for the simple reason that the taxpayer did not participate in the audit — exactly what OCC cautioned against.

Providing taxpayers with an adequate explanation for the ban on Form 886-A is important not only as a matter of sound tax administration and because it is required by IRS procedures, but also because the explanation on Form 886-A may be the only explanation taxpayers receive contemporaneously with the statutory notice of deficiency.<sup>70</sup>

#### **6. The IRS usually did not speak to taxpayers in the sample who were being audited for the first time before imposing a ban, as required by IRS procedures.**

If the audit that resulted in the ban was the first time the taxpayer had been audited since 2006, we considered it a first-time audit.<sup>71</sup> We adopted this approach because we did not find it reasonable to expect taxpayers to recall or retain information they may have learned in an audit more than ten years ago, especially as the rules for claiming the credits changed over the years. Moreover, the IRS advises taxpayers that they generally must retain their tax records for three years from the time they filed a (non-fraudulent) return.<sup>72</sup> Where there was a prior year's audit of the same credit, but the audit had not concluded by the time the taxpayer filed a return for tax year 2016, we treated the audit of tax year 2016 as a first-time audit. We adopted this approach to recognize that a taxpayer may have known a previous year was being audited (*e.g.*, tax year 2015), but as long as the audit of that earlier year was still open, the taxpayer did not have the benefit of knowing whether or why there was any error on that return when filing the return for tax year 2016.<sup>73</sup>

In first-time audit cases in which the taxpayer participated in the audit, the reviewers ascertained whether the IRS spoke with the taxpayer before imposing the ban, as required by IRS procedures. There were 44 cases in our sample in which the taxpayer was being audited for the first time and participated in the audit. Of those 44 cases, we found 17 cases in which the IRS spoke to the taxpayer as required. Thus, the IRS is following its own procedures that apply to first-time audits only 39 percent of the time.<sup>74</sup>

68 At the 95 percent confidence level, the margin of error is +/- 8.4 percent.

69 At the 95 percent confidence level, the margin of error is +/- 11.5 percent. Five out of the eight cases involved misreported income, which resulted in disallowance of the EITC.

70 The version of Letter 3219, Statutory Notice of Deficiency, issued to taxpayers in our sample does not specifically reference the two-year ban, but recites that "The enclosed statement shows how we figured the deficiency." The referenced enclosed statement generally included Form 4549, Income Tax Examination Changes, Form 886-A, or both.

71 The IRS sometimes appeared to not to consider the current audit a first-time audit if there had ever been a prior audit: for example, auditors in two cases referenced audits from more than a decade ago. The IRS did not speak with the taxpayer in either case before imposing the ban.

72 IRS, How Long Should I Keep Records? (July 10, 2019), <https://www.irs.gov/businesses/small-businesses-self-employed/how-long-should-i-keep-records>.

73 We identified four cases with this fact pattern.

74 17 cases out of 44 cases is 39 percent. The margin of error for this finding at the 95 percent confidence level is +/- 14.3 percent.



## 7. From documents they submitted, it appears that taxpayers often believed they qualified for the credit, and auditors sometimes imposed the ban for mere negligence.

As noted above, out of the 289 cases in the sample, the IRS requested additional documentation from the taxpayer in 280 cases. Taxpayers submitted documents in 181 of those 280 cases, or 65 percent of the time.

In 97 of the 181 cases, or 54 percent of the time, it appeared from the documents submitted that the taxpayer believed he or she qualified for the credit.<sup>75</sup> For example, one of the 97 taxpayers, filing as a head of household, claimed the EITC and CTC with respect to one qualifying child. In response to the auditor's request for additional information, the taxpayer submitted documents that included:

- A birth certificate establishing that the claimed qualifying child was the taxpayer's child and met the age requirement;
- A lease agreement showing that taxpayer and the child lived at the same address;<sup>76</sup> and
- A utilities bill for the address shown on the lease.<sup>77</sup>

As noted, the auditor rejected the documents (and we do not imply that the auditor should have accepted them). However, the auditor noted in the workpapers: "TP has displayed negligence (a willful disregard for rules and regulations) in claiming the dependent. The accuracy-related penalty (PEN) for negligence and the 2-year ban for CTC/EIC are being asserted at this time." This was not the only case in our sample in which the auditor equated negligence with willful disregard of rules and regulations and believed that mere negligence by the taxpayer justified imposing a ban.<sup>78</sup>

In 24 of the 181 cases in which taxpayers submitted documents in response to a request by the IRS, or 13 percent of the time, it was unclear from the documents submitted whether the taxpayer believed he or she qualified for the credit. In some of these cases the work papers show the auditor vacillated, changing an initial decision to not impose the ban.<sup>79</sup>

In only 60 of the 181 cases, or 33 percent of the time, were the documents clearly insufficient to support the claimed credit, raising the possibility that the taxpayer had the requisite state of mind to justify the ban.<sup>80</sup> For example, to substantiate income, a taxpayer submitted a Form 1099 that appeared false.

75 The margin of error for this finding at the 95 percent confidence level is +/- 7.1 percent.

76 The auditor rejected the lease agreement as satisfying the residency test, with the notation "Not accepted. Incomplete. The [other parent] of the children was not named as an occupant. A lease alone cannot be used to verify residency or support because it was unsigned." We are uncertain why it was relevant to the auditor that the other parent was not named as an occupant on the lease.

77 The auditor rejected the utilities bill as evidence, with the notation "Considered, but not accepted. No proof of payment. Clearly stated only 1 occupant during those timeframes."

78 At least one of the 97 cases involved a second auditor who changed the first auditor's determination not to impose a ban. In that case, the first auditor's workpapers note: "Not asserting the two year ban as there is no evidence that the taxpayer recklessly or intentionally disregarded the EIC rules. TP [taxpayer] was partially allowed EIC in [year of earlier] audit. Some EIC rules have changed since the last audit. There is no evidence TP is aware of and understands current EIC rules and regulations." The second auditor determined to impose the ban, noting "TP was examined during [year of earlier audit]. TP corresponded 3 times to the examination and signed the Form 4549 agreed per examination changes. TP was made aware of the rules and regulations regarding Earned Income Credit."

79 The margin of error for this finding at the 95 percent confidence level is +/- 4.8 percent.

80 At the 95 percent confidence level, the margin of error is +/- 6.7 percent.

In some cases in the sample, the auditor imposed the ban while also determining that a negligence penalty under IRC § 6662(c) did not apply. The workpapers in several of these cases simply recite that there was “no clear evidence of taxpayer’s disregard/negligence of the rules and regulations in completing tax return.”

**8. The IRS did not often impose bans systemically, but when taxpayers responded to proposed systemic bans the IRS did not follow its procedures.**

Overall, of the 3,831 audits of tax year 2016 that resulted in a ban, 125 were designated with project code 27 or 28. We found 13 project 27 or 28 cases in our sample. Of the 13 cases, there were four cases in which the taxpayers responded to the correspondence from the IRS about the proposed ban. In only one of those four cases was there managerial approval for the ban. In only one of those four cases (a different case than the one that had the required managerial approval) was there an adequate explanation to the taxpayer of the reason for imposing the ban. In other words, there were no cases in which a taxpayer responded to a proposed automatic ban and the IRS proceeded with the ban only after obtaining managerial approval and providing an explanation to the taxpayer, as required by IRS procedures.<sup>81</sup>

**9. Taxpayers rarely sought audit reconsideration of the ban, but even when credits were allowed after reconsideration, the ban was not always removed.**

Overall, of the 3,831 taxpayers who were subjected to a ban as a result of audits of tax year 2016 returns, 86 sought audit reconsiderations. In 25 of the 86 cases, almost a third of the time, all or part of the banned credit was allowed.

In six of the 25 cases, the credit was fully allowed. However, the ban was removed in only one of these six cases; the ban remains in effect in the other five. In 19 of the 25 audit reconsideration cases, the credit was partially allowed; the ban was not removed in any of these cases.

**10. The IRS did not often disallow credits pursuant to its summary assessment authority, and taxpayers rarely challenged the summary assessments.**

Of the 3,831 taxpayers on whom a ban was imposed as a result of an audit of their 2016 return, 203 (including nine taxpayers in our sample) were issued a notice of summary assessment because they claimed a banned credit on their 2017 return.<sup>82</sup> Of these 203 taxpayers, 31 (none of whom were included in our sample) responded to the notice of summary assessment and were issued a statutory notice of deficiency. None of the 31 taxpayers petitioned the Tax Court in response to the statutory notice of deficiency. Of the 3,831 taxpayers, 354 were issued a notice of summary assessment as a result of claiming a banned credit on their 2018 return. None of them were issued a statutory notice of deficiency.

<sup>81</sup> Due to the small sample size, we do not project these findings to the population.

<sup>82</sup> IRS CDW, IMF, IRTF, as of cycle 201939.

## CONCLUSION

The IRS imposes two-year bans when the statutory requirements have not been met, *i.e.*, in the absence of a determination that the taxpayer claimed the credit due to reckless or intentional disregard of rules and regulations. The IRS also fails to follow its own procedures: required managerial approval is often not secured before the ban is imposed, an adequate explanation of why the ban was imposed is frequently lacking, and auditors usually do not telephone a taxpayer before imposing the ban when required to do so. Taxpayers are harmed not only because they are deprived of credits for which they are eligible but also because challenging the appropriateness of the ban is procedurally difficult.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Revise procedures for imposing two-year bans to require IRS employees to speak with the taxpayer in every case before imposing a ban.
2. Suspend the practice of automatically imposing two-year bans.
3. Conduct quality reviews for at least three years of every case in which the IRS proposes to impose the two-year ban.