

GAO

Report to the Honorable
William V. Roth, Jr., U.S. Senate

October 1994

TAX
ADMINISTRATION

Earned Income
Credit—Data on
Noncompliance and
Illegal Alien Recipients



General Government Division

B-258683

October 25, 1994

The Honorable William V. Roth, Jr.
United States Senate

Dear Senator Roth:

This report responds to your request for information on the Earned Income Credit (EIC). For tax year 1993,¹ about 14.7 million low-income taxpayers claimed about \$15 billion in EIC benefits. Congress and the Internal Revenue Service (IRS) have long been concerned about noncompliance² with EIC requirements.³ As requested, this report includes IRS' preliminary data on the extent of noncompliance with EIC requirements in tax year 1993 and describes the data available on the number of illegal aliens⁴ who received EIC benefits.

Results in Brief

Currently, no reliable data exist on the extent of noncompliance with EIC requirements among all EIC claimants. Taxpayer Compliance Measurement Programs (TCMP) in 1982, 1985, and 1988 found significant EIC noncompliance. EIC requirements have been altered substantially since 1988; therefore, these TCMP results may not be indicative of the noncompliance rate for the recipients of the current EIC. Nevertheless, IRS believes significant noncompliance continues.

In response to recent concerns about EIC-related fraud on returns filed electronically, IRS is studying a sample of these returns filed during a 2-week period in January 1994. IRS' preliminary analysis of the returns showed that an estimated 29 percent of the 1.3 million EIC returns filed electronically during the period had claimed too large a refund, and about 13 percent of the returns filed was estimated by IRS as having intentionally claimed too much EIC. Of the \$1.5 billion of EIC claimed in this period, an estimated \$358 million was erroneously claimed—about \$183 million, or 12 percent, was classified as intentional error. We believe that this intentional category comes closest of any IRS category in the study to

¹Tax year 1993 data throughout this report are based on data available as of Aug. 27, 1994, unless otherwise noted.

²Throughout this report we use the term "noncompliance" to include erroneous EIC claims caused by negligence, mistakes, confusion, and fraud.

³See Related GAO Products.

⁴A foreign person who is in the United States without a lawful immigration status.

measuring EIC fraud.⁵ IRS is now using additional information that was not available early in 1994 to complete analyses of the returns. IRS officials said they expected these additional analyses to lead to a higher error rate than the preliminary estimate. However, the study's results can be generalized only to the 1.3 million EIC returns filed electronically during the 2-week period because these filers may have characteristics that differ from those who file later.

Another IRS study is under way that is intended to measure EIC noncompliance for the complete 1993 tax year for the electronic and paper returns. Until IRS completes this second study, the only information available about tax year 1993 EIC noncompliance by taxpayers who filed paper returns comes from IRS' efforts to detect inaccurate or improper returns as they are processed. These data show the amount of noncompliance that IRS discovered while processing EIC returns but do not measure the universe of noncompliance.

Throughout the 1994 tax filing season, IRS had controls in place to prevent EIC refunds from being issued when information on the paper returns suggested an error. For example, the EIC Compliance Initiative⁶ delayed over \$500 million in refunds while EIC recipients were asked to prove their eligibility. Final action on these cases was pending as of September 30, 1994, but IRS officials said they believe that most of the requested refunds ultimately will be denied because taxpayers will not be able to prove their eligibility.

In another effort, as of September 30, 1994, IRS' Criminal Investigation Division's fraud detection teams identified about 72,000 fraudulent returns filed electronically and on paper; about 92 percent were returns with EIC claims. IRS was able to stop about \$111 million, or 74 percent, in refunds from being released to taxpayers.

Tax law does not, according to IRS officials, prohibit illegal aliens from paying taxes or receiving the EIC. Since taxpayers are not required to identify themselves as illegal aliens on their tax returns, IRS does not know how many illegal aliens receive EIC benefits. Information currently reported on tax returns cannot be used to accurately identify all illegal aliens who file EIC returns. However, some tax returns contained information that led IRS to conclude that 160,000 taxpayers who had filed

⁵Determining whether a refund is fraudulent requires determining the taxpayer's intent, which is difficult to prove.

⁶The EIC Compliance Initiative is a program established in 1994 to prevent erroneous EIC refunds.

for the EIC for tax year 1993 likely were illegal aliens, and IRS said that most of these claims will be denied because the taxpayers cannot support their claims.

Background

The EIC is a refundable tax credit available to low-income working families with children.⁷ Congress established the EIC in 1975 to achieve two long-term objectives: (1) to offset the impact of Social Security taxes on low-income families and (2) to encourage low-income families to seek employment rather than welfare. EIC coverage and the amount of benefits have expanded since 1975.

For tax year 1993, about 14.7 million taxpayers claimed about \$15 billion in EIC benefits—8.7 million taxpayers filed paper returns and 6 million filed electronically. To be eligible for any EIC in tax year 1993, a taxpayer must have had earned income of less than \$23,050 and had one or more qualifying children who met the age, relationship, and residency tests. The Omnibus Budget Reconciliation Act (OBRA) of 1993 greatly increased the number of taxpayers eligible for the EIC and the amount of the credit beginning in tax year 1994. The act also increased the income ranges for EIC eligibility and allowed claims by taxpayers without children beginning in tax year 1994. The maximum income qualifying for the EIC will rise to \$27,000 in 1996, and the maximum credit will rise from \$2,364—for tax year 1993—to \$3,370 in tax year 1996.⁸

IRS has estimated that about 20 million taxpayers will file for the EIC for tax year 1994—about 5 million more than filed for tax year 1993. Most of this increase is expected to be filers without children.

Although noncompliance has resulted in many taxpayers receiving the EIC when they do not qualify for it or receiving too much EIC, many families who qualify for the EIC may not be receiving it at all. Researchers have estimated that between 75 and 86 percent of all eligible families actually claimed the EIC in 1990.⁹

⁷The Omnibus Budget Reconciliation Act of 1993 revised the EIC, in part making certain taxpayers without children eligible for the credit.

⁸All monetary figures are stated in 1994 dollars. Under OBRA 1993, amounts would be higher in 1995 and 1996 than shown here because of annual inflation adjustments.

⁹Yin et al., Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, American Tax Policy Institute, Feb. 1994.

Objectives, Scope, and Methodology

Our objectives were to report for tax year 1993 on what is known about (1) the extent of EIC noncompliance and (2) the number of illegal aliens who received EIC benefits.

To achieve our objectives, we

- reviewed IRS' study of EIC claims on tax returns filed electronically in a 2-week period in January 1994,
- obtained information on IRS controls and initiatives to detect and prevent noncompliance with EIC provisions,
- reviewed IRS' Criminal Investigation monthly reports of filing fraud statistics,
- monitored the results of IRS' internal audits of refund fraud issues,
- interviewed IRS National Office officials responsible for various EIC activities, and
- interviewed officials in the Cincinnati and Fresno Service Centers responsible for EIC-related studies or investigations.

We relied on noncompliance data provided in IRS reports and did not verify the data. We did not compare the noncompliance rate for the EIC with the noncompliance rate for other tax provisions.

We did our work from March through September 1994 in accordance with generally accepted government auditing standards. We discussed our draft report in an October 18, 1994, exit conference with IRS National Office officials, including the Fraud Executive, EIC Study Coordinator, and representatives from the Office of Chief Counsel. We also discussed our draft with U.S. Treasury officials from the Office of Tax Analysis. The IRS and Treasury officials offered comments to improve the accuracy and clarity of the draft report. We made appropriate changes in the report.

Noncompliance With the EIC

IRS' TCMP data from 1982 and 1985 indicated a significant level of EIC noncompliance. The most recent TCMP data, from 1988, showed that noncompliance levels remained high. About 42 percent of the EIC recipients received too large a credit, with about 32 percent of EIC recipients not able to show that they were entitled to any credit. Of the \$5.6 billion awarded in EIC in 1988, about \$1.9 billion (34 percent) was awarded erroneously. However, these TCMP results may not be relevant for the current EIC because the credit has been changed substantially since 1988. For instance, the largest portion of noncompliance found in 1988 was associated with errors in taxpayers' filing status and the number of

dependent children. OBRA 1990 reduced the importance of filing status in determining EIC eligibility and created the qualifying children definition to address these problems. OBRA 1990 and additional changes in 1993 also broadened the EIC coverage and increased the amount of the EIC. Furthermore, the 1988 EIC returns were filed on paper, like all other returns, but about 41 percent of the 1993 returns were filed electronically.

Because of growing concerns about EIC-related fraud on returns filed electronically, IRS conducted a study in 1994 to obtain current information about the types of EIC errors and the level of fraudulent claims. IRS sampled about 1,100 of the 1.3 million EIC returns filed electronically during a 2-week period in January 1994.¹⁰ These returns were sent to IRS special agents in the field who contacted the taxpayers, employers, and individuals who helped the taxpayers file their returns. The agents verified tax return information, including income and number of qualifying children claimed. In cases where the taxpayers overstated their EIC claim, the special agents were asked to assess whether an error was intentional. Some taxpayers admitted that they lied on their returns, while in other cases the special agents relied on their experience and training to judge taxpayers' intentions. Although using agents' judgment to determine taxpayers' intentions may be an imperfect method, we believe it is the most reliable measure we found for the amount of fraud involved in EIC returns.

IRS has compiled preliminary data on the study results based on available information as of July 1994 and plans to complete the study by December 1994. The results can be generalized only to the 1.3 million EIC returns filed electronically during the 2-week period studied because these early filers may have characteristics that differ from those who file later. On the basis of the preliminary analysis, IRS estimated that for these electronic EIC returns

- 29 percent of taxpayers claimed too large an EIC—22 percent claimed the credit when they were not entitled to it, and 7 percent claimed more than they were entitled to.
- \$358 million was erroneously claimed out of about \$1.5 billion claimed during this period.
- 13 percent of the taxpayers intentionally claimed too much EIC and these intentional claims accounted for \$183 million, or about half of the \$358 million erroneously claimed.

¹⁰The 1.3 million returns filed during this 2-week period represented about 22 percent of the approximately 6 million EIC returns filed electronically for tax year 1993.

According to IRS, about 3 percent of taxpayers claimed a total of about \$7 million less EIC than they were entitled to receive during the 2-week period studied.¹¹

Based on IRS' preliminary analysis of the study data, most EIC errors have been linked to issues involving filing status and qualifying children. IRS expects the overall error rates to increase as it reviews additional data, which should identify more errors, such as use of duplicate dependent Social Security numbers (SSN) and inaccurately reported income.

As of September 30, 1994, IRS was studying another random sample of about 700 tax year 1993 EIC returns that were filed electronically and on paper throughout the 1994 filing season. In early 1995, IRS plans to use these data to obtain a better estimate of the extent of EIC noncompliance.

IRS Controls Found Noncompliance

As tax returns are processed, IRS has various controls to detect erroneous returns. Some controls apply to paper returns only, some to electronically filed returns only, and some to both.

When a paper tax return is received, IRS personnel perform an initial review to make sure the return is complete and contains basic EIC qualifying information. They enter some information from paper returns into their computer systems. During this initial review, for tax year 1993, IRS personnel identified about 150,000 taxpayers who claimed the EIC although the return information indicated they were not entitled to it. The majority of the taxpayers were disqualified because of problems related to the qualifying child, such as a child who exceeded the age limit.

Beginning in January 1994, during the initial review of paper tax returns, IRS personnel also pulled returns out of the processing stream if the return was missing an SSN for the qualifying child and if the tax refund exceeded a certain dollar threshold. This effort was called the EIC Compliance Initiative. IRS suspended the EIC refund claimed and asked the taxpayer to submit proof of qualification for the EIC. If the taxpayer responded with the necessary proof, the refund was released. If the taxpayer submitted insufficient proof or failed to respond, IRS' policy would be to permanently deny the refund.

¹¹These data do not include those taxpayers who did not claim the EIC.

As of September 30, 1994, IRS had delayed about \$500 million in potentially erroneous EIC refunds claimed on about 400,000 returns out of about 8.7 million paper EIC returns. IRS officials said they expected most of these refunds to be permanently denied because many taxpayers did not respond to IRS' requests for information or could not support their claims. IRS officials consider the EIC Compliance Initiative to be effective and plan to provide resources to review about 1.2 million returns next year.

For electronically filed returns, IRS' initial reviews of the returns are done electronically. IRS had an up-front computer check to prevent questionable electronic EIC returns from being accepted in 1994. IRS rejected about 610,000 returns out of about 6 million electronically filed EIC returns where the qualifying child's SSN on the Schedule EIC did not match Social Security Administration's (SSA) records.¹² IRS does not know how many rejected electronically filed EIC returns were resubmitted on paper, corrected and refiled electronically, or not refiled at all.

After electronic returns pass up-front computer checks and paper returns pass manual checks, an IRS computer program analyzes all returns to identify those that are potentially fraudulent. The returns with refunds identified by the computer as having greater likelihood of fraud are then reviewed by service center fraud detection teams. The number of fraudulent returns detected by IRS has grown steadily over recent years. As of September 30, 1994, out of approximately 80 million electronic and paper returns claiming a refund, IRS had identified 72,425 fraudulent returns that involved \$150 million in refunds. IRS denied \$111 million (74 percent) of the refunds before they were released to the taxpayers, about 92 percent of these returns were EIC-related. For the same period in 1993, IRS detected 59,261 fraudulent returns involving \$110 million in refunds and denied \$78 million (71 percent) of the refunds.

Illegal Aliens Can Receive the EIC

The Internal Revenue Code does not prohibit illegal aliens from receiving the EIC if they meet the prescribed eligibility requirements. IRS forms do not require illegal aliens to identify themselves as such; therefore, IRS does not know how many illegal aliens may be receiving the EIC.

IRS needs an identification number, normally the taxpayer's SSN, to process a tax return. IRS assigns a temporary Taxpayer Identification Number (TIN) when any taxpayer files a return with an invalid SSN, a blank space, or the

¹²IRS does not know, however, how many of these returns were submitted by (1) persons attempting to defraud IRS or (2) taxpayers and tax preparers who made mistakes in recording or transcribing the child's name and/or SSNs.

code “205(c).”¹³ The designation 205(c) is often used by taxpayers to indicate they are not eligible to receive an SSN.¹⁴ Thus, IRS officials said taxpayers who enter this code are likely to be illegal aliens. However, IRS’ computers do not tabulate the total number of taxpayers who have entered 205(c) on their tax returns and IRS personnel do not determine whether illegal aliens or others received the temporary TINS.

Limited data from manual reviews under the 1994 EIC Compliance Initiative show that a minimum of 160,000 taxpayers, out of about 8.7 million who filed paper returns claiming the EIC, entered 205(c) instead of an SSN for a qualifying child. According to IRS officials, the taxpayers who filed these returns likely are illegal aliens. IRS expects most of these refunds to be denied because taxpayers will not be able to support their claims. For example, IRS expects many claims to be denied because dependents will not meet residency requirements. In addition to the 160,000, an unknown number of illegal aliens would have received the EIC because the amount they claimed was below the Compliance Initiative’s dollar threshold.

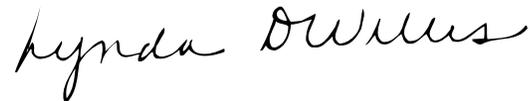
Unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days after its issuance date. At that time, we will send copies of this report to various interested congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others on request.

¹³The designation 205(c) refers to section 205(c) of the Social Security Act as amended. This section specifies the rules for issuing SSNs. Most legal aliens can obtain an SSN if they meet the applicable requirements. Section 205(c) does not refer to illegal aliens.

¹⁴Some illegal aliens have SSNs. For instance, in some cases, SSNs may have been issued while individuals were legally present in the United States, and the individuals are now illegal aliens because they overstayed their visas. An SSN also may have been illegally obtained by an individual.

The major contributors to this report are listed in the appendix. Please contact me on (202) 512-8633 if you have any questions about this report.

Sincerely yours,

A handwritten signature in black ink that reads "Lynda D. Willis". The signature is written in a cursive style with a large, prominent "L" and "D".

Lynda D. Willis
Associate Director, Tax Policy and
Administration Issues

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

Michael Brostek, Assistant Director, Tax Policy and
Administration Issues
Mary Phillips, Assignment Manager

**Cincinnati Regional
Office**

William Bricking, Evaluator-in-Charge
Robert Lidman, Issue Area Manager
Ellen Soltow, Evaluator

Appendix I
Major Contributors to This Report

Related GAO Products

IRS Automation: Controlling Electronic Filing Fraud and Improper Access to Taxpayer Data (GAO/T-AIMD/GGD-94-183, July 19, 1994).

Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89, Feb. 10, 1994).

Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993).

Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved (GAO/GGD-93-145, Sept. 24, 1993).

Tax Administration: IRS' 1992 Filing Season Was Successful but Not Without Problems (GAO/GGD-92-132, Sept. 15, 1992).

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested

