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EARNED INCOME CREDIT

Noncompliance And Potential
Eligibility Revisions

Statement of Lynda D. Willis, Associate Director
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EARNED INCOME CREDIT: NONCOMPLIANCE AND
POTENTIAL ELIGIBILITY REVISIONS

SUMMARY OF STATEMENT BY
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The Earned Income Credit (EIC) is a major federal effort to assist the working poor. As of May 26, 1995, about 17.3 million returns claimed nearly \$20 billion in EIC for tax year 1994. Over the years EIC has been intended to (1) offset the impact of Social Security taxes on low-income workers and (2) encourage low-income individuals to seek employment rather than welfare. In the 1993 expansion of EIC, Congress also recognized a role for it in alleviating poverty. GAO's statement makes the following points:

- A reliable overall measurement of noncompliance with EIC provisions has not been made since 1988. But noncompliance appears to be a problem. The Internal Revenue Service (IRS) studied electronically filed EIC claims during 2 weeks of January 1994. IRS' final estimate is that 39 percent of the return filers claimed credit they were not entitled to receive--either in whole or in part. On the other hand, 6 percent of return filers claimed too little EIC. The percent of dollars erroneously claimed was smaller than the percent of incorrect returns--26 percent of refund amounts sought were overclaims and about 1 percent were underclaims. The IRS final report does not include an estimate of intentional errors. IRS' preliminary results had indicated that about 13 percent of EIC return filers may have intentionally erred when requesting or calculating their credit.

Judging by problems spotted by IRS personnel, noncompliance on EIC paper returns is also a concern. As of May 26, 1995, IRS had identified over 3 million paper returns that lacked valid Social Security numbers (SSN) for dependents or EIC qualifying children. IRS asked a significant portion of these taxpayers to provide additional proof of their eligibility.

IRS took several steps this filing season to combat fraudulent or erroneous returns, especially EIC returns. The success of these steps is as yet uncertain. However, IRS is conducting a study of EIC compliance which will help identify whether noncompliance was reduced. Study results may not be available until this fall.

- Although EIC is intended to assist the working poor, EIC eligibility criteria have not considered all of the resources recipients may have to support themselves and their families. However, the Self-Employed Health Insurance Act of 1995 included a provision, effective next year, that denies EIC to

claimants who have income from certain types of assets. The act makes claimants ineligible for EIC if they receive more than \$2,350 annually in specified asset-derived income. If Congress wishes to revisit this test, it could consider including additional forms of asset-derived income, such as estate and trust income, as well as changing the threshold amount.

Another approach to taking into account more of taxpayers' resources would be to add certain income to their adjusted gross income when determining EIC awards. According to Joint Committee on Taxation estimates done for Senator Roth, up to \$2.1 billion could be saved in fiscal year 1997 by recognizing certain nontaxed income as well as child support payments.

Both an EIC wealth test and an expanded definition of taxpayers' adjusted gross incomes (AGI) make EIC more complex and add to the burden on taxpayers and IRS. Also, since income information reported on tax returns can only roughly reflect taxpayers' actual wealth, using such data to determine EIC eligibility could raise fairness concerns.

- No one knows how many illegal aliens receive EIC. Illegal aliens may receive EIC if they meet the credit's eligibility rules. Awarding EIC to illegal aliens, however, works at cross-purposes with federal policies that prohibit illegal aliens from legally working in the United States. If the EIC criteria were revised to require that all EIC recipients have valid SSNs for work purposes, which illegal aliens are not eligible to receive, then illegal aliens would no longer qualify for EIC.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to assist in your review of the Earned Income Credit (EIC). Our testimony is based on a body of work we have done on EIC, including our current work for Chairman William V. Roth, Jr., Senate Committee on Governmental Affairs. It is also based on work we have done related to electronic filing fraud and the Internal Revenue Service's (IRS) annual performance in processing tax returns.

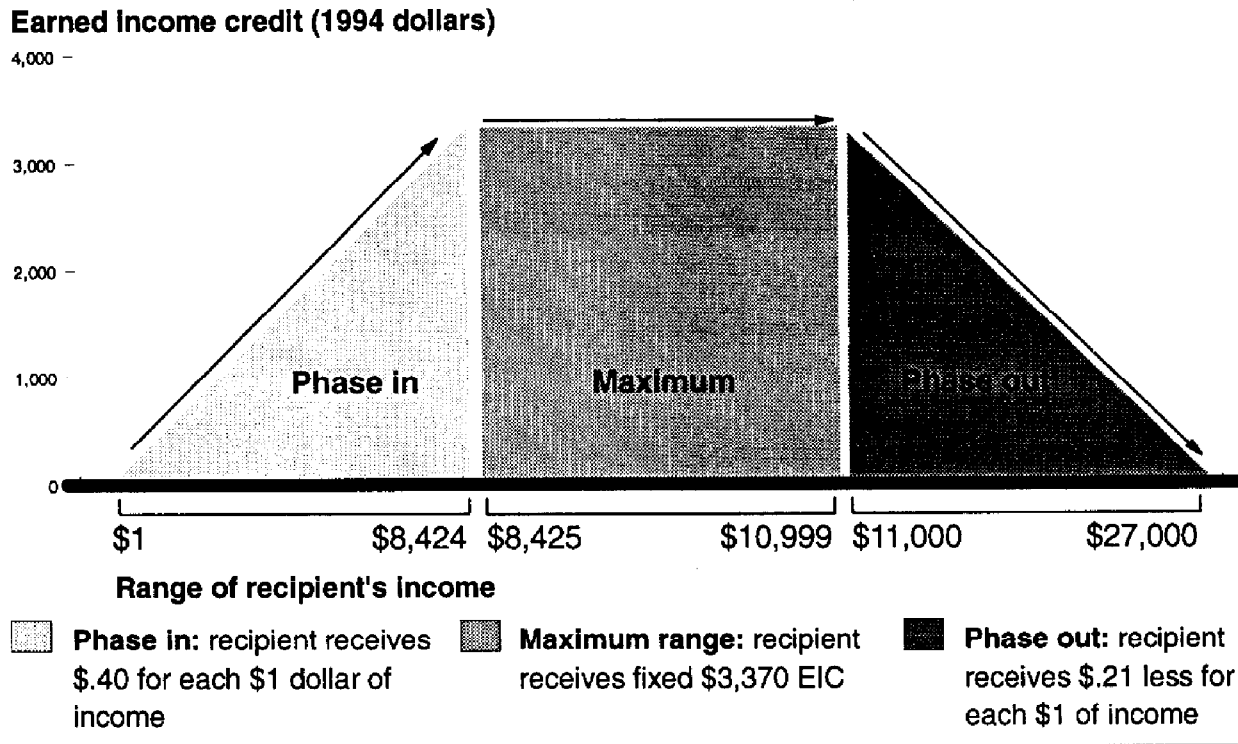
BACKGROUND

Originally authorized in 1975, EIC provides assistance to low-income working taxpayers to offset the impact of Social Security taxes and to encourage them to work. At various times, Congress has broadened EIC coverage and increased the credit amount to (1) ensure that EIC amounts would not fall in purchasing power, (2) increase or maintain the progressivity of the tax system, and (3) better ensure that working individuals would have incomes above the poverty line. As figure 1 illustrates, with these changes the overall cost¹ of EIC is expected to increase more than five-fold in real terms between 1988 and 1996, when EIC costs are estimated to total \$24.5 billion.

¹The cost figures for EIC include the portion of EIC that offsets taxes recipients may owe as well as any refunds beyond taxes due, which are considered a budget outlay. The cost figures do not include costs IRS incurs to administer EIC.

Figure 2: Range of EIC For Recipients With Two Qualifying Children (Effective in 1996)

GAO Range of EIC for Recipients With Two Qualifying Children (1996)



Source: Congressional Research Service.

The Self-Employed Health Insurance Act of 1995 further modified the EIC. Although the overall approach of phasing EIC awards in and out on the basis of taxpayers' income was not changed, the act incorporated a test which will deny the EIC to claimants who receive interest, dividends, tax-exempt interest, or positive net rental and royalty income whose sum is more than \$2,350 annually.

NONCOMPLIANCE AND IRS ENFORCEMENT EFFORTS

Noncompliance has been and continues to be a problem with regard to EIC.² IRS has expanded its effort to detect and deter EIC noncompliance.

Extent of Noncompliance

Noncompliance is not a new problem for the EIC. For instance, compliance measurements done by IRS in 1988 estimated that about 42 percent of EIC recipients received too large a credit and about 34 percent of the total EIC paid out may have been awarded erroneously.

Although a current, statistically valid measure of overall EIC compliance does not exist, the results of limited studies and of IRS efforts to enforce EIC suggest that a significant compliance problem remains. An IRS study of electronically-filed EIC returns during a 2-week period in January 1994 produced a final estimate that 39 percent of the return filers claimed EIC amounts they were not entitled to receive--the total dollars overclaimed represented 26 percent of total EIC claims during the 2-week period studied. The IRS final report does not include an estimate of intentional errors. However, IRS' preliminary results from this study had estimated that thirteen percent of the EIC returns had intentional errors--a surrogate measure of possible fraud.

Compliance problems in the opposite direction also occurred among EIC claimants. During the period studied, IRS estimates that 6 percent of EIC returns claimed less EIC than they should have--amounting to an underclaim of about 1 percent of total dollars claimed. Researchers also have estimated that between 14 and 25 percent of eligible families in 1990 did not claim the credit.³

When considering actions to address the EIC's noncompliance problem, the perspective of noncompliance problems in other programs may be useful. Whether EIC noncompliance is higher than for other programs depends in part on what the EIC is compared to and what is considered in making the comparison.

Within the tax system, the EIC noncompliance rate tends to be high, but is not the highest. For instance, IRS believes that "informal suppliers"--self-employed individuals who operate on a

²Noncompliance includes erroneous EIC claims caused by negligence, mistakes, confusion, and fraud.

³Yin et al., Improving Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, American Tax Policy Institute, Feb. 1994.

cash basis--do not report 89 percent of their income. The self-employed as a group are estimated to underreport their income by 64 percent. Of course, these examples are for compliance in reporting income to pay taxes. In contrast, the EIC is a refundable credit, with most of the funds distributed classified as federal outlays.

Among federal outlay programs that are similar in size to the EIC and serve similar populations, noncompliance rates appear to be lower than the EIC's. According to state-reported data, in 1992 the Food Stamp program over-issued food stamps to 17.6 percent of applicants. State-reported data also show that the program under-issued food stamps to 9.9 percent of applicants. Overall, Food Stamp overpayments in 1992 represented about 8.2 percent of total benefits paid under the program. We were unable to find an estimate of overpayments to applicants for the Aid to Families with Dependent Children (AFDC). The AFDC program had overpayments representing 5.3 percent of total AFDC benefits in that year.

However, the lower noncompliance rates for these programs are associated with administrative costs that likely are many times higher than those of EIC because case workers are required to verify the recipients' qualifications or need. In 1993, AFDC administrative costs represented about 11.6 percent of total AFDC expenditures and Food Stamp administrative costs represented about 12.4 percent of expenditures. EIC administrative costs are not compiled by IRS. However, based on average processing costs for tax forms and assuming that all of the cost of identifying and investigating fraudulent refund schemes is EIC-related, we believe that EIC administrative costs may not exceed 1 percent of EIC program costs.

IRS Efforts to Detect and Deter Noncompliance

This filing season, IRS expanded its efforts to ensure taxpayer compliance. In doing so, IRS used lessons learned from its 1994 study and enforcement experience to improve its systems of identifying possible noncompliant returns. Verifying Social Security Numbers (SSN) validity was key to IRS' efforts. IRS checked the validity of SSNs--expanding its efforts this year primarily to emphasize those used for dependents and EIC-qualifying children. As of May 26, 1995, IRS had identified 4.3 million instances of problems with EIC and non-EIC returns that had been filed electronically. IRS rejected the tax returns associated with these problems. However, the number of rejected returns is unknown.⁴ As of May 26, 1995, IRS had also

⁴Because a return can be rejected for more than one reason, the number of notices may exceed the number of returns. IRS does not know how many of these returns were submitted by (1) persons

identified over 3 million paper returns that lacked valid SSNs for dependents or EIC-qualifying children. IRS asked a significant portion of the taxpayers to provide additional proof of eligibility.⁵

Not surprisingly for such a new initiative, some problems occurred. The expanded SSN verification procedures for paper returns identified many problem returns, but some that should have been selected were not. IRS identified approximately the volume of paper returns with invalid SSNs that it had expected to handle during the filing season. However, the volume of these returns fluctuated widely among IRS Service Centers. For example, one Service Center received about 360 percent of its expected volume, while another received only 61 percent. For the 1995 filing season, IRS was not able to redistribute the workload among the Service Centers. As a result, Service Centers used somewhat different criteria for determining which taxpayers would be asked to provide additional evidence of their EIC eligibility. Computer problems also occurred during the filing season, which caused some returns not to be selected when they should have been.

In addition, IRS delayed refunds primarily in an attempt to identify SSNs used on more than one tax return--its duplicate SSN effort. (IRS had identified duplicate SSNs as a problem during the 1994 filing season.) By May 26, 1995, 6.4 million refunds (primarily EIC returns) had been delayed up to 8 weeks.

IRS also experienced some problems as it began checking for duplicate SSNs. These problems included difficulties in constructing the database to use in identifying duplicate SSNs, poorly organized computer listings that enforcement personnel found difficult to use, and cumbersome procedures for coordinating the work of different IRS Service Centers. IRS is analyzing the results of this year's initiative and plans to make changes for 1996. Further automation of the process is a primary goal.

The steps IRS took this year seem to have been focused appropriately on current indicators of problematic returns. However, it is still too early to assess the success of IRS' new

attempting to defraud the IRS or (2) taxpayers or tax preparers who made mistakes in recording or transcribing SSNs.

⁵The President's proposal, discussed on page 16, would require EIC claimants to have valid SSNs for themselves, their spouses, and their EIC-qualifying children. The proposal also requests authorization to use a simplified procedure to handle returns lacking such SSNs. This proposal may not assist IRS in dealing with invalid dependents' SSNs.

or expanded enforcement initiatives. IRS is conducting a study that should yield statistically-valid measures of compliance with EIC. This study includes both electronic and paper returns filed throughout the filing season. The study should shed light on whether compliance has improved subsequent to the IRS enforcement initiatives. However, results probably may not be available until fall of 1995.

Additional Efforts Needed

Although some improvement in EIC compliance levels may result from IRS' efforts to better verify EIC claimants' eligibility before processing refunds, IRS cannot currently verify all eligibility criteria before sending refunds to taxpayers. In the long run, sound enforcement of EIC may require even better verification of recipients' eligibility before refunds are made.

We have made several recommendations in the past that could help to make EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix I, those recommendations called for (1) eliminating differences between the definition of a qualifying child for EIC purposes and the definition of a dependent for purposes of claiming a dependency exemption; (2) encouraging the advance payment option, whereby persons eligible for EIC can choose to receive it in advance as part of their paychecks; and (3) moving toward more timely computer matching of employer wage information with tax return data.

BETTER MEASURING EIC FILERS' RESOURCES TO DETERMINE ELIGIBILITY

Although EIC is intended to provide assistance to the working poor, claimants' wealth is not taken directly into account in determining EIC eligibility or the amount of the credit provided--as it is for certain welfare programs,. However, the Self-Employed Health Insurance Act of 1995 created a test of EIC claimants' wealth that will be effective as of January 1, 1996. This test does not include some types of income taxpayers may receive.

At Chairman Roth's request, we assessed the changes in overall EIC costs that might result from including a wealth test and a more comprehensive adjusted gross income test in determining EIC eligibility and credit amounts. We also evaluated the administrative implications of implementing these tests.

Generally, to facilitate administration of the expanded eligibility tests, we restricted the income items used in the tests to those that are currently reported in some form on the individual's income tax return. For the wealth test, we analyzed asset-derived income such as taxable interest and dividends, tax-exempt interest, estate and trust income, rental income, and

capital gains. For the expanded adjusted gross income test, we first analyzed the impacts of including nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions in the taxpayer's EIC-adjusted gross income. At Chairman Roth's request, we subsequently added child support payments--which do not currently appear on any IRS form--to the income items.

After we discussed the results of our initial review of the asset-derived income on tax returns that could be included in a wealth test, the potential magnitude of change in EIC payments that would result, and the administrative issues associated with incorporating such a test into EIC, Senator Roth requested revenue estimates covering the next 5 years from the Joint Committee on Taxation. The Joint Committee estimates indicated that potential savings were significant, but that they varied depending on the types of income included in a wealth test and the threshold used to disqualify EIC claimants.

We similarly analyzed the effects of expanding taxpayers' adjusted gross incomes for EIC purposes to include nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions. For child support payments, we reviewed the administrative issues associated with including such income in an expanded adjusted gross income test. According to Joint Committee on Taxation estimates, expanding adjusted gross income to include nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions could yield \$1.45 billion in EIC savings in fiscal year 1997. Adding child support payments to the expanded adjusted gross income would increase those savings by another \$686 million according to Joint Committee estimates.

A disadvantage of an indirect wealth test or an expanded adjusted gross income definition is that both would add to EIC's complexity and administrative burden. Complexity, which has been a continuing EIC issue, can lead to increased errors and dissuade deserving taxpayers from claiming the credit. Of those potential changes to EIC criteria that we analyzed, adding child support to adjusted gross income likely would cause IRS the greatest administrative problems, because IRS does not have a ready way to verify such income.

There also are significant limitations in measuring potential EIC recipients' actual wealth by the income they reported on tax returns. For instance, this test would not measure the value of such taxpayer assets as capital stock funds that yield little, if any, annual income. These limitations could raise concerns that taxpayers with similar wealth could be treated differently for EIC.

The President's Budget proposals for fiscal year 1996 also included a change in EIC eligibility criteria--that EIC be denied

to anyone whose aggregate interest and dividend income exceeded \$2,500. The \$2,500 threshold was to be indexed for inflation. The President's proposal was incorporated into H.R. 831. During congressional consideration of the bill, the test was modified. As ultimately passed, the test will deny EIC to claimants who receive more than \$2,350 annually in interest, dividends, tax-exempt interest, or positive net rental and royalty income. The \$2,350 threshold will not be indexed for inflation. Options for widening asset-derived income included in the test include using net estate and trust income, net capital gains, and lower threshold levels. Adopting an expanded definition of taxpayers' adjusted gross incomes also remains as an option for taking taxpayers' resources more fully into account when determining EIC eligibility and credit amounts.⁶

ILLEGAL ALIEN RECIPIENTS

The Internal Revenue Code does not prohibit illegal aliens from receiving EIC, if they meet the prescribed eligibility requirements. However, illegal aliens cannot be employed lawfully in the United States. Because EIC is intended in part to encourage employment, it works at cross purposes to the prohibition on employment of illegal aliens.

Although no one knows how many illegal aliens may be claiming and receiving EIC, IRS officials estimated that a minimum of 160,000 taxpayers, out of about 8.7 million who filed paper returns claiming EIC in 1994, were likely to be illegal aliens.⁷ IRS expected most of these refunds to be denied because taxpayers likely would not support their claims by verifying that the qualifying child met the age, relationship, and residency requirements.

Some unknown portion of returns may also be filed by illegal aliens who use SSNs belonging to other individuals. If successfully implemented, IRS' new efforts to detect SSNs that

⁶These options are discussed in our report, Earned Income Credit: Targeting to the Working Poor (GAO/GGD-95-122BR, March 31, 1995).

⁷IRS officials made this estimate based on their enforcement experience and the number of taxpayers entering a code "205(c)" instead of an SSN for their qualifying child. EIC claimants are required to provide an SSN or taxpayer identification number for themselves and their qualifying children. The designation 205(c) is often used by taxpayers to indicate they are not eligible to receive an SSN. Due to a change in how data are compiled, IRS no longer separately identifies the number of 205(c) codes entered by taxpayers in place of SSNs.

are invalid or have been used on more than one tax return should reduce the number of illegal aliens as well as U.S. citizens incorrectly receiving EIC.

A Senate bill introduced by Senator Roth in 1994 and the administration's proposed Tax Compliance Act of 1995 (H.R. 981 and S. 453) would deny EIC to illegal aliens. The administration's proposal would require that all EIC claimants provide SSNs that are valid for employment in the United States for themselves, their spouses, and their EIC-qualifying children. Because illegal aliens do not qualify for SSNs that are valid for employment in the United States, they would not be able to receive EIC. The administration's proposal would permit IRS to use streamlined procedures to enforce the requirement that EIC claimants have valid work-related SSNs.

The administration estimates that requiring all EIC recipients to provide valid work-related SSNs, and using streamlined procedures to enforce this requirement, would yield about \$400 million in savings in fiscal year 1997.

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Mr. Chairman, this concludes my prepared statement. My colleagues and I would welcome any questions that you or Members of the Committee may have.

WHAT COULD BE DONE TO MAKE EIC LESS OF A PROBLEM?

Refundable credits, like EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there also is concern that not all those eligible for EIC are receiving it. We have made several recommendations in the past that could help to make EIC less of a problem for IRS and taxpayers.

The definitions of a qualifying child for purposes of claiming EIC and of a dependent for purposes of claiming a dependency exemption are not the same. A key difference in the two definitions is the requirement, for purposes of claiming a dependency exemption, that the taxpayer provide over 50 percent of a dependent's support (usually referred to as the "support test"). There is no support test in the definition of a qualifying child for EIC purposes. We addressed this problem in a March 1993 report in which we analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.⁸ On the basis of our analysis, we recommended that Congress 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.

A second issue is the timing of payment. Persons eligible to receive EIC can choose to receive it in a lump sum payment after filing a tax return or in advance as part of their paycheck. In February 1992, we reported that fewer than 1 percent of EIC recipients in 1989 took advantage of that second option.⁹ Although use of the advance payment option would help taxpayers benefit from the credit sooner, it could also create problems for IRS if persons receiving the advance payment filed a tax return later but did not report that they had received the credit in advance. Under IRS' returns processing procedures in place at the time we did our review, those persons could receive the credit again as a lump sum payment. We recommended that IRS take various steps to (1) better ensure that eligible taxpayers are aware of the advance payment option and (2) prevent those who take advantage of that option from receiving the credit a second time. IRS has taken steps to better publicize the availability of the advance payment option and is manually checking for duplicate payments of EIC. Advance EIC remains, however, a

⁸Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, March 19, 1993).

⁹Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

rarely used option--as of May 26, 1995, about 1 percent of EIC recipients had reported using the advanced EIC for tax year 1994.

With respect to fraud on electronically filed returns, we recommended in December 1992 that IRS work toward electronically matching employer wage information with electronic return data.¹⁰ As of June 1995, IRS had not implemented our recommendation, largely because that kind of match is currently beyond IRS' computer capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is because of the time it takes to verify the information and correct any errors.¹¹ IRS has begun to test the possibility of getting partial year's wage information from the states and using it as a means of verifying that the taxpayer is employed and as a source of information on the taxpayer's amount of earned income.

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¹⁰Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

¹¹Under the Electronic Management System--one of many planned components of Tax Systems Modernization--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

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