## Session 4: Helping Taxpayers Get it Right

### Moderator:

**Theresa Pattara**  
H&R Block

### The Nontaxable Combat Pay Election and the Earned Income Tax Credit

**Patricia Tong**  
Treasury Office of Tax Analysis

### Pilot Project to Assess Validation of EITC Eligibility with State Data

**Elaine Maag**  
The Urban Institute

### IRS Preparer-Level Treatment Tests

**Karen Masken**  
IRS, Return Preparer Office

### Discussants:

**Deena Ackerman**  
Treasury Office of Tax Analysis  
**Dayanand Manoli**  
University of Texas
The Nontaxable Combat Pay Election and the EITC

Suzanne Gleason and Patricia K. Tong
IRS-TPC Research Conference
June 18, 2015

*These views are the authors and do not necessarily reflect those of the U.S. Department of the Treasury or the U.S Department of Defense.
Background

• Combat zone tax exclusion: Military service members do not pay income taxes on any income received in any month in which they spent time in a combat zone.
  – Capped at $88,416 in 2009.
• Earned income tax credit (EITC) is calculated based on earnings.
• Exclusion of combat zone earnings will reduce the EITC among some low-income military members.
2009 EITC for Married Filing Jointly Couple with 2 Qualifying Children
Nontaxable Combat Pay Election (NCPE)

• Created in tax year 2004.
• Gives service members the option to include nontaxable combat pay in EITC earnings.
• Default setting is to exclude nontaxable combat pay.
• NCPE gives military personnel the option to include or exclude all of their nontaxable combat pay.
Questions

• Do military service members optimize their EITC?
  • Do observable characteristics differ between optimizers and non-optimizers?

• To what extent are service members eligible for the EITC because of the combat zone tax exclusion?
  • Do observable characteristics differ between those who are newly eligible and always eligible?

• What is the cost of the nontaxable combat pay election?
Motivation

• Federal income tax system has become more complex as policy makers continue to use taxes to provide income support and incentivize certain behaviors.
• To what extent do targeted populations understand how to correctly claim credits on their own or is a tax preparer necessary?
• Evidence that people do not understand the relationship between earned income and EITC (Chetty and Saez, 2013).
Data

- Merge individual level military personnel characteristics from the Department of Defense to IRS tax return and W-2 data for tax years 2005-2009.
- Restrict data to EITC-eligible military service members with nontaxable combat pay reported on their W-2s.
  - EITC-eligible includes all individuals who are eligible when combat pay is excluded from EITC earned income
  - Almost 1 million individuals
  - Represents 30% of service members with nontaxable combat pay.
EITC Optimization

- Calculate EITC earned income both with and without nontaxable combat pay and compare amounts to IRS reported EITC earned income.
- Calculate EITC both with and without nontaxable combat pay to determine optimal amount.
- 82% optimize EITC.

<table>
<thead>
<tr>
<th></th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use NCPE</td>
<td>45,909 (4.6%)</td>
<td>9,514 (1%)</td>
</tr>
<tr>
<td>Do Not Use NCPE</td>
<td>18,490 (1.9%)</td>
<td>913,454 (92.5%)</td>
</tr>
</tbody>
</table>
Summary Statistics by EITC Optimization

- Distributions by service and pay grade are similar.
- On average, non-optimizers are older, more likely to file as unmarried, and have lower AGI than optimizers.
- Among non-optimizers, 62% are filers who do not claim EITC, 31% are non-filers, 4% claim EITC and use the NCPE, 3% claim EITC and do not use the NCPE.

<table>
<thead>
<tr>
<th></th>
<th>Non-optimizers</th>
<th>Optimizers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Gross Income</td>
<td>$12,127 (14,047)</td>
<td>$17,522 (10,756)</td>
</tr>
<tr>
<td>Nontaxable Combat Pay</td>
<td>$23,635 (16,004)</td>
<td>$21,887 (14,970)</td>
</tr>
<tr>
<td>Paid Preparer</td>
<td>0.28 (0.45)</td>
<td>0.60 (0.49)</td>
</tr>
</tbody>
</table>

Notes: In millions of 2009 dollars
Do military service members optimize their EITC?

Optimization Rate

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Optimization Rate</td>
<td>82%</td>
<td>71%</td>
<td>83%</td>
</tr>
</tbody>
</table>

Average Loss Among Non-Optimizers

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Loss Among Non-Optimizers</td>
<td>$1,191</td>
<td>$1,571</td>
<td>$1,145</td>
</tr>
</tbody>
</table>

Use a Paid Tax Preparer

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use a Paid Tax Preparer</td>
<td>54%</td>
<td>57%</td>
<td>54%</td>
</tr>
</tbody>
</table>

Optimization Rate By Paid Preparer Use:

<table>
<thead>
<tr>
<th></th>
<th>No Paid Tax Preparer</th>
<th>Yes Paid Tax Preparer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Optimization Rate</td>
<td>73%</td>
<td>91%</td>
</tr>
</tbody>
</table>

Average Loss Among Non-Optimizers

<table>
<thead>
<tr>
<th></th>
<th>No Paid Tax Preparer</th>
<th>Yes Paid Tax Preparer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Loss Among Non-Optimizers</td>
<td>$1,232</td>
<td>$1,083</td>
</tr>
</tbody>
</table>

Observations

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Observations</td>
<td>987,454</td>
<td>64,399</td>
<td>922,968</td>
</tr>
</tbody>
</table>

Percentage

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Should Use NCPE</th>
<th>Should Not Use NCPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>6.52%</td>
<td>93.47%</td>
<td></td>
</tr>
</tbody>
</table>
# Distribution of Personnel Who Do Not Optimize the EITC by Size of EITC Loss

<table>
<thead>
<tr>
<th>EITC Loss Range</th>
<th>All Non-Optimizers</th>
<th>EITC Claimants</th>
<th>Non-EITC Claimants</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Filers</td>
<td>Non-Filers</td>
<td>Filers</td>
</tr>
<tr>
<td>EITC Loss ≤ 100</td>
<td>12%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>100 &lt; EITC Loss ≤ 500</td>
<td>47%</td>
<td>31%</td>
<td>53%</td>
</tr>
<tr>
<td>500 &lt; EITC Loss ≤ 1000</td>
<td>5%</td>
<td>21%</td>
<td>4%</td>
</tr>
<tr>
<td>1000 &lt; EITC Loss ≤ 2000</td>
<td>10%</td>
<td>23%</td>
<td>8%</td>
</tr>
<tr>
<td>2000 &lt; EITC Loss</td>
<td>30%</td>
<td>12%</td>
<td>21%</td>
</tr>
<tr>
<td>Observations</td>
<td>172,808</td>
<td>12,011</td>
<td>106,637</td>
</tr>
</tbody>
</table>

Excluding those with EITC Loss ≤ $500:
- Reduces sample by over 100K
- Increases optimization rate from 82% to 92%
- Disparity in optimization rate by those who should (79%) and should not use the NCPE (93%) increases.
EITC Eligibility

• Always Eligible if individual qualifies even if combat pay were required to be included in EITC earned income.
  – Includes those with zero taxable earnings.

• Newly Eligible if individual would not qualify if combat pay were required to be included in EITC earned income.

• 56% are Newly Eligible.
## Summary Statistics by Always and Newly Eligible

<table>
<thead>
<tr>
<th></th>
<th>Always Eligible</th>
<th></th>
<th>Newly Eligible</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Optimize EITC</td>
<td>0.87</td>
<td>(0.34)</td>
<td>0.79</td>
</tr>
<tr>
<td></td>
<td>Use NCPE</td>
<td>0.13</td>
<td>(0.33)</td>
<td>0.00</td>
</tr>
<tr>
<td></td>
<td>Age</td>
<td>27.97</td>
<td>(5.71)</td>
<td>32.14</td>
</tr>
<tr>
<td></td>
<td>Single</td>
<td>0.07</td>
<td>(0.26)</td>
<td>0.26</td>
</tr>
<tr>
<td></td>
<td>Any EITC Kids</td>
<td>0.97</td>
<td>(0.16)</td>
<td>0.60</td>
</tr>
<tr>
<td></td>
<td>Claim EITC</td>
<td>0.90</td>
<td>(0.30)</td>
<td>0.79</td>
</tr>
<tr>
<td></td>
<td>EITC</td>
<td>$2,902</td>
<td>(1,399)</td>
<td>$1,335</td>
</tr>
<tr>
<td></td>
<td>Nontaxable Combat Pay</td>
<td>$13,867</td>
<td>(8,894)</td>
<td>$28,658</td>
</tr>
<tr>
<td></td>
<td>Observations</td>
<td>431,590</td>
<td></td>
<td>555,777</td>
</tr>
</tbody>
</table>
## Cost Estimates

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Cost of NCPE</td>
<td>9.3</td>
<td>7.2</td>
<td>8.0</td>
<td>9.6</td>
<td>15.1</td>
</tr>
<tr>
<td>Total Cost of Combat Zone Tax Exclusion</td>
<td>3,500</td>
<td>3,400</td>
<td>3,900</td>
<td>3,800</td>
<td>3,600</td>
</tr>
</tbody>
</table>

Notes: In millions of 2009 dollars

- Total Cost of NCPE is the difference between the EITC claimed with the inclusion of combat pay and the amount of EITC that would have been claimed if nontaxable combat pay were excluded from EITC earned income:
  - Restricted to individuals who use the NCPE.

- The cost of the NCPE represents <1% of the total cost of the Combat Zone Tax Exclusion.
Conclusion

• 82% optimize EITC.
• Optimization rates are lower for those who should use the NCPE. These differences remain when conditioning on paid tax preparer use and are larger among those who do not use a paid tax preparer.
• The combat zone tax exclusion increases EITC eligibility.
• NCPE cost is <1% of the total cost of the combat zone tax exclusion in any given year between 2005-2009.
• The NCPE increases complexity in the tax code while the segment of the military population who benefits from the NCPE is small.
Using Supplemental Nutrition Assistance Program Data in EITC Administration

June 18, 2015
Elaine Maag
IRS-TPC Research Conference
Goal: Reduce improper payments of EITC claims

In 2007, 21.2-25.8% of EITC payments estimated to be overclaims; $13.7 - $16.7 billion

Leading cause when type of error is known is claiming non-qualified child

Can state benefit program data help reduce improper payments?
Key EITC Qualifying Elements

Marital Status

Relationship

Citizenship Status

Income

Residency

Student

Disability
Description of EITC

FIGURE 1. EARNED INCOME TAX CREDIT, 2015

Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,520 higher than shown.

Source: Tax Policy Center, 2015
## Description of SNAP

### Table 1. SNAP Income Test October 1, 2014 through September 30, 2015

<table>
<thead>
<tr>
<th>Household Size</th>
<th>Gross Monthly Income (130 percent of federal poverty level)</th>
<th>Net Monthly Income (100 percent of federal poverty level)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,265</td>
<td>$973</td>
</tr>
<tr>
<td>2</td>
<td>$1,705</td>
<td>$1,311</td>
</tr>
<tr>
<td>3</td>
<td>$2,144</td>
<td>$1,650</td>
</tr>
<tr>
<td>Each additional member</td>
<td>+440</td>
<td>+339</td>
</tr>
</tbody>
</table>

Why SNAP Data Might be Helpful

- Some overlap in recipients anticipated
  - But...some SNAP beneficiaries have no earnings
  - And...EITC provides benefits to some people with higher incomes than SNAP allows

- SNAP benefits based on the group of people who share meals
  - Can include multiple tax units
  - SNAP applicants and beneficiaries report living arrangements and relationships to other household members
Problem with SNAP data

- Recertify only once or twice each year
  - We assume if we observe a household that looks the same in two periods, we assume it looked that way in the intervening period.

- Monthly vs. annual data

- Timing inconsistent with tax year

- Self-reported
Tax units in Florida SNAP data

- Unmatched: 50%
- Childless EITC: 8%
- Some adults: 1%
- All members: 24%
- All adults, some children: 2%
- All adults, no children: 5%
- No adults, some children: 10%

www.taxpolicycenter.org
Residency Test: Families with Children

- Full Match: All children fail, 0% No children pass
- Missing Child: All adults, some children, 2% All adults, no children, 5%
- 0 Children: All members, 24%
Residency Test: Children Claimed by People Not in SNAP Unit

- All children fail: 100%
- No adults, some children: 10%
Some evidence that people claim different people on their tax returns than they report to SNAP offices

- Observe adults in the data without children for at least 6 months
- Observe children in the data with different adults for at least 6 months
“Childless” EITC Claims: Presence of Qualifying Child

- Some Evidence
- Insufficient information

Childless EITC 8%
Outreach

- Some people in SNAP data with earnings don’t file tax return
  - Most have no earnings, are not citizens, or do not have a qualifying childre
- 11,600 adults appear eligible for the EITC for workers with children
Conclusion

- SNAP data can contribute to understanding residency during audit selection, but data are not of high enough quality to use in pre-refund math error authority
  - Must make assumptions about household stability
  - Most returns identified with SNAP data were already identified by IRS during audit selection
IRS Preparer-Level Treatment Tests

Karen Masken

June 18, 2015
The views expressed here are those of the author and do not necessarily represent the views of the IRS
Introduction

• Background
• Motivation
• Issues Addressed
• Preparer Selection
• Treatments
• Evaluation Technique
• Results
• Summary
In 2010, the Internal Revenue Service (IRS) adopted regulations aimed at establishing standards among tax return preparers. By January 1, 2011, preparers were required to register with the IRS in order to receive a preparer tax identification number (PTIN) and enter it on returns they prepare. The objective was to improve voluntary compliance by supporting the paid preparer community and providing oversight of the industry with the goal of reducing errors on tax returns. The Return Preparer Office (RPO) was formed to meet this objective. The three primary strategic goals of RPO are:

1. Register and promote a qualified tax professional community
2. Improve the compliance and accuracy of returns prepared by tax professionals
3. Support a stakeholder-focused culture that encourages voluntary compliance and continuous improvement
In 2012 RPO implemented a multi-year study to test the effectiveness of various treatments in moving preparers and their clients toward greater voluntary compliance

- **Goals of the study**
  - What types of treatments are cost effective
  - Is effectiveness persistent (recidivism)
  - Segmentation of preparers to minimize costs
Motivation

Compliance Spectrum

Compliant
Those towards the compliant end of the spectrum might be moved by inexpensive light touches / nudges e.g., letters

Noncompliant / Fraud
Those towards the noncompliant end of the spectrum may require more expensive and intrusive treatments e.g., audits / injunctions
Motivation (cont.)

- Scarce treatment resources
- Little is known about the effectiveness of preparer-based treatments
- Traditionally IRS has focused enforcement resources on the non-compliant / fraud end of the spectrum
  - These treatments are expensive
  - Finding less costly but effective treatments for those in the middle of the spectrum could have a significant impact on voluntary compliance
- Relied on non-targeted services (e.g., tax forums, webinars, etc.) to nudge preparers to be more compliant
Issues Addressed

• Schedule C Net Income
  – Schedule C accounts for almost 30% of Individual Income Tax gap (~$68 billion)
  – Around 75% of Schedule C returns are paid prepared
  – About 75% of paid prepared returns with Schedule C have errors

• Additional Child Tax Credit (ACTC)
  – Emerging Issue, particularly children w/ ITINs
  – Around 65% of ACTC claims are paid prepared
  – ~1% of preparers responsible for 60% of children w/ ITINs
Preparer Selection: Schedule C

- Error detection model developed using National Research Program (NRP) data
- Modeled at the taxpayer level then rolled up to the preparer
- Endogeneity issue led to decision to select preparers with majority of their Schedule C returns flagged by the model
Preparer Selection: ACTC

- No error detection model development
- Based on prevalence of ACTC returns
- Children w/ ITINs:
  - At least 20 returns had ACTC children w/ ITINs
  - At least 15% of ACTC returns had children w/ ITINs
- General ACTC:
  - Did not meet above criteria
  - At least 20 returns had ACTC claims
  - Majority of returns had ACTC claims
Treatments: Schedule C

First Year (1250 preparers in each treatment):
1. Educational visit by Revenue Agent
2. Letter reminding preparers of due diligence requirements and warning they and or their clients may be audited
3. Letter with same message of due diligence but also suggesting preparer take continuing education regarding Schedule C

Second Year (1250 preparers in each treatment):
1. Educational Visit repeated
2. Due Diligence Letter sent to subgroup
3. Continuing Education Letter dropped
Treatments: ACTC

1. Educational letter explaining introduction of Schedule 8812 with emphasis on when children with ITINs qualify (3500 preparers)

2. Educational letter explaining introduction of Schedule 8812 (5000 preparers)
Evaluation Technique

Difference in Differences used for both

- **Schedule C**
  1. Difference in success rate* before and after treatment
  2. Difference between test and control groups
    * predefined as a 5 percentage point drop in returns selected

- **ACTC**
  1. Difference in ACTC claims before and after treatment
  2. Difference between test and control groups
### Percentage Point Difference Between Test and Control Groups:

#### Success Rates

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Educational Visit</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>Due Diligence Letter</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Continuing Education Letter</td>
<td>8</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

### Percentage Point Difference Between Test and Control Groups:

#### Recidivism Rates for Year 1 in Year 2

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Educational Visit</td>
<td>-6</td>
</tr>
<tr>
<td>Due Diligence Letter</td>
<td>2</td>
</tr>
<tr>
<td>Continuing Education Letter</td>
<td>-1</td>
</tr>
</tbody>
</table>
## Results: Schedule C (cont.)

For Successful Test Group Preparers in Year 1:

<table>
<thead>
<tr>
<th></th>
<th>Educational Visit</th>
<th>Due Diligence Letter</th>
<th>Continuing Education Letter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Returns in 2013</td>
<td>140,900</td>
<td>113,000</td>
<td>123,800</td>
</tr>
<tr>
<td>Number of returns with Sch C</td>
<td>37,000</td>
<td>31,200</td>
<td>32,000</td>
</tr>
<tr>
<td>Average percentage point decline in clients flagged</td>
<td>19%</td>
<td>17%</td>
<td>18%</td>
</tr>
<tr>
<td>Est. number of taxpayers moved toward voluntary compliance</td>
<td>7,100</td>
<td>5,400</td>
<td>5,800</td>
</tr>
</tbody>
</table>
### Percentage Point Difference Between Test and Control Groups: Decline in Average Number

<table>
<thead>
<tr>
<th></th>
<th>ITIN Letter</th>
<th>General Letter</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACTC Claims</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>ACTC Children Claimed</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>ACTC Children w/ ITINs</td>
<td>10</td>
<td>n.a.</td>
</tr>
</tbody>
</table>
Summary: Schedule C

- All 3 treatments were found to be effective
- Letters less effective overall but also much less costly
- Results in year 2 are consistent with year 1
- Results in year 1 are persistent in year 2
  (Recidivism non-apparent)
Summary: ACTC

- Both treatments were found to be effective

- An educational letter can be a cost-effective way to improve voluntary compliance

- Targeted messaging, instead of expensive error detection models, can be a cost-effective way to improve voluntary compliance
2015 IRS-TPC Research Conference

Session 4: Helping Taxpayers Get it Right

Moderator: Theresa Pattara  
H&R Block

The Nontaxable Combat Pay Election and the Earned Income Tax Credit: Patricia Tong  
Treasury Office of Tax Analysis

Pilot Project to Assess Validation of EITC Eligibility with State Data: Elaine Maag  
The Urban Institute

IRS Preparer-Level Treatment Tests: Karen Masken  
IRS, Return Preparer Office

Discussants: Deena Ackerman  
Treasury Office of Tax Analysis
Dayanand Manoli  
University of Texas