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Report to the Chairman, Committee on Finance, U.S. Senate

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TAX ADMINISTRATION

Erroneous Dependent and Filing Status Claims

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The Honorable Daniel Patrick Moynihan
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

This report responds to the request from the former Chairman of the Committee that we review taxpayer compliance in claiming the dependent exemption and filing status. Specifically, we were asked to (1) identify the sources of any erroneous dependent and filing status claims, (2) determine whether the laws on dependents and filing status need to be simplified, (3) determine what the Internal Revenue Service (IRS) is doing to address any erroneous claims, and (4) recommend any changes that IRS could make in its compliance programs. We briefed the Committee on the preliminary results of our work on February 5, 1993.

According to IRS' Taxpayer Compliance Measurement Program (TCMP), taxpayers erroneously claimed exemptions for an estimated 9 million dependents for 1988.[1] As a result, taxpayers improperly lowered their taxable income by an estimated $17 billion. IRS' TCMP data also showed that an estimated 3 million taxpayers claimed the wrong filing status. We identified the sources for both types of erroneous claims by analyzing a random sample of TCMP audits for tax year 1988. Appendix II describes our sample selection, statistical analysis, and margins of error for estimates discussed in this report.

Background

Under Section 151 of the Internal Revenue Code, an individual can claim a personal tax exemption when filing a tax return or be claimed as a dependent on another person's tax return. Five tests govern whether a taxpayer can claim another person as a dependent: (1) a dependent cannot have gross income that exceeds the exemption amount unless the dependent is the taxpayer's child under age 19 or a full-time student under age 24; (2) a dependent cannot file a joint return except to get a refund of withheld taxes; (3) a dependent must be a U.S. citizen or resident or a resident of Mexico or Canada; (4) a dependent must live with the taxpayer the entire year as a household member or be related to the taxpayer; and

[1]For about 30 years, TCMP has been IRS' program for gathering reliable and comprehensive data on compliance. For individuals, IRS collects TCMP data every 3 to 4 years by auditing all tax return lines for a random sample of taxpayers. Tax year 1988 is the most recent year for which TCMP results are available.

(5) a taxpayer must provide over 50 percent of a dependent's support (support test). Appendix I provides more details on these five tests.

To meet the support test, the taxpayer must calculate the dependent's pro rata share of housing, food, and other expenses such as medical, clothing, and education. The taxpayer must maintain detailed financial records to document that he or she furnished more than 50 percent of the amount spent to support the dependent. If a taxpayer has inadequate records, IRS can disallow the dependent exemption even if the taxpayer furnished more than 50 percent of the support.

The Earned Income Credit (EIC) is a special tax credit for lower income workers with children. Prior to 1991, the five dependent tests were used to determine whether taxpayers had a "qualifying child" for the EIC. In 1990, Congress simplified the rules for defining a "qualifying child" by replacing the five dependent tests with three tests that are easier to meet. Today, taxpayers may claim the EIC if they meet income limits (earned income under $21,250 in 1991) and have a child who is (1) related to the taxpayer (relationship test), (2) under age 19 or a full-time student under age 24 (age test), and (3) living with the taxpayer generally more than 6 months (residency test).

For 1991, 13.2 million taxpayers claimed the EIC, which ranged up to $2,020. These taxpayers were eligible to claim the EIC if their earned income and adjusted gross income were less than $21,250 for 1991. Because the support test is no longer required for the EIC but still is required to claim a dependent exemption, taxpayers may be able to claim a child for the EIC but not claim the same child as a dependent.

Taxpayers must use one of five filing statuses, each having different standard deductions and tax rates: (1) married filing jointly, (2) married filing separately, (3) single, (4) qualifying widow(er) with dependent child, and (5) head of household. The last two filing statuses provide single taxpayers with a higher standard deduction and lower tax rate than the single filing status. These two also have tests similar to those for dependent and EIC claims. In addition to a residency test, which is required to claim the EIC, they each require meeting a household maintenance test.

The maintenance test for filing as a head of household requires taxpayers to pay more than half the cost to maintain a household. To meet this test, taxpayers need to keep detailed records and make financial calculations. They must track the total cost to maintain a home, including costs for rent or mortgage, utilities, property taxes, insurance, repairs, and food. Then, they must determine what portion of this total they paid.

This household maintenance test is similar to the dependent support test. Both tests track similar costs and require similar financial records and calculations. Moreover, housing costs are generally the largest cost in supporting a dependent.

Results in Brief

According to our estimates, the primary source (73 percent) of erroneous dependent claims for 1988 was the taxpayers' failure to meet the dependent support test.[2] Of those not meeting this test, taxpayers did not provide the necessary financial support for an estimated 57 percent of the dependents. For the remaining estimated 43 percent, taxpayers did not have adequate records to show whether they provided the necessary support. Generally, these were lower income taxpayers (average adjusted gross income of $17,653), some of whom may have met the support test had they kept adequate records.

We found that the support test was too complex and burdensome for many taxpayers to voluntarily comply because it required them to maintain detailed records and make difficult financial analyses. We analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.[3] Under one of these—replacing the support test with the simpler residency test used in the EIC—taxpayers could claim a dependent exemption if a dependent lived with them more than 6 months and met the other dependent tests. This is the only alternative among the four we analyzed that would eliminate the complexity of the support test, which according to our analysis was the primary source of erroneous dependent claims. Another advantage of the residency test is that it would reduce taxpayers' burden by making the tests for claiming a dependent similar to those for claiming the EIC.

[2]For various reasons, as discussed in appendix II, our sample only covered an estimated 6.1 million of the 9 million erroneous dependent claims for 1988. From analyzing the sample cases, we estimated that 4 million taxpayers made these errors, of which about an estimated 1.6 million also claimed the head of household filing status in error. Both types of erroneous claims resulted in an estimated $1.8 billion in lost revenues.

[3]The residency test alternative is similar to one proposed in a Senate bill, S. 1821, introduced in October 1991. The other three alternatives were described by Professor Deborah H. Schenk in the New York University Law Review, Fall 1989.

If the support test were replaced with the residency test, burden or complexity would not be reduced for taxpayers having dependents and claiming head of household filing status. These taxpayers would still have to meet the maintenance test, which we found is nearly as complex as the support test. A need for simpler laws in this area is apparent from IRS data that show the head of household filing status accounted for an estimated 82 percent of all filing status errors in 1988.

Because the costs of residency are generally the largest of any household costs, the maintenance test is largely redundant. If Congress were to adopt the residency test for dependent claims, it might also want to eliminate the maintenance test. Doing so would lower the burden not only for taxpayers claiming dependents but also for taxpayers claiming head of household filing status.

Even if Congress enacts these simplification proposals, we found that IRS could do more to detect any remaining erroneous dependent claims. For 1988, IRS matched about 3 percent of dependents' social security numbers (SSN) to identify dependents who were claimed on more than one tax return or did not meet income and age requirements. If IRS had had a 100-percent matching program for 1988, IRS could have generated an estimated $751 million in additional tax revenues at a cost that ranges between $45 million to $60 million.

A 100-percent matching program coupled with the simpler rules we propose would address an estimated 4.3 million (71 percent) of the 6.1 million erroneous dependent claims. We based this estimate on the sample cases we analyzed for 1988.

Objectives, Scope, and Methodology

Our objectives were to

- identify the sources of any erroneous dependent and filing status claims,
- determine whether the laws on dependents and filing status need to be simplified,
- determine what IRS is doing to address any erroneous claims, and
- recommend any changes that IRS could make in its compliance programs.

To determine the sources of erroneous dependent and filing status claims, we reviewed a random sample of 554 individual tax returns for 1988 in which an IRS auditor disallowed one or more dependent exemptions. We drew this sample from the 54,000 cases in the 1988 TCMP. We had requested and received more audited tax returns to review, but for various reasons we did not receive all of the requested returns and could not use some returns that we did receive. As a result, we could only reliably estimate our results to about 6 million of the 9 million erroneous dependent claims. Appendix II describes these reasons as well as our sampling and statistical analysis.

Our analysis of these cases also allowed us to consider whether the laws on dependents are too complex for taxpayers to comply voluntarily. We identified possible legislative changes to simplify the laws on dependents by reviewing academic, legal, and other related publications as well as proposed legislation.

To identify what IRS is doing and could do to address any erroneous claims, we met with IRS officials and reviewed the results of any compliance programs.

We did our work between March 1992 and February 1993 in accordance with generally accepted government auditing standards.

Dependent and Filing Status Laws Can Be Simplified

Of the five dependent tests, we found the most complex and burdensome is the support test. Unlike the other tests, this test requires taxpayers to make complex calculations and keep detailed records to show they provide more than half of the dependent's support. They must track how much they spend for a dependent's expenses such as food, housing, clothing, medical and dental care, education, and transportation. They then have to compute the dependent's share of these expenses and determine whether they provided more than half of that dependent's support.

We estimated that taxpayers' failure to meet the support test accounted for 73 percent of the erroneous dependent claims for 1988.[4] Of the claims not meeting the support test, an estimated 57 percent failed because taxpayers did not provide over half of the support and an estimated 43 percent failed because they did not keep adequate records to prove they met this test. These taxpayers had lower income (average adjusted gross

[4]The 73 percent that failed to meet the support test accounted for an estimated 4.5 million of the estimated 6.1 million erroneous claims. Of these 4.5 million claims, an estimated 2.6 million (57 percent) failed because the taxpayers did not provide over half the support and an estimated 1.9 million (43 percent) failed because taxpayers lacked adequate records.

income of $17,653) and might have met the support test had they kept adequate records.[5]

Because the support test is no longer required for the EIC but still is required to claim a dependent exemption, taxpayers may be able to claim a child for the EIC but not claim the same child as a dependent. If current EIC tests for defining a qualifying child had been in effect in 1988, an estimated 890,000 low-income taxpayers of the estimated 4 million taxpayers whose dependent claim for 1988 was disallowed would have been eligible for the EIC but could not have claimed an exemption for that child.

Alternative Ways to Simplify the Support Test

Our review of recent literature and legislative proposals identified four alternatives to simplify the laws on dependent exemptions. We identified two alternatives that would simplify the dependent support test and two others that do not address the support test but would have broader effects on the exemption rules. Brief descriptions of all four alternatives follow.

- Replace the support test with the residency test when the dependent lives with the taxpayer. A residency test approximates the greatest component of support—the cost of housing. However, the current support test would remain in effect when the dependent does not live with the taxpayer.
- Simplify the support test by replacing the 50-percent support standard with a fixed minimum amount. A taxpayer could claim an exemption if he or she pays the minimum amount and no other taxpayer pays the minimum amount. The minimum amount would at least equal the value of an exemption (e.g., $2,150 in 1991). If more than one taxpayer pays this minimum, the taxpayer with whom the dependent lives would claim the exemption or the taxpayers themselves would decide who claims the exemption.
- Limit the dependent exemption to children. No exemption would be allowed for other types of dependents.
- Replace the dependent exemption and standard deduction with a family support allowance. The allowance amount would vary by family size and marital status.

We analyzed these four alternatives using five criteria (see app. I). The first three criteria encompass IRS' strategic objectives while the last two address general considerations in making tax law changes. Only the first

[5]The confidence interval for this estimate ranged from an average adjusted gross income of $13,156 to $22,150.

two alternatives—a residency test and the fixed minimum amount—simplify the complex support test. Our evaluations of these two alternatives for each of the five criteria are summarized below.

- Taxpayer Burden: While both alternatives would likely reduce the burden on taxpayers, the residency test would be the least burdensome. With the exception of head of household filing status claims, it would eliminate the need for taxpayers to maintain detailed records and make complex calculations to determine whether they provided over half of the support. It has the added advantage of being consistent with the tests for the EIC, which should further reduce the burden. Under the fixed minimum amount, taxpayers would still have to maintain records to prove that they had provided the minimum amount.
- Voluntary Compliance: Both alternatives should improve voluntary compliance to some degree because (1) taxpayer burden would be reduced and (2) some dependent claims that were denied under the support test would no longer be erroneous under the alternatives.
- IRS Productivity: While both alternatives should improve productivity because IRS would have fewer records to check, the residency test alternative should produce the largest gains. IRS examiners would not need to check whether a taxpayer paid the minimum support. For taxpayers claiming the EIC, the examiner—after determining the residency test was met for the dependent—would not have to separately determine whether the dependent met the residency test for the EIC.
- Equity: Both alternatives would preserve the principle that the taxpayer providing the support for a dependent should be allowed to claim that dependent as an exemption. However, a fixed minimum amount test could deny the exemption to more low-income taxpayers. If the dependent resided with such taxpayers, they could claim the exemption under the residency test but not under the fixed amount test if the support provided by them fell below the fixed amount.
- Revenue Impact: Both alternatives are likely to reduce revenue by an unknown amount because more taxpayers could claim exemptions. However, we believe that any estimate of the revenue loss should recognize that TCMP data show taxpayers tended to claim the exemption if the dependent lived with them. Thus, to the extent the two alternatives parallel existing taxpayer behavior, the revenue loss may be minimal.

Simplifying Rules for Filing as Head of Household

If the support test were replaced with a residency test, the burden or complexity would generally not change for taxpayers who claim head of household filing status. Most of the burden would remain because taxpayers claiming head of household filing status still have to meet the maintenance test, which is nearly as complex as the support test.

The need for simpler rules is apparent from IRS data that show the head of household filing status accounted for an estimated 82 percent of all filing status errors in 1988. In addition, we found that the dependent support test led to most of these errors. From our sample, we estimated that about 1.3 million (84 percent) of the erroneous head of household claims in our sample occurred because the taxpayer did not meet the support test and claimed a dependent exemption in error. We estimated that the remaining 257,000 (16 percent) of the head of household claims were incorrect because the taxpayer did not maintain a household or the dependent did not live with the taxpayer for half of the year.

Because the costs of residency are generally the largest of all household costs, the maintenance test is redundant. If Congress were to replace the support test with a residency test for dependent exemptions, it might also want to eliminate the maintenance test. This would reduce burden not only for taxpayers claiming dependents but also for taxpayers claiming head of household filing status.

If the maintenance test were eliminated, single parents who share housing or receive housing assistance from government or other sources could each file as a head of household. We do not know how this change would affect the number of head of household claims.

IRS Could Do More to Identify Erroneous Dependent Claims

Although simplifying the laws on dependent exemptions should help to improve voluntary compliance, IRS still needs compliance programs to identify improper claims. Prior to 1987, IRS relied on audits of tax returns to detect erroneous dependent claims. However, IRS only audited about 1 percent of individual returns in recent years. Beginning in 1987, a new law required taxpayers to report their dependents' SSNs on tax returns. Besides deterring noncompliance in claiming dependents, this reporting provides IRS with a systematic way to detect taxpayers who still claim erroneous dependent exemptions.

Under a special revenue initiative, IRS received funds to computer match 3 percent of the SSNs of dependents claimed with all the SSNs on other tax returns as well as on government databases for certain entitlement programs and information returns. This match can detect if the same dependent is claimed more than once or may have income or government assistance that would disqualify them as dependents.

IRS has experienced some operational problems with the 3-percent match. For example, IRS' errors in entering SSN data into its computers produced cases in which the same dependent appeared to be claimed twice but actually was not. Also, when two taxpayers claimed the same dependent, IRS did not always follow up with both taxpayers to see who claimed the dependent in error. Further, IRS tax examiners made procedural errors that precluded IRS from taking action to resolve the discrepancy.

We believe that improved IRS management could address these problems satisfactorily, making a 100-percent match feasible. For example, many problems would be eliminated if IRS better ensured that its staff correctly entered SSNs reported by the taxpayers into IRS' computer database or follows up when a dependent appears to be claimed as an exemption more than once.

Assuming IRS corrects these problems, we estimated that 2.4 million (39 percent) of the estimated 6.1 million erroneous dependent claims covered in our review of 1988 TCMP cases could have been found under a 100-percent computer match. IRS' match would have identified dependents who had too much income to be claimed as a dependent by someone else or had been claimed more than once. IRS could have assessed an additional estimated $751 million in recommended taxes at an estimated cost of $52 million.[6] For this reason, we believe a 100-percent match would be cost-effective.

The remaining estimated 3.7 million (61 percent) erroneous dependent claims could not have been identified by matching. To find the errors, IRS had to interview taxpayers or examine taxpayers' records.

Ways to Address Most Erroneous Dependent Claims

Replacing the complex support test with the simpler residency test and beginning a 100-percent matching program would address an estimated 4.3 million (71 percent) of the estimated 6.1 million erroneous dependent claims in our review. This estimate includes 3.5 million ineligible dependents who would be eligible to be claimed as dependents if Congress

[6]IRS estimated it would cost $20 million to enter all dependent SSNs into its computer. Using IRS' average costs for its existing match to identify unreported income, we estimated that IRS also would spend $32 million to manually follow up on cases that the computer identifies as potential noncompliance. Accounting for margins of error, our $52 million cost estimate could be as low as $45 million and as high as $60 million.

were to adopt a residency test. We estimated that the remaining 800,000 erroneous dependent claims could be detected by a 100-percent computer match.[7]

Such a match would also likely be cost-effective. For the 1992 tax year, the potential tax consequence from identifying just these estimated 800,000 erroneous dependent claims could range from $276 million at a 15-percent rate up to $570 million at a 31-percent rate. This match would be relatively simple compared to IRS' existing matches that have to search multiple tax return lines to find unreported income (e.g., self-employment income). More importantly, we believe that this match—compared to audits of individuals—would provide a more comprehensive and less burdensome way to induce voluntary compliance and identify those who do not comply.

Conclusions

The rules for claiming dependent exemptions are too complex and burdensome for many taxpayers to comply. Among the five tests for claiming dependents, the support test was not complied with most often (an estimated 73 percent). Of the two related alternatives to that test, replacing the support test with the residency test used for the EIC when the dependent lives with the taxpayer appears to have more advantages than the fixed minimum amount.

With this residency test, the maintenance test for filing as a head of household would be redundant and may not be needed. If the maintenance test did not exist, taxpayers could then use the same residency test to determine eligibility for: (1) dependent claims, (2) the EIC, and (3) head of household filing status.

We found that IRS could identify many erroneous dependent claims by expanding its limited computer matching program. While this program had operational problems, our analysis indicated that these problems could be readily resolved. By resolving these problems, IRS could cost-effectively do a 100-percent computer match. Such a matching program in combination with a residency test for dependent exemptions would have addressed an estimated 71 percent of the erroneous dependent exemption claims we analyzed.

[7]The 800,000 estimate is lower than our 2.4 million estimate because the residency test would eliminate many errors that otherwise would be detected in a match.

Matters for Congressional Consideration

Congress should consider enacting legislation that would substitute a residency test similar to that used in the EIC program for the dependent support test when the dependent lives with the taxpayer. If this legislation is enacted, Congress also should consider eliminating the household maintenance test as a condition for claiming the head of household filing status.

Recommendation to the Commissioner of Internal Revenue

We recommend that IRS correct the operational problems in its limited matching program and implement a 100-percent computer matching program to identify erroneous dependent claims.

Agency Comments

We received oral comments from responsible IRS officials. They agreed with our findings and conclusions about the support test and maintenance test. They also said that our recommendation to them has merit and that they would consider it.

As agreed with the Committee, unless you publicly announce the contents of this report earlier, we plan no further distribution for 30 days. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix III. If you have any questions, please contact me at (202) 272-7904.

Sincerely yours,

Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

Contents

Abbreviations

EIC	Earned Income Credit
IRS	Internal Revenue Service
SSN	Social Security Number
TCMP	Taxpayer Compliance Measurement Program

Alternatives to Simplify Dependent Exemption Rules

Five tests govern whether a taxpayer can claim a dependent as an exemption. Descriptions of these five tests follow.

1. Gross Income Test: A dependent usually cannot earn more in gross income than the value of the exemption. In 1991, the exemption amount was $2,150. Nontaxable income, such as welfare and social security benefits, is not included in determining gross income. Children who are under the age of 19 or are full-time students under the age of 24 are not subject to the gross income test.

2. Joint Return Test: A dependent usually cannot file a joint return. A married dependent can only file a joint return with his or her spouse to get a refund of all tax withheld.

3. Citizenship Test: A dependent must be a U.S. citizen or resident or a resident of Canada or Mexico. An exemption can be claimed for an adopted alien child living the entire year with a U.S. citizen in a foreign country.

4. Relationship/Member of Household Test: A dependent must live with the taxpayer for the entire year as a member of the taxpayer's household or be related to the taxpayer. A relative does not have to live with the taxpayer.

5. Support Test: A taxpayer must provide over half the dependent's support. Unlike the gross income test, this test considers all income, whether taxable or not. Taxpayers are expected to keep detailed records of the support they provide to dependents, including housing, food, clothing, medical, and educational support. If several taxpayers support a dependent but none of them provide over half the support, a taxpayer who meets all other tests and pays at least 10 percent of the dependent's support can claim the dependent.

Four Possible Alternatives

By reviewing recent literature and legislative proposals, we identified four ways to simplify the dependent rules. Two would change the support test. Two would not change the support test but would make broader changes to the dependent exemptions rules. We focused our analysis on changes to the support test because the test led to most erroneous dependent claims.

Changes to the Dependency Support Test

- Replace the support test with the residency test when the dependent lives with the taxpayer. A residency test approximates the greatest component of support—the cost of housing. The current support test would remain in effect when the dependent does not live with the taxpayer or in special cases when residency would not approximate support.

- Replace the 50-percent support standard with a fixed minimum amount, such as the amount of an exemption. A taxpayer could claim an exemption if he or she pays the minimum amount and no other taxpayer pays the minimum amount. If more than one taxpayer provides the minimum support, the taxpayer with whom the dependent lives can claim the exemption or the taxpayers can decide among themselves who will claim the exemption.

Changes to Dependency Rules Other Than the Support Test

- Limit the dependent exemption to children. No exemption would be allowed for other types of dependents.
- Replace the dependent exemption and standard deduction with a family support allowance. Taxpayers would select the family allowance based on family size and marital status.

Evaluation of Alternatives

We evaluated the four alternatives to simplify the dependency requirements using the following criteria:

- Taxpayer Burden: Does the proposed change reduce the amount of paperwork and number of decisions for the taxpayer? For example, does the change make the definition of a dependent consistent with the EIC definition of a qualifying child?
- Voluntary Compliance: Does the proposed change increase or decrease compliance with the dependency requirements? For example, will taxpayers claim fewer erroneous dependents?
- IRS' Productivity: Does the proposed change make it easier for IRS to administer the dependency requirements? For example, will it be less costly for IRS to check compliance?
- Equity: Does the change preserve the principle that a person who supports an individual is entitled to a tax exemption as well as the principle of ability to pay?
- Effect on Revenue: Does the proposed change increase or decrease federal revenues?

Our evaluations of each of the four alternatives against these five criteria follow.

Residency Test

Taxpayer Burden

Taxpayer burden in most cases would decrease. The taxpayer would only have to establish that his dependent lived with him for more than 6 months. Taxpayers would have no need to keep records of how much they spent for the dependent's support. Also, a residency test would make the definition of a dependent consistent with the EIC definition of a qualifying child, which should reduce burden. However, taxpayer burden would not decrease for taxpayers claiming dependents who do not reside with them. They still would have to apply the support test.

Voluntary Compliance

Voluntary compliance is likely to improve because taxpayer burden would be reduced and many taxpayers already claim dependent exemptions for those living with them.

IRS' Productivity

IRS' productivity is likely to increase. Administration would be easier when dependents reside with the taxpayer because IRS would not have to verify the amount of support provided to the dependents. Also, for those taxpayers who receive the EIC, IRS would not have to make separate determinations for qualifying children and for dependent exemptions.

Equity

Equity would probably increase. Because the cost of housing approximates the greatest component of support, a residency test would maintain support as a criterion. A residency test would eliminate the inequity in meeting the support test for large, low-income households. For example, under the current support test, after allocating expenses among the members of a large, low-income household, the amount of support allocated to each member may not be very large. If a member has some income, then the taxpayer is unlikely to meet the 50-percent support test in order to claim that member as a dependent.

Effect on Revenue

Revenue could potentially decrease because more taxpayers would be eligible to claim exemptions. However, on the basis of our analysis of erroneous dependent claims, such taxpayers already appear to be claiming exemptions when the dependent lives with them. If most taxpayers who claim dependent exemptions do this, using the residency test would reflect reality and result in little revenue loss as to such taxpayers.

Fixed Amount Standard

Taxpayer Burden

Taxpayers' burden would be somewhat reduced because they would only need to document that they provided the minimum amount of support. However, this change would not bring the definition of a dependent for exemption purposes into conformance with the definition of qualifying child for the EIC.

Voluntary Compliance:

The proposed change would reduce complexity as well as errors in making dependency determinations, which likely would improve compliance.

IRS' Productivity

Productivity would likely improve, but IRS would still have to ensure (1) the taxpayer paid the minimum amount and (2) no other taxpayer claimed the dependent.

Equity

Equity would probably decline. This standard does not account for geographic differences in cost of living. Also, lower-income parents whose support to their children happens to fall below the exemption amount would be denied the exemption. On the other hand, this standard would retain support as a concept.

Effect on Revenue

The revenue effect would depend on the fixed amount selected. The higher the fixed amount, the lower the revenue loss would be.

Exemption for Child Only

Taxpayer Burden

Impact on taxpayer burden would be mixed. The proposal would not change the definition of a dependent, and the current problems with the support test would remain. However, the burden would be eliminated for those taxpayers who previously claimed exemptions for other types of dependents.

Voluntary Compliance

Taxpayers' compliance would likely improve because they would only have to make sure they comply with the definition of a child.

IRS' Productivity

Productivity would likely increase. Administration would be easier because IRS would only have to ensure that the dependent was the taxpayer's child.

Equity

Equity would probably decline for some taxpayers. Taxpayers could not claim exemptions for parents or others they support. If residency were included in the definition of "child," support would remain a criterion.

Effect on Revenue

Revenue could potentially increase because the total number of exemptions would decrease.

Family Support Allowance

Taxpayer Burden

The family support allowance does not address the definition of dependent. Therefore, the taxpayer burden associated with the dependent support test would remain. However, a family support allowance would reduce the burden associated with independently calculating the standard deduction and exemptions. Instead, taxpayers would determine their support allowance from one table based on their marital status and number of dependents.

Voluntary Compliance

Compliance would probably remain the same since the current dependent support tests would remain.

IRS' Productivity

Productivity would likely remain the same. The administrative problems concerning dependent determinations would not change. IRS would still have to determine whether taxpayers meet the support test.

Equity

Equity would remain the same because support would still be a basis for an exemption.

Effect on Revenue

The revenue effect would depend on the amount of the allowance. If the family support allowance were to equal the standard deduction and dependent exemption amounts, revenue would likely remain the same.

Statistical Sampling Methodology and Precision of Estimates

This appendix describes the statistical sampling methodology we used to determine reasons for erroneous dependent exemptions. We analyzed our sample data to determine whether these erroneous exemptions could be reduced through tax law changes or identified by IRS through computer matching. From our sample data, we developed population estimates on why taxpayers lost exemptions as well as estimates on the amount of additional tax liability.

The statistical estimates in the report are point estimates that are weighted to account for strata size. Point estimates alone are not adequate representations of statistical results because statistical estimates correspond to range estimates stated at a 95-percent confidence level. The narrower a confidence interval, the more reliable a point estimate becomes as representative. The precision of estimates varies with sample size, variability between sample observations, and the characteristics of the sampling process.

For example, our point estimate of 6.1 million erroneous dependent exemptions for 1988 has a range estimate (i.e., confidence interval) of 5 million to 7.2 million at the 95-percent confidence level. This means that we have a 95-percent chance that the actual number of erroneous exemptions is between 5 million to 7.2 million. It also means that we have a 5-percent chance that the actual number is not within this range.

Statistical Estimates on Disallowed Exemptions

The data we used came from IRS records in the automated TCMP file. The records covered tax year 1988 and were the most recent data available when we began. The TCMP file corresponded to a stratified, nationwide IRS sample that included 54,095 tax returns in 224 strata. The IRS strata are defined by taxpayer income category and geographic region. Each tax return selected for the TCMP sample was audited by IRS staff to determine whether the correct taxes had been computed. If errors were found, the taxpayer was assessed the appropriate additional tax.

We focused on 3,098 tax returns in the TCMP sample for which the IRS changed the number of exemptions claimed. From this group, we selected a probability subsample of 958 tax returns. This sample included all cases in 97 TCMP strata in which 4 or fewer tax returns had a change in the exemptions as a result of the IRS audit. We sampled the remaining 127 TCMP strata with 5 or more tax returns in which exemptions changed. We then asked IRS for the 958 tax returns we selected for our sample. However, our usable sample consisted of 554 tax returns. Of the other 404 returns, 180 returns could not be obtained, 51 returns were misclassified, 88 returns had an increase in the number of exemptions allowed, and 85 returns were cases in which IRS disallowed the exemptions by default because the taxpayer did not respond to the audit notice. We dropped these 85 cases because we could not determine whether the exemptions would have been allowed if the taxpayer had responded. Table II.1 shows the disposition of the sample and the estimated populations.

Table II.1: Point Estimates and Confidence Intervals on the Disposition of TCMP Tax Returns in GAO's Subsample

Tax return category	Number of tax returns in sample	Point estimate[a]	Upper limit[a]	Lower limit[a]
Disallowed exemptions	554	4.0	4.5	3.5
Increased exemptions	88	0.4	0.6	0.3
Disposition unknown	85	1.1	1.6	0.8
Subtotal	**727**	**5.6**	**6.2**	**5.1**
Misclassified returns	51	0.5	0.8	0.2
Returns not provided	180	0.8	1.1	0.5
Total sample[b]	**958**	**6.9**	**7.4**	**6.5**

[a]Numbers in millions.

[b]Sums may not add due to rounding.

Source: GAO analysis of IRS data.

For the 554 tax returns, we analyzed why exemptions were disallowed and whether the disallowed exemptions could be identified through computer matching. On the basis of these 554 tax returns, our analysis addressed a population of an estimated 4 million tax returns. This population understated the total population of tax returns for which exemptions were disallowed. We had to exclude returns not provided by IRS and returns for which the taxpayer did not respond to IRS' audit notice. Table II.2 presents point estimates and confidence intervals for estimates on variables involving dependent claims.

Table II.2: Point Estimates and Confidence Intervals on Dependent Variables for Tax Year 1988

	Point estimate		Confidence interval at the 95% confidence level	
Variable estimated	**Number or dollar amount[a]**	**Percent**	**Number or dollar amount[a]**	**Percent**
Erroneous dependents	6.1	100	5.0-7.2	[b]
Taxpayers claiming erroneous dependents	4.0	100	3.5-4.5	[b]
Lost tax revenue	$1,800	[b]	$1,500-$2,100	[b]
Disallowed dependents due to support test	4.5	73	3.3-5.6	66-80
Excess support from dependents	2.6	57	1.7-3.4	48-67
Inadequate records	1.9	43	1.1-2.8	33-52
Dependent errors that matching can find	2.4	39	1.7-3.1	30-49
Additional tax from doing matching	$751	[b]	$556-$946	[b]
Dependent errors not found by matching	3.7	61	2.6-4.8	51-71
Dependent errors that could have been corrected	4.3	71	3.4-5.2	62-79
With residency test	3.5	57	2.6-4.3	48-65
With matching	0.8	32	0.6-1.1	26-39

[a]Numbers and dollar amounts in millions.

[b]Not applicable.

Source: GAO analysis of IRS data.

Table II.3: Point Estimates and Confidence Intervals on Head of Household and EIC Claims for Tax Year 1988

	Point estimate		Confidence interval at the 95% confidence level	
Variable estimated	**Number[a]**	**Percent**	**Number[a]**	**Percent**
Erroneous head of household claims	1.6	100	1.1-2.0	[b]
Due to support test	1.3	84	0.9-1.7	74-93
Due to other reasons	0.3	16	0.12-0.4	9-24
Taxpayers who could have claimed the EIC but not a dependent	0.89	100	0.5-1.3	[b]

[a]Numbers in millions.

[b]Not applicable.

Source: GAO analysis of IRS data.

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