United States General Accounting Office

GAO

Report to Congressional Requesters

September 2003

EARNED INCOME CREDIT

Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete

GAO-03-794

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Highlights

Highlights of GAO-03-794, a report to congressional requesters

Why GAO Did This Study

The Earned Income Credit (EIC), a tax credit available to the working poor, has experienced high rates of noncompliance. Unlike many benefit programs, EIC recipients generally receive payments without advance, formal determinations of eligibility; the Internal Revenue Service (IRS) checks some taxpayers' eligibility later. IRS estimated that tax year 1999 EIC overclaim rates, the most recent data available, to be between 27 and 32 percent of dollars claimed or between $8.5 billion and $9.9 billion. To address overclaims, IRS plans to test a new certification program.

Because IRS's plans have garnered much attention, you asked us to (1) describe the design and basis for the EIC qualifying child certification program, (2) describe the current status of the program, including significant changes, and (3) assess whether the program is adequately developed to prevent unreasonable burden on EIC taxpayers and improve compliance so that the test should proceed.

What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue accelerate the development of IRS's plan to evaluate the certification test. The plan should demonstrate how the program's objectives would be evaluated, including milestones for conducting the evaluation. The Commissioner said that IRS would further develop its evaluation plan as we recommended.

www.gao.gov/cgi-bin/getrpt?GAO-03-794.

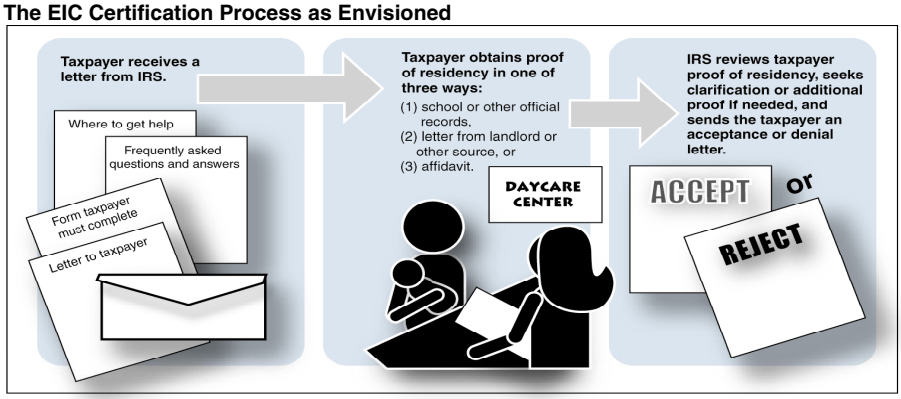
To view the full report, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

The Assistant Treasury Secretary and IRS Commissioner convened a task force to identify ways of reducing EIC overclaims while minimizing taxpayer burden and maintaining the EIC's relatively high participation rate. In August 2002, the Secretary approved a recommendation to certify taxpayers' eligibility to claim EIC qualifying children. The proposal is based on analyses of the leading sources of EIC errors, thus focusing attention and burden on the subset of taxpayers most likely to make those errors.

Since August 2002, IRS has made key changes to the certification program, including concentrating on residency certification and postponing relationship certification, delaying program implementation until later this year, and reducing the test sample from 45,000 to 25,000. Despite the changes, the process for selecting taxpayers, what taxpayers will receive from IRS, what taxpayers are required to provide, and the program's goals remain fundamentally the same as originally planned. In addition, IRS has emphasized that program expansions, if any, will depend on the results of this year's test. The process would involve three key stages as shown below.

The EIC Certification Process as Envisioned



Source: GAO analysis of IRS data.

These changes, including the most recent, help achieve a better balance between preventing unreasonable taxpayer burden and addressing the EIC's high overclaim rate and support IRS's plans to test the certification program. However, IRS's plan for evaluating the test is incomplete, presenting only some information on how IRS would evaluate whether certification would reduce the EIC overclaim rate, minimize burden, and maintain a relatively high participation rate. The plan proposes potential options for identifying how and when certain critical data will be obtained, but does not provide further details on when decisions will be made or on the specific data that will be collected. Officials have developed preliminary drafts identifying data to be obtained and have begun considering how to use contractors to gather the data. Because the data relate to taxpayers' actions that will occur next spring, IRS appears to have some time to finalize its evaluation plan.

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Abbreviations

EIC	Earned Income Credit
IRS	Internal Revenue Service
AGI	Adjusted Gross Income
FCR	Federal Case Registry
SB/SE	Small Business/Self Employed
NRP	National Research Program
TCMP	Taxpayer Compliance Measurement Program

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

September 30, 2003

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Earl Pomeroy
Ranking Minority Member, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Earned Income Credit (EIC), a tax credit available to the working poor, has generally been considered a successful antipoverty program by researchers. In recent years, the Internal Revenue Service (IRS) has paid about $30 billion annually to about 20 million EIC recipients. However, the EIC program has long experienced high rates of noncompliance. For tax year 1999, IRS estimated the EIC overclaim rates[1] ranged between 27 and 32 percent of dollars claimed or between $8.5 billion and $9.9 billion. Unlike many benefit programs, EIC recipients generally receive payments without a prior, complete review of their eligibility; IRS checks some aspects of taxpayers' eligibility before and after the credit is granted.

To help combat the high rates of noncompliance, IRS plans to test a new program, beginning in December 2003.[2] Referred to as the qualifying child certification program, some taxpayers will be asked to verify EIC "residency" requirements[3] for their qualifying children before getting that portion of their refund or reduction in tax liability. IRS plans to test the EIC program with 25,000 taxpayers whose residency cannot be confirmed

[1]Overclaim rates are calculated based on erroneous claim amounts less any amounts IRS recovered or expects to recover, such as through examinations. IRS also has limited information on underclaim rates, or instances in which taxpayers claimed less than they were entitled to receive. This report primarily focuses on IRS's efforts to address noncompliance related to overclaims using the qualifying child certification program.

[2]The program discussed in this report is one part of a strategy to target three major known sources of EIC noncompliance. The other two parts involve the improper reporting of filing status, such as among married taxpayers who report as single or head of household to avoid reporting their spouse's income, and income misreporting, such as underreporting earned income.

[3]Taxpayers must meet multiple criteria in order to claim the EIC, as shown in table 1. Residence is one criterion for a taxpayer with a qualifying child.

through other means. Future plans for the program largely depend upon the results of this test.

Because IRS's plans surrounding the program have garnered much attention, you asked us to respond to questions about the qualifying child certification program. These questions cover various topics, such as the status of the program, understandability of letters and forms going to taxpayers, certification requirements and taxpayers' ability to comply, taxpayer burden, impact on compliance rates, impact of recent legislative changes, and data from other federal or state benefit programs. We grouped these questions into three objectives: (1) describe the design and basis for the EIC qualifying child certification program as proposed by the EIC task force, (2) describe the current status of the program, including significant changes since program approval, and (3) assess whether the program is adequately developed to (a) prevent unreasonable burdens on EIC taxpayers and (b) improve compliance so that the test should proceed. In addition, you asked us to provide readily available information on the (1) significant noncompliance rates other than for the EIC and (2) overclaim rates and administrative costs of comparable benefit programs administered by states or the federal government and any verification process used by these programs. This information is presented in appendixes I and II, respectively.

This report is based primarily on our previous work and analysis of IRS and Department of the Treasury documents and reports, new letters and forms that will be sent to taxpayers, and interviews with senior officials at IRS and Treasury. We did not verify the accuracy of reports or data obtained. Rather, we reviewed the steps IRS officials had taken to implement the program and determined, to the extent possible, how they assured themselves that the program had been adequately developed to prevent unreasonable burden and improve compliance. We did not determine the adequacy of various other preparations for the qualifying child test, such as staffing and training of staff. Appendix III provides more detail on the scope and methodology used in conducting our work.

Results in Brief

Due to persistently high EIC noncompliance, among other factors, the Assistant Secretary of the Treasury and IRS Commissioner convened a task force in February 2002 to find ways of reducing EIC overclaim rates while minimizing the burden to taxpayers and maintaining the EIC's relatively high participation rate. The task force considered the likely effect of recent legislative changes on EIC compliance in formulating its proposal to

combat noncompliance. It also considered various options, such as partnering with other federal or state agencies to verify EIC taxpayers' eligibility. The task force analyzed data and reviewed studies to design the program to focus on known sources of noncompliance. In August 2002, the Treasury Secretary approved the task force recommendation that IRS certify the eligibility of taxpayers' qualifying children. Only taxpayers most likely to make errors and whose qualifying child eligibility cannot be verified from available information would be asked to certify.

Since taking its broad charge from the task force, IRS obtained input from external and internal stakeholders, and made key changes to the certification program, including (1) concentrating on residency certification and postponing the relationship certification for an undetermined period of time, (2) delaying program implementation until later this year, and (3) reducing the test sample from 45,000 to 25,000. According to IRS officials, the relationship portion of the program was postponed indefinitely for several reasons, including concerns raised about the proposed relationship certification form and studies that have shown meeting requirements for relationship is less of a compliance issue than meeting residency requirements. IRS had previously changed the start date of the test, and, as we were finalizing this report, announced in August 2003, that it was again delaying the program and now plans to send letters about the qualifying child certification program to taxpayers in December 2003. With this change, taxpayers will now have to provide proof that qualifying children meet the residency test when they file their 2003 individual income tax returns; thus, any unresolved issues could result in frozen refunds. As part of the August announcement, IRS also reduced the number of taxpayers that will be included in the test from 45,000 to 25,000, in part, in response to comments received during a 30-day public period. However, these changes create additional challenges for IRS and taxpayers. For example, the test will no longer be a direct test of the original concept of certifying taxpayer eligibility in advance of the filing season. At the same time, the process for selecting taxpayers, what taxpayers will receive from IRS, and what taxpayers will be asked to provide to prove the residency of a qualifying child remains basically the same as originally planned. Further, IRS officials have emphasized that program expansions, if any, will depend on the results of the test.

The changes made in the proposed certification program—including the ones announced in August—help achieve a better balance between preventing unreasonable taxpayer burden and addressing the EIC's high overclaim rate, and support IRS's plans to move forward with the residency

test. The qualifying child program is based on analyses of the leading sources of EIC errors, thus focusing attention and burden on the subset of taxpayers making those errors as opposed to all EIC recipients. In addition, IRS has taken steps to address the burden taxpayers will experience as participants in the test this year. However, IRS's plan for evaluating the results of the test is not yet complete. Although an evaluation plan does not have to completely identify all issues or how they will be evaluated prior to a program's start, the more completely a plan is developed, the more likely that the evaluation will be sufficient to support future decisions. The draft evaluation plan presents only some information on how IRS will show whether certification's objectives—reduce the overclaim rate, minimize burden, and maintain the EIC's relatively high participation rate—will be achieved. However, the plan proposes potential options for identifying how and when some critical data will be obtained and analyzed, but does not provide further details on when, how, and by whom decisions will be made on the specific data that will be collected. Officials have developed preliminary drafts identifying data to be obtained and have begun considering how to use contractors to gather the data. Since the data relates to taxpayers' actions that will occur next spring, IRS has some time to finalize the evaluation plan.

We are recommending that the Commissioner of Internal Revenue, to the extent possible, accelerate the development of the evaluation plan, and have the plan demonstrate how each program objective will be evaluated, including milestones for critical steps such as how data will be obtained and analyzed in time to support decisions about the future of IRS's certification program.

We requested comments on a draft of this report from the Commissioner of Internal Revenue. We received written comments, which are reprinted in appendix VI. In his comments, the Commissioner said that IRS would be including the components we suggested in their evaluation plan and said that IRS is working to incorporate these components well before the certification test begins. We further discuss the Commissioner's comments in the "Agency Comments and Our Evaluation" section of the report.

Background

Congress enacted the EIC in 1975[4] with the goal of offsetting the Social Security taxes paid by the working poor and creating a greater work incentive for low-income taxpayers. According to data cited in the task force report, an estimated 4.3 million individuals were lifted out of poverty in 1998 by the EIC, including 2.3 million children.

The EIC is a refundable tax credit, meaning that qualifying working taxpayers may receive a refund greater than the amount of income tax paid during the year. Taxpayers can qualify for the credit in one of two ways: with a "qualifying child" or by "income only," if they do not have a qualifying child. For example, for tax year 2002, the amount of EIC that could be claimed with a qualifying child or children ranged from $0 to $4,140. EIC payments have a phase-in range in which higher incomes yield higher EIC amounts, a plateau phase in which EIC amounts remain the same even as income rises, and a phase-out range in which higher incomes yield lower EIC payments or tax liability.

EIC requirements for tax year 2002 include rules for everyone, additional rules for taxpayers with qualifying children, and additional rules for taxpayers without qualifying children, as shown in table 1.

[4]26 U.S.C. Sec. 32.

Table 1: EIC Requirements for Tax Year 2002

Rules for all taxpayers claiming the EIC	Additional rules for taxpayers with a qualifying child	Additional rules for taxpayers without a qualifying child
Must have a valid Social Security number	Income limitations: If one child: $29,201 (or $30,201 if married filing jointly). If more than one child: $33,178 (or $34,178 if married filing jointly).	Income limitations: $11,060 (or $12,060 if married filing jointly).
Cannot use married filing separately status	Child must meet age, relationship, and residency tests	Must be at least 25 years old, but under 65
Must be a U.S. citizen or resident alien all year	Child can be claimed by one taxpayer only	Taxpayer cannot be the dependent of another person
Cannot file form 2555 or 2555-EZ	Taxpayer cannot be a qualifying child of another taxpayer	Taxpayer cannot be a qualifying child of another taxpayer
Investment income must be $2,550 or less		Must have lived in U.S. more than half of a year
Must have earned income		

Source: IRS.

IRS has periodically measured EIC compliance for overclaims and underclaims. The most current data available, for tax year 1999, show EIC overclaim rates estimated to be between 27 and 32 percent of dollars claimed or between $8.5 billion and $9.9 billion. IRS has limited data on underclaims, which for tax year 1999 were estimated to be between $710 million and $765 million.[5] IRS has tried to reduce noncompliance through various means, including education and outreach to taxpayers and tax return preparers. In addition, Congress has enacted legislation aimed at resolving some concerns with EIC rules. Because a new analysis of EIC compliance using 2001 tax return information is not expected to be complete until late in 2004, IRS does not know whether compliance has significantly changed since 1999, but officials do not think it has improved

[5]Underclaims refers to the amount in which taxpayers claimed less than what they were entitled to receive.

substantially. Because of the persistently high rates of noncompliance, we have identified the EIC program as a high-risk area for IRS since 1995.[6]

Currently, taxpayers claim the EIC by filing an individual income tax return (e.g., a Form 1040 or 1040A) and including a Schedule EIC—a procedure similar for claiming other tax credits. Unlike with other benefit programs such as Supplemental Security Income, however, EIC taxpayers are not required to be found qualified before claiming the credit or file any other documents with their return to establish eligibility. Instead, IRS uses four primary means to evaluate EIC eligibility and check for noncompliance after the return is filed and checks some aspects of taxpayers' eligibility before and after the credit is granted: (1) the math error program, (2) correspondence and face-to-face examinations (also called audits), (3) the document matching program, and (4) criminal investigations. Some of these means, such as the math error program, check all EIC returns, but only for limited aspects of eligibility. Other means, such as examinations, only check a small subset of EIC returns, but the review is more expansive. In general, IRS subjects all returns to its math error program and takes corrective action on errors found. Depending on the resources IRS has available, IRS works only a small portion of cases identified as potentially meriting follow-up under its examination, document matching, and criminal investigations efforts.

While processing all tax returns, IRS uses its automated math error program to identify and correct the simpler errors found in claiming the EIC. For example, the math error program can identify invalid Social Security numbers and taxpayers who fail to follow recertification requirements.[7] As a result, some inappropriate EIC claims are stopped before refunds are issued. During fiscal year 2001, IRS stopped more than 371,000 incorrect EIC claims using its math error authority. After identifying errors, IRS corrects them so the tax return can be processed and sends a computerized notice to the taxpayer identifying the error and stating that IRS disallowed or reduced the EIC claim. The notice tells

[6]Prior to 2001, EIC was part of a broader IRS tax filing fraud high-risk area. Beginning in 2001, the focus of that designation was narrowed to EIC specifically. U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: January 2001).

[7]Taxpayers are required to meet recertification requirements when they have been denied the EIC in a previous year. Recertification involves taxpayers providing documentation, such as a birth certificate, to support their claim of a relationship to a qualifying child.

taxpayers that if they can correct the error, the EIC claim will be allowed and any refund related to the EIC claim will be issued.

Two types of examinations—-correspondence and face-to-face—are used when EIC noncompliance is suspected, in most cases before refunds are issued. IRS uses various systematic means to "score" the likelihood of noncompliance on any return and uses experienced staff to manually identify the specific items on returns for examination. Most EIC examinations occur shortly after a return is filed, largely because of the difficulty in recovering refunds. IRS stops refunds on these returns until examinations are completed. This contrasts with IRS's normal examination practice of performing examinations many months after tax returns have been processed and any refunds paid. The EIC examinations usually rely on correspondence with taxpayers rather than face-to-face contacts. IRS completed about 368,000 EIC related correspondence exams during fiscal year 2002. IRS tends to use face-to-face meetings with taxpayers to examine tax returns with EIC claims on a very limited basis and primarily when examinations are initiated for other reasons. As part of either type of examination, however, IRS would describe the potential noncompliance in a computerized notice to taxpayers claiming the EIC. IRS requests documentation, such as a school record or birth certificate, to establish EIC requirements. Depending on whether IRS officials accept or reject the support, they may make changes to the return and refund related to the EIC claim. If taxpayers disagree with IRS's decisions, they have the right to appeal administratively and/or through the courts.

IRS also uses its document matching programs to identify potentially misreported income on tax returns claiming the EIC. By comparing the tax return to wage and income statements provided by third parties such as employers and financial institutions, the document-matching program identifies whether a taxpayer appears to have misreported income. Given the phase-in and phase-out ranges of the EIC, some taxpayers may claim too much EIC by overreporting or underreporting their income. This program notifies such taxpayers months after returns are filed and refunds are issued. Similar to audits, a notice is issued telling a taxpayer that an error appears to have been made, that he or she may disagree and provide any support for income reported, and that he or she may appeal IRS's decision about additional taxes owed. Unlike audits, the program is highly automated and is designed to require less contact with taxpayers by IRS staff.

IRS also uses criminal investigations to stop the payment of false refunds, identify refund scams/schemes, and prosecute perpetrators, including those with fraudulent EIC claims. For EIC, IRS uses a specific computer program that looks for questionable refund claims and for return preparers known to have prepared questionable returns. IRS also has teams that scan returns and receive referrals from other parts of IRS and informants. IRS stops many returns as they are being processed so that criminal investigators can review the claims before the refund is paid or after the return has been processed.

Task Force Considered Much Information Related to EIC Compliance before Recommending Qualifying Child Certification Program

When IRS's study of EIC compliance rates for 1999 was released, the Assistant Secretary of the Treasury and IRS Commissioner convened a task force in February 2002 to find ways of reducing EIC overclaims while minimizing the burden to taxpayers and maintaining the EIC's relatively high participation rate. The task force considered whether changes in statutes recently enacted by Congress or proposed by Treasury may have lessened the need for new EIC compliance initiatives and concluded that, while statutory changes addressed some sources of noncompliance, they likely would not reduce other leading sources of noncompliance. The task force also considered a range of new methods, including partnering with other federal or state agencies or programs and developing a new database to verify EIC eligibility before issuing tax refunds, but decided that these options were not viable. Ultimately, the task force recommended the qualifying child certification program. The task force reviewed IRS's EIC compliance study results and other data, as well as other studies, to identify the sources and develop new methods of addressing noncompliance.

Task Force Convened to Address Long-Standing Compliance Problem

The joint Treasury and IRS task force addressed a long-standing problem of high EIC overclaim rates. Although the release of IRS's 1999 compliance study precipitated the formation of the EIC task force in February 2002, the study results were generally consistent with high overclaim rates reported in prior IRS studies. While some stakeholders view the 1999 study as having some methodological weaknesses, it showed that of the approximately 20 million taxpayers that claimed the EIC in 1999, 46 to 50 percent of their tax returns had errors that led to claiming too much of the credit (IRS often refers to this as the error rate). IRS also estimated that the total dollars overclaimed on those returns represented between 27 and 32 percent of total EIC dollars claimed in 1999, or between $8.5 billion and $9.9 billion.

IRS also has some data on underclaims—instances where taxpayers claimed less than they were entitled to receive. For tax year 1999, underclaims were estimated to be between $710 million and $765 million.

IRS has conducted EIC compliance studies for several years and the overclaim rate, which is the percentage of total dollars paid out in error, was estimated to be about 24 percent in tax year 1994. According to IRS officials, because different methodologies were used in the subsequent studies, changes in estimated overclaims found in other studies do not support conclusions about trends in the overclaim rate over time. However, IRS officials also acknowledged the overclaim rate has not improved significantly. Overclaim rates for tax years 1997 and 1999 are shown in table 2. The information in table 2 does not reflect the current compliance situation; for example, it does not reflect the presumably positive impact of new legislation that has taken effect since 1999 aimed at improving compliance.

Table 2: EIC Overclaim Rates for 1997 and 1999

Tax year	Lower-bound rate	Upper-bound rate
1997	23.8%	25.6%
1999	27.0%	31.7%

Source: IRS data.

Note: Because not all individuals responded to audit contacts, IRS uses certain assumptions to estimate the overclaim rate range. The lower-bound rate assumes that the overclaim rate for the nonrespondents is the same as for the respondents, while the upper-bound assumes that all nonrespondents are overclaims.

Although IRS's studies have shown high EIC overclaim rates for many years, other studies had shown that EIC's participation rate was fairly high. For example, in 2001 we reported that an estimated three of every four eligible participants received the EIC in tax year 1999.[8] For taxpayers with one or two qualifying children, we estimated that participation rates exceeded 90 percent. Individuals with no children, who receive a much smaller credit than taxpayers with qualifying children, had a much lower participation rate that we estimated to be about 45 percent. Although at the time we reported that available data did not enable us to determine the

[8]U.S. General Accounting Office, *Earned Income Tax Credit Participation*, GAO-02-290R (Washington, D.C.: Dec. 14, 2001).

reasons for these differences, IRS officials attributed these differences, in part, to the lower EIC amounts allowed for individuals and because the program did not include individuals without children when it first began.

Task Force Reviewed Recent Legislative Changes Likely to Improve Compliance

The EIC task force reviewed whether recent statutory changes have the potential to reduce the major sources of EIC noncompliance, either by changing the rules or providing IRS new enforcement options. Because the study of tax year 1999 compliance was the most recent available, the task force lacked data on the effect of the recent changes and relied on other analyses that showed whether the changes would affect compliance. Of the recent changes, the task force estimated that one change, to the Adjusted Gross Income (AGI) tiebreaker rule,[9] would likely reduce noncompliance. The task force judged that the other legislative changes, including those proposed by Treasury, while potentially helping reduce noncompliance from other sources, would not be enough to reduce noncompliance without further IRS efforts.

Three key pieces of legislation, which have been recently enacted or taken effect, were at least partially aimed at improving EIC compliance, as shown in table 3. They may eventually help reduce noncompliance after taxpayers and tax preparers become familiar with the new laws. The statutory changes were to serve several purposes, including improving compliance and simplifying tax laws associated with the EIC.

[9]The new AGI tiebreaker rule applies when two taxpayers can claim the same qualifying child. If one of the taxpayers claiming the credit is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent or parents. If both parents claim the child and parents do not file a joint return, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period during the year, and second of the parent with the highest adjusted gross income. If none of the taxpayers claiming the child as qualifying is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

Table 3: Recent Statutory Changes

Law	Change
Economic Growth and Tax Relief Reconciliation Act of 2001(P.L. 107-16, March 7, 2001)	This act made several changes, including (a) effective for tax years after December 31, 2001, simplifying the "Adjusted Gross Income tiebreaker rule," (b) for tax years beginning after December 31, 2001, establishing a new definition for earned income by eliminating non-taxable earned income and by having the Earned Income Credit (EIC) based on adjusted gross income, (c) for tax years beginning after December 31, 2001, amending the definition of a foster child by reducing the residency requirement to over half a year, and (d) effective January 1, 2004, allowing the IRS to use math error authority to deny EIC claims if the Federal Case Registry (FCR) indicates that the taxpayer is the noncustodial parent of the qualifying child with whom the credit is claimed.
Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170, December 17, 1999)	Effective after December 31, 1999, part of this act simplified the definition of a foster child.
Tax Relief Act of 1997 (P.L. 105-34, August 5, 1997)	After October 1,1998, this act requires that each record in the state registry include the Social Security number of any child for whom support has been ordered. This information is included in the FCR database. It also requires an applicant for a Social Security number who is under age 18 to provide his or her parent's Social Security numbers, in addition to other required evidence, such as age, identity, and citizenship.

Source: GAO analysis of legislation.

A Treasury study showed that the change in the AGI tiebreaker rule effective for tax years after December 31, 2001, would likely have eliminated about $1.4 billion of the nearly $2 billion in tax year 1999 EIC overclaims that were due to tiebreaker errors. Accordingly, the task force decided that this source of EIC overclaims did not need to be further addressed by a new compliance initiative.

Although officials recognized the benefits of these recent legislative changes to help improve EIC compliance, they concluded that additional initiatives were still needed. For example, officials recognized the value of IRS being able to use math error authority to deny EIC claims on and after January 1, 2004, when the Department of Health and Human Services' Federal Case Registry (FCR) indicates that the taxpayer is the noncustodial parent of the qualifying child. However, officials told us that this authority

was limited and not applicable to a significant number of taxpayers whose compliance may be problematic. IRS has a study in process to determine the effectiveness of using FCR data to deny EIC claims using its math authority. The study was scheduled for completion by July 30, 2003, but as of August 20, 2003, was not yet completed.

Task Force Considered Three Alternatives to Improve Qualifying Child Compliance

The EIC task force considered three key options to verify taxpayers' qualifying children: (1) partnering with other federal or state agencies or government programs to verify EIC taxpayers' eligibility, (2) creating a federal database that would automatically match and detect questionable or erroneous EIC claims, and (3) certifying taxpayers' eligibility for certain EIC criteria. Ultimately, in August 2002, the Secretary of the Treasury approved the qualifying child certification program, which at the time was to include providing proof of eligibility in advance of the filing season (July–December), and was referred to as "precertification."

The first two options were expected to impose little or no documentation requirements on taxpayers. The task force was trying to determine for both options whether sufficient information was already available from others, or that little additional information would need to be collected by others, to verify a taxpayer's qualifying children. However, the task force found that there was little overlap between the EIC population and verification criteria used to administer other federal or state programs. In addition, although some databases existed, the task force found that they could not be used to effectively verify EIC eligibility, largely for the same reason. Consequently, the task force judged that these options were not likely to be useful in addressing EIC compliance problems. Similarly, the task force also found that if a federal database were created to facilitate EIC verification, IRS would have to gather the bulk of the information itself, thus imposing a burden on taxpayers, which would also be costly and time-consuming for IRS. The third option, which the task force selected, required taxpayers to demonstrate EIC eligibility for certain criteria, namely residency and relationship tests for qualifying children, prior to receiving the credit.

The relative cost of the options the task force considered did not drive the decision to select the qualifying child program because the other two alternatives were not considered viable. The task force did compare IRS's EIC administrative costs to those of other federal benefit programs and found them to be much smaller. IRS has had a special appropriation for EIC compliance initiatives since 1998—and has received about $875 million

total through fiscal year 2003. It requested a total of about $250 million in fiscal year 2004, which included $100 million for the EIC compliance initiatives, including the qualifying child program, and about $150 million for the special appropriation. IRS estimated that this $250 million[10] total was about 0.8 percent of the total annual EIC benefits distributed, and therefore much smaller than the 9 to 13 percent administrative costs the task force had found for other benefit programs. See appendix II for more information we obtained on administrative costs for other benefit programs.

Task Force Reviewed Studies and Data to Design Initiatives Focused on Known Sources of Compliance Problems

The EIC task force reviewed IRS studies, other IRS data, and studies by other parties to better understand the sources of EIC noncompliance and devise new initiatives to address those known sources. In reviewing IRS studies and data, the task force found that the three leading sources of EIC errors resulting in overclaims in 1999 were (1) claiming nonqualifying children incorrectly, accounting for about $3 billion, (2) using the wrong filing status, accounting for about $2 billion, and (3) misreporting income, also accounting for about $2 billion. Three administrative proposals resulted, involving (1) qualifying child certification, (2) improper filing status, and (3) income misreporting.[11] In 1999, another leading source of EIC overclaims involved taxpayers with lower modified adjusted gross income claiming a child when another person with a higher income should have done so. The task force did not propose an initiative dealing with these errors, primarily because the "AGI tiebreaker" legislation was specifically enacted to decrease this source of noncompliance, as previously discussed.

[10]In addition to the $250 million that IRS requested in its fiscal year 2004 budget request to administer the EIC, IRS incurs some additional costs. For example, IRS incurs costs to process the EIC tax returns. Therefore, the full cost of administering the EIC is not known.

[11]Improper filing status claims and income misreporting are other common problems associated with the EIC. IRS plans to verify the filing status for about 41,650 cases in fiscal year 2004, but the criteria for selecting the cases have not yet been finally determined. In fiscal year 2004, IRS plans to use document matching to verify the income reported by about 300,000 EIC filers who have a history of misreporting income for 2 consecutive years in order to increase (or receive) the EIC. Depending on how well these efforts work in fiscal year 2004, they would be expanded in future years. Also see U.S. General Accounting Office, *May 20 Oversight Hearing on the Internal Revenue Service – Questions for the Record*, GAO-03-962R (Washington, D.C.: June 27, 2003).

To deal with the error attributable to claiming children who are not EIC qualifying children, the task force proposed a qualifying child certification program. Based on analyses of past compliance data, IRS found that taxpayers who overclaimed the EIC, most frequently claimed children who did not meet the residency or relationship criteria.[12] As a result, the task force proposed the qualifying child program that was to include an annual residency certification and a one-time relationship certification.

Under this program, during the period from July through December, taxpayers would have been asked to document that the children they intend to claim under the EIC, meet the EIC relationship and residency criteria. The task force proposed targeting the program to those taxpayers with qualifying children for whom IRS could not establish residency or relationship through other available means and it proposed that this concept be tested on a sample of EIC taxpayers for the tax year 2003. The task force envisioned that ultimately all EIC claimants whose eligibility could not be verified through available means would be asked to provide additional eligibility documentation prior to the filing season. Taxpayers who successfully certified qualifying children's eligibility in advance of the filing season would have their claims processed and paid expeditiously during the filing season, absent any other problems with their tax return or EIC claim. Having taxpayers certify between July and December was also intended to allow IRS to process the taxpayers' documents outside of the filing season when IRS processing systems are in highest demand. Taxpayers who did not respond and/or were unable to document their eligibility during the certification period, but then claimed the EIC when they submitted their tax returns, would have the EIC portion of their tax refund frozen. Then they would be required to provide the same documentation during or after the filing season as they were asked to provide during the certification period. When and if they document their eligibility, the EIC portion of their refunds would be released.

[12]For 2002 returns, taxpayers who claim the EIC with a qualifying child must meet certain tests, including residency and relationship. To meet the residency test, the qualifying child had to live with the taxpayer in the United States for more than half of the year. To meet the relationship test, the qualifying child had to be a son, daughter, adopted child, stepchild of the taxpayer, or a descendent of any such individual. Sisters, brothers, stepsisters, stepbrothers, and descendents of any such individual also qualify if the taxpayer cares for the individual as they would their own child. In addition, a foster child can qualify for the relationship test if certain conditions are met. Internal Revenue Service, *Earned Income Credit (EIC)*, Publication 596 (Washington, D.C.: 2002).

Process for Identifying Taxpayers When IRS Planned to Certify for Relationship

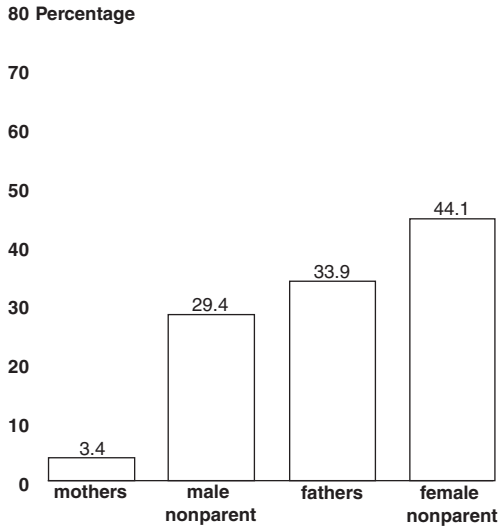
According IRS officials, as the task force neared its end and before the Secretary of the Treasury approved the program, IRS developed a means for using existing data to determine whether each taxpayer likely would meet the relationship or residency test for children they had claimed for EIC for tax year 2002. For relationship, IRS developed a plan to match taxpayers to several databases that show the parents of children. For instance, one database IRS planned to use was the Social Security Administration's database (which IRS refers to as KIDLINK) that ties parent's and children's Social Security numbers for children born after 1998 in U.S. hospitals. For tax year 2003, IRS had planned to match 1.6 million, or 10 percent of the approximately 16 million EIC taxpayers with a qualifying child, to the databases. Under this scenario, any taxpayer who was not shown to be the parent of a qualifying child claimed for tax year 2002 would then be part of the population from which IRS would randomly select taxpayers to test for relationship.

Process for Identifying Taxpayers to Certify for Residency

IRS considered the work of the task force in developing a comparable means for using available data to identify those who have met the residency criterion. The task force had analyzed data from the 1999 compliance study and information in other reports.[13] It found that residency errors related to qualifying children were often correlated with the taxpayer's relationship to the child and the taxpayer's filing status and gender. The analysis showed that, overall, parents who filed married filing jointly were the most compliant when compared to taxpayers filing single or head of household in claiming a qualifying child who meets the residency test. Married filing jointly parents had the fewest qualifying child residency errors—1.5 percent—compared to any other combination of taxpayers by relationship to the child, gender, or tax filing status. Among taxpayers who file single or head of household, mothers were the most compliant (see figure 1).

[13]Andrew J. Cherlin and Paula Fomby, "Welfare, Children, and Families: A Three-City Study," *A Closer Look at Changes in Children's Living Arrangements in Low-Income Families*, Working Paper 02-01(Baltimore, MD.: Johns Hopkins University, Feb. 20, 2002), and Allen Dupree and Wendell Primus, *Declining Share of Children Lived with Single Mothers in the Late 1990s: Substantial Difference by Race and Income* (Washington, D.C.: Center on Budget and Policy Priorities, June 15, 2001). We did not review these studies in detail. Instead, we relied upon IRS's assessment.

Figure 1: Estimated Percentage of EIC Taxpayers (with Children) Who Made Residency Errors and Filed Single or Head of Household in Tax Year 1999



Source: IRS data.

Note: This figure reflects residency errors only. Mothers who filed as single or head of household, for example, made qualifying child residency errors 3.4 percent of the time, while 96.6 percent of the time, they either made no errors or errors other than residency-related errors.

The task force also found other reports that reinforced the results of its analysis. Specifically, an independent study of low-income households in three urban areas estimated that children resided with biological mothers 90 percent of the time. Another study estimated that 89 percent of children in low-income households lived with both parents or their mother.

IRS used this information to propose a process for identifying taxpayers to include in the population that would be subject to the residency certification requirement. IRS proposed that the 1.6 million taxpayers, or 10 percent of the 16 million taxpayers with a qualifying child, would be matched to the FCR database. IRS officials considered the FCR to be the most useful database for identifying those meeting the residency requirements. This database compiles court and other records that indicate who is the custodian for a child (which could be a parent or nonparent). IRS assumes that children live with the custodian of record. According to IRS, the FCR database contains custodial information for about 40 percent of the EIC population. If a taxpayer matched as the custodian of the child claimed for the EIC for 2002, the taxpayer would not

be among those needing to certify. When the FCR database showed someone was the custodian of a child other than the EIC taxpayer who had claimed that child for the EIC in 2002, those taxpayers would be among the group from which the residency certification sample would be drawn.

When the FCR contains no information about the child a taxpayer had claimed for EIC in 2002, the IRS would attempt to establish the relationship of taxpayers to qualifying children by comparing information in several databases. Those taxpayers IRS could identify from databases as the child's mother would be excluded from the sample, if they filed married filing jointly, single, or as head of household. Mothers would be excluded on the basis of the task force analyses showing mothers to be among the most compliant on the residency criterion. Also excluded from the sample would be fathers who filed as married filing jointly. Otherwise, all males who were shown to be a child's father filing single or head of household would be included in the group from which the certification sample would be drawn because of the data showing a high level of noncompliance on the residency criterion for these taxpayers. Finally, all nonparents who are not shown in the FCR to be the custodian would go into the group from which taxpayers would be selected for residency certification, also due to information showing nonparents to be among the less compliant taxpayers on the residency criterion. The selection processes for relationship and residency would have, therefore, yielded a group of taxpayers that would include some needing to certify for relationship only, some for residency only, and some to certify for both.

IRS Has Made Key Changes to Its Initial Qualifying Child Certification Program and More May Occur

Since adopting the EIC task force recommendations in August 2002, IRS has made key changes to the qualifying child certification program in response to input received and additional analyses done. Some of these changes include (1) postponing relationship certification for an undetermined period of time, (2) delaying program implementation, and (3) reducing the test sample from 45,000 to 25,000. However, these changes create additional challenges for IRS and taxpayers. Despite these challenges, the process for selecting taxpayers, what taxpayers will receive from IRS, and what taxpayers will be required to provide remains basically the same as originally planned. According to officials, the same factors were considered when setting the new sample size, which is still designed to allow IRS to achieve the same goals as the original sample size, albeit to a lesser extent.

In addition, IRS has emphasized that program expansions, if any, will depend on the results of this year's test. Concerns we identified in our report on recertification[14] were considered and taken into account by IRS in designing the new qualifying child certification program.

IRS Broadly Adopted Task Force Recommendations in Its Initial Design of the Qualifying Child Certification Program

IRS took the broad charge from the EIC task force and designed the qualifying child certification program. Its focus was to decrease the EIC overclaim rate while striving to maintain the high rate of participation and minimize taxpayer burden. Initially, IRS decided that the certification program would involve

- testing of 45,000 taxpayers for both relationship and residency beginning in July 2003, and
- immediately expanding the certification program for relationship to 2 million taxpayers in 2005 and to both relationship and residency in substantial numbers in future years.

However, as IRS obtained input on the program, it modified these plans.

Certification for Residency Only Is to Begin in December 2003 for 25,000 Taxpayers

Since initially formulating plans for the qualifying child certification, IRS has made multiple changes to the program. First, IRS postponed relationship certification for an undetermined period for a number of reasons. IRS had developed a draft form for certifying relationships and obtained input on the form from external and internal stakeholders. Some stakeholders raised concerns about whether taxpayers would be able to provide some of the types of documentation IRS planned to request, such as marriage certificates, within the time envisioned. IRS officials said that testing the relationship certification this year was postponed, in part, because these concerns were unresolved. The officials also noted that Treasury studies have shown relationship requirements to be a lesser compliance issue than residency, and taxpayers that were found to be

[14] The "certification" program is different from the IRS "recertification" program, which is required by statute. Recertification was implemented in 1998 and requires taxpayers who have been disallowed the EIC through an IRS examination to substantiate their qualification for the EIC, i.e., recertify before they receive the credit again. U.S. General Accounting Office, *Opportunities to Make Recertification Program Less Confusing and More Consistent*, GAO-02-449 (Washington, D.C.: Apr. 25, 2002).

noncompliant with relationship requirements were also often noncompliant due to residency errors. Since both residency and relationship requirements have to be met, if taxpayers fail certification on residency there would be no need to test on relationship. Consequently, officials gave a higher priority for testing residency certification.

Second, IRS has changed the start date of the test twice. Originally, IRS planned to start the test in July 2003, but postponed implementation until mid-August. As we were finalizing this report, IRS announced in August that it now plans to begin the test in December 2003, in conjunction with the 2004 tax filing season. (Appendix IV shows key milestones from 2002 through 2005.) According to IRS officials and documents, implementation was postponed from July to August to allow time to conduct focus group testing, request and obtain public comments during a 30-day period, and make changes to the program as a result of those efforts. Thereafter, IRS postponed implementation a second time from August to December to ensure (1) taxpayers have better access to tax practitioners since many only operate during the filing season and (2) more time for outreach and education.

However, as a result of the delays, taxpayers will be providing proof of residency documentation during the filing season and not "precertifying" before the filing season as originally envisioned. This change is important and creates additional challenges for both IRS and taxpayers, as follows:

- Taxpayers will no longer have the opportunity to provide proof of qualifying child residency, correspond with IRS in advance of the filing season, and resolve any potential issues before filing their tax returns. Because all correspondence will take place during the filing season, selected taxpayers could experience a delay in receiving the EIC portion of any refund, if the EIC portion is frozen because of any problems until certification is successfully completed.

- IRS will no longer be able to spread out its workload and processing may be slower since certification will occur during the filing season—IRS's busiest time of year.

- IRS will not have the opportunity to assess taxpayers' ease or difficulty in obtaining required documentation in advance of the filing season and whether taxpayers would do so. This is important because taxpayers may be given the opportunity to certify in advance of the filing season in future years.

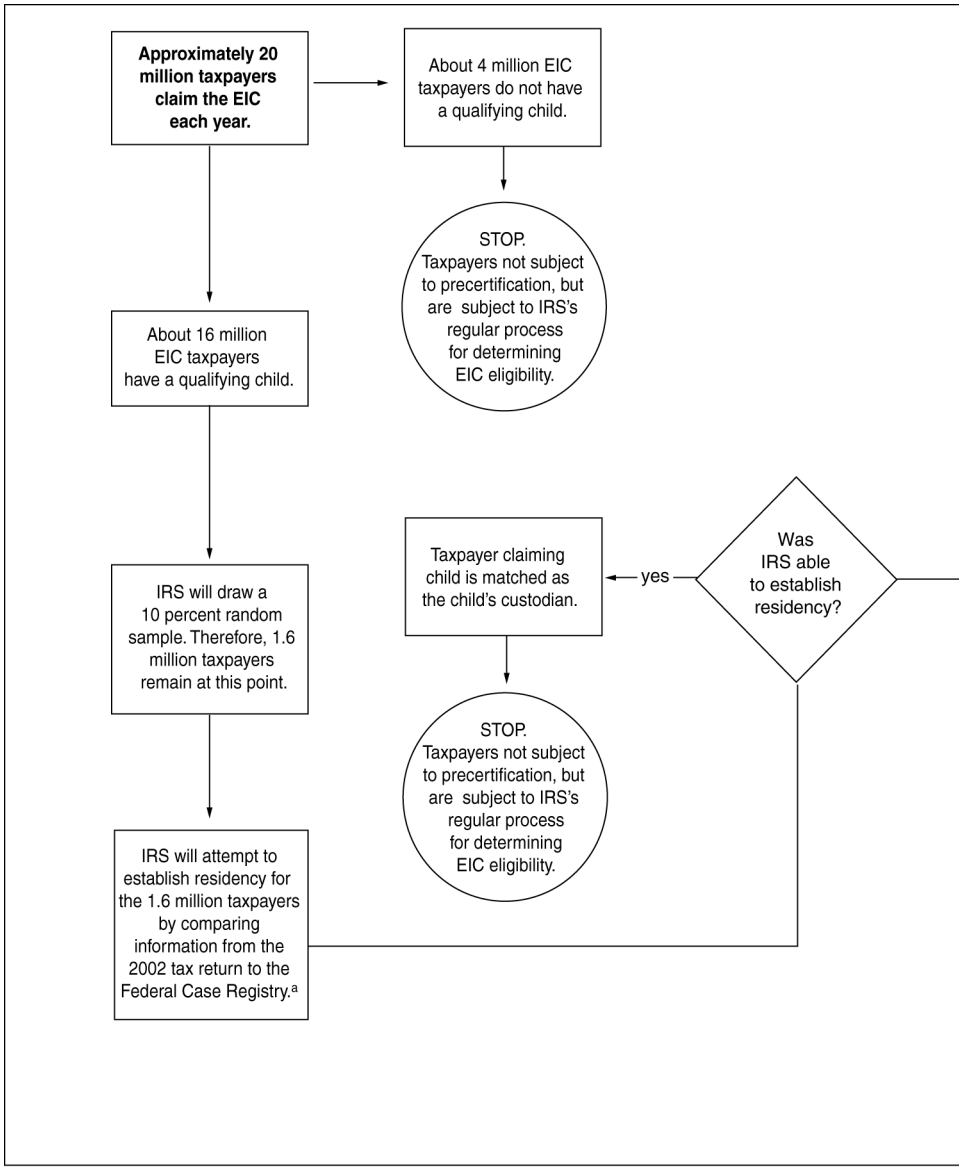
Third, IRS reduced the number of taxpayers included in the test from 45,000 to 25,000, in part, in response to comments received during the 30-day public period. According to IRS officials, despite reducing the number of taxpayers included in the test, the sample size should still allow IRS to make statistically valid measurements of results in addition to helping IRS meet its desired goals of protecting revenue and testing the process for conducting the certification program. In addition, the smaller sample should help mitigate the challenge related to processing the certification forms during the filing season.

Process for Selecting Taxpayers, What They Will Receive, and What They Will Provide to IRS Remains Basically the Same

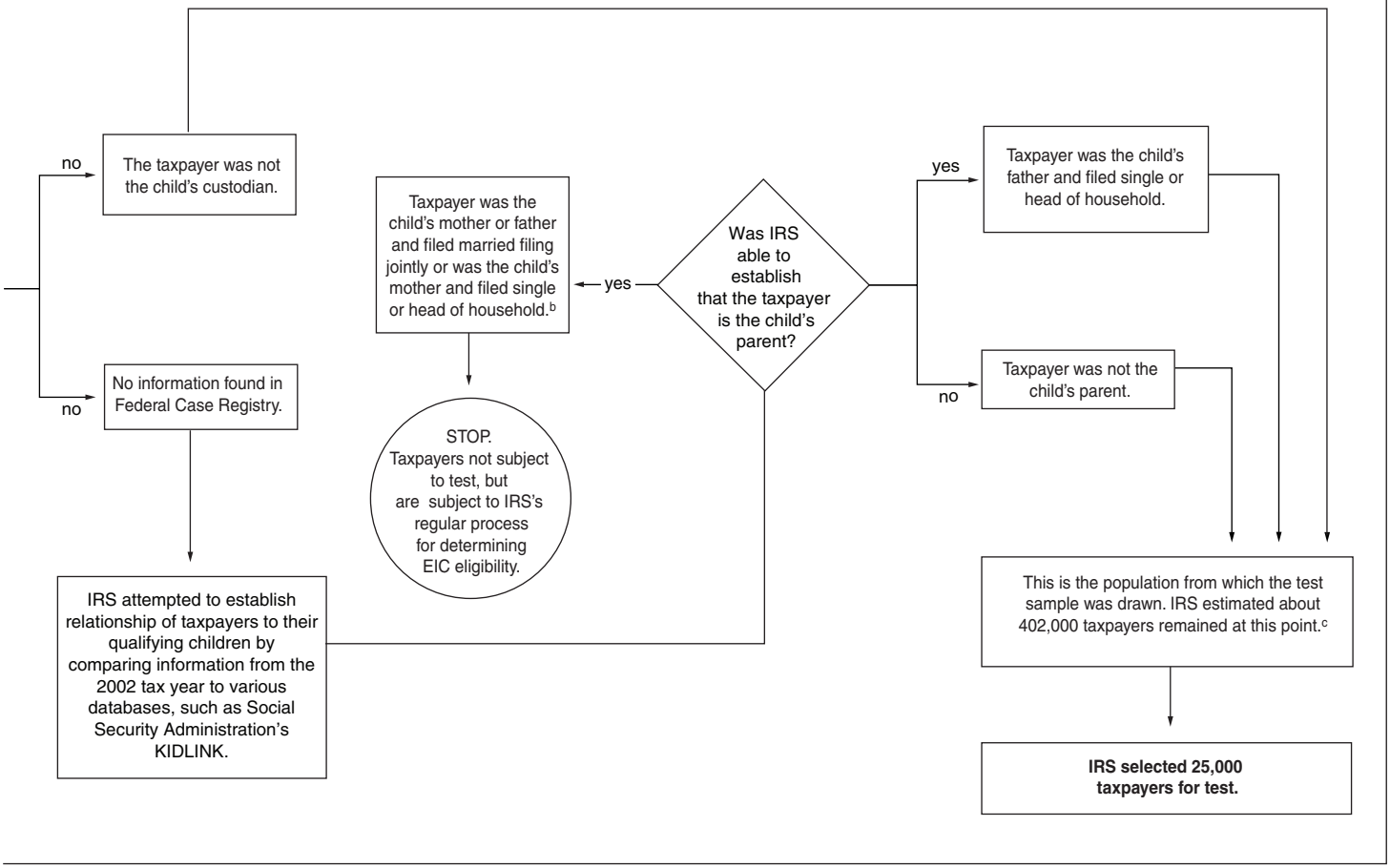
Despite these changes, how IRS selected taxpayers for the test, what taxpayers will receive from IRS, and what taxpayers will be asked to provide as proof of residency for qualifying children will remain fundamentally the same. IRS's process for selecting the taxpayers for the test is shown in figure 2.[15] Using this process, IRS selected 25,000 taxpayers in August. The 25,000 represents about 0.16 percent of the approximately 16 million EIC claimants with a qualifying child in tax year 2002 and about 0.13 percent of the approximately 20 million EIC recipients overall.

[15]IRS will exclude from its sample taxpayers who are subject to an examination, investigation, or other treatment at the same time.

Figure 2: IRS's Process to Identify the Population of Taxpayers from Which the 25,000 Person Test Sample Was Drawn



Source: GAO analysis of IRS data.



[a]The FCR contains custodial and welfare assistance data. If there is a match showing that the taxpayer is the child's custodian, regardless of the taxpayer's gender, filing status, or relationship to the child, IRS assumes the child resides with the taxpayer.

[b]These taxpayers are excluded, based on (1) IRS compliance data that show married filing jointly parents are 20 times more compliant on residency than nonparents, and single or head of household mothers are 10 times more compliant on residency than single or head of household fathers and (2)

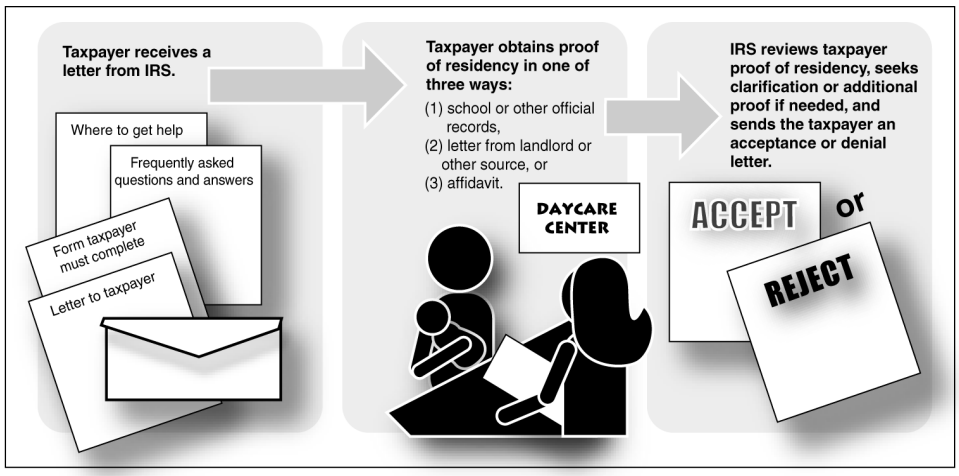
private studies that show about 90 percent of children in low income households live with their mother or both parents.

[c]IRS estimates that using the FCR and other databases will exclude almost 75 percent of the 1.6 million taxpayers. Therefore, about 402,000 taxpayers were included in the population from which IRS drew the certification sample.

According to agency officials, IRS will now send the 25,000 taxpayers forms and instructions about the program in December instead of this summer. IRS plans to send Notice 84-A, a letter informing them about the new program; Form 8836, "Qualifying Children Residency Statement;" Publication 3211M, "Earned Income Tax Credit Question and Answers;" and Publication 4134, "Free/Nominal Cost Assistance Available for Low Income Taxpayers." However, officials are changing these documents based on the public comments received. Appendix V has the most current copies of these documents.

Once taxpayers receive this information from IRS, they would obtain documentation to prove the qualifying child's residency and send it back to IRS. IRS examiners would review the documentation and send a letter back to the taxpayer either accepting or rejecting the claim, as shown in figure 3.

Figure 3: The EIC Certification Process as Envisioned



Source: GAO analysis of IRS data.

IRS currently envisions that the 25,000 taxpayers selected for certification will be required to provide proof that the qualifying child meets residency requirements before getting the EIC portion of their refund. IRS officials

say that taxpayers who are able to establish eligibility when filing their tax return should receive their refunds more expeditiously than those who do not. Taxpayers selected for certification but who are not able to provide the necessary documentation will be treated essentially the same as taxpayers undergoing a correspondence audit. The EIC portion of their refund—if they are to get one—will be frozen until proof of eligibility is established.

Same Factors Considered When Setting Smaller Sample Size

According to IRS's draft evaluation plan for the certification test and our discussions with officials, three factors were considered in setting the original sample size of 45,000: (1) show that certification would "protect revenue," (2) determine whether the test will succeed, and (3) test its processes and systems. According to IRS officials, the smaller sample size of 25,000 is designed to allow IRS to achieve the same goals as the original sample size, albeit to a lesser extent.

One factor considered by IRS for the certification test was to stop as large an amount of EIC overclaims due to ineligible qualifying children as possible during the 2003 tax year. To determine how many taxpayers to include in the certification test to achieve this goal, officials said they determined the maximum number of staff that could be assigned to and adequately supported by the planned central unit in Kansas City that would be responsible for the certification program. Based on the maximum number of staff that could be assigned and assumptions about how many cases staff could handle, IRS calculated that 45,000 taxpayers could be included in the test. IRS estimated that $114.5 million in protected revenues could be realized from including 45,000 taxpayers in the test. Based on the revised sample size of 25,000, IRS now estimates that $63.6 million in protected revenues could be realized.

A second factor considered was to have a large enough sample to support analyses of whether the test succeeds. For instance, IRS is interested in how many taxpayers provide the information needed for IRS to determine qualifying child eligibility, whether taxpayers in the sample population who are actually qualified to claim the EIC do not do so with their 2003 tax return and why, and whether taxpayers found the certification process burdensome. IRS's draft plan for evaluating the certification test notes that the original 45,000 sample size was much larger than needed to obtain statistically valid measures of test results. The draft plan indicated that a sample size of about 3,600 taxpayers, which would have provided an estimate at 95 percent confidence levels plus or minus 5 percent, was the

number of taxpayers needed for IRS to determine qualifying child eligibility. According to the draft plan, the 45,000 sample size would allow very precise estimates for the population as a whole and should provide statistically valid information about sub-sets of claimants. Despite the reduction to 25,000, IRS officials still believe that this sample size will allow for precise estimates for the universe as a whole and smaller subsets as well.

Finally, a third factor in selecting both the 45,000 and 25,000 sample sizes was to have a large enough sample to test the processes and systems that would be required if IRS were to expand certification in the coming year. IRS had been preparing to work on approximately 25,000 certification cases during the filing season under its original plan for 45,000 taxpayers. It based the 25,000 on worst case assumptions about how many of the 45,000 would not opt to submit proof of eligibility in advance of the filing season and, instead, would have submitted their documentation during the filing season. In addition, for this goal, the draft plan preceded IRS's current thinking that the certification program likely will not be expanded as rapidly next year, if expanded at all. However, according to IRS officials, based on the number of cases IRS estimates can be worked on and what it plans to achieve under this goal, the 25,000 sample size is appropriate to help test the systems and processes.

Future Expansion of Certification Program Depends on Test Results

Although IRS has consistently referred to the certification effort as a test, officials recently have stressed this point. For example, officials have recently referred to the efforts for this year as a "pilot or proof of concept." Furthermore, as a result of the most recent changes, the program will no longer take place in advance of the filing season, but instead, during the filing season. IRS officials told us that it is unlikely that the certification program will be expanded to cover 2 million claimants in the summer of 2004, as originally anticipated. Instead, IRS officials plan to assess the program's overall effectiveness and make any necessary modifications before expanding it to additional EIC claimants in the future. Thus, particularly in light of IRS's most recent announcement and according to IRS officials, the program may be expanded more slowly, if at all, depending upon the evaluation results. Officials also said that test results will contribute to a future decision about whether certification, if continued, will precede the filing season or be part of the filing season as it will be this year.

Input from Focus Groups and Others Has Resulted in Changes and May Result in More

On the basis of stakeholder input, focus groups, and other input, IRS has made several changes to the planned certification test in addition to those discussed previously. IRS held informal meetings with external and internal stakeholders, focus group meetings with taxpayers and paid preparers, and one-on-one interviews with third parties to share the certification letters, forms, and/or instructions and obtain views on aspects of the new process. In response, IRS took several actions, including revising the forms. As of August 2003, IRS was evaluating comments received during the 30-day public comment period, which IRS officials said may result in additional changes.

IRS held several informal meetings with external and internal parties with an interest in the qualifying child certification program. In March 2003, the Stakeholder Partnership, Education, and Communication Organization[16] and the National Taxpayer Advocate held four informal meetings with various external stakeholders, such as representatives of the National League of Cities, the Boston EIC Coalition, and the American Institute of Certified Public Accountants. Similarly, IRS officials coordinated the certification initiative with internal stakeholders, such as representatives from the Compliance unit, Wage and Investment operating division, Small Business/Self Employed (SB/SE) operating division, and Forms and Publications unit. The purpose of these meetings was to discuss the EIC certification proposal and share the drafts of the two new certification tax forms—Form 8836, "Qualifying Children Residency Statement," and Form 8856, "Qualifying Child Relationship Statement." Officials told us they received comments from these groups of stakeholders and revised and improved the forms based on the feedback received. For example, for the residency form IRS added a list of community-based organizations and a list of acceptable third parties from which IRS would accept affidavits.

After incorporating the recommendations from these informal meetings, officials said they felt comfortable with testing the Form 8836, its instructions, and the accompanying letter in other ways, including focus groups, one-on-one interviews, and a 30-day public comment period.[17]

[16] The Stakeholder Partnership, Education, and Communication Organization is a unit with IRS's Wage and Investment operating division. Its role is to educate and assist taxpayers before their returns are filed.

[17] Before the focus groups commenced, IRS had decided to move forward only with the residency certification.

In June 2003, a contractor conducted nine focus groups, five with taxpayers who claimed EIC in tax year 2002, and four with tax preparers who had prepared returns for taxpayers claiming EIC. In addition to the focus groups, the contractor also conducted nine one-on-one interviews with a cross section of the third parties listed on Part IV of the Form 8836 (the participants were landlords, employers, and child care providers). The goal of the testing was to determine whether individuals understood the documents and thought they could obtain the requested supporting documents and whether the suggested third parties would be willing to sign the affidavit.

The focus groups and interviews were held in Philadelphia, Chicago, Dallas, and Los Angeles. These cities were selected because of their high EIC population. The participants were selected using screening guidelines developed by IRS in conjunction with the contractor. Taxpayers were selected on the basis that they claimed the EIC for tax year 2002 with a qualifying child. Similarly, preparers were selected on the basis that they worked as a tax preparer on federal tax returns for 2002 and prepared tax returns for clients claiming EIC with a qualifying child. Those selected for one-on-one interviews represented a cross section of the types of individuals IRS deemed credible to provide affidavit information about the EIC claimant. In total, 816 people were contacted and 109 agreed to participate in the focus group testing. Of the 109, 88 persons arrived for the testing and 81 actually participated in the focus groups. For the one-on-one interviews, 12 individuals were qualified to participate and 9 actually participated in the interviews.[18]

Key IRS officials were on site during the focus groups and one-on-one interviews to observe the participants' comments. A variety of comments were received and some changes were made. For example, IRS highlighted where taxpayers and third parties were to sign the forms. Although the contractor's report of these meetings was not available before the public comment period, IRS officials who attended the meetings concluded that they had not received any feedback that would preclude moving forward with getting comments from the public.

[18]According to IRS officials, approval from the Office of Management and Budget is required in situations where the agency conducts interviews with more than nine private sector participants. However, because conducting such interviews was suggested later in the process and because OMB had been briefed on the development of the certification test, IRS did not seek that approval.

During the comment period, anyone could write or go to IRS's Web site and provide any comments or opinions about the qualifying child certification program, including the form IRS expected to use and the data it planned to request to prove eligibility. According to IRS, during the 30-day public comment period, IRS received about 200 communications containing comments. Any other comments about the certification program are due by December 31, 2003. In addition, individuals can comment on the certification process during the filing season until April 15, 2004. As of August 2003, IRS officials were reviewing the comments received and anticipated making additional changes to the forms and publications shown in appendix V.

Our Concerns with IRS's Recertification Were Considered as IRS Designed the Qualifying Child Certification Program

IRS officials told us they considered the recommendations in our recertification report[19] when planning their certification program. We agree that our applicable recommendations have been considered. Whether the strategies IRS adopted to deal with the concerns that led to our recertification report recommendations are successful will not be known until IRS evaluates the certification test.

Our recertification report described three aspects of the recertification process that caused problems for taxpayers. Specifically,

- one form used for recertification was of questionable value to IRS and another form was potentially confusing to taxpayers;
- taxpayers were asked to submit information that was difficult for them to obtain or inconsistent with what many IRS examiners considered acceptable; and
- IRS examiners' inconsistent assessment of documentation submitted by taxpayers could result in different recertification decisions for taxpayers in similar circumstances.

IRS has taken steps to deal with all of these concerns in designing the certification process. Regarding the problems with recertification forms, the form that was of questionable value to IRS, which was essentially a means for taxpayers to tell IRS that they wished to be considered for

[19] GAO-02-449.

recertification, is not applicable to the certification program. The other recertification form told taxpayers what they had to submit to establish their eligibility for the EIC. We found that this form could confuse taxpayers into believing they had to show that a qualifying child was also their dependent, a criterion not applicable to EIC eligibility. We also found that the form provided insufficient guidance to taxpayers on what information they needed to provide to prove that qualifying children met the EIC eligibility requirements. We made several recommendations, including that IRS should clarify taxpayers do not need to demonstrate that qualifying children are also dependents, help taxpayers better understand what documentation they need to provide to establish their relationship with any qualifying children, eliminate a requirement that statements from child care providers be notarized, and encourage taxpayers to submit more than one type of documentation.

Regarding our concerns about taxpayers who were recertifying being asked to submit documentation that was difficult for them to obtain and that tax examiners did not all accept, we found, for example, that EIC taxpayers' living arrangements could make providing various documents difficult. We also found taxpayers did not always understand that school records were for a calendar year and therefore needed to cover the spring and fall of separate school years. We also found situations in which IRS examiners would not accept a document even though the recertification form listed the document as being acceptable. This concern overlapped with our finding that IRS examiners' were inconsistent in their assessment of whether documentation provided by the taxpayers was sufficient to establish their qualifications for the EIC.

Regarding our concerns about inconsistent documentation, IRS again took actions intended to deal with our concerns in developing the certification program. By introducing a new option—obtaining an affidavit affirming that a qualifying child resided with the taxpayer for more than half the year—IRS intended to give taxpayers another means of showing that the residency requirement is met, which would prevent the taxpayer having to obtain the other types of documents that the draft certification form lists. Although IRS did not, as we recommended, create a new form to be used by taxpayers when seeking school records, it did follow our alternative recommendation that IRS clearly remind taxpayers that they need records for part of 2 school years. The information is included in the certification form's instructions, which contain an example where a taxpayer must provide records from 2 school years. Finally, by centralizing the EIC certification processing in one location—Kansas City—and providing

training to those who will be involved, IRS is seeking to ensure a higher level of consistency in how tax examiners judge whether taxpayers adequately establish that qualifying children meet the residency criterion for EIC.

Whether the manner in which IRS took our recertification recommendations into account when designing the certification program will be successful will not be known until IRS evaluates the certification test.

Qualifying Child Certification Program Developed to Improve Compliance While Considering Taxpayers' Burden, but Plan for Evaluating Test Is Incomplete

The certification program appears to be adequately developed to potentially improve EIC compliance with consideration for minimizing taxpayer burden so that testing should proceed, particularly in light of IRS's recent announcement further delaying the program's start and reducing the sample size. For example, the EIC task force and IRS have taken steps that directly minimized the number of taxpayers who will be burdened by the certification program. That is, the certification proposal is based on analyses of the leading sources of EIC errors detected in earlier studies, thus focusing attention and burden on the subset of taxpayers making those errors, as opposed to all EIC recipients. In addition, IRS has taken steps to address the burden taxpayers will experience as participants in the certification test this year.

Although IRS has made and is continuing to make progress in defining its plan to evaluate the certification test, the plan is incomplete. For example, the draft plan does not indicate how and when some information that will be needed to evaluate whether certification achieves its objectives will be obtained and analyzed. However, officials recognize the draft plan needs to be further developed and the importance of doing so quickly.

Initial Design and Subsequent Changes May Improve EIC Compliance and Have Helped to Minimize Burden

In initially designing and subsequently modifying the EIC certification program, officials took into account the burden that taxpayers may experience while attempting to improve compliance. Officials designed the program to include, and thus burden, only the taxpayers most likely to make the errors that contribute most to the EIC's overclaim rate. By focusing on these noncompliant taxpayers, IRS expects to improve EIC compliance. In addition, officials took a number of steps, such as obtaining input from external and internal stakeholders that resulted in changes and delaying the program while considering comments received during the

comment period, which should reduce the burden on those taxpayers who are identified to certify.

To help improve compliance, the task force focused on known sources of noncompliance including claiming nonqualifying children, filing status, and misreporting income. To deal with errors attributable to claiming nonqualifying children, the task force proposed a program for certifying the eligibility for qualifying children and envisioned targeting taxpayers most likely to make those errors. In contrast, other benefit programs that we reviewed generally require all applicants to provide documentation before receiving assistance. For example, to receive Supplemental Security Income, an individual must visit a Social Security office, meet with a representative, and provide documentation including birth certificates and payroll information. The Social Security Administration then matches this information to determine eligibility in advance of benefits being received. IRS's certification effort, even if fully implemented, would require only a subset of all EIC taxpayers to provide documentation to support their eligibility and only when IRS is unable to verify eligibility from other sources of information.

After the proposal was formally adopted, IRS took a number of steps in developing plans for implementation that have been intended at least in part to minimize the burden that taxpayers actually asked to certify would experience, including the following.

- IRS has undertaken more activities than usual to ensure the residency form and other explanatory documents related to the certification program have been reviewed by those who would use them.[20] IRS sought feedback from focus groups and stakeholders on various aspects of the certification test and the draft letter, form, and instruction proposed for the residency test, such as whether taxpayers will be able to obtain and provide documents within the time available, and made some changes to the proposed form due to that feedback. As previously described, IRS held focus groups with taxpayers, paid tax preparers, and other parties to obtain feedback on certification. Officials also interviewed a small number of third parties who would be called upon

[20] IRS generally tests few forms and instructions with taxpayers before using them. See U.S. General Accounting Office, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

to provide requested documents. IRS also held a 30-day open period to receive comments from any interested party and expects to revise certification materials due to comments received. Finally, IRS officials say they will again revisit, among other things, the appropriateness of the forms and explanations going to taxpayers after evaluating the results of this year's test of certification.

- IRS considered the issues we raised in our report about the recertification program[21] when planning for certification. For example, as discussed previously in this report, IRS developed a standard form that includes an affidavit, which taxpayers can provide to third parties, such as an employer, as an alternative to obtaining other documents to prove residency. We also noted in our report that examiners inconsistently accepted or declined supporting documentation for recertification purposes. To address this concern, IRS officials conducted special training and have all certification examiners in one location, Kansas City, where EIC claims will be processed.

- IRS provided taxpayers with a variety of documentation choices in order to prove eligibility for their qualifying children. To certify for residency, taxpayers will need to provide Form 8836, "Qualifying Children Residency Statement," with one or more of the following supporting documents:

  - school records, medical records, day care provider records, leases, or social service agency records that show the parent's name and the child's name and address, and the dates that the child lived with the parent; or

  - a letter on official letterhead for a qualifying child from the child's school, health care provider, landlord, or member of the clergy that shows the parent's name and the child's name and address, and dates that the child lived with the parent; or

  - a third party affidavit from a clergy member, community-based organization official, health care provider, landlord or property manager, school official, or day-care provider.

[21] GAO-02-449.

- IRS dropped for an undetermined period of time, its plan to ask taxpayers to certify their relationship to qualifying children. IRS officials do not know whether or if they will test certification of relationships in the future. Various external stakeholders had expressed concerns about whether taxpayers would be able to provide the type of documents, such as marriage and birth certificates, which IRS had planned to request to document relationships to qualifying children on time. Also, IRS officials said that the relationship portion of the program was dropped for other reasons, including that (1) studies that have shown relationship requirements to be less of a compliance issue than residency and (2) taxpayers found to be noncompliant because of relationship requirements often were also noncompliant due to residency errors. As a result, certification will only include residency this year.

As part of its effort to balance burden with ensuring compliance, IRS made the changes listed above. As we drafted this report, it had not yet determined what additional changes it would make to the forms on the basis of comments received during the 30-day public comment period, but officials said more changes will likely result. As previously discussed, the initial design of the residency form was responsive to concerns we raised in our earlier report on IRS's recertification program. Additional changes, especially dropping relationship recertification, were responsive to the concerns that stakeholders raised before the public comment period. Accordingly, the current draft residency certification form addresses many burden concerns.

IRS's Plan for Evaluating the Test Is Incomplete

Although IRS has made and is continuing to make progress in defining its plan to evaluate the certification test, the plan is not yet complete. From its inception, the certification program was intended to: (1) reduce the EIC's overclaim rate, (2) minimize burden on taxpayers and (3) maintain the EIC's relatively high participation rate. Although there are many ways to organize an evaluation, determining whether the major objectives of a program are accomplished should help policymakers determine whether and how to proceed with the program. The draft plan is not explicitly organized to show whether certification's objectives are achieved, but does present some information on how IRS would evaluate these objectives. However, the plan proposed potential options for identifying how and when some critical data will be obtained and analyzed, but does not provide further details on when decisions will be made on specific data that will be collected, how, and by whom. Officials recognize that the draft plan

needs to be further developed and the importance of doing so quickly. They have, for instance, developed preliminary drafts identifying additional data needed and have begun considering how to use contractors to gather the data. Because evaluating these objectives will depend in part on actions of EIC certification participants that will now occur as part of next year's filing season, IRS appears to have some time before it must make final decisions on how it will determine whether the objectives were met.

Although an evaluation plan may not have to completely identify all issues that need to be evaluated and precisely how they will be evaluated before a program begins, the more completely such a plan is developed before a program is implemented, the more likely that the evaluation will be sufficient to support future decisions. For example, identifying key questions that need to be answered before a project's implementation increases the chances that necessary data will be collected to answer those questions. IRS's *Internal Revenue Manual*[22] recognizes the desirability of having evaluation plans in place before a project is implemented. For instance, it requires such plans before reorganizations.

IRS has been preparing an evaluation plan for the certification test and has a draft plan, dated April 22, 2003. That draft describes how IRS expects to evaluate the program and the process IRS used to select taxpayers for the test.

The draft plan identifies one "threshold" question for evaluating the certification program: whether the claimant selected for the test provided the required information to allow IRS to determine the eligibility of qualifying children regardless of whether the claimant was determined to be eligible or not. The plan lists data that are to be gathered throughout the certification program to answer this question.

The threshold question is part of what must be included in determining whether certification for residency helps lower EIC overclaims, but additional information is needed. Although not tying methodologies or planned data collection specifically to whether certification lowers the EIC overclaim rate, the draft plan has a combination of approaches that should contribute to answering this question. For example, the draft plan identified data that IRS would gather throughout the test on how many taxpayers in the test sample certify or fail to do so in advance of the filing

[22]See *Internal Revenue Manual* 1.1.4 and 1.2.1.

season as well as how many prove that children meet the EIC residency test during the filing season.[23]

The extent to which certification may reduce overclaims due to qualifying children not meeting the residency requirement, however, will depend significantly on why some taxpayers will not attempt to certify and why some will fail to claim the EIC, or as much EIC, for tax year 2003 as they did for 2002. The draft plan takes into account that some taxpayers may receive the certification materials, determine that a child does not meet the residency test, and therefore not attempt to certify and not claim the EIC with their 2003 tax return or claim EIC on another basis. IRS expects to use available data to help assess whether the taxpayer had a filing requirement and whether the taxpayer may have been eligible to claim the EIC (e.g., did the taxpayer's income fall within the appropriate range?). In addition, the draft plan proposes that IRS use a contractor or another third party to gather information from taxpayers about why they did not claim the EIC. A subsequent document cites ideas for the types of questions that could be asked.

Regarding the burden certification imposes on taxpayers who participate, the plan is not organized to show how this will be evaluated, but it recognizes that participants' burden should be evaluated. For example, the data IRS plans to collect throughout the process will have some utility in answering this question. IRS will keep track of the number of communications back and forth between IRS and the taxpayer before a tax examiner makes a final certification decision. IRS's plan also recognizes that some information on burden will need to be collected directly from taxpayers. The plan includes a general description of a potential opinion survey that would gather burden-related information from certification participants. Little or no detail is provided on how taxpayers would be selected for such a survey, what types of questions would be asked, and when the survey would be done; however, some of this information is shown in a subsequent draft document. Because taxpayers will not have completed their certification experience until sometime next filing season, IRS has some time to decide whether to do such a survey and how to define its parameters.

[23]IRS's draft evaluation plan preceded its decision to test certification during the 2004 filing season. These data will now need to be collected during the filing season.

Regarding the objective of maintaining the EIC's relatively high participation rate, the draft plan proposes to obtain information from those taxpayers who are asked to certify, do not, and then fail to claim the EIC. The plan proposes to use a contractor or other third party to gather information from these taxpayers about why they did not claim the EIC. The plan does not amply describe how and when final decisions would be made about selecting contractors or another third party to do this, when the contractor would contact taxpayers, or what data they would attempt to obtain from the taxpayers. Because the population IRS will need to contact for these surveys will not be known until during and after the spring of 2004, IRS has a number of months to further develop and implement an approach.

Recognizing that its plans need to be further developed, IRS officials have continued to explore how the evaluation will be done. For example, officials have drafted ideas for the type of survey questions a contractor or other party would ask of EIC taxpayers to help IRS assess why taxpayers take, or do not take, various actions (such as why they may stop claiming the EIC after being asked to certify eligibility) and to assess taxpayers' experiences under the certification program, including the burdens they experience. In addition, officials have begun identifying potential contractors who would perform the surveys and considering contracting options. According to IRS officials and documents, some discussions have been held with potential contractors to gain a better understanding of ways to test the survey instruments, techniques available to ensure the best possible response rate, and the number of taxpayers needing to be contacted to have useful results.

Finally, because IRS would like to undertake some version of the qualifying child program next year, possibly including certification during the latter part of 2004, the timely production of evaluative data for this year's test will be critical for supporting decisions about what form future efforts will take. IRS is aware of the tight schedule. Officials note that while they will not have complete information on which to base some decisions about whether and how to continue with implementation in 2004 before those decisions must be made, they expect to have preliminary data in a timely fashion. For example, IRS will not be able to completely answer whether, and if so, why, taxpayers who are legitimately qualified to receive the EIC do not claim it when they file their 2003 tax return until the end of the 2003 tax filing season, or later if taxpayers request a filing extension. IRS does expect that its contractor will have contacted many, if not most, of the taxpayers who file returns before the end of the filing season and do not

claim EIC. Thus, IRS expects to know during the fall of 2004 why many taxpayers in the certification test stop claiming the EIC.

Some Implementation Issues Not Reviewed

We did not evaluate some implementation issues because they were outside the scope of our review, still under development, or the Treasury Inspector General for Tax Administration had audits planned in these areas. Nonetheless, implementation issues could affect whether IRS is able to fully implement the certification test and ultimately improve compliance. We did not assess (1) whether IRS assigned an appropriate number of staff to assist taxpayers with questions and process the forms and documents relating to certification, (2) the adequacy of training materials for staff or the procedures put in place to help examiners consistently accept or decline taxpayers' supporting documentation, (3) the design or reliability of the databases that will be used to capture and evaluate program information, and (4) supporting tools, which examiners will use to do their job.

IRS has developed broad plans for processing the certification workload. Officials identified about 30 different offices that will be affected by the new certification program. As a key part of its processing strategy, IRS plans to dedicate employees at its Kansas City campus to process cases, answer a special toll-free number, and make updates to a certification database based on responses from the test of the 25,000 taxpayers. The Kansas City site will have about 180 staff, the bulk of whom will come on-board between September and December 2003. Approximately 40 staff took initial training between April and June 2003.

Conclusions

Given the persistently high EIC overclaim rates, that the certification program is a test, and that IRS has taken key steps to address burden issues and focus the test on individuals least likely to meet the qualifying child residency requirements, we believe IRS has struck a reasonable balance between preventing unreasonable burden on EIC taxpayers and balancing the need to obtain information on whether certification can be a useful approach to improving EIC compliance. In addition, with the recent program changes announced in August, it appears that IRS is taking even more steps to be mindful of these concerns. Although certification during the 2004 filing season gives IRS somewhat more time to modify the forms and take other actions to potentially further reduce the burden on taxpayers subject to the test, it also creates new challenges for IRS. The

test will no longer be a direct test of the original concept of certifying taxpayer eligibility in advance of the filing season. Instead, testing will occur during the filing season—IRS's busiest time of year—and gives IRS only indirect evidence on how well certification may work before the filing season as originally envisioned. Further, because IRS currently plans for taxpayers to have to successfully provide proof of eligibility when they file their individual income tax return or have a refund frozen until they do, a greater portion of the taxpayers chosen for the test may have their refunds delayed than if certification had been done before the filing season. Finally, like virtually all aspects of the qualifying child certification program, IRS's future plans have yet to be determined and are largely dependent of the results and subsequent evaluations of this test.

For various reasons, we did not review in detail some implementation issues, such as staffing and procedures for handling taxpayer responses, which could affect whether IRS is able to successfully implement the certification test. Thus, our opinion on whether IRS is ready to proceed is based only on whether it has adequately developed the test to prevent unreasonable burden and to improve compliance.

Although the balance IRS has struck supports proceeding with the test, IRS's plan for evaluating the certification program test is incomplete. IRS recognizes the need to evaluate the test and is developing its plan to do so. For some key test objectives, IRS has preliminarily identified some data that it believes must be collected to determine whether certification's objectives are achieved and has broadly identified when and how that information will be collected. Because the data are related to taxpayers' actions that will occur later this year or next spring, IRS appears to have some time to finalize its evaluation plan.

Recommendations for Executive Action

Given that the qualifying child certification program is a key part of IRS's plans for reducing EIC overclaims and that certification is intended to help reduce overclaims while minimizing the burden on taxpayers and maintaining the EIC's participation rate, the Commissioner of Internal Revenue should, to the extent possible, accelerate development of the evaluation plan for the test. The plan should demonstrate how each of the certification's objectives will be evaluated, including milestones for such critical steps as defining the specific data that will be collected, who will collect the data, and how the data will be analyzed in time to support decisions about the future of the program.

Agency Comments and Our Evaluation

While not explicitly agreeing with our recommendation, in his September 22, 2003, letter, the Commissioner of Internal Revenue said that IRS would be including the components we suggested in their evaluation plan and said that IRS is working to incorporate these components well before the certification test begins. The Commissioner said that our discussion of the evaluation plan is essentially accurate, but provided an enclosure to his letter that noted supplemental information on the plan. We are aware of the information described in the enclosure to the Commissioner's letter, and considered it when drafting our report.

The Commissioner also raised concerns about the comparability of EIC error rates to the error rates in taxpayers' reporting of certain types of income. We concurred that, by-and-large, the compliance data on reporting of these types of income are not comparable to the EIC error rate. As a result, we no longer show those comparisons in our final report.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Finance and the House Committee on Ways and Means. We are also sending copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

This report was prepared under the direction of Joanna Stamatiades, Assistant Director. Other major contributors are acknowledged in appendix VII. If you have any questions about this report, contact Ms. Stamatiades at (404) 679-1900 or me on (202) 512-9110.

Michael Brostek
Director, Tax Issues

Significant Noncompliance Rates Other Than for the EIC

The IRS has compliance data on some taxpayer groups such as individuals and small businesses and some tax items such as income and credits. By-and-large, the compliance data IRS currently has are not comparable to the EIC. IRS is implementing its National Research Program (NRP), which will provide new compliance data in 2004. In the meantime, IRS is using its Strategic Planning and Performance Management process to prioritize compliance issues.

The compliance data that IRS has available for some taxpayer groups and tax items are largely based on the Taxpayer Compliance Measurement Program (TCMP),[1] which was last conducted in 1988. However, these data cannot be compared to the EIC overclaim or error rates, in part because these data are 15 or more years old and reliable inferences cannot be drawn because much of the tax system and the economy have changed during that time. In addition, the methods used to calculate compliance rates for TCMP are different than those used to calculate EIC.

In late 2002, IRS began implementing its new NRP, a detailed study of individual taxpayers' compliance.[2] As part of NRP, IRS has identified a random sample of approximately 47,000 returns from tax year 2001 and is in the process of verifying the information on the returns through reviews of IRS and third-party data. Where necessary to confirm the accuracy of taxpayer-reported information, IRS is conducting either correspondence or face-to-face examinations. IRS intends to conduct additional NRP reviews of additional types of taxpayers, such as small corporations, and use the NRP periodically to measure compliance of individual taxpayers.

The NRP sample of 47,000 returns includes about 7,300 EIC returns. These EIC returns are subject to the same processes as the other returns in the sample, and will include a review of the taxpayers' eligibility for the EIC. In order to determine whether the NRP review of these returns will yield results methodologically similar to those of the 1999 EIC compliance study, IRS is also comparing the results of the 1999 compliance study with NRP by putting a sample of returns from the 1999 study through NRP processes

[1]For almost 30 years, the Taxpayer Compliance Measurement Program was IRS's method for statistically estimating the voluntary compliance of taxpayers in reporting their tax obligations.

[2]Among other things, IRS plans to use NRP data to update the formulas used to select tax returns for examination and allow it to design programs that will help taxpayers comply with tax laws.

(not including examinations). According to IRS officials, this should allow them to see the impact of the methodological differences between the compliance study and NRP review. IRS expects the results of the comparison study by September 2003. IRS plans to have preliminary NRP results in May 2004 and final results in November 2004.

Until better compliance measurement data are available, IRS's organizational divisions use the Strategic Planning Budgeting and Performance Management process to prioritize the compliance problems IRS faces. Through this process, IRS says that it (1) identifies and explores critical trends, issues, and problems, (2) develops operational priorities and improvement projects to address existing or emerging problems, (3) explores drivers of program resources in order to develop resource allocation targets for carrying out the proposed strategies, and (4) enables division commissioners and the senior leadership teams to prioritize the strategies and projects and determine the resource requirements to apply to each strategy, operational priority, and improvement project.

Based on managers' judgments made during this process, the Small Business/Self Employed (SB/SE) operating division, for example, identified its top six compliance priorities for fiscal year 2003 and 2004:

- high income nonfilers (income greater than $100,000),
- abusive offshore financial transactions,
- promoter investigations (those selling tax schemes to others),
- abusive tax avoidance transactions,
- high income taxpayers (income greater than $1 million), and
- returns with a high probability of unreported income.

SB/SE, which conducts few examinations of EIC claims, did not consider EIC in this prioritization exercise since EIC has its own dedicated appropriation.[3] Because IRS used different means to identify and prioritize these potentially noncompliant taxpayer groups, their identification as

[3]Personnel in IRS's Wage and Investment operating division conduct the majority of EIC examinations.

SB/SE priorities does not mean their noncompliance rate is comparable to noncompliance rates established for EIC or rates, which will be determined through the current or future NRPs or other EIC compliance studies.

Overclaim Rates, Administrative Costs, and Eligibility Verification Processes of Benefit Programs

In addition to the data we complied on IRS's EIC and qualifying child certification program, we also compiled overclaim rate and administrative cost data, as well as information on the eligibility verification processes, for nine other federal or state benefit programs. We selected the nine benefit programs because each requires some type of certification for benefits, similar to the EIC, and because the EIC task force reviewed the same programs. We did not do a comprehensive analysis to determine which programs, if any, are most comparable to the EIC, nor did we determine whether the information reported is comparable across programs.

The overclaim rates, administrative costs, and the eligibility verification processes for the EIC and the other nine benefit programs—-Unemployment Insurance, Supplemental Security Income, Social Security Disability Insurance, the National School Lunch program, the Food Stamp program, Housing and Urban Development rental assistance, Medicaid, Medicare, and Temporary Assistance for Needy Families—-are shown in table 4.

Overclaim rates for programs other than the EIC for which data were available ranged from 0.2 to 10.7 percent. These overclaim rates reflect the percentage of total dollars paid out in error, not, for example, the percentage of claimants who made errors.[1] To calculate the overclaim rates, most of the nine agencies selected a sample of program participants and conducted a detailed analysis of the cases. This can involve collection of additional supporting documentation, personal contacts with employers and other third parties, or home visits to program recipients. A description of how the overclaim rates were calculated is in table 5.

Administrative costs range from $123 million to $11.9 billion for the nine programs. Administrative costs reported by federal agencies are likely not comparable across programs and may not include all of the costs involved in administering the programs. For example, various agencies and entities at the federal, state, and local levels have administrative responsibilities under the National School Lunch program. However, while the federal budget provides funds separate from program dollars to pay for administrative processes at the federal and state level, officials at the local

[1]We use the term overclaim rate to be the total excess payments made in error. This is generally referred to as the error or overpayment rate in the other programs we reviewed.

level pay for administrative costs from program dollars that include federal and state funding and student meal payments.[2]

The process used to determine and validate eligibility varies significantly. Some programs, such as the school lunch program, rely primarily on self-reported information and verification is limited. Other programs, such as the Food Stamp program, require program staff to conduct extensive verification.

Table 4: Overclaim Rates, Administrative Costs, and Eligibility Verification Processes for EIC and Other Programs

Program	Overclaim rate[a]	Administrative cost	Eligibility verification process
Earned Income Credit	27–32 percent (tax year 1999)	$145 million[b] (tax year 1999)	Currently, no certification requirement exists. An EIC claimant's return is selected for examination when it meets certain selection criteria that points to potential overclaim. When this occurs, documentation is generally requested to establish requirements for EIC and related issues using document request forms including for qualifying child, filing status, and dependency issues.
Unemployment Insurance	8 percent[c] (fiscal year 2001)	$2.3 billion[d] (fiscal year 2001)	Eligibility for unemployment insurance benefits is determined under state law, so the information applicants are required to provide varies by state. States rely heavily on self-reported information; in some states applicants can apply over the telephone or on-line. Only a limited number of states independently verify claimants' identity by using the Social Security Administration's State Online Query system, which can match a claimant's name, date of birth, and Social Security number. States may use independent automated data sources to verify other eligibility factors such as wages and employment status.

[2]See, for example, U.S. General Accounting Office, *School Meal Programs: Estimated Costs for Three Administrative Processes at Selected Locations*, GAO-02-944 (Washington, D.C.: Sept. 25, 2002).

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Program	Overclaim rate[a]	Administrative cost	Eligibility verification process
Supplemental Security Income	7.2 percent[e] (fiscal year 2001)	$2.8 billion[e] (fiscal year 2002)	Supplemental Security Income is available to individuals who are blind or disabled and poor. The amount of Supplemental Security Income an individual receives depends on several factors including, but not limited to, other sources of income and living arrangements. To apply for Supplemental Security Income, applicants must visit a Social Security office and meet with a Social Security representative. Examples of documentation required under the program include: (1) social security card; (2) birth certificate or other proof of age; (3) mortgage or lease; (4) payroll slips, bank books, insurance policies, and other records about income and assets; (5) names and addresses of doctors (if disabled); and (6) proof of United States citizenship or noncitizen status. To verify this information, the Social Security Administration uses computer matches to compare Supplemental Security Income records against recipient information contained in records of third parties, such as other federal and state government agencies. The Social Security Administration periodically conducts "redetermination" reviews to verify eligibility factors such as income, resources, and living arrangements. Recipients' eligibility is to be reviewed at least every 6 years.
Social Security Disability Insurance	0.2 percent[e] (fiscal year 2001)	$2.0 billion[e] (fiscal year 2001)	Social Security Disability Income provides income support benefits to former workers who have suffered a long-term disability. Applicants can start their application online, but before they are approved for benefits, applicants must provide the following documentation to a social security office: (1) a Social Security number; (2) birth certificate or other proof of age; (3) medical information, such as names and addresses of doctors and medical records; (4) work history for the prior 15 years; and (5) a W-2 or tax return.
School Lunch	Not known	$123 million[f] (fiscal year 2002)	Households submit applications with self-reported information, including the names of household members and all sources of income for each household member, and the Social Security number of the adult that signs the application. Alternatively, children with Temporary Assistance for Needy Families or Food Stamp case number can be certified directly. Generally, no documentation or additional support is requested at the time of application. Local authorities verify eligibility for free and reduced price meals for a sample of applications using either random or focused sampling techniques.

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Program	Overclaim rate[a]	Administrative cost	Eligibility verification process
Food Stamps	8.66 percent[g] (fiscal year 2001)	$2.4 billion[h] (fiscal year 2002)	Food Stamp applicants are asked to provide documentary evidence of household assets, income, and allowable deductions, as well as proof of noncitizen status. Allowable deductions may include housing and utility expenses, medical expenses, and child support payments. If documentary evidence is not available, state agencies may use other means of verifying information provided by applicants, including contacting third parties. State agencies are required to verify certain information on income and deductions and states may opt to require verification of additional information. State agencies may establish their own standards for the use of verification subject to the parameters specified in federal regulations.
Housing and Urban Development rental assistance programs	10.7 percent[i] (fiscal year 2001)	$945 million[j] (fiscal year 2001)	Applicants must provide third party verification of the following factors: (1) family annual income, (2) value of assets, (3) expenses related to deductions from annual income, and (4) other factors that affect the determination of adjusted income. Housing agencies may require documentation or they may verify self-reported information by telephone. Individual housing agencies determine their own verification procedures.
Medicaid	Not known	11.9 billion[k] (fiscal year 2001)	Medicaid provides health insurance coverage to certain low income adults and children in a program jointly administered and funded by the federal government and the states. While the Social Security Administration sets the income threshold for Supplemental Security Income-related Medicaid eligibility annually, most Medicaid eligibility requirements and verification procedures are determined at the state level and vary by state. For example, some states require applicants to provide documentation of both income and allowable deductions, such as child care expenses and child support payments. Other states require applicants to provide information on income and deductions but do not require further documentation. Federal law requires that Medicaid applicants provide a Social Security number, unless the applicant refuses to obtain a number because of well established religious objections. While states are required to establish procedures for the periodic redetermination of a recipient's Medicaid eligibility at least annually, the procedures may vary by state.
Medicare	6.3 percent[l] (fiscal year 2002)	4.4 billion[m] (fiscal year 2001)	The Centers for Medicare and Medicaid Services administers the Medicare program; however, the Social Security Administration determines entitlement to Medicare benefits. Retired recipients who are receiving retirement benefits from Social Security or the Railroad Retirement Board are automatically enrolled in Medicare the month they turn 65. Individuals who are under age 65 and disabled are also automatically enrolled in Medicare after they have been receiving Social Security or Railroad Retirement disability payments for 24 months. All other individuals (e.g., retired individuals who are not eligible for Social Security and individuals who have end stage renal disease) are required to file a Medicare application at a Social Security office.

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Program	Overclaim rate[a]	Administrative cost	Eligibility verification process
Temporary Assistance for Needy Families	Not yet Available	$2.3 billion[n]	Eligibility requirements are determined at the state or local level, and therefore vary by state and locality.

Source: GAO analysis of multiple agency data.

[a]See table 6 for information on how overclaim rates were calculated for each program.

[b]IRS does not know the full cost of administering the EIC; for example, the $145 million does not include the cost of processing EIC returns.

[c]United States Department of Labor Benefit Accuracy Measurement data.

[d]United States Department of Labor.

[e]Social Security Administration, *Performance and Accountability Report, fiscal year 2002.*

[f]United States Department of Agriculture Food and Nutrition Service. Includes state expenses for administering the School Breakfast Program, the Child and Adult Care Food Program, and the Special Milk Program.

[g]United States Department of Agriculture Food and Nutrition Service, Quality Control Division.

[h]United States Department of Agriculture Food and Nutrition Service.

[i]Housing and Urban Development's Audit of Financial Statements Fiscal Year 2002 and 2001, 2003-Fiscal Year 2004 (January 31, 2001), Note 17, p. 104ff.

[j]Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations for 2003, Hearings. 552-070-28357-9, p.106.

[k]Health and Human Services' *Financial Management Report, fiscal year 2001.*

[l]Health and Human Services' Office of Inspector General, Improper Fiscal Year 2002 Medicare Fee-For-Service Payments A-17-02-0220, (January 2003).

[m]The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, 2003 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds. Administrative cost figure includes administrative costs for both Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds. Administrative costs for Hospital Insurance include the costs of experiments and demonstration projects as well as fraud and abuse control expenses.

[n]Health and Human Services' Administration for Children and Families, *Temporary Assistance for Needy Families Program Fifth Annual Report to Congress. (February 2003).*

To the extent known, how the overclaim rates are calculated, for the nine benefits program we reviewed, including EIC, is shown in table 5.

Table 5: How Overclaim Rates Are Calculated for Selected Benefit Programs

Program	How overclaim rates are calculated
Earned Income Credit	Compliance study based on audits of a statistically representative sample of taxpayers and adjustments made to their tax returns.
Unemployment Insurance	The quality assurance system is used to estimate overpayments based on a statistically valid sample of Unemployment Insurance claims from each state. Investigators conduct detailed, comprehensive analyses of each case by personally contacting employers, claimants, and third parties. Investigators typically spend 5 to 8 hours examining each case.
Supplemental Security Income	The payment accuracy rate is based on a detailed analysis of a sample of Supplemental Security Income cases. However, the Social Security Administration's Office of Inspector General reported that not all types of overpayments are counted as errors so payment accuracy rates do not correspond to overpayments reported in the Social Security Administration's financial statements.
Social Security Disability Insurance	The overpayment overclaim rate is based on a monthly sample selection from the payment rolls consisting of beneficiaries in current payment status. For each sampled case, the recipient or representative payee is interviewed, collateral contacts are made as needed, and all factors of eligibility are redeveloped as of the current sample month.
School Lunch	The United States Department of Agriculture does not routinely collect data on the percentage of ineligible children receiving free or reduced price school lunches.
Food Stamps	Under the food stamp quality control system, states draw a statistical sample, review case information, and make home visits to determine whether households were eligible for benefits and received the correct benefit payment. Regional offices validate the results by reviewing a subset of each state's overpayment and underpayment errors as necessary.
Housing and Urban Development rental assistance programs	The overclaim rate is based on an in-depth analysis of a statistical sample of cases. The overclaim rate showed an increase in 2001 over previous years largely because Housing and Urban Development expanded its methodology for measuring error to cover three types of program errors – incorrect reporting of income by tenants; mistakes by public housing agencies, owners, and renting agents in calculating income and rent amounts; and mistakes made by public housing agencies, owners, and renting agents in completing appropriate paperwork and billing Housing and Urban Development for rental assistance.
Medicaid	GAO has found that few states measure the overall accuracy of their payments.[a]
Medicare	This overclaim rate for Medicare fee-for-service claims is based on a review of claims conducted by the Housing and Human Service's Inspector General's office. The Inspector General used a multistage stratified sample design. For each claim, the provider was contacted and asked to provide copies of all medical records supporting services billed. These records were assessed to determine whether the services billed were reasonable, adequately documented, medically necessary, and coded in accordance with Medicare reimbursement rules and regulations. Billing practices were also reviewed. Starting in fiscal year 2003, the Centers for Medicare and Medicaid Services will publish a national overclaim rate developed through the Comprehensive Error Rate Testing Program and the Hospital Payment Monitoring Program. These programs build on the Inspector General's methodology.
Temporary Assistance for Needy Families	Payment accuracy overclaim rates have not yet been calculated for the Temporary Assistance for Needy Families' program.

Source: GAO analysis of multiple agency data.

[a]U.S. General Accounting Office State, *Efforts to Control Improper Payments Vary,* GAO-01-662 (Washington, DC: June 7, 2001).

Objectives, Scope, and Methodology

Objectives

We were asked to respond to 12 questions about IRS's certification program, as shown in table 6.

Table 6: Questions We Were Asked

1.	What is the status of the EIC certification program, including the timing and number/types of taxpayers to be contacted?
2.	Has IRS "tested" or conducted a "focus-group" of any related letters, forms, or documents for understandability and other issues; and, if so, what have been the results of such efforts?
3.	(a) What is the appropriateness of the draft certification forms and explanations? (b) What are IRS's plans for processing them? (c) What types of documents will EIC taxpayers need to provide the IRS? (d) Will taxpayers generally be able to obtain the required documentation to otherwise establish eligibility within the required time frame, such as for marriage certificates, school transcripts, and rental agreements?
4.	What is the range of alternatives considered by IRS for obtaining similarly reliable documentation, including the cost of alternatives, and taking into account the cost of EIC noncompliance?
5.	What is the percentage of EIC claimants that would be required to precertify prior to the 2004 filing season?
6.	What information does IRS have regarding differences in the EIC overclaim rate among EIC claimants that are positively correlated with filing status, relationship to the qualifying child, or other factors?
7.	To what extent are the issues of concern in GAO's report on the current recertification program of similar concern in the new certification program, including probable solutions to problem areas?
8.	Does GAO believe the certification program has been adequately developed to prevent unreasonable burdens on EIC taxpayers and to improve compliance?
9.	What is the current process for evaluating EIC eligibility?
10.	(a) What is the current EIC error rate? (b) Have recent statutory changes had an impact on the error rate or on the rate of overpayments? (c) Were these statutory changes for the purpose of deterring noncompliance?
11.	What are the error rates of non-EIC taxpayer groups having significant compliance issues?
12.	What are the error rates of comparable benefit programs administered by states or the federal government and do these programs use any verification process?

Source: Subcommittee on Oversight, House Committe on Ways and Means.

In consultation with our requesters' offices, we grouped these questions into three objectives, as follows: (1) describe the design and basis for the EIC qualifying child certification program as proposed by the EIC task force, (2) describe the current status of the program, including significant changes since program approval, and (3) assess whether the program is

adequately developed to (a) prevent unreasonable burdens on EIC taxpayers and (b) improve compliance so that the test should proceed. In addition, we were asked to provide readily available information on (1) significant noncompliance rates other than for the EIC and (2) the overclaim rates and administrative costs of comparable benefit programs administered by states or the federal government and any verification process used by these programs.

Scope and Methodology

To respond to all of the questions, we reviewed and analyzed relevant IRS and other documentation, such as compliance reports, EIC task force reports, draft letters and forms, testing and focus group records, implementation plans, evaluation plans, and our prior products, and interviewed Department of the Treasury and IRS officials involved in the EIC certification program, including the Assistant to the Commissioner; the National Taxpayer Advocate; Research, Analysis, and Statistics officials; and members of the qualifying child certification implementation team. We did not verify the accuracy of the data shown in the various reports that we reviewed. Rather, we reviewed the steps IRS had taken to implement the certification program and determined, to the extent possible, how IRS ensured that the program had been adequately developed to prevent unreasonable burden and improve compliance. We did not evaluate whether IRS's preparations for implementing the certification test, such as staffing and training, were sufficiently developed to support proceeding with the test, because they were outside the scope of our review, still under development, or the Treasury Inspector General for Tax Administration had audits planned.

The first objective includes, in order, our response to questions 10, 4, and 6. To determine the current EIC error rates and whether any studies had been done on the impact of recent statutory changes on error rates, we reviewed IRS's most recent compliance study, the Treasury Inspector General for Tax Administration reports and our previous reports, and interviewed IRS officials. In addition, we reviewed the legislative history of recent statutory changes—effective since 1999—that pertained to EIC. We analyzed these data and IRS and Treasury reports to determine whether an analysis on the impact of the legislative changes on EIC error or overclaim rates had been conducted. To determine the range of alternatives considered by the task force, we reviewed documents and interviewed members of the EIC task force. To determine the correlation between overall EIC error rates, filing status, and gender, we interviewed officials from Research, Analysis, and

Statistics and analyzed their data, and reviewed the EIC task force reports and Treasury's past compliance studies.

The second objective included, in order, our response to questions one, five, two, and seven. To determine the status of the EIC certification program, including the number and types of taxpayers to be contacted, we interviewed IRS and Treasury officials and reviewed documents showing timelines and key milestones. We reviewed plans for the certification program, such as IRS's Concept of Operations and the 2004 Increment Evaluation Plan, in conjunction with IRS's current process for evaluating EIC eligibility. To calculate the percentage of EIC claimants subject to certification in 2004, we divided the planned sample size by the number of EIC claimants with qualifying children. To obtain information on IRS's testing of letters, forms, and documents for understandability, we observed the focus group testing that IRS conducted in Dallas, Tex., with EIC taxpayers, tax preparers, and other parties to understand how IRS assured itself that such persons understood the forms and thought they could obtain the required documentation. For whether items of concern we found within the recertification program could have similar concerns in the new initiative, we analyzed our prior reports on IRS's recertification program and IRS's progress in implementing our recommendations, then we compared our analysis to the certification plans.

The third objective includes, in order, our responses to questions eight and three. To make our determination as to whether the program had been adequately developed to improve compliance with minimal burden to taxpayers, we asked IRS officials to describe and provide documentation to support the steps they took to assure that the program was adequately developed. This included interviews and a high-level review of key steps and decisions found in various documents, such as the EIC task force reports, the Concept of Operations, staffing plans, training materials, and the evaluation plan. To determine the potential extent of the burden on taxpayers, we reviewed reports from outside groups that analyze programs and policies for low-income groups. We obtained the opinions of IRS officials and discussed those of outside stakeholders, such as representatives from the Annie E. Casey Foundation, low income taxpayer clinics, and large tax preparation organizations, that IRS had met with about any problems taxpayers might have in complying with the documentation requirements to establish EIC eligibility. We also interviewed IRS officials and reviewed EIC task force documents to learn about the range of alternatives taxpayers have available to obtain similarly

reliable documentation, if they were unable to comply with the certification documentation requirements.

Our responses to questions 11 and 12 are in appendixes I and II, respectively. To determine the error rates of non-EIC taxpayer groups having significant compliance issues, we reviewed compliance research reports, interviewed officials about IRS's National Research Program, and reviewed information contained in the Strategy and Program Plan. We discussed our analysis with key IRS officials, including representatives of the Assistant to the Commissioner. To determine the overclaim rates, administrative costs, and verification process of comparable benefit programs administered by states or the federal government, we researched our prior reports and contacted our staff knowledgeable about the selected programs. We selected nine programs to review: Unemployment Insurance, Supplemental Security Income, Social Security Disability Insurance, school lunch, food stamps, Housing and Urban Development rental assistance, Medicaid and Medicare, and Temporary Assistance for Needy Families. We chose these programs largely because they were the same programs the EIC task force reviewed and because each of them had some sort of precertification program. We did not do a comprehensive analysis to determine which programs, if any, were most comparable to the EIC, nor did we determine whether the information reported for each program was consistent and could be compared across programs. We did not do additional analyses to determine how administrative costs compared to program outlays.

Our response to question nine is in the background section of this report. To determine the current process for determining EIC eligibility, we reviewed relevant IRS documents and our prior reports. We verified the accuracy of this information in interviews with IRS officials.

We conducted our work in Atlanta, Ga., Dallas, Tex., and Washington, D.C., from May 2003 through September 2003 in accordance with generally accepted government auditing standards.

Key Milestones for the Qualifying Child Certification Program

Key milestones for the certification program for fiscal years 2002 through 2005, are shown in figure 4.

Figure 4: Key Milestones for the Certification Program

2002	**February** • EIC task force formed.	**July** • EIC task force recommendations approved.	**August** • Qualifying child certification concept and detailed plans developed (through February 2003).	
2003	**March** • Informal meetings with internal and external stakeholders held.	**June** • Focus group testing and one-on-one interviews held.	**July** • A 30-day public comment period ends.	**December** • Letters notifying taxpayers of residency certification requirements begin to be mailed.
2004	**January** • Eligibility determinations to be made (through October 2004 with extensions).	**July** • Possible pilot for certification in advance of the 2005 filing season initiated–letters to taxpayers to be mailed.	**September** • Preliminary evaluation report for qualifying child certification test to be completed.	
2005	**January** • Final evaluation report for qualifying child certification test to be completed.			

Source: GAO analysis of IRS data.

Documents Related to the Precertification Program

According to agency officials, IRS will send each of the 25,000 taxpayers subject to precertification four documents, including (1) Notice 84-A, a letter informing taxpayers about the new program; (2) Form 8836, "Qualifying Children Residency Statement;" (3) Publication 3211M, "Earned Income Tax Credit Question and Answers;" and (4) Publication 4134, "Free/Nominal Cost Assistance Available for Low Income Taxpayers." Copies of these documents, current as of September 2003, follow.

Notice Number: 84A
Date of this Notice:
Taxpayer Identification Number:
Form:
Tax Period:
For assistance you may call us at:
1-800-294-2723

Taxpayer Name
Street Address
City, State, Zip

YOU NEED THIS NEW FORM
TO CLAIM THE EARNED INCOME CREDIT

WHY WE'RE SENDING YOU THIS FORM

We're sending you Form 8836 because you claimed the earned income credit (EIC) based on at least one child on your 2002 tax return. Before you claim your children for the EIC for 2003, you must show that your children lived with you for more than half of this year.

Your claim, however, also must pass all the other legally required tests. Our publication *Earned Income Credit Questions and Answers Brochure* (Publication 3211 M) has more information about the other tests.

WHAT YOU NEED TO DO NOW

If you want to continue to claim your children for EIC for 2003, you must fill out this form.

Please send us this form now. Then, when you file your 2003 tax return, we'll send your EIC without delay.

Read the instructions for help on how to show your children lived with you for more than half the year. Then fill out the form and, if you need to, attach any required documents.

Send the completed form and documents to this address:

Internal Revenue Service
Stop 4300, Annex R2
Kansas City, MO 64999-0065

WHAT WE'LL DO ONCE WE HEAR FROM YOU

We'll review the information you send us and let you know if you can claim your children for EIC next year. If we need more information, we'll contact you.

HOW TO GET HELP

Call 1-800-294-2723 if you need assistance. You may also visit any IRS Taxpayer Assistance Center for help.

Help is also available at Low Income Taxpayer Clinics listed in the enclosed Publication 4134.

Enclosures: Form 8836 (2), *Qualifying Children Residency Statement*
Publication 3211 M, *Earned Income Credit Questions and Answers Brochure*
Publication 4134, *Free/Nominal Cost Assistance Availability for Low Income Taxpayers*
Envelope

(al otro lado en español)

Form **8836**

Department of the Treasury
Internal Revenue Service

Qualifying Children Residency Statement

▶ See instructions starting on page 2.

OMB No. 1545-1829

2003

Attachment Sequence No. 136

Part I **Taxpayer Information (to be completed by taxpayer)**

Your first name and initial	Last name	**Your social security number**
If you will be filing a joint return for 2003, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions		Your daytime phone number ( )
City, town or post office, state, and ZIP code		Your evening phone number ( )

Part II **Qualifying Children Information (to be completed by taxpayer)**
Caution. If you have two qualifying children, see instructions before completing this part.

Child 1 ▶	Child's first name	Last name	Child's social security number
Child 2 ▶	Child's first name	Last name	Child's social security number

Part III **Proof of Residency (to be completed by taxpayer) (see instructions)**

Check **one or more** boxes below and attach any required documentation. The combined documentation must include your name, the child's name, street address, and dates the child lived with you to show that you and the child lived together for **more than half** of 2003. See **Residency Test** on page 2 for details and exceptions.

☐ I have attached copies of one or more of the following official records: Child-care records, community-based organization records, employment records, Indian tribal enrollment records, leases, medical records, religious records, school records, social service agency records, or utility bills.

☐ I have attached a letter on official letterhead from one or more of the following third parties: Child-care provider, clergy, community-based organization official, employer, health-care provider, Indian tribal official, landlord or property manager, school official, social service agency official, or utility company.

☐ A third party has completed Part IV below.

Note. The IRS may contact the third party who signs Part IV and any person or organization that provides the documentation you attach to this form.

Under penalties of perjury, I declare that I have examined this statement, and to the best of my knowledge and belief, it is true, correct, and complete.

Taxpayer Sign Here ▶ **Signature of spouse named in Part I** ▶ **Date** ▶

Part IV **Third Party Affidavit (to be completed by third party if the last box in Part III is checked)**

First, check the box below that best describes your relationship to the taxpayer or one or both children named above.

☐ Child-care provider ☐ Clergy ☐ Community-based organization official ☐ Employer ☐ Health-care provider
☐ Indian tribal official ☐ Landlord or property manager ☐ School official ☐ Social service agency official

Next, complete the following statement.

Based on my records or personal knowledge, I believe that one (or both) of the above-named taxpayer(s) **and** (check the box that applies)
☐ Child 1 ☐ Child 2 ☐ Child 1 and 2 lived together at the following address:

Address (number and street) ▶ _____

City, town or post office, state, and ZIP code ▶ _____

from month ▶ _____ day ▶ _____, **2003, through** month ▶ _____ day ▶ _____, **2003.**

Under penalties of perjury, I declare that I have examined this affidavit, and to the best of my knowledge and belief, it is true, correct, and complete.

Third Party Sign Here ▶ Date ▶

Your name (print or type) ▶ Title (if any) ▶

Name of organization (if any) ▶

Address (including city, town or post office, state, and ZIP code)	Your daytime phone number ( )

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 14955C Form **8836** (2003)

The Earned Income Tax Credit (EITC)

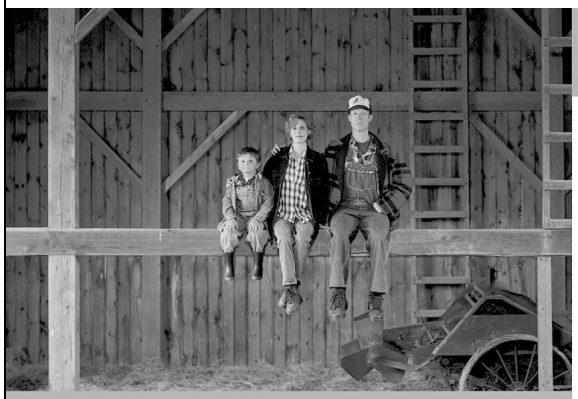
for people who work but don't earn high incomes.

EITC Q's & A's

You may have earned it.

why not claim it?

IRS Department of the Treasury
Internal Revenue Service
Publication 3211M (07-03)
Catalog Number 36621F



Q: Am I eligible to claim the EITC?

A: To claim the EITC on your 2003 tax return, you must meet the following requirements:

- You must have earned income from employment or from self-employment.
- Your earned income and adjusted gross income (AGI) must be less than:
  - $33,692 if you have more than one qualifying child ($34,692, if married, filing jointly);
  - $29,666 if you have one qualifying child ($30,666, if married, filing jointly);
  - $11,230 if you have no qualifying child ($12,230, if married, filing jointly).
- Your investment income (such as interest) must be $2,600 or less.
- Your filing status cannot be married, filing separately.
- You must be a U.S. citizen or resident alien all year, or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return.
- You cannot be a qualifying child of another person.
- If you do not have a qualifying child, you must:
  - be age 25 but under 65 at the end of the year,
  - live in the United States* for more than half the year, and
  - not qualify as a dependent of another person.

* U.S. military personnel on extended active duty outside the United States are considered to live in the United States while on active duty.

Q: Who is a qualifying child?

A: A qualifying child is a child who:

- Is your:
  - son, daughter, stepson, stepdaughter or a descendent of any of them, or
  - brother, sister, stepbrother, stepsister, or a descendent of any of them, and whom you care for as your own child, or
  - eligible foster child (placed with you by an authorized placement agency whom you care for as your own child).
- At the end of the year was:
  - Under age 19, or
  - Under age 24 and a full-time student, or
  - Any age if permanently and totally disabled at any time during the year.
- Lived with you in the United States for more than half of the year (residency test).
- An adopted child is treated as a child by blood.

Q: What if I have the same qualifying child as someone else?

A: You and the other person(s) can decide who will claim the credit using that qualifying child. If you cannot agree, the tie-breaker rule applies.

Q: What is the tie-breaker rule?

A: Under the tie-breaker rule, the child is treated as a qualifying child only of:

- The parent, if only one of the persons is the child's parent, or
- The parent with whom the child lived the longest during the year, if two of the persons are the child's parent, and they do not file a joint return together, or
- The parent with the highest AGI if the child lived with each parent for the same amount of time during the year, and they do not file a joint return together, or
- The person with the highest AGI, if none of the persons is the child's parent.

EITC

Q: What is earned income?

A: Earned income is income you get from employment or self-employment.

- Earned income includes:
  - Taxable wages, salaries and tips;
  - Net earnings from self-employment;
  - Gross income received as a statutory employee.
- Beginning in 2002, earned income no longer includes nontaxable employee compensation.

Q: Do I need a Social Security number?

A: You, your spouse (if filing jointly) and any qualifying child you list on Schedule EIC must have valid SSNs issued by the Social Security Administration.

- If an SSN was obtained solely to receive federally funded benefits, such as food stamps, it is not valid for EITC purposes. The Social Security card will generally say NOT VALID FOR EMPLOYMENT.
- If you or your spouse (if filing jointly) have an individual taxpayer identification number (ITIN), you cannot get any EITC.
- If a qualifying child has an ITIN or an adoption taxpayer identification number (ATIN), you cannot get the EITC on the basis of that child.

Q: How do I figure my EITC?

A: If you qualify for this credit, you have options:

- In most cases, all you need to claim the EITC is your tax return and instructions: 1040, 1040A or 1040EZ. However, if you have a more complicated return, you may need to use Publication 596, *Earned Income Credit*. If so, your Form 1040 instructions will refer you to that publication.
- If you have a qualifying child, you must complete and attach Schedule EIC to your return.
- If your EITC for 1997 or later was denied or reduced by the IRS as the result of an audit, to claim the credit for 2003 you may need to attach Form 8862, *Information to Claim Earned Income Credit after Disallowance*, to your return. See Publication 596 or the instructions for Form 8862.
- If you would like the IRS to figure your EITC for you, follow the instructions in your tax booklet.

Q: How do I get advance EITC?

A: If you expect to qualify for the EITC in the year 2004, you can get part of the credit in your paycheck. You must:

- Receive wages.
- Expect to be eligible for the credit and have at least one qualifying child.
- Complete Form W-5, *Earned Income Credit Advance Payment Certificate*, and give it to your employer.

The IRS provides help and free tax materials in many ways.

- Web site: www.irs.gov/eitc
- Volunteer Income Tax Assistance (VITA) sites. IRS VITA volunteers can help you complete your tax return for free. Call 1-800-829-1040 for a site near you.
- Call 1-800-829-1040 for answers to EITC and other tax questions.
- Call 1-800-829-3676 for a free copy of Publication 596 and other IRS forms and publications.
- If you have access to TTY/TDD equipment for the hearing impaired, call 1-800-829-4059.

EITC

If you are a low income taxpayer who cannot afford professional tax assistance during audits of your federal income tax return, you may qualify for help from Low Income Taxpayer Clinics or other organizations that provide free assistance in tax disputes.

Low Income Taxpayer Clinics (LITCs) represent low income taxpayers before the Internal Revenue Service in audit, appeals, and collection issues, for free or for a nominal charge.

Low Income Taxpayer Clinics receive partial funding from the IRS. However, the clinics and their volunteers are completely independent of and are not associated with the federal government. These clinics are operated by nonprofit organizations or academic institutions.

These Federally-funded clinics are listed below. Each clinic independently decides if you meet its income guidelines[1] and other criteria before it agrees to represent you.

Low income taxpayers also may be able to receive assistance from attorney referral systems operated by state bar associations, local societies of accountants, and other nonprofit tax professional organizations.

This notice is not, and should not be understood to be, a recommendation by the IRS that you retain a Low Income Taxpayer Clinic or other similar organization to represent you before the IRS.

[1] The Department of Health and Human Services (HHS) publishes poverty guidelines. IRS Publication 3319, *Grant Application Package and Guidelines* lists income ceilings for low income representation and contains a table for a family unit from 1 to 5.

Size of Family Unit	Income Ceiling (250% of Poverty Guidelines)
1	$22,450
2	$30,300
3	$38,150
4	$46,000
5	$53,800
6	$61,700

Low Income Taxpayer Clinics (LITCs)

State	City	Name	Phone
Alabama	Birmingham	Lawson State College	(205) 925-1039
Alaska	Anchorage	Alaska Business Development Center, Inc.	(907) 562-0335
Arizona	Phoenix	Community Legal Services, Inc.	(602) 258-3434 ext. 230
Arizona	Chinle	DNA-People's Legal Service, Inc.	(928) 674-2402
Arkansas	Little Rock	University of Arkansas at Little Rock	(501) 324-9912
California	Fresno	Central California Legal Services, Inc.	(209) 723-5466 ext 101
California	Los Angeles	HIV & AIDS Legal Services Alliance (HALSA)	(213) 201-1381
California	Los Angeles	Community Based Education and Development	(323) 937-7772
California	Los Angeles	Filipino American Service Group, Inc.	(213) 487-9804
California	Los Angeles	Korean Resource Center	(323) 937-3718
California	Los Angeles	Pepperdine University	(213) 347-6357 ext 4406
California	Orange	Chapman University School of Law	(714) 628-2535
California	Redwood City	Association of Cultural Advancement for Vietnamese	(650) 368-4200
California	San Diego	University of San Diego School of Law	(619) 260-7470
California	San Francisco	Nihonmachi Legal Outreach	(415) 567-6255
California	San Francisco	San Francisco Bar Association Volunteer Legal Services Program	(415) 575-3130
California	Santa Ana	Legal Aid Society of Orange County	(800) 834-5001
Colorado	Denver	University of Denver College of Law	(303) 871-6368
Connecticut	Hamden	Quinnipiac College School of Law	(203) 582-3238
Connecticut	Hartford	University of Connecticut School of Law	(860) 570-5165
DC	Washington	American University	(202) 274-4164
DC	Washington	Central American Resource Center	(202) 328-9799
Delaware	Wilmington	Delaware Community Reinvestment Action Council, Inc.	(877) 825-0750
Delaware	Wilmington	Legal Services Corporation of Delaware, Inc.	(302) 575-0408 ext 102
Florida	Daytona Beach	Central Florida Legal Services, Inc.	(386) 255-6573
Florida	Florida City	Coalition of Florida Farmworker Organizations, Inc.	(305) 246-4779
Florida	Gainesville	Three Rivers Legal Services, Inc.	(352) 372-0519
Florida	Miami	Legal Services of Greater Miami, Inc.	(305) 576-0080 ext 507
Florida	Pensacola	Northwest Florida Legal Services, Inc.	(850) 432-3999
Florida	Tallahassee	Legal Services of North Florida	(850) 385-9007
Florida	Tampa	Bay Area Legal Services, Inc.	(813) 232-1222 ext 144
Georgia	Atlanta	Georgia State Foundation	(404) 651-1412
Georgia	Atlanta	Morehouse College	(404) 681-2800
Georgia	Atlanta	Atlanta One Stop Capital Shop, Inc.	(404) 853-7671
Georgia	Hinesville	JC Visions and Associates, Inc.	(912) 877-4243
Hawaii	Honolulu	Hawaii Pro Bono Lawyer Project Legal Services of Hawaii	(808) 528-7051
Hawaii	Honolulu	Legal Aid Society of Hawaii	(808) 527-8058
Idaho	Moscow	University of Idaho	(208) 885-6541
Illinois	Chicago	Loyola University Chicago School of Law	(312) 915-6426
Illinois	Chicago	Korean American Resource & Cultural Center	(773) 506-9158
Illinois	Chicago	Tax Assistance Program- It Adds Up	(312) 822-0595
Illinois	Chicago	Illinois Institute of Technology	(312) 906-5070
Illinois	Chicago	Center for Economic Progress	(312) 252-0280 ext 280
Indiana	Columbus	Su Casa Columbus	(812) 375-9370
Indiana	Indianapolis	Neighborhood Christian Legal Clinic	(317) 415-5337
Indiana	Valparaiso	The Lutheran University Association d.b.a. Valparaiso University	(219) 465-7903
Iowa	Des Moines	Iowa Legal Aid	(515) 243-2151
Kansas	Emporia	Emporia State University	(620) 341-5693
Kansas	Kansas City	El Centro, Inc.	(913) 281-1186
Kansas	Lawrence	University of Kansas Legal Services for Students	(785) 864-5665
Kentucky	Highland Heights	Northern Kentucky University	(859) 572-6124
Kentucky	Louisville	Legal Aid Society, Inc. (Volunteer Lawyer Program)	(502) 584-1254
Louisiana	Baton Rouge	Southern University Law Clinic	(225) 771-3333
Louisiana	New Orleans	New Orleans Legal Assistance Corporation	(504) 529-1000
Maine	Portland	Pine Tree Legal Assistance	(207) 942-8241
Maryland	Baltimore	Maryland Volunteer Lawyers Service	(410) 539-6800

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Low Income Taxpayer Clinics (LITCs)

Maryland	Bowie	National Tax Clinic, Inc.	(301) 249-8820
Massachusetts	Boston	Greater Boston Legal Services	(617) 371-1234
Massachusetts	Lynn	Neighborhood Legal Services, Inc.	(781) 599-7730
Massachusetts	New Bedford	Southeastern Massachusetts Legal Assistance Corp.	(508) 586-2110
Massachusetts	Somerville	Community Action Agency of Somerville, Inc.	(617) 623-7370
Massachusetts	Waltham	Bentley College	(781) 891-2170
Michigan	Detroit	Accounting Aid Society	(313) 647-9620
Michigan	East Lansing	Michigan State University-Detroit College of Law	(517) 336-8084
Michigan	Flint	Legal Services of Eastern Michigan	(810) 234-2621
Minnesota	Minneapolis	Mid-Minnesota Legal Assistance	(612) 332-1441
Minnesota	Minneapolis	Regents of the University of Minnesota	(612) 625-5515
Mississippi	Hattiesburg	Southeast MS Legal Services Corporation	(601) 545-2950
Mississippi	Oxford	North Mississippi Rural Legal Services	(662) 627-4184
Missouri	Kansas City	Budget and Financial Management Assistance	(816) 221-2034
Missouri	Kansas City	University of Missouri Kansas City/KC Tax Clinic	(816) 235-6201
Missouri	Springfield	Southwest Missouri State University	(417) 836-5414
Montana	Missoula	Montana Legal Services Association	(406) 543-8343
Nebraska	Lincoln	Nebraska Legal Services	(877) 250-2016
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Comments from the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 17, 2003

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues Team
U.S. General Accounting Office
441 G. Street, N.W.
Washington, DC 20548

Dear Mr. Brostek:

I am pleased your report, *Earned Income Credit: Qualifying Child Certification Test Appears Justified, But Evaluation Plan Is Incomplete* (GAO-03-794), recognizes the usefulness of our planned EITC certification test. We have worked extremely hard to design the test and to incorporate feedback from numerous stakeholders. I believe the test will produce a large amount of useful information that will enable the IRS to improve the way we administer the EITC program. Though your point that our evaluation plan is a work in progress is accurate, I believe this condition is to be expected at this point in our implementation planning.

I am particularly pleased you identified some of the work the IRS has done in developing the certification pilot, including:

- Designing the program to focus on known sources of noncompliance and on only those taxpayers whose qualifying child eligibility we cannot verify from available information and on those taxpayers most likely to make errors.

- Taking steps to address all of the concerns you have raised in your review of the existing recertification program. In particular, we have clarified the documentation requirements, developed a standard form, expanded documentation options, and centralized certification processing to help ensure consistent treatment of claimants.

- Attempting to minimize taxpayer burden and improve EITC compliance by obtaining input from external and internal stakeholders that resulted in changes that should reduce the burden on those eligible taxpayers who are selected to certify.

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- Undertaking more steps than usual to ensure the residency form and other explanatory documents for the certification program have been reviewed by those who would use them.

While the focus of your report is the certification pilot, the pilot is only one part of an integrated 5-point initiative that also includes: (1) reducing the backlog of pending EITC examinations to ensure that eligible taxpayers receive their refunds quickly, (2) reviewing the existing audit process to minimize the burden on taxpayers and improve the quality of communications with taxpayers, including notices, (3) increasing outreach efforts to encourage more eligible taxpayers to claim the EITC and to ensure that the requirements for claiming the credit are clearly understood, and (4) enhancing compliance efforts toward taxpayers who claim the credit but are ineligible because their income is too high. This last item includes the filing status and income misreporting proposals that, along with qualifying child certification, comprised a holistic approach to address the three major sources of EITC non-compliance.

Recommendation that the Commissioner of Internal Revenue accelerate the development of IRS's plans to evaluate the certification test. You correctly observe that we have adequate but limited time to finalize the plan. We have considered the components you have suggested are needed for a robust plan. We are working to bring those components together well before the certification pilot begins in January 2004. We will make sure that the objectives of the evaluation plan are clearly articulated, that all necessary data and perspectives are captured, and that all explicit assignments and timeframes are established for the completion of the components of the evaluation.

To provide a more complete picture of the evaluation plan efforts made to date, we have included an enclosure that contains a description of additional evaluation plan information that was not included in your report.

We will also incorporate, where appropriate, your suggestions and the suggestions of the third party that will be independently reviewing the evaluation plan. Mark Mazur, Director, Research, Analysis and Statistics, is the IRS official responsible for the evaluation plan.

Finally, we have one comment on Appendix I, which lists five types of misreported income estimated by the IRS for 1992. You compare these figures to estimates of EITC non-compliance for 1999. We note, however, that the percentage of EITC non-compliance presented in the 1999 Compliance Study is not comparable to the percentages of misreported income listed in Appendix I. The EITC overclaim rate is the dollar amount erroneously paid divided by the dollar amount *actually* paid. In contrast, the estimated non-compliance percentages listed in Appendix I are net misreporting percentages, defined as the net amount of income erroneously reported divided by the total amount of income

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that *should* have been reported. Therefore, these figures are not strictly comparable.

If you have any questions, or if you would like to discuss this response in more detail, please contact David R. Williams, who was recently designated to lead this critically important integrated EITC initiative, at (202) 622-5440.

Sincerely,

Mark W. Everson

Enclosure

Additional Program Evaluation Planning Activities Not Discussed in the GAO Draft Report

The IRS draft evaluation plan provides a framework for both a quantitative analysis of *what* the selected claimants experience throughout the certification process and a qualitative analysis of *why* they have those experiences. The IRS will perform the quantitative analysis using data that it will collect throughout the certification pilot, and a third-party contractor will perform the qualitative analysis through surveys. The IRS continues to refine the evaluation framework to reflect modifications to the certification pilot and to provide greater detail about the execution of the evaluation plan. The GAO discussion of the evaluation framework is essentially accurate, but it does not include important information about the planning that has already occurred and continues to occur that will result in the specificity that IRS and GAO agree are needed before the certification process test commences in January 2004.

The GAO states that the draft evaluation plan identifies a threshold question of "whether the claimant selected for the test provided the required information to allow IRS to determine the eligibility of the qualifying children regardless of whether the claimant was determined eligible or not." The GAO seems to agree that the IRS sufficiently developed an evaluation plan to answer that question.
The GAO, however, does not include the information that the IRS will capture to address this and numerous other relevant questions. This information includes:

- Claimant characteristics
- Qualifying child eligibility
- Point in time when a claimant attempts to certify
- Number of times a claimant attempts to certify
- Iterations to successfully certify
- Reasons for iterations
- Time elapsed from receipt of claimant certification information to IRS eligibility determinaiton
- Documentation submitted by the claimant to certify
- Ability to successfully certify

The evaluation plan explains that this information will be available on an on-going basis, but that statistically precise information will not be available until the selected taxpayers' residency eligibility is finally determined. The plan also provides for analysis of the data to be produced approximately every two months. Thus, information will be available at the end of March for those taxpayers who file early and by the end of May for those taxpayers who filed at any point in the filing season.

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The plan also states that IRS will analyze data about selected taxpayers who have not responded to the certification notice. The IRS analysis will include data to discern whether the claimant had a filing requirement and whether EITC eligibility or ineligibility is apparent from available IRS information.

The GAO states that the IRS must answer additional questions, beyond the threshold question, to determine whether residency certification reduces EITC overclaims, specifically: (1) why a taxpayer does not attempt to certify or why he or she is unable to do so and (2) how burdensome is the certification requirement. We believe the plan and corresponding data that the IRS intends to capture will provide the information to address these and other relevant questions.

As GAO acknowledges, the IRS will:

- Compare the experiences of the taxpayers selected for certification to a control group of taxpayers (with similar characteristics to the certification pilot group)
- Evaluate all available data to discern information about those claimants who do not attempt to certify or chose not to claim EITC.
- Use a third-party to gather information through a survey of a sample of taxpayers selected for certification (including both taxpayers who attempt to certify and those who do not) to understand why taxpayers are unwilling or unable to certify and to determine the burden imposed by the certification process.

The IRS has prepared a draft survey plan as an aid to the third-party contractor, who would conduct the survey. This plan includes over 40 questions, including specific questions about why taxpayers did or did not certify; the cost, time, money and difficulty involved in obtaining documentation; and the availability of IRS and other assistance. As we have explained to GAO, we cannot actually contract for the survey until we know funds will be available for this purpose in the FY04 budget.

The evaluation plan provides for the IRS to collect data in July or August 2004 for those claimants who fail to certify and fail to claim EITC. In addition, the draft survey plan likewise discusses when the third-party would contact taxpayers. Specifically, the survey plan states that the contractor could begin surveying some claimants as soon as their returns have been processed and certification determinations made. It also recognizes that some surveys cannot begin until after the filing season. Because taxpayers can submit their documentation throughout the filing season, we will not know until after the filing season ends whether a taxpayer has been unwilling or unable to certify. Similarly, a taxpayer who delays certification until the end of the filing season will not be able to discuss how burdensome the process was until after he or she has actually undergone that process.

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We have refined the certification pilot in response to internal and external stakeholder comments. We are also refining the evaluation plans to ensure they reflect the changes to the certification pilot. This will, of course, include modifications to the data being captured and the schedule for the analyses. We advised GAO that, in response to public comments, we have arranged to have an independent third party review the evaluation plan (including the sample selection) to ensure that the pilot and evaluation will allow us to effectively assess the residency certification process. This third-party review will be similar in scope to third-party review of the National Research Program.

GAO Contacts and Staff Acknowledgments

GAO Contacts

Michael Brostek (202) 512-9110
Joanna Stamatiades (404) 679-1984

Acknowledgments

In addition to those named above, Tiffany Brown, Evan Gilman, Veronica Mayhand, Kathryn Larin, David Lewis, Donna Miller, Libby Mixon, Cheryl Peterson, and Tom Short made key contributions to this report.

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