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**EARNED INCOME CREDIT**

**Targeting to the Working Poor**

Statement of  
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EARNED INCOME CREDIT: TARGETING TO THE WORKING POOR

SUMMARY OF STATEMENT BY  
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The Earned Income Credit (EIC), which is expected to provide about \$22 billion in tax credits in 1995, is a major federal effort to assist the working poor. The EIC is 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. 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 estimated that 29 percent of the returns claimed too much EIC, and that about 13 percent of them may have done so intentionally. Judging by problems spotted by IRS personnel, noncompliance on EIC paper returns is also a concern. In 1994, IRS withheld refunds totaling about \$500 million from about 400,000 paper return filers due to insufficient proof that they qualified.

This year IRS has taken several steps to detect and prevent erroneous payments to EIC claimants. If implemented effectively, these steps could help improve the overall level of EIC compliance.

- Although the EIC is intended to assist the working poor, EIC eligibility criteria do not consider all of the resources recipients may have to support themselves and their families. At your request, the Joint Committee on Taxation (JCT) has estimated that changing eligibility criteria to test for taxpayers' wealth could yield between \$318 million and \$971 million in revenue savings in fiscal year 1997, depending on the design of the test. Another approach taking into account taxpayers' resources would add certain income to taxpayers' adjusted gross income when determining EIC awards. According to JCT estimates, up to \$2.1 billion could be saved in fiscal year 1997 by recognizing this income. Either attempt to better measure resources available to taxpayers would make the EIC more complex and add to the burden on taxpayers and IRS. Also, income information reported on tax returns can only roughly reflect taxpayers' actual wealth, and using such data to determine EIC eligibility could raise fairness concerns.

-- No one knows how many illegal aliens receive the EIC. Illegal aliens may receive the EIC if they meet the credit's eligibility rules. Awarding the 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 so that all EIC recipients needed valid Social Security numbers for work purposes, illegal aliens would no longer qualify.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to assist in your effort to better ensure that only the working poor receive the Earned Income Credit (EIC). As you requested, we are providing a report on the EIC along with our testimony today. I ask your permission to have the report inserted in the hearing record. Our testimony and the accompanying report are part of our ongoing work for you.<sup>1</sup>

#### BACKGROUND

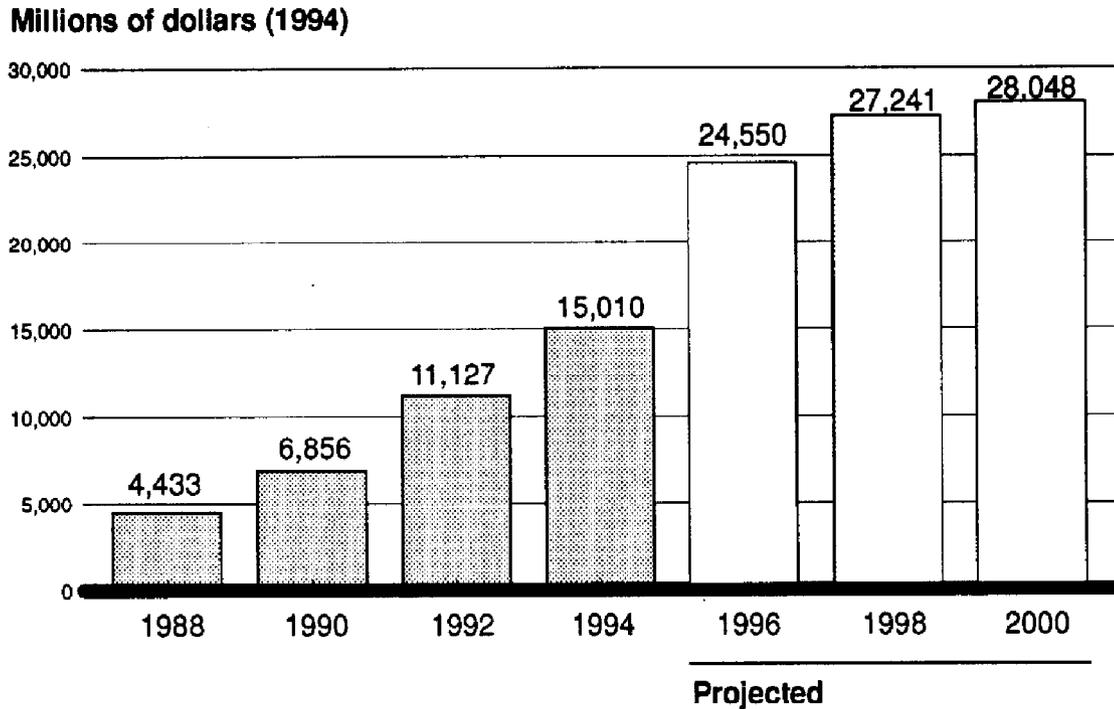
Originally authorized in 1975, the EIC provides assistance to low-income working taxpayers to offset the impact of Social Security taxes and to encourage them to work. At various times Congress has broadened EIC coverage and increased the credit amount to ensure that the EIC amounts would not fall in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

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<sup>1</sup>Tax Administration: Earned Income Credit--Data on Noncompliance and Illegal Alien Recipients (GAO/GGD-95-27, Oct. 25, 1994) focused on EIC noncompliance.

FIGURE 1: GROWTH IN EIC PROGRAM COSTS (1988 - 2000)

GAO Growth in EIC Program Costs  
(1988 - 2000)



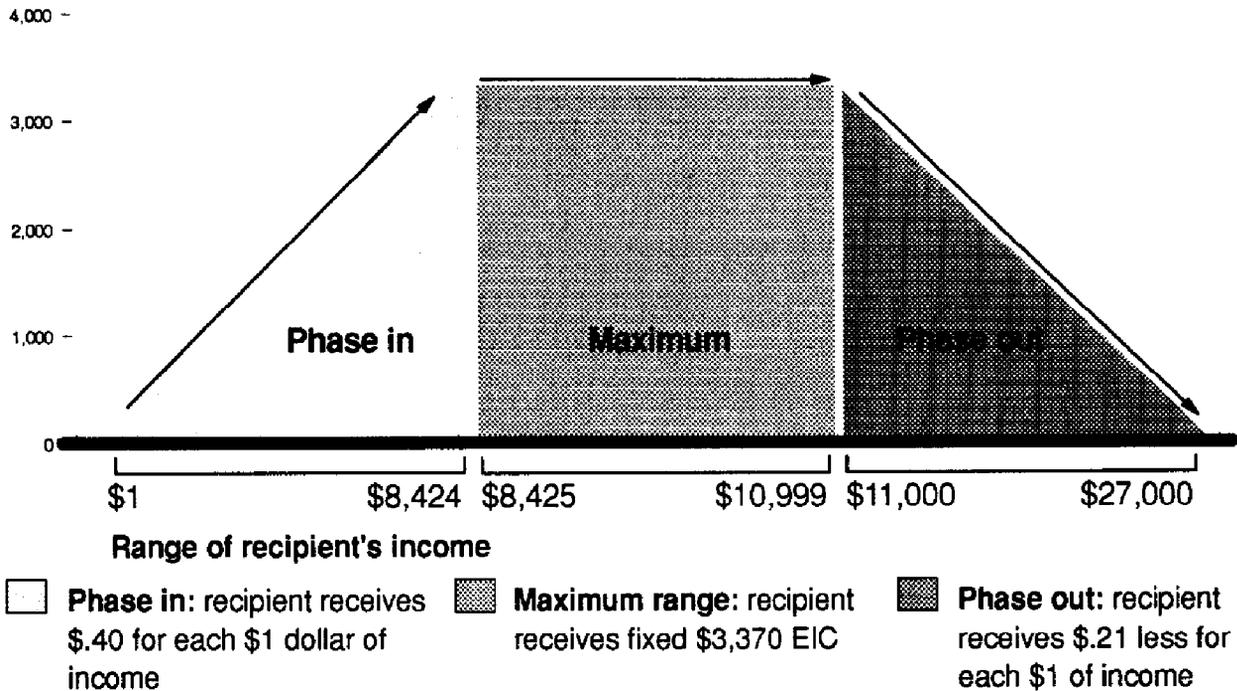
Source: Fiscal year estimates from the Presidents' 1990, 1992, 1994, 1996 budgets.

The most recent changes to the EIC, in the Omnibus Budget Reconciliation Act (OBRA) of 1993, increased the maximum credit available and the income level at which individuals can qualify for the credit. For the first time, it granted eligibility to certain low-income taxpayers without children. As figure 2 illustrates, the credit gradually phases in, plateaus at a maximum amount of \$3,370 for a taxpayer with two qualifying children in 1996, and then phases out until it reaches zero.

FIGURE 2: RANGE OF EIC FOR RECIPIENTS WITH TWO QUALIFYING CHILDREN (1996)

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

**Earned Income credit (1994 dollars)**



Source: Congressional Research Service.

NONCOMPLIANCE

Noncompliance has been and continues to be a problem for the EIC.<sup>2</sup> For instance, compliance measurements done by the Internal Revenue Service (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.

<sup>2</sup>Noncompliance includes erroneous EIC claims caused by negligence, mistakes, confusion, and fraud.

Although a current, statistically-valid measure of overall EIC compliance does not exist, the results of limited studies and of IRS efforts to enforce the EIC suggest that a significant compliance problem remains. An IRS study of electronically-filed EIC returns during a 2-week period in January 1994 found an estimated 29 percent of returns claimed too much EIC; 13 percent of the returns were judged to have intentional errors--a surrogate measure of possible fraud.

This filing season, IRS has expanded its efforts to ensure EIC compliance. In doing so, IRS is using lessons learned from its 1994 study and enforcement experience to improve its systems to identify possible noncompliant returns. Verifying Social Security number accuracy is key to IRS' efforts. IRS checks the accuracy of Social Security numbers--expanding their efforts this year to emphasize those used for dependents and EIC qualifying children. As of March 17, 1995, IRS' verification procedures had identified nearly 4.1 million instances of problems with returns. These primarily involved returns that did not appear to contain valid SSNs for dependents or qualifying children.

In addition, as of March 17, 1995, IRS had delayed refunds to at least 2.9 million EIC claimants for up to 8 weeks. This delay is intended to allow IRS staff time to identify any SSNs that have been used on more than one tax return. IRS identified duplicate SSNs as a problem during the 1994 filing season. For the delayed returns, IRS generally sends out the portion of any refund that was due to overpayment of taxes but withholds the EIC portion of the refund claimed.

Not surprisingly with a large new initiative, IRS experienced some problems as it began checking for duplicate SSNs. These problems included difficulties in constructing the data base to use in identifying the duplicate SSNs, poorly-organized computer listings that enforcement personnel found difficult to use, and cumbersome procedures for coordinating among IRS service centers. IRS national office officials told us that initial problems with the duplicate SSN system had been overcome early in the filing season. But compliance personnel continue to report problems using duplicate SSN data. We intend to continue monitoring this effort.

Although it is too early to assess the success of IRS' new or expanded enforcement initiatives, the steps taken seem to be focusing appropriately on current indicators of problematic returns. Despite 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 the 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 the EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix I, those recommendations called for 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; encouraging the advance payment option, whereby persons eligible for the EIC can choose to receive it in advance as part of their paychecks; and moving toward timely computer matching of employer wage information with tax return data.

BETTER MEASURING EIC FILERS' RESOURCES  
TO DETERMINE ELIGIBILITY

Although the EIC is intended to provide assistance to the working poor, unlike certain welfare programs, taxpayer wealth is not taken directly into account in determining EIC eligibility or the amount of the credit received. EIC criteria also do not consider all types of income taxpayers may receive.

At your request, we assessed the potential changes in overall EIC costs that might result from including a wealth test and a more comprehensive adjusted gross income test in determining eligibility. We also evaluated the administrative implications of expanding the eligibility criteria. Generally, to facilitate administration of the expanded eligibility criteria, we initially looked at items 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 adjusted gross income. At your request, we subsequently added child support payments--which do not currently appear on any IRS form--to the income items.

Based on our work, you requested that JCT provide revenue estimates for various eligibility options we had reviewed. According to JCT estimates, denying the EIC to taxpayers whose income from wealth exceeds a certain threshold could reduce program costs \$318 to \$971 million in fiscal year 1997, depending on the design of the test.

Expanding taxpayers' adjusted gross income to include nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions could yield \$1.45 billion in the same period, according to JCT estimates. Also adding child support payments to the expanded adjusted gross income would increase 1997 revenue savings by another \$686 million.

However, adding an indirect wealth test or an expanded adjusted gross income definition to the EIC eligibility criteria would add to the EIC's complexity and administrative burden. Complexity has been a continuing EIC issue because it can lead to increased errors and dissuade deserving taxpayers from claiming the credit. Of the potential changes to EIC criteria, adding child support to taxpayers' adjusted gross income likely would cause the greatest complexity, because information on such income is not collected by IRS, and systems may not exist to generate the information.

There are significant limitations in measuring potential EIC recipients' actual wealth through income reported on tax returns. For instance, such a test would not measure the value of taxpayer assets such 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 the EIC.

#### ILLEGAL ALIEN RECIPIENTS

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

Although no one knows how many illegal aliens may be claiming and receiving the EIC, IRS estimated that a minimum of 160,000 taxpayers, out of about 8.7 million who filed paper returns claiming the EIC in 1994, were likely to be illegal aliens.<sup>3</sup> IRS expected most of these refunds to be denied, because taxpayers would not support their claims by verifying that the dependent met the age, relationship, and residency requirement.

Some unknown portion of returns may also be filed by illegal aliens who use SSNs belonging to other individuals. IRS' new efforts to detect duplicate uses of SSNs, if successfully implemented, should reduce the number of illegal aliens as well as U.S. citizens incorrectly receiving the EIC.

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<sup>3</sup>IRS 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.

A Senate bill you introduced in 1994 and the administration's Tax Compliance Act of 1995 (H.R. 981 and S. 453) would deny the EIC to illegal aliens. The administration's proposal would require that all EIC recipients provide SSNs that are valid for employment in the United States for themselves, for their spouses, if applicable, and for qualifying children. Because illegal aliens cannot qualify for SSNs that are valid for employment in the United States, they would not be able to receive the 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 revenue 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 may have.

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

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

The definitions of a qualifying child for purposes of claiming the 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 (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.<sup>4</sup> 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.

Persons eligible to receive the 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 less than 1 percent of EIC recipients in 1989 took advantage of that second option.<sup>5</sup> 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 later filed a tax return 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. When last we checked, IRS had taken steps to better publicize the availability of the advance payment option but had not revised its procedures to protect against duplicate payment of the EIC.

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<sup>4</sup>Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993).

<sup>5</sup>Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

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<sup>6</sup>. 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.<sup>7</sup> IRS has begun to test the possibility of getting partial year's wage information from the states and using that to verify that the taxpayer is employed and to have some information on the taxpayer's amount of earned income.

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<sup>6</sup>Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

<sup>7</sup>Under 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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