

# 2008 Software Developers Report

Potential Software Enhancements to Improve the Accuracy of Tax Returns Claiming Earned Income Tax Credit and Help Paid Preparers Meet Their EITC Due Diligence Requirements.

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## Executive Summary

Tax software plays a significant role in the preparation of the more than 22 million EITC returns filed each year. Feedback from the EITC tax preparer community indicates preparers rely heavily on tax software to prepare accurate tax returns and to meet EITC due diligence requirements. Taxpayers and the Internal Revenue Service expect tax preparers to be knowledgeable in the tax law; tax software is not a substitute for the tax preparers' knowledge. Although tax software cannot act as a replacement for tax preparers' knowledge and professional responsibility, software enhancements may provide additional tools to assist preparers in preparing accurate returns and meeting their EITC due diligence requirements.

The IRS Earned Income Tax Credit (EITC) Office and various software industry representatives from within the membership of the National Association of Computerized Tax Processors (NACTP) and the Council of Electronic Revenue Communication Advancement (CERCA) formed a joint working group, the IRS/EITC Software Developers Working Group. Over 80% of EITC electronic returns are prepared using software developed by companies represented by the members of the Working Group.

The Working Group's goal is to identify best practices and software enhancements that could improve the quality of EITC returns, increase EITC participation for eligible taxpayers and help paid preparers meet their due diligence requirements.

## **Voluntary Implementation of Recommendations**

The recommendations of the Working Group will be communicated to the software developer industry with the expectation that software companies will implement some or all of the recommendations. The implementation of these recommendations is voluntary and should not be interpreted as regulatory. In addition, the contents of this report do not constitute official IRS guidance.

## **Background**

### *Purpose of Report*

The purpose of this document is to summarize the issues and challenges faced by the EITC program and the issues and potential changes/solutions identified by the Working Group during their March 2008 and May 2008 workshops and several conference calls. This report will detail scenarios recognized by the group where software enhancements could be used to address three issues - qualifying child, filing status and misreported income. These issues accounted for more than 60% of the EITC overclaims according to the last comprehensive EITC compliance study for tax year 1999.

### *Key Stakeholders*

Although the primary audience of the Working Group recommendations is the tax software industry, the white paper will be shared with paid preparers and the IRS community. Members of the Working Group are expected to socialize the information from the Working Group meetings to others within their companies and industry and provide feedback to the group. In order to obtain more information or provide feedback, contact Peter Maser (Peter.E.Maser@irs.gov) or a member of the Working Group.

## **Today's Challenges**

### *The Case for Change*

Tax software plays a significant role in the preparation of the more than 22 million EITC returns filed each year. Over 70% of EITC returns are prepared by paid preparers. These paid preparers use tax preparation software 86% of the time. Taxpayers preparing their own returns use software 60% of the time. Feedback from the EITC tax preparer community tells us that preparers rely heavily on their tax software to prepare accurate tax returns and to meet their EITC due diligence requirements. Although tax software cannot act as a substitute for tax preparers' knowledge and professional responsibility, software enhancements may assist preparers in preparing accurate returns and meeting their EITC due diligence requirements.

The error rate on EITC returns is estimated at 23%-28%, resulting in \$10-\$12 billion in erroneous claims annually. The most significant EITC error issues are:

- 24.9% of EITC errors resulted from issues related to the Qualifying Child. The primary issue was taxpayers claiming a child that did not meet the residency requirement.
- 21.4% of EITC errors involved Misreported Income. This includes taxpayers over-reporting or under-reporting earned income, modifying adjusted gross income or under-reporting investment income.
- 10.7% of EITC errors resulted from Incorrect Filing Status, specifically married taxpayers that file as single or head of household (HOH) when they should have filed as Married Filing Separate (MFS) or Married Filing Joint (MFJ).
- 6.7% of EITC errors resulted from a combination of Incorrect Filing Status and Qualifying Child issues.

| <i>Type of Errors</i>                                     | <b>Returns</b>                |                | <b>EITC Overclaims</b>        |                |
|---|-------------------------------|----------------|-------------------------------|----------------|
|   | <i>Number<br/>(thousands)</i> | <i>Percent</i> | <i>Dollars<br/>(millions)</i> | <i>Percent</i> |
| Qualifying Child  | 1316                          | 16.3           | 2253                          | 24.9           |
| Misreported Income  | 3366                          | 41.7           | 1940                          | 21.4           |
| Incorrect Filing Status                                   | 702                           | 8.7            | 971                           | 10.7           |
| Combination of Incorrect Filing Status & Qualifying Child | 274                           | 3.4            | 607                           | 6.7            |

## **IRS Addresses EITC Challenges**

### *IRS EITC Preparer Initiatives*

In the past, IRS focused much of its EITC outreach and compliance efforts on taxpayers. However, IRS recognized that preparers can have a broader influence on EITC tax returns and taxpayers. One of IRS's new focuses is to address paid preparer EITC due diligence through compliance and outreach and education.

The IRS conducts the following preparer compliance treatments:

- Due Diligence Visits (DDV)/Audit Program
- E-file Sanctions
- Injunction Actions Barring Preparers from Return Preparation
- Criminal Prosecutions

The current IRS outreach and education initiatives include:

- New Proposed Regulations on the EITC Due Diligence "Knowledge" Requirement
- Software Developers Partnership
- Tax Practitioner Institutes Training Module
- IRS Nationwide Tax Forums Due Diligence Seminars and Roundtables
- Due Diligence Phone Forum
- New Due Diligence Publication
- EITC Practitioner Toolkit Enhancements
- irs.gov Enhancements