

GAO

Report to the Chairman, Committee on  
Ways and Means, House of  
Representatives, and to the Honorable  
Larry E. Craig, U.S. Senate

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July 1998

# EARNED INCOME CREDIT

## IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance



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

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**General Government Division**

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July 28, 1998

The Honorable Bill Archer  
Chairman, Committee on Ways and Means  
House of Representatives

The Honorable Larry E. Craig  
United States Senate

In April 1997, the Internal Revenue Service (IRS) published the results of its tax year 1994 Earned Income Credit (EIC) compliance study. The study showed that of \$17.2 billion in EIC claimed during the study period, taxpayers overclaimed about \$4.4 billion, or about 26 percent. In response to your request, we (1) evaluated IRS' study methodology to determine if the reported results were reasonably accurate, (2) identified the primary sources of EIC noncompliance<sup>1</sup> found in the study, and (3) determined whether recent IRS compliance efforts are designed to address the primary sources of noncompliance.

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## Results in Brief

IRS' estimate of \$4.4 billion in EIC overclaims has a 95 percent confidence interval of \$4.0 billion to \$4.9 billion. Our evaluation of the study methodology showed that the estimate is reasonably accurate and representative of EIC claimants filing between January 15 and April 21, 1995. Some aspects of the study methodology affected the precision of the results; but, given the scale of the findings, these limitations do not affect the study's message or its usefulness in designing compliance approaches.

Although it is a reasonable estimate of EIC overclaims, the entire \$4.4 billion should not be viewed as potential savings to the government had IRS somehow been able to prevent or correct all of these EIC errors. For returns filed with an EIC claim, the tax year 1994 study was designed to evaluate taxpayers' compliance with each EIC eligibility filing requirement, to produce an overall estimate of EIC amounts claimed in error, and to identify the sources of these errors. The study was not designed to detect or quantify EIC claims that taxpayers could have made but did not. For example, the \$4.4 billion overclaim estimate includes about \$780 million in overclaims associated with errors in applying the "adjusted gross income (AGI) tiebreaker" rule. That rule provides that if a child meets the conditions to be a qualifying child of more than one person, only the person who had the highest AGI may treat that child as a qualifying child.

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<sup>1</sup>"Noncompliance," as used in this report, includes errors caused by taxpayer mistakes, negligence, or fraud. Determining whether an EIC claim is fraudulent requires knowing the taxpayer's intent, which is difficult to prove.

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As the 1994 study was designed, if IRS determined under the AGI tiebreaker rules that a person claiming the EIC was not entitled to it because there was another person in the household with a higher income, IRS would disallow the claim and include it as an overclaim in computing the study results. However, because these overclaims are not offset by any claim that could have been made by the other person involved in the tiebreaker, the ultimate savings to the government could be less than \$780 million.

The largest source of taxpayer error identified by the tax year 1994 study relates to EIC requirements that are difficult for IRS to verify—those related to eligibility of qualifying children. Taxpayer returns with qualifying child errors accounted for about two-thirds of the \$4.4 billion in overclaims. Failure to meet the child residency test (living with the taxpayer for more than 6 months, or 1 year if a foster child) was the most common of the qualifying child errors, followed by errors in applying the AGI tiebreaker rules.

Unlike income transfer programs such as Temporary Assistance for Needy Families and Food Stamps, the EIC was designed to be administered through the tax system.<sup>2</sup> This choice generally should result in lower administrative costs and higher participation rates and emphasizes that the credit is for working taxpayers. The trade-off, however, is higher noncompliance. EIC eligibility, particularly related to qualifying children, is difficult for IRS to verify through its traditional enforcement procedures, such as matching return data to third-party information reports. Correctly applying the residency test and AGI tiebreaker rules, for example, often involves understanding complex living arrangements and child custody issues. Organizations that administer programs like Food Stamps are set up to investigate and verify this type of eligibility before payment is made; IRS is not. Thoroughly verifying qualifying child eligibility basically requires IRS to do an audit of the type done in the EIC compliance studies—a costly, time-consuming, and intrusive proposition. IRS has designed some compliance efforts to reduce qualifying child noncompliance but cannot fully address a significant root cause—design of the EIC itself.

With new enforcement tools provided by Congress and an increase in funding specifically designated for EIC-related activities, IRS began implementing in fiscal year 1998 a plan that, over a period of 5 years, calls for attacking EIC noncompliance through expanded customer service and public outreach, strengthened enforcement, and enhanced research.

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<sup>2</sup>As a refundable tax credit, EIC amounts in excess of tax liability paid through the income tax system are transferred to taxpayers through an income tax refund.

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Together, these activities make up the “EIC compliance initiative.” Many parts of that initiative are targeted at the primary sources of EIC noncompliance identified in the tax year 1994 compliance study. Most of the efforts that make up the EIC compliance initiative had not progressed far enough at the time we completed our audit for us to make any judgment about their effectiveness. However, in reviewing IRS’ efforts for tax year 1997, we identified several implementation issues that could diminish the initiative’s impact. For example, EIC claimants often file quite early in the filing season because they receive sizable refunds; however, IRS offered several of its EIC-related customer service programs during the 1998 filing season after many EIC claimants had already filed their returns.

IRS plans to measure the overall impact of the compliance initiative on the overclaim rate<sup>3</sup> through annual studies of EIC compliance starting with a baseline study of tax year 1997 returns. However, the 5-year initiative could be into its fourth year before IRS has tax year 1997 and 1998 study data to compare in assessing the initiative’s results. That would be too late for IRS to identify and implement meaningful adjustments to the initiative. IRS also plans to measure the results of individual initiative components implemented in 1998, but some of these results will not be available for initial planning of fiscal year 1999 activities.

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## Background

The EIC is a refundable tax credit available to low-income, working taxpayers. Congress created the credit in 1975 to offset the impact of Social Security taxes on low-income families and encourage low-income workers to seek employment rather than welfare.

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## EIC Eligibility

The amount of a taxpayer’s credit depends on the number of qualifying children who meet age, relationship, and residency tests and on the nature and amount of qualifying income.

Taxpayers with children can claim the EIC if they (1) have at least one EIC qualifying child,<sup>4</sup> (2) meet income tests, (3) file with any filing status except “married filing separately,” and (4) were not a nonresident alien for any part of the year. To claim the EIC without a qualifying child, taxpayers

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<sup>3</sup>The overclaim rate refers to the amount of EIC overclaimed divided by the amount of EIC claimed on taxpayer returns, corrected for math errors.

<sup>4</sup>Complex living arrangements, such as when two unrelated families share a home or when divorced parents have joint custody of a child, often make it difficult to determine who can claim a child for the EIC.

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have to meet requirements 2, 3 and 4, be at least 25 but less than 65 at the end of the year, have lived in the United States for more than half the year, and must not be claimed as a dependent on another return.

The credit amount gradually increases with increasing income, plateaus at a maximum amount, and then gradually decreases (in a “phase-out range”) until it reaches zero when the taxpayer’s earned income or AGI exceeds the allowable maximum. Taxpayers with AGI falling in the credit’s phase-out range are to receive the lesser amount resulting from using their earned income or AGI in calculating the credit.

Recently, Congress made changes to EIC eligibility rules in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193) and the Taxpayer Relief Act of 1997 (P.L. 105-34). These changes, affecting returns filed for tax year 1996 and after,

- denied the EIC to any taxpayer with investment income over a certain threshold (\$2,250 for tax year 1997);<sup>5</sup>
- defined a “modified AGI” to be used in calculating the credit that excludes certain losses from investments and businesses;<sup>6</sup>
- denied the credit to taxpayers without valid Social Security numbers (SSN);<sup>7</sup> and
- excluded certain workfare payments<sup>8</sup> from wages for EIC purposes.

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<sup>5</sup>The investment income exclusion is basically an indirect wealth test intended to eliminate certain taxpayers from the EIC program. Investment income includes taxable and nontaxable interest, taxable dividends, net rent and royalty income derived from sources outside the taxpayer’s ordinary course of trade or business, capital gain net income, and passive activity net income. This provision was effective beginning in tax year 1996 with a threshold of \$2,200. The threshold is to be indexed for inflation and was increased accordingly to \$2,250 for tax year 1997.

<sup>6</sup>Effective beginning in tax year 1996, modified AGI for the purposes of the EIC meant AGI determined without regard to (1) net capital losses, (2) net losses from trusts and estates, (3) net losses from rents and royalties derived outside the taxpayer’s normal course of trade or business, and (4) 50 percent of net losses from trades or businesses. The losses subject to the 50-percent exclusion are to be computed separately with respect to sole proprietorships other than farming, farming sole proprietorships, and other trades or businesses. Effective for tax year 1998, taxpayers are required to add to modified AGI (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements if not rolled over into similar vehicles during the applicable rollover period. Also beginning with tax year 1998, the disregarded amount of net losses from trades or businesses increased from 50 percent to 75 percent with the same computation rules.

<sup>7</sup>Taxpayers were already required to provide valid SSNs for qualifying children.

<sup>8</sup>Generally, under the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, the receipt of certain government assistance payments is denied unless the recipient meets certain work requirements. Wages earned through state-subsidized work experience and community service programs are referred to as “workfare payments” and are excluded from earned income for the purposes of the EIC.

Table 1 compares the maximum EIC amounts and income limits for tax years 1994 and 1997.

**Table 1: Maximum EIC Amounts and Income Limits for Tax Years 1994 and 1997**

| Number of EIC qualifying children | Tax year 1994      |                          | Tax year 1997      |                          |
|-----------------------------------|--------------------|--------------------------|--------------------|--------------------------|
|                                   | Maximum EIC amount | Maximum allowable income | Maximum EIC amount | Maximum allowable income |
| None                              | \$306              | \$8,999                  | \$332              | \$9,769                  |
| One                               | 2,038              | 23,754                   | 2,210              | 25,759                   |
| Two                               | 2,528              | 25,295                   | 3,656              | 29,289                   |

Source: IRS EIC tables.

## How IRS Detects and Pursues Noncompliant Returns

IRS checks individual returns, with and without the EIC, for compliance while the return is initially being processed and in the months after filing. Some noncompliance involves mathematical errors and other obvious mistakes made by taxpayers or their representatives in preparing the returns. Other noncompliance involves mistakes that can be detected only through an audit of the return.

The easiest EIC mistakes to identify and correct are those that IRS classifies as math errors. These errors, identified as the return is processed, include EIC computation errors and certain qualifying errors (e.g., missing SSNs for taxpayers and their children).<sup>9</sup> For returns filed on paper, staff in IRS' service centers are to enter tax return and Schedule EIC data into computers that check for math errors. If a math error that affects EIC eligibility or the size of the EIC claim is found, IRS is to reduce or deny the EIC accordingly. IRS is to then send a notice to the taxpayer explaining the change to his or her tax liability and refund. Taxpayers have 60 days to protest IRS' actions, either in writing or by telephone, and to provide additional data supporting their original claims. If taxpayers do not respond to IRS' notice, they are to get no further correspondence from IRS about that matter unless they fail to pay any additional tax that was assessed as a result of IRS' change.

<sup>9</sup>Until the 1997 filing season, SSN errors were not considered math errors and had to be corrected using the examination procedures discussed at the end of this section. In 1997, as a result of a provision in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, IRS began treating missing or incorrect SSNs as math errors, similar to the way it had historically handled computational mistakes.

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Returns that taxpayers attempt to submit electronically are subject to a series of computerized “filters” that screen the submission for accuracy and completeness. Submissions with computational mistakes or missing or invalid data are to be rejected. A taxpayer whose electronic submission has been rejected can either correct the mistake(s) and resubmit the electronic return or file the return on paper (with or without the corrections). If filed on paper, the return would be subjected to the math error procedures described in the preceding paragraph.

The most serious form of noncompliance involves deliberate attempts to defraud the government through, for example, phony refund claims. IRS’ primary effort to identify fraudulent refund claims, including those involving the EIC, is the Questionable Refund Program (QRP), established in the 1970s and run by IRS’ Criminal Investigation Division. Using a scoring system based on known noncompliance patterns, an IRS computer program analyzes all incoming returns to identify those that are potentially fraudulent. Then, questionable refund detection teams in the 10 service centers are to perform more in-depth reviews and, if a return is considered fraudulent, stop any refund before it is issued.

IRS’ examination units in service centers and district offices review other potentially erroneous EIC claims that do not meet the criteria for inclusion in the math error or questionable refund programs. Service center staff review cases that do not require face-to-face contact with the taxpayer. Cases requiring face-to-face contact are done by district offices. Questionable refund detection teams are to refer cases with EIC errors that are not considered fraudulent to the examination units. Examination staff may also review cases included in special enforcement or compliance research projects. When examination staff determine that an EIC claim is erroneous, they are to notify the taxpayer of that finding and advise the taxpayer of his or her appeal rights. If the taxpayer agrees with IRS’ finding or disagrees with the finding but fails to overturn it on appeal, the claimed EIC is to be disallowed or adjusted in accordance with the examiner’s findings.

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## IRS’ EIC Compliance Studies

IRS has undertaken a series of EIC compliance studies in recent years. In the first study, IRS sampled returns with EIC claims that had been filed electronically during a 2-week period in January 1994. The results, which could be generalized only to electronic returns filed during that 2-week period, showed that 39 percent of the returns involved overstated EIC claims that represented 26 percent of the dollars claimed. To learn more

about EIC compliance, IRS conducted a broader study of tax year 1994 returns filed both electronically and on paper. The results of that study, released in April 1997, are the subject of this report. In 1996, IRS began a third study involving tax year 1995 returns. As of June 1998, IRS had not completed its analysis of the data from that study. All three of these EIC compliance studies predated the SSN-related math error procedures that were first implemented in 1997. However, as noted later, IRS adjusted the findings of its tax year 1994 study to show what the noncompliance rate would have been if those procedures had been in place then.

As part of a 5 year EIC compliance initiative begun in fiscal year 1998 and discussed later in this report, IRS plans to measure its progress in reducing the EIC overclaim rate through annual studies of returns filed with an EIC claim. According to IRS, the first study of about 2,500 tax year 1997 EIC returns filed from January through May 1998 is designed to provide a baseline measure of the validity of EIC claims and types of EIC errors. IRS' time line for the study shows that it expects to have a final report prepared by December 31, 1999.<sup>10</sup> The results of subsequent studies are to be compared with that baseline to identify changes in EIC compliance.

## Objectives, Scope, and Methodology

Our objectives were to (1) evaluate IRS' tax year 1994 EIC compliance study methodology to determine if the reported results were reasonably accurate, (2) identify the primary sources of EIC noncompliance found in that study, and (3) determine whether recent IRS compliance efforts are designed to address the primary sources of noncompliance.

To evaluate IRS' study methodology and the accuracy of IRS' compliance study results, we reviewed written documentation on the study's methodology, reviewed 122 case files,<sup>11</sup> interviewed IRS and Treasury officials involved in the study, reviewed computer programs written by IRS and Treasury's Office of Tax Analysis (OTA) that were used to create and edit the final dataset, and calculated confidence intervals for the data presented in IRS' April 1997 report. To assess IRS' methodology, we determined whether IRS used generally accepted social science standards,

<sup>10</sup>In commenting on a draft of this report, IRS officials told us they plan to issue an interim report earlier in 1999 based on preliminary data they expect to be available by the end of 1998.

<sup>11</sup>Our objectives in reviewing study case files were to improve our general understanding of how the study cases were audited, to research case-specific data questions raised during our initial analyses, and to verify corrections and additions to the data made by Department of the Treasury staff. Given these objectives, we judgmentally selected 122 cases to review. Because Treasury did extensive internal consistency testing on the data, we did not verify data entry on a statistical sample of returns; rather, we verified data entry for key variables on these 122 returns.

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which include the use of (1) unbiased sample selection procedures, (2) data collection controls, (3) procedures to ensure quality of data used, and (4) appropriate statistical procedures to generalize the data gathered and analyzed. In doing so, we considered the following questions:

- Does the study population appear to represent the population of all EIC filers during the period from January 15 through April 21, 1995?
- Was the sample drawn in accordance with probability selection principles?
- Were sufficient data verifying compliance with all EIC eligibility requirements collected from the EIC claimant and other sources?
- Were IRS staff collecting the data knowledgeable of how to apply EIC eligibility rules?
- Did the data collection procedures include controls to help ensure consistency in the evaluation of cases?
- Was data entry into the final database verified?
- Was the database checked for internal consistency, outliers, and invalid codes?
- How precise were the reported overclaim estimates?

We also reviewed available data on IRS' design of the tax year 1997 EIC compliance study to see how, if at all, that study addressed problems we identified with the tax year 1994 study.

To determine the primary sources of EIC noncompliance on tax year 1994 returns, we analyzed the tax year 1994 study dataset as provided by IRS and modified through OTA editing programs. All data are estimates based on the study sample. Accordingly, we calculated confidence intervals at the 95 percent confidence level to indicate the precision of the estimates. Unless otherwise noted, the confidence intervals for percentages are  $\pm 5$  percentage points or less; for other statistics, the intervals are  $\pm 10$  percent or less of the reported value.

To determine whether recent IRS compliance efforts addressed the primary sources of noncompliance, we

- reviewed IRS documents to identify the scope of EIC-related activities and related implementation plans;
- interviewed officials responsible for designing and implementing EIC-related activities at IRS' National Office, its Brookhaven, Cincinnati, and Fresno Service Centers, and its Northern California District Office; and
- obtained available data on the results of EIC programs.

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We did our work from September 1997 through May 1998 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Commissioner of Internal Revenue and the Secretary of the Treasury, or their designees. The Commissioner of Internal Revenue and Treasury Deputy Assistant Secretary (Tax Analysis) responded in letters dated July 2, 1998, and June 29, 1998, respectively. Their comments are summarized at the end of this letter and are reprinted in appendixes I and II. On July 1, 1998, we met with IRS officials, including the Deputy Chief of Operations, the Acting Assistant Commissioner for Customer Service, and the Assistant Commissioner for Research/Statistics of Income, to discuss the Commissioner's comments. In addition, IRS and OTA provided technical comments on our draft. We made changes to the report in response to the comments where appropriate.

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## IRS' Tax Year 1994 EIC Study Methodology Followed Generally Accepted Social Science Standards

IRS found that of \$17.2 billion in EIC claimed during the January 15 to April 21, 1995, study period, taxpayers overclaimed \$4.4 billion, or 25.8 percent of total EIC claimed.<sup>12</sup> To determine whether this \$4.4 billion overclaim estimate is reasonably accurate, we evaluated IRS' study methodology. Our evaluation was based on the extent to which IRS used generally accepted social science standards for a research project of this kind. These standards include use of (1) unbiased sample selection procedures, (2) data collection controls, (3) procedures to ensure quality of data used, and (4) appropriate statistical procedures to generalize the data gathered and analyzed.

Before discussing our analyses, however, it is important to put IRS' study findings in perspective. For returns filed with an EIC claim, the tax year 1994 study was designed to evaluate taxpayers' compliance with each EIC eligibility filing requirement, to produce an overall estimate of EIC amounts claimed in error, and to identify the sources of error. The study was not designed to detect or quantify EIC claims that taxpayers could have made, but did not. For example, the \$4.4 billion overclaim estimate includes

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<sup>12</sup>The study does not reflect IRS procedures initiated in the 1997 filing season that allowed IRS, under math error authority, to reduce or deny EIC claims on returns filed with missing or invalid SSNs for qualifying children. According to IRS and OTA analysis, had this SSN math error authority been available when taxpayers filed their 1994 returns, overclaims would have been reduced by about \$814 million and the overclaim rate would have been about 21 percent. According to OTA, this estimate does not include overclaims that could have been detected if the taxpayer did not provide a valid SSN for a child under the age of 1; such errors could not be detected using the tax year 1994 study data because taxpayers were not required to provide SSNs for infants. Also according to OTA, the estimate does not include overclaims associated with invalid SSNs for primary or secondary taxpayers, because the data provided by IRS regarding invalid SSNs did not include this information.

about \$780 million in overclaims associated with errors in applying the AGI tiebreaker rule. That rule provides that if a child meets the conditions to be a qualifying child of more than one person, only the person who had the highest AGI may treat that child as a qualifying child. As the 1994 study was designed, if IRS determined under the AGI tiebreaker rules that a person claiming the EIC was not entitled to it because there was another person in the household with a higher income, IRS would disallow the claim and include it as an overclaim in computing the study results. However, because these overclaims are not offset by any claim that could have been made by the other person involved in the tiebreaker, the ultimate savings to the government could be less than \$780 million.

With this basic limitation in mind, we found that overall, IRS' study was designed and conducted in such a way that it produced a reasonably accurate estimate of noncompliance on returns filed with an EIC claim. Although some issues with the study design affected the precision of the results, our analysis showed that these limitations did not affect the study's major message or its usefulness in designing compliance approaches.

## IRS' Study Methodology Supported the Reported Findings

IRS' study is representative of taxpayers filing an EIC claim on a tax year 1994 return filed between January 15 and April 21, 1995.<sup>13</sup> We found that IRS used an appropriate statistical sampling procedure to select the 2,046 returns included in the study,<sup>14</sup> and the sample appears to represent taxpayers who filed an EIC claim during that period. As an indicator of whether the EIC study sample was representative of EIC returns filed during

<sup>13</sup>Based on a comparison to IRS data on EIC returns filed for the full year, the sample represents about 80 percent of EIC returns for tax year 1994. The weighted estimate from the tax year 1994 EIC study showed 15 million EIC returns filed between January 15 and April 21, 1995. The weighted estimate from IRS' Statistics of Income (SOI) sample of all returns filed in 1995 showed 19 million EIC returns. This indicates that about 20 percent of EIC filers for tax year 1994 filed outside the study period. The study's estimate of \$4.4 billion in overclaims does not include overclaims among those 20 percent. If the excluded 20 percent are equally as likely to be noncompliant as the taxpayers represented by the sample, then the overclaim estimate for the entire tax year will be about 20 percent more than reported. If the excluded filers are more or less compliant, then the impact is unknown. IRS' study of tax year 1997 returns extended sampling through May 1998 and should represent an even larger proportion of the EIC filing population for that year.

<sup>14</sup>IRS used a two-stage poststratified systematic sample design. In the first stage, IRS selected .04 percent of electronic and .05 percent of paper EIC returns filed at each service center. The returns were selected after the math errors had been corrected. In the second stage, the selected returns were classified into one of four subgroups, or strata. The strata and sampling rates were (1) 100 percent of male head of household or single filers claiming qualifying children, (2) 25 percent of female head of household or single filers claiming qualifying children, (3) 10 percent of married taxpayers filing jointly or as qualified widow(er)s and claiming qualifying children, and (4) 4 percent of filers claiming the EIC with no qualifying children. The final sample consisted of 2,046 returns—1,250 paper and 796 electronic.

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the study time frame, we assumed that study returns should have characteristics similar to EIC returns filed during the entire year, as measured in IRS' SOI sample of tax year 1994 returns filed throughout 1995. IRS' April 1997 compliance study report compared weighted data on the distribution of claimants by paper or electronic filing, filing status, number of qualifying children, AGI range, and source of income for the study sample and the full tax year 1994 SOI sample. With the exception of the percentage of EIC claimants reporting self-employment income (6.3 percent among taxpayers in the compliance study compared to 15.3 percent of taxpayers in the SOI sample), weighted compliance study data closely paralleled data based on the SOI sample. The apparent underrepresentation of claimants reporting self-employment income is discussed in more detail later.

In evaluating how IRS collected data on the accuracy of taxpayers' EIC claims, we considered the following criteria: (1) whether IRS collected sufficient data to verify each aspect of EIC eligibility, (2) whether field agents and case reviewers knew how EIC rules were to be applied, and (3) whether the study procedures included controls designed to ensure consistency among cases. After reviewing study documentation and selected case files, we concluded that overall, IRS' study methodology met these criteria.

IRS' data collection proceeded in two stages: initial taxpayer interviews and supplemental data collection in the field and a final review of complete case files at the Cincinnati Service Center. For each taxpayer in the study, IRS built a case file including transcripts of prior years' returns, the tax year 1994 return, associated information reports (W-2s and 1099s), information on duplicate use of or invalid qualifying child SSNs, and dates of birth for filers and their children. Field agents were given initial case files containing data available at the time, written instructions on the information required to verify the claim, and checksheets to record findings. These instructions and checksheets covered all aspects of EIC eligibility. Field agents were required to contact, in person, the taxpayer; employers; the transmitter of the electronically filed return, if any; and the paid preparer, if any. If additional information was needed to verify the claim, the agents were to contact neighbors, schools, or state agencies as

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appropriate.<sup>15</sup> This type of face-to-face contact with the taxpayer was necessary to verify the claim because eligibility of qualifying children is self-determined; and, other than SSNs, IRS does not have third-party information that can be used to verify the children's eligibility. Data collection by the field agents was followed by a "best and final" review at the Cincinnati Service Center. These reviewers had access to additional information, primarily third-party income reports, that was not available at the time the field agents contacted the taxpayers. Using this additional information, the reviewers made final decisions regarding disposition of the claim.

Most of the taxpayer interviews and other field data collection were done by IRS special agents from the Criminal Investigation Division or revenue agents from the Examination Division. The service center reviewers were Criminal Investigation Division tax examiners. On the basis of our prior work, we consider these staff generally to be adequately trained in audit techniques and how to apply EIC rules.

IRS' study methodology included controls designed to ensure consistency among cases. IRS used standard data collection checksheets and written instructions as one means to ensure consistent data collection.<sup>16</sup> In addition, after completing an investigation, the field agents were instructed to call a study coordinator at IRS' Cincinnati Service Center to discuss the case. This study coordinator was to review the findings to ensure completeness and consistency with other cases before the case was sent to the Cincinnati Service Center for final review. In spite of these controls, we found one consistency-related issue, regarding the corrected filing status for married taxpayers who erroneously filed as head of household, that may have systematically affected the study findings. This issue is discussed in more detail later.

In reviewing IRS' procedures for ensuring the quality of final study data used, we considered whether IRS (1) verified data entry into the final database; and (2) checked for internal consistency, outliers, and invalid

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<sup>15</sup>In reviewing case files, we found six instances in which the file did not contain all data relevant to the taxpayer's EIC claim. In one case, for example, a taxpayer filed as head of household and claimed a qualifying child. The Cincinnati Service Center reviewer noted in the case file that the agent did not get an SSN for the qualifying child's father, did not find out if anyone else lived in the household, and did not verify that the qualifying child actually resided there. Within our sample, these appeared to be isolated instances, however, and not systematic errors.

<sup>16</sup>Several parallel questions on the field agent and final review checksheets were not always worded the same way, or with the same choices, which led to some inconsistent coding. For example, the field agent checksheet item regarding qualifying child errors did not include a choice for "child does not exist," and initial coding of these situations was inconsistent. In editing the data, IRS and OTA searched for and corrected these types of inconsistencies.

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codes. We found that OTA staff did a comprehensive review of the database to find and correct internal consistency and data transcription errors. This review of the data was necessary because IRS did not verify data entry or check for internal consistency within case records as the database was created.<sup>17</sup> We verified data entry of key variables for the 122 cases included in our case file review and found no data errors. We used the OTA-corrected data for our analysis.

IRS and OTA used the data to estimate the total amount of EIC overclaimed by the population represented by the sample of taxpayers filing EIC claims from January 15 to April 21, 1995. We replicated this analysis and arrived at the same totals. Data from the study are estimates based on the sample of EIC returns. To indicate the precision of these estimates, we calculated confidence intervals at the 95 percent confidence level. For example, as shown in table 2, IRS determined that taxpayers overclaimed a total of \$4,448 million in EIC. The 95 percent confidence interval for this estimate is  $\pm$  \$412 million ( $\pm$  9.3 percent of \$4,448 million). This indicates that we are 95-percent confident that the actual overclaim amount is between \$4,036 million and \$4,860 million. The confidence interval for the 25.8 percent overclaim rate ranges from 23.4 percent to 28.2 percent.

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<sup>17</sup>IRS' tax year 1997 EIC compliance study documents show that IRS plans to use OTA's data verification programs at the time data are entered into the database.

**Table 2: EIC Overclaims on Tax Year 1994 Returns by Number of Qualifying Children Claimed**

Number of returns and dollar amounts in millions

| Number of qualifying children claimed                              | EIC amount as claimed on taxpayer returns |                     | EIC amount overclaimed |                      |
|--|---|---------------------|------------------------|----------------------|
|  | Number of returns                         | Amount              | Number of returns      | Amount               |
| <b>One or two</b>  |   |                     |                        |                      |
| Point estimate   | 12.0                                      | \$16,722            | 4.2                    | \$4,368              |
| 95% confidence interval  | 11.5 - 12.5                               | \$15,908 - \$17,536 | 3.9 - 4.5              | \$3,959 - \$4,777    |
| Confidence interval as a percentage of point estimate <sup>a</sup> | ± 4.2%                                    | ± 4.9%              | ± 7.1%                 | ± 9.4%               |
| <b>None</b>  |   |                     |                        |                      |
| Point estimate   | 3.0                                       | \$513               | 0.5                    | \$81                 |
| 95% confidence interval  | 2.3 - 3.7                                 | \$376 - \$650       | 0.2 - 0.8              | \$24 - \$138         |
| Confidence interval as a percentage of point estimate <sup>a</sup> | ± 23.3%                                   | ± 26.7%             | ± 60.0%                | ± 70.4%              |
| <b>Total</b>   |   |                     |                        |                      |
| Point estimate   | 15.0                                      | \$17,235            | 4.7                    | \$4,448 <sup>b</sup> |
| 95% confidence interval  | 14.2 - 15.8                               | \$16,429 - \$18,041 | 4.3 - 5.1              | \$4,036 - \$4,860    |
| Confidence interval as a percentage of point estimate <sup>a</sup> | ± 5.3%                                    | ± 4.7%              | ± 8.5%                 | ± 9.3%               |

<sup>a</sup>To calculate the confidence interval as a ± percentage of the point estimate, we divided the dollar range of the 95 percent interval by 2 to express it as a ± value, then divided that figure by the point estimate. For example, the 95 percent confidence interval for EIC amounts claimed by taxpayers with one or two qualifying children is \$15,908 to \$17,536 million—a range of \$1,628 million or ± \$814 million from the point estimate. The \$814 million is 4.9 percent of the point estimate.

<sup>b</sup>Total does not add due to rounding.

Source: GAO analysis of IRS' tax year 1994 EIC compliance study data.

As shown in table 2, taxpayers with no qualifying children accounted for only a small portion of the EIC dollars claimed for tax year 1994 and \$81 million of the overclaim total. The 95 percent confidence interval is \$24 million to \$138 million.

Besides the overclaim estimate in table 2, IRS included in its report an estimate of total underclaims by taxpayers filing a tax year 1994 return with an EIC claim.<sup>18</sup> That estimate was \$293 million<sup>19</sup> and has a confidence interval of \$129 million to \$457 million, or ± 56.0 percent of the point estimate. The sample of taxpayers with underclaimed EIC is too small to allow IRS to make reliable estimates by number of qualifying children.

<sup>18</sup>This underclaim estimate applies only to returns filed with an EIC claim. It does not include EIC claims that taxpayers could have made but did not.

<sup>19</sup>The \$4.4 billion overclaim estimate does not net out these underclaims.

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## Minor Methodology Problems Affected the Precision of IRS' Study Results

Through our review of IRS' study methodology, we identified two issues that affected the final study results. These issues are (1) apparent underrepresentation in the sample of claimants reporting self-employment income on a Schedule C and (2) apparent inconsistencies in correcting the filing status of married taxpayers who erroneously filed as head of household. Although we were not able to precisely quantify their net impact, our analysis showed that neither of these issues was large enough in scale to alter the major study findings.

Filers who report self-employment income on a Schedule C appear to be underrepresented in the tax year 1994 EIC study sample. SOI data for all taxpayers who filed in 1995 show that 15.3 percent of EIC claimants reported Schedule C income. In contrast, 6.3 percent of claimants in the EIC compliance study filed a Schedule C. Self-employment income is often not subject to third-party information reporting; consequently, IRS has found that Schedule C filers in general are more likely to misreport their income than are taxpayers with wage income. A change in income, however, will often result in an incremental change in the EIC rather than a full denial. The impact of underrepresenting Schedule C filers in the tax year 1994 study is unknown and depends on how the filers left out of the sample might differ from those included. IRS' ongoing compliance study of tax year 1997 EIC returns includes specific sampling of Schedule C returns and will sample through May; that study should be more representative of Schedule C EIC filers.

Inconsistencies in determining the correct filing status for married taxpayers who erroneously filed as head of household also may have affected the final overclaim estimate. Taxpayers who use a filing status of married filing separately are ineligible for the EIC. Married taxpayers filing a joint return can claim the EIC if their joint income is within the eligible income range and they meet other qualifying criteria. When a taxpayer erroneously claimed head of household and was living with his or her spouse, the data collection instructions for the tax year 1994 study specifically directed field agents to use the filing status most advantageous to the taxpayer, usually married filing jointly (with appropriate changes to income, dependents, exemptions, etc.).

We, and OTA staff who also reviewed case files, found instances in which field agents did not follow these instructions. The \$4.4 billion overclaim estimate included \$631 million<sup>20</sup> accounted for by taxpayers whose filing status was changed by IRS to married filing separately in the absence of

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<sup>20</sup>Confidence interval is  $\pm 29$  percent of the point estimate.

qualifying child errors and whose EIC was denied completely. It appears that some of these taxpayers may have been eligible for the EIC had IRS prepared a joint return; and, to the extent that their joint income would have allowed an EIC claim, the \$631 million may be overstated.<sup>21</sup> Although this filing status issue reduces the precision of the study findings, particularly in terms of identifying sources of noncompliance, we believe its impact to be relatively minor given the size of the total overclaim estimate. IRS data collection instructions for the tax year 1997 study state that field agents should attempt to obtain a copy of the spouse's 1997 return to insert into the case file when filing status is changed to married filing jointly or married filing separately. However, the instructions did not specifically state that married filing jointly should be the presumptive filing status.

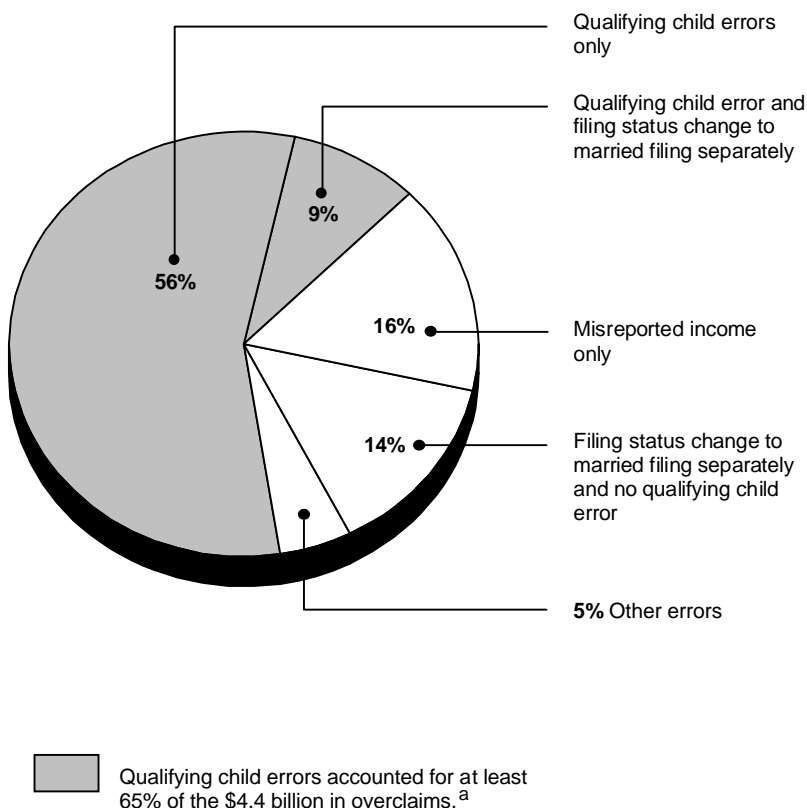
## Largest Source of EIC Overclaims for Tax Year 1994 Was Nonqualifying Children

The largest source of noncompliance found in the tax year 1994 study relates to the EIC requirements most difficult for IRS to verify—those related to the eligibility of qualifying children. As shown in figure 1, taxpayer returns with qualifying child errors accounted for at least 65 percent of the \$4.4 billion in overclaims—56 percent from returns with qualifying child errors only and an additional 9 percent from returns with qualifying child errors made in conjunction with a filing status change to married filing separately.<sup>22</sup> Claiming a child who did not meet residency requirements was the most common qualifying child error, and errors claiming head of household status often occurred with claims for nonqualifying children. Misreported income accounted for another 16 percent of the overclaim total; taxpayers whose filing status was changed to married filing separately, in the absence of qualifying child errors, accounted for most of the remainder.

<sup>21</sup>We do know that of the 423,000 returns (confidence interval  $\pm 20.6$  percent of the estimate) that IRS changed from head of household to married filing jointly, 58 percent (confidence interval  $\pm 11$  percentage points) still qualified for some amount of EIC.

<sup>22</sup>The "other error" category in figure 1 includes some returns with both qualifying child and income errors.

**Figure 1: Sources of EIC Overclaim Errors, Tax Year 1994**



<sup>a</sup>The "other error" category includes some returns with both qualifying child and income errors.

Source: GAO analysis of IRS' tax year 1994 EIC compliance study data.

## Failure to Meet Residency Requirements Was the Predominant Qualifying Child Error

In order for a taxpayer to claim a qualifying child,<sup>23</sup> the following rules applied for tax year 1994.

1. **Relationship:** The child must have been the taxpayer's son, daughter, adopted child, grandchild, stepchild, or eligible foster child. A foster child is defined as any child cared for as the taxpayer's own.<sup>24</sup>

<sup>23</sup>The definition of a qualifying child for the EIC differs from the definition of a dependent used to claim a tax exemption. One major difference is that to claim a dependent, the taxpayer generally must have provided over half the child's support during the calendar year. In contrast, EIC qualifying child eligibility depends on residency and does not include a financial support test.

<sup>24</sup>If the child was married at the end of the year, that child is generally a qualifying child only if the taxpayer can claim the child as a dependent.

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2. Age: The child must have been under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled.
  3. Residence: The child must have lived in the United States with the taxpayer for more than half of the year or the entire year for foster children.<sup>25</sup>
  4. AGI tiebreaker: If a child meets the conditions to be a qualifying child of more than one person, only the person who had the highest AGI may treat that child as a qualifying child. This rule does not apply if the other person is the taxpayer's spouse and they are filing a joint return. For example, if a child meets conditions to be a qualifying child for both a parent and grandparent who share a household and the grandparent has a higher AGI, the grandparent must claim the child. If the grandparent's AGI exceeds the maximum income threshold, neither the parent nor the grandparent may claim the EIC for that child.

As shown in table 3, qualifying child errors were involved in overclaims totaling \$3.1 billion. About \$1.7 billion<sup>26</sup> of that amount involved qualifying children who did not meet the residency test, either alone or in combination with a failure to meet the relationship test. Failure to apply the AGI tiebreaker rules added an additional \$782 million in overclaims. Together, these two types of qualifying child errors accounted for about half of the \$4.4 billion overclaim total. As noted earlier, however, IRS' study did not offset overclaims by claims that could have been made by other taxpayers. For example, in AGI tiebreaker cases, it is possible that the taxpayer with the higher AGI might have been able to claim an EIC. It is also possible in residency cases that a taxpayer in the household where the child actually lives could make an EIC claim for the child in question. The extent to which AGI tiebreaker and residency cases involved an EIC claim that could have been made by another taxpayer, but was not, is unknown.

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<sup>25</sup>A child is considered to have lived with the taxpayer for the full year if the child was born or died during the year and the child lived with the taxpayer for the entire time the child was alive during the year. Beginning in tax year 1995, the EIC was extended to taxpayers living outside the United States because of a military assignment if they meet all other criteria.

<sup>26</sup>Confidence interval is  $\pm 12$  percent of the point estimate.

**Table 3: EIC Overclaims Involving a Qualifying Child Error, by Qualifying Child Test Failed, Tax Year 1994**

Number of returns in thousands, dollars in millions

| Qualifying child test failed | Point estimates for overclaims with a qualifying child error |                            | Confidence interval at the 95% confidence level <sup>a</sup> |                          |
|------------------------------|--|----------------------------|--|--------------------------|
|                              | Returns  | Amount                     | Returns  | Amount                   |
| Residency only               | 1,102  | \$1,470                    | 937 - 1,267  | \$1,238 - \$1,702        |
| AGI tiebreaker only          | 578  | 782                        | 450 - 706  | 585 - 979                |
| Relationship only            | 228  | 324                        | 155 - 301  | 207 - 441                |
| Residency and relationship   | 132  | 181                        | 80 - 184   | 98 - 264                 |
| Other <sup>b</sup>           | 257  | 324                        | 169 - 345  | 204 - 444                |
| <b>Total</b>                 | <b>2,297</b>   | <b>\$3,080<sup>c</sup></b> | <b>2,067 - 2,527</b>   | <b>\$2,740 - \$3,420</b> |

Note: The table includes data for all qualifying child errors, including those made in conjunction with income or filing status errors.

<sup>a</sup>Confidence intervals for overclaim return and amount totals, expressed as percentages, are  $\pm 10$  percent and  $\pm 11$  percent of the point estimates, respectively. Others range from  $\pm 15$  percent to  $\pm 46$  percent.

<sup>b</sup>The "other" category includes qualifying child age errors, unspecified child errors, qualifying children found not to exist, and combinations of errors other than relationship and residency.

<sup>c</sup>Column does not add to total due to rounding.

Source: GAO analysis of IRS' tax year 1994 EIC compliance study data.

## Erroneous Filings as Head of Household Often Occurred With an EIC Overclaim

Filing status per se does not affect either EIC eligibility or credit amounts, except for married taxpayers filing separate returns who are ineligible for the EIC. As shown in table 4, however, head of household errors occurred on returns accounting for \$3.4 billion in overclaims, or about three-quarters of the \$4.4 billion in overclaims on all returns. For taxpayers whose filing status was changed to single, qualifying child errors accounted for most of the overclaims. For taxpayers whose filing status was changed to married filing jointly, most of the overclaims were attributed to income errors. Among taxpayers whose EIC was denied because their filing status was changed to married filing separately, about 40 percent of the overclaim amounts were also associated with qualifying child errors.

**Table 4: EIC Amounts Overclaimed by Taxpayers Erroneously Filing as Head of Household, by Corrected Filing Status, Tax Year 1994**

Dollars in millions

| Head of household filing status changed to: | Point estimates for amount of EIC overclaimed | Confidence interval at the 95% confidence level <sup>a</sup> |
|---|---|--|
| Single                                      | \$1,964                                       | \$1,712 - \$2,216  |
| Married filing jointly                      | 390   | 277 - 503  |
| Married filing separately                   | 1,008   | 792 - 1,224  |
| <b>Total</b>                                | <b>\$3,362</b>                                | <b>\$3,029 - \$3,695</b>                                     |

<sup>a</sup>Confidence intervals expressed as percentages range from  $\pm 10$  percent to  $\pm 29$  percent of point estimates.

Source: GAO analysis of IRS' tax year 1994 EIC compliance study data.

Among all taxpayers who filed as head of household for tax year 1994, regardless of final filing status, male taxpayers had an overclaim rate nearly twice that of female taxpayers.<sup>27</sup> Of \$3.2 billion in EIC claims by male head of household filers, \$1.7 billion, or about 51 percent,<sup>28</sup> was overclaimed. In contrast, female head of household filers overclaimed \$2.0 billion,<sup>29</sup> or about 25 percent,<sup>30</sup> of \$8.2 billion in EIC they claimed.

## Misreported Income Accounted for a Relatively Small Portion of EIC Overclaims

Errors in reporting income, with no other eligibility errors, accounted for \$708 million<sup>31</sup> in EIC overclaims, or 16 percent of total overclaims. Included in this group are taxpayers who (1) used the correct filing status but misreported their income or (2) were married and erroneously filed as head of household or single and whose filing status was changed to married filing jointly. The filing status error, per se, had no impact on the EIC; however, when IRS changed the filing status to married filing jointly and modified the taxpayers' returns to include the correct combined income for both parties, the EIC was often reduced or denied completely.

<sup>27</sup>As the sample returns were selected, IRS used taxpayers' names to determine gender. For those cases in which the taxpayer's gender was not obvious, IRS referred to SOI files, which include gender data. Gender information was confirmed during the taxpayer interview.

<sup>28</sup>Percentage calculated using the actual estimates rather than the rounded numbers presented in this sentence.

<sup>29</sup>Confidence interval is  $\pm 16$  percent of the point estimate.

<sup>30</sup>Percentage calculated using the actual estimates rather than the rounded numbers presented in this sentence.

<sup>31</sup>Confidence interval is  $\pm 27$  percent of the point estimate.

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These adjustments accounted for about \$309 million<sup>32</sup> of the income-related overclaims.

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## Returns Done by Informal Preparers Had a Higher Overclaim Rate

In general, about half of EIC claimants use a return preparer rather than completing the return themselves. Using codes developed by OTA,<sup>33</sup> we grouped prepared returns into the following three categories: those prepared by (1) “formal preparers,” which includes attorneys, Certified Public Accountants, national tax preparation companies, and enrolled agents;<sup>34</sup> (2) “IRS preparers,” which includes staff at IRS walk-in sites and at IRS-supported volunteer organizations like Volunteer Income Tax Assistance and Tax Counseling for the Elderly; and (3) “local or informal preparers,” which includes anyone not in the other two categories.

The study data show that there was little difference in EIC noncompliance between self-prepared returns and those done by preparers. Both groups had overclaim rates of about 26 percent. A more detailed analysis, however, shows that overclaim rates varied by type of preparer. As shown in figure 2, the rate on returns prepared by local or informal preparers was 31 percent; the overclaim rate on returns prepared by formal preparers was 20 percent. The sample included too few IRS-prepared returns to allow us to make a reliable overclaim estimate for that group.

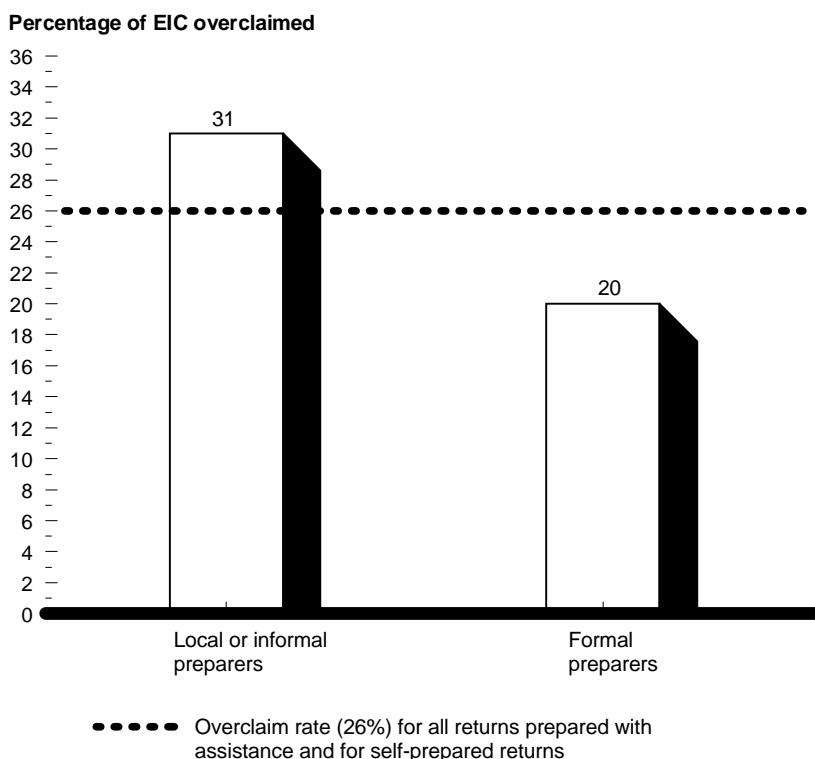
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<sup>32</sup>Confidence interval is  $\pm 34$  percent of the point estimate.

<sup>33</sup>According to OTA, it used two approaches to classify a return as being done by a preparer. Under the first approach, a return was classified as being done by a preparer only if a preparer was indicated on the filer’s return. Under the second approach, a return was classified as being done by a preparer if a preparer was indicated on the filer’s return or if IRS investigators found evidence that a preparer was used. There was little difference in the analysis results between the two groups; for our analysis, we used the second approach.

<sup>34</sup>An enrolled agent is a preparer who has demonstrated special competence in tax matters on a written examination administered by IRS.

**Figure 2: EIC Overclaim Rates for Returns Done by Paid Preparers, by Type of Preparer, Tax Year 1994**



Note: Formal preparers include attorneys, Certified Public Accountants, enrolled agents, and national tax preparation firms.

Source: GAO analysis of IRS' tax year 1994 EIC compliance study data.

## Tax Year 1994 Study Provided Limited Data on Taxpayer Intent

Knowing the extent to which EIC overclaims are due to honest mistakes versus intentional misstatements is important in targeting compliance approaches. If, for example, errors are due to a misunderstanding of EIC rules, taxpayer education and assistance efforts would be warranted. Taxpayers intentionally misclaiming the EIC require different approaches. As part of the tax year 1994 study, IRS made a determination of taxpayer intent. Both field agents and Cincinnati Service Center case reviewers were to classify taxpayers' errors as intentional (e.g., the taxpayer knew that a child did not meet EIC qualifying child tests); or unintentional (e.g., the taxpayer did not understand the eligibility rules or EIC instructions). We found that field agents had not made determinations of intent in about 40 percent of the final overclaim cases. In almost all of these instances, however, Cincinnati reviewers made a determination of intent as part of

their best and final review. Based on best and final case data, about one-half of the 4.7 million returns with an EIC overclaim and two-thirds of the total amount overclaimed were considered to be the result of intentional errors. These assessments are judgmental in nature and should not be considered precise measures of intentional and unintentional taxpayer errors. However, the results do indicate that IRS' compliance efforts should include activities aimed at taxpayers who intentionally misclaim the EIC.

Examiners working tax year 1997 compliance study cases are to collect data related to taxpayer intent. The data collection checklist for that study includes a question asking examiners to decide if errors were due to complexity of the tax form, difficulty understanding the law, a computational error, a potential fraud scheme, or some other reason. This provides more specific choices, particularly for unintentional error, but the determinations of intent will still be judgmental.

## Recent Compliance Efforts Are Aimed at Major Sources of Noncompliance, but It Is Too Early to Measure Their Effect

With new enforcement tools provided by Congress and an increase in funding specifically designated for EIC-related activities, IRS began implementing in fiscal year 1998 a plan that calls for attacking EIC noncompliance through expanded customer service and public outreach, strengthened enforcement, and enhanced research. Together, these activities constitute what we refer to as the "EIC compliance initiative." Many parts of that initiative are targeted at the major sources of EIC noncompliance discussed in the prior section. However, in reviewing IRS' efforts for tax year 1997, we identified several implementation issues that could diminish the initiative's impact.

As we have previously testified before Congress,<sup>35</sup> IRS' ability to reduce EIC noncompliance is limited by the design of the credit. Unlike income transfer programs such as Temporary Assistance for Needy Families and Food Stamps, the EIC is designed to be administered through the tax system rather than through other state or federal agencies. This choice generally should result in lower administrative costs and higher participation rates and emphasizes that the credit is for working taxpayers. The trade-off, however, is higher noncompliance. EIC eligibility, particularly related to qualifying children, is difficult for IRS to verify through traditional enforcement procedures, such as matching return data to third-party information reports. Correctly applying the residency test

<sup>35</sup>Earned Income Credit: Noncompliance and Potential Eligibility Revisions (GAO/T-GGD-95-179, June 8, 1995); and Tax Administration: Earned Income Credit Noncompliance (GAO/T-GGD-97-105, May 8, 1997).

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and AGI tiebreaker rules, for example, often involves understanding complex living arrangements and child custody issues. Organizations that administer programs like Food Stamps are set up to investigate and verify this type of eligibility before payment is made; IRS is not. Thoroughly verifying qualifying child eligibility basically requires IRS to do an audit of the type done in the EIC compliance studies—a costly, time-consuming, and intrusive proposition. IRS has designed some compliance efforts to reduce qualifying child noncompliance but cannot fully address a significant root cause—design of the EIC itself.

Most of the efforts that make up the EIC compliance initiative had not progressed far enough at the time we completed our audit for us to make any judgment about their effectiveness. IRS plans to measure the overall impact of its compliance initiative on the EIC overclaim rate through annual studies of EIC compliance starting with a baseline study of tax year 1997 returns. However, the 5-year initiative could be into its fourth year before IRS has tax year 1997 and 1998 study data to compare in assessing the initiative's results. That would be too late for IRS to identify and implement meaningful adjustments to the initiative. IRS plans to measure the results of individual programs implemented in 1998, but some of these results will not be available for planning fiscal year 1999 activities.

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## Recent Legislation Was Aimed at Reducing EIC Noncompliance

Upon release of IRS' April 1997 report on the results of its tax year 1994 EIC compliance study, the Department of the Treasury announced six legislative proposals directed at reducing EIC noncompliance. Congress included four of the six proposals in the Taxpayer Relief Act of 1997 (TRA97). Specifically, these provisions (1) require paid preparers to fulfill certain due diligence standards when preparing EIC claims for taxpayers; (2) provide that taxpayers who fraudulently claim the EIC can be denied the credit for 10 years, and those who recklessly or intentionally disregard the rules and regulations can be denied the credit for 2 years; (3) provide that taxpayers who are denied the EIC through IRS' deficiency procedures<sup>36</sup> are ineligible to claim the EIC in subsequent years unless they provide evidence of their eligibility through a recertification process; and (4) allow IRS to levy up to 15 percent of unemployment and means-tested public assistance and certain other specified payments. In addition, TRA97 included provisions that (1) give IRS access to the Department of Health and Human Service's (HHS) Federal Case Registry of Child Support Orders, a federal database compiling state information on child support payments

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<sup>36</sup>As defined by IRS, deficiency procedures include administrative procedures, other than procedures related to math or clerical errors, that result in an assessment of a deficiency in tax.

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that could help IRS identify erroneous EIC claims by noncustodial parents; and (2) require the Social Security Administration (SSA) to collect SSNs of birth parents and provide IRS with information linking the parents' and child's SSNs.

Besides the new enforcement tools provided in TRA97, Congress began funding the EIC compliance initiative. For fiscal year 1998, the first year of what is to be a 5-year effort, Congress appropriated \$138 million. For the second year (fiscal year 1999), IRS has requested \$143 million. Funding over the full 5 years is expected to total \$716 million. IRS is using the compliance initiative funds to expand existing EIC-related activities and to initiate several new efforts, including implementation of the TRA97 provisions.

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### **IRS' Efforts Are Targeted at Major Sources of EIC Errors**

The various activities being funded as part of the EIC compliance initiative in fiscal year 1998 fall into three broad categories: (1) customer service and public outreach, (2) enforcement, and (3) compliance research. Primary efforts in each of those categories are listed in table 5.

**Table 5: IRS' EIC Compliance Actions in Fiscal Year 1998**

| <b>EIC-related compliance activities for fiscal year 1998</b>   |  |
|---|--|
| <b>Customer service and public outreach</b>   |  |
| • Expanded telephone access for EIC-related issues to 7 days a week, 24 hours a day   |  |
| • Provided Saturday assistance at more than 150 walk-in sites from March 7 to April 11, 1998  |  |
| • Promoted March 28 as EIC Awareness Day and April 4 and 11 as Problem Prevention days  |  |
| • Took various steps to alert taxpayers and practitioners about changes relating to the EIC   |  |
| <b>Enforcement</b>  |  |
| • Issued notice 97-65 notifying practitioners of new due diligence requirements and allocated 18 staff years to do face-to-face compliance reviews of return preparers  |  |
| • Increased QRP staffing to screen 1.3 million more questionable returns  |  |
| • Increased staffing in correspondence examination program to handle a total of 50,000 EIC case referrals, primarily from the QRP   |  |
| • Increased Criminal Investigation staffing by 40 special agents and 10 aides to investigate potential fraud cases, including those involving return preparers  |  |
| • Issued notices informing more than 383,000 EIC taxpayers that IRS had identified an SSN problem on their tax year 1996 returns and reminding them to correct the problem before filing their tax year 1997 returns          |  |
| • Expanded the EIC math error program to include invalid SSNs for primary taxpayers <sup>a</sup>  |  |
| • Increased staffing to process a total of 25,000 cases involving taxpayers who, after receiving a math error notice denying their EIC claim, protest IRS' action but provide no documentation to substantiate their protests |  |
| • Selected 140,000 returns for audit because of duplicate use of SSNs for EIC qualifying children   |  |
| • Increased staffing to audit about 300,000 tax returns with potential errors claiming head of household filing status and qualifying children  |  |
| <b>Compliance research</b>  |  |
| • Baseline compliance study of tax year 1997 EIC returns  |  |
| • EIC claimant profile study and longitudinal study of EIC claimant filing patterns   |  |
| • Feasibility analysis for using two federal databases as authorized under TRA97: the SSA database linking parent and child SSNs and the HHS Federal Case Registry of Child Support Orders                                    |  |
| • Study of noncompliance among EIC claimants who report income from self-employment   |  |

<sup>a</sup>The "primary" taxpayer is the taxpayer filing the return or, on a joint return, the taxpayer listed first.

Source: IRS EIC compliance initiative documents.

As indicated in table 5 and discussed in more detail below, several components of the EIC compliance initiative are directed at issues that were identified by the tax year 1994 EIC compliance study as major sources of EIC errors.

#### Customer Service and Outreach

To the extent that EIC errors, whether they involve qualifying children requirements, filing status, or misreported income, are unintentional and

due to a misunderstanding of the rules, IRS' customer service and outreach efforts may help improve compliance. IRS data show that many taxpayers took advantage of the expanded customer service IRS offered in 1998. For example, IRS expanded telephone access for EIC-related issues to 7 days a week, 24 hours a day. According to IRS data, 95,000 taxpayers called the EIC assistance lines during the times when IRS' other assistance lines were not available. In addition, IRS provided Saturday walk-in assistance at between 152 and 173 sites from March 7 through April 11, 1998. IRS data show that staff available on these 6 Saturdays helped 2,949 taxpayers prepare their EIC returns and provided 1,032 others with different types of EIC-related assistance. According to IRS, this is in addition to 185,305 EIC taxpayers assisted on weekdays during the filing season.

Some choices IRS made in implementing its assistance and outreach efforts in 1998, however, limited the number of persons who might have benefited. For example:

- IRS did not offer Saturday walk-in assistance until March 7, by which time millions of EIC claims had already been filed. IRS reported that it had received about 7.4 million EIC claims as of February 21, 1998—2 weeks before the first Saturday that walk-in help was available. EIC Awareness and Problem Prevention days were held even later in the filing season. IRS said that it did not offer Saturday service earlier in the year because “prior to receiving the [EIC] appropriation, we had anticipated having Saturday service for only the last six weeks of the filing season” when, according to IRS officials, demand among all filers is generally higher. The date for the EIC Awareness Day was selected so that IRS would have adequate time to publicize and provide for quality service to the public. IRS officials said, in retrospect, it could have been more effective if scheduled earlier.
- IRS did not advertise the 24-hour availability of telephone assistance for EIC-related issues. IRS informed taxpayers of this service only if they received a notice from IRS about a problem with the EIC claims on their tax returns. IRS officials told us that they did not advertise this service because they thought that it would lead to many non-EIC calls during the hours when other assistance lines were closed.<sup>37</sup>

As noted earlier, TRA97 included provisions that allow IRS to deny future EIC claims. These provisions are to be implemented in 1999, based on returns filed in 1998. For example, persons found to have intentionally disregarded the rules and regulations in filing their EIC claims in 1998 can be denied the

<sup>37</sup>This should not be a problem in 1999 when IRS plans to offer 24-hour assistance on all of its telephone assistance lines. In commenting on a draft of this report, IRS said that this expanded service will be advertised in all tax packages and elsewhere.

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credit for the following 2 years. IRS attempted to warn taxpayers about the implication of these provisions before they filed their returns in 1998. Those outreach efforts were intended to create a deterrent effect by providing an incentive for intentionally noncompliant taxpayers to file a correct return and for other taxpayers to be sure that they understand the EIC rules before filing. To the extent that result was achieved, the number of EIC errors may have been reduced. Although we have no way of knowing how successful those warnings were in encouraging better compliance, we believe that the chances for success might have been enhanced if IRS had done a better job of publicizing those warnings.

In that regard, IRS' income tax return instructions did not alert taxpayers as clearly as they could have about the TRA97 provisions and their implications. The tax year 1997 Form 1040 tax package included the following statement in its general information on "what's new for 1997": **"Caution:** If it is determined that you are not entitled to the EIC you claim, you may not be allowed to take the credit for certain future years. See **[Publication] 596** for details." A reference to this caution was not included later in the package either with the instructions for filling in the EIC line item on the tax return, the EIC worksheets, or the Schedule EIC that taxpayers must submit with their returns to substantiate their EIC claims. Thus, IRS was relying on taxpayers to read the general information in the front of the tax package before preparing their returns and, assuming they did, to order Publication 596 for details. For tax year 1996, about 19 million taxpayers claimed the EIC and IRS distributed about 636,000 copies of Publication 596. We believe that potential EIC claimants would have been more likely to read the relevant information from Publication 596 if it had been included in the Form 1040 instructions, along with statements in the EIC-specific parts of those instructions that clearly alerted taxpayers to the existence of that warning and where to find it.<sup>38</sup>

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<sup>38</sup>The tax year 1997 version of Publication 596, entitled Earned Income Credit, included the following two paragraphs:

"Beginning in 1997, if you improperly claim the [EIC] due to reckless or intentional disregard of IRS rules or regulations, you cannot claim the credit for the next 2 years. Also, if you fraudulently claim the [EIC] you cannot claim the credit for the next 10 years. These sanctions are in addition to any other penalty imposed, such as the accuracy-related penalty or the fraud penalty.

"Beginning in 1997, if you improperly claim the [EIC] and IRS denies it as a result of deficiency procedures, you cannot claim the credit again unless you provide information required by the IRS that shows you are eligible to claim the credit. The IRS will send you information about how to become recertified. If you claim the credit without first being recertified by the IRS, your claim will automatically be denied. The recertification procedures can apply if you are subject to the above described 2- or 10-year disallowance period."

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## Enforcement and Research

The customer service and outreach efforts discussed above are generally broad based and not targeted to specific sources of EIC noncompliance. In contrast, IRS' compliance initiative includes several enforcement and research activities that are specifically targeted on issues relating to qualifying children, the head of household filing status, noncompliant return preparers, and misreported income.

Qualifying child errors. IRS' tax year 1994 EIC compliance study showed that qualifying child errors associated with the residency requirement and AGI tiebreaker rules accounted for about half of the \$4.4 billion EIC overclaim total and 1.8 million<sup>39</sup> of the 2.3 million returns with a qualifying child error. These errors undoubtedly included both unintentional mistakes and intentional noncompliance and involved a variety of complex living situations.

IRS is able to verify some EIC eligibility criteria using tax return or Schedule EIC information and does so through its math error program as returns are submitted. IRS receives few indicators, however, of other problematic eligibility requirements, such as qualifying child residency or the presence of another taxpayer in the household who should be claiming the child. IRS has targeted its enforcement efforts on those compliance problems that can be identified from tax return information or profiles of noncompliant returns and is able to resolve some eligibility issues through correspondence audits. However, the bulk of noncompliance, primarily related to qualifying children, can best be identified through face-to-face audits.

One component of the compliance initiative that combines elements of customer outreach and enforcement is targeted on cases where a qualifying child's SSN is used on more than one tax return for the same tax year. Because a qualifying child can be claimed only once, resolution of these duplicate SSN cases should eliminate EIC claims by taxpayers with whom the child did not reside. For the outreach portion of this effort, IRS identified about 225,000 qualifying child SSNs that had been used by more than one taxpayer on tax year 1996 returns. In December 1997, IRS sent taxpayers using these SSNs (about 383,000 taxpayers) a notice informing them of the problem and reminding them to file a correct return for tax year 1997. To evaluate the effectiveness of these notices, IRS plans to check for duplicate use of these qualifying child SSNs on tax year 1997 returns. According to IRS, it plans to begin its evaluation in September 1998 and report the results in February 1999.

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<sup>39</sup>Confidence interval is  $\pm 11$  percent of the point estimate.

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For the compliance portion of this effort, IRS allocated additional staff to audit as many as 140,000 taxpayers who had used about 92,000 duplicate qualifying child SSNs in both tax years 1995 and 1996.<sup>40</sup> According to IRS officials, as of May 16, 1998, about 103,000 of the 140,000 taxpayers had filed tax year 1997 returns, and IRS had frozen their refunds. Also as of May 16, 1998, however, IRS had released 49,000 of the refunds for taxpayers who had corresponded with IRS but whose conflicting claims for the child(ren) in question were not resolved.<sup>41</sup> In discussing the release of these refunds, IRS officials told us that it could not process the amount of correspondence received because IRS (1) did not have enough time to adequately prepare for the start of this project (e.g., get staff assigned, procedures developed, and training done); and (2) had underestimated the volume of taxpayer contacts it would receive. Although IRS is continuing to investigate these cases, its effectiveness in protecting the revenue has been compromised because it is more difficult (and more costly) to recoup an erroneous refund once it has been released. IRS officials told us that meaningful data on the results of this effort would not be available until September 1998.

Another way that IRS attempts to deal with qualifying child errors is to deny EIC claims when the taxpayer has failed to provide valid SSNs for the listed children.<sup>42</sup> This effort, which is part of IRS' math error program, began before the compliance initiative and has continued as part of the initiative. As of June 4, 1998, IRS had sent about 535,000 EIC SSN-related math error notices to tax year 1997 filers; at the same point in 1997, IRS had sent about 774,000 such notices to tax year 1996 filers. IRS data for all of tax year 1996 show that it stopped approximately \$876 million in erroneous refunds through the EIC SSN math error program. As of March 1998, IRS data show that it stopped about \$414 million in tax year 1997 refunds.<sup>43</sup> IRS expected to issue fewer SSN math error notices in 1998 because IRS, before the 1998 filing season, had sent notices to about 600,000 taxpayers with known SSN problems telling them what to do to correct the situation before filing their tax year 1997 returns.

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<sup>40</sup>The 140,000 taxpayers selected for audit as part of this project were not included in the group of 383,000 taxpayers who received notices related to duplicate SSN use.

<sup>41</sup>Also as of May 16, 1998, IRS had released refunds for 21,000 taxpayers who did not claim the disputed child for 1997 and another 4,500 taxpayers who, on the basis of audits of 1996 returns, were entitled to claim the disputed child(ren).

<sup>42</sup>A valid SSN is one in which the SSN and associated name match the information in SSA's files.

<sup>43</sup>If taxpayers, after receiving the math error notice, correct the SSN problems that caused their refunds to be stopped, IRS is to release the refunds. Because that process can take several months, the \$414 million in stopped refunds as of March 1998 is likely to decrease as the year progresses.

TRA97 included provisions giving IRS access to an SSA data file linking parent and child SSNs and a Federal Case Registry of Child Support Orders to be administered by HHS. The Federal Case Registry is to be a compilation of state child support and custody data. Access to both data files is intended to augment IRS' ability to detect EIC claims for nonqualifying children. Both, however, are still in development, and IRS plans to do a "feasibility analysis" regarding their use. However, it will be several years before IRS will be able to use these data. Access, in terms of the specific data fields IRS can obtain, is still a major issue to be resolved among the three agencies. In addition to access issues, IRS' feasibility analysis is to include an assessment of data accuracy, currency, and completeness—factors that will be especially important for the custodial data to be useful.

Filing status errors. IRS' tax year 1994 study showed that a large proportion of qualifying child errors occurred in tandem with erroneous claims of head of household status. One of the components of the EIC compliance initiative involves increased staffing to expand a project aimed at a universe of about 345,000 head of household EIC claimants whose returns contain other indicators of potential qualifying child problems. This project was initiated in 1997 with audits of about 53,000 returns and expanded in 1998 to 313,000 returns. As of March 1998, about 50,700 of the 53,000 audits begun in 1997 had been closed; and about 43,400 of those closures (86 percent) resulted in tax changes totaling about \$107 million. On the basis of those results, IRS expects that about 85 to 90 percent of the 1998 audits will result in a change to the EIC claim. According to IRS, results of these audits will not be available until late 1998 or early 1999. IRS officials estimated that about 25 percent of the 313,000 audits will be completed by September 30, 1998.

Errors involving misreported income. Misreported income accounted for about 16 percent of the total EIC overclaims identified in IRS' tax year 1994 EIC compliance study. Many of IRS' traditional compliance activities are designed to identify returns with misreported income. For example, EIC returns are subject to IRS' document matching program, which compares W-2 wage reports and other income information reports (e.g., those filed on Form 1099) with income reported on tax returns. Because misreported income is of particular concern within that segment of the population that reports self-employment income on Schedule C, the EIC compliance initiative includes a study of noncompliance among EIC claimants who report self-employment income. IRS selected a sample of tax year 1997 returns, held the refunds, and plans to complete the audits by September 1998. IRS plans to issue a report of its findings in February 1999.

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Paid preparer noncompliance. The tax year 1994 study data showed that returns prepared by local or informal preparers had a higher overclaim rate (31 percent) than the returns prepared by formal preparers (20 percent). To address preparer noncompliance, TRA97 imposed due diligence requirements on paid preparers who complete EIC returns and fines for preparers who fail to comply with those requirements. In December 1997, IRS issued specific due diligence requirements<sup>44</sup> and publicized these requirements in mailings to practitioners. IRS did not institute at a national level specific procedures to monitor compliance with the due diligence requirements during the 1998 filing season. However, individual field offices may have done some monitoring. At the Northern California District Office, for example, we were told that staff phoned about 560 preparers in the district to inform them of the due diligence requirements and inquired into conformity with those requirements as part of the district's normal monitoring visits to about 100 preparers. IRS informed us that national-level plans for the 1999 filing season include due diligence monitoring visits to EIC return preparers, but IRS has not decided on the procedures for these visits, the number of visits, or the extent to which they will target those preparers most likely to be noncompliant (i.e., local or informal preparers).

As part of the EIC compliance initiative, IRS also planned to increase district office Criminal Investigation staffing in fiscal year 1998 to investigate potential EIC fraud cases, including cases involving return preparers. The increased staffing was to include a total of 40 special agents and 10 investigative aides. For fiscal year 1998 as of May 31, 1998, 31 paid preparer cases have been opened compared to 44 for all of fiscal year 1997.

Fraud detection. IRS' QRP is aimed at identifying tax returns with potentially fraudulent refund claims. The scoring system used to identify these returns is based on known characteristics of potentially fraudulent returns. As part of the compliance initiative, IRS expanded QRP staffing to allow screening of 1.3 million more returns in fiscal year 1998 than in fiscal year 1997, for a total of 4 million returns. According to IRS, as of April 30, 1998, QRP teams had scanned about 2.3 million potentially fraudulent EIC

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<sup>44</sup>Under these requirements, a paid preparer must (1) complete an EIC eligibility checklist or some substitute form that contains the same information; (2) complete the EIC worksheet, or keep a paper or electronic record of the EIC computation that includes the computation method and information used; (3) not know or have reason to know that any information used to determine EIC eligibility is incorrect; and (4) retain, for 3 years, a copy of the completed checklist, the worksheet, and a record of how and when the information was obtained and who provided the information.

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returns and had identified 6,476 returns with erroneous EIC claims totaling \$17.6 million.

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### **Timely Data on the Results of EIC Compliance Efforts Would Facilitate Decisionmaking**

As is evident from our discussion of the various elements of the EIC compliance initiative, there was little information available at the time we completed our audit work on the results of IRS' efforts and thus little basis for us or IRS to assess their effectiveness. Such data and assessments are crucial as IRS decides on the compliance initiative's future direction.

An obvious question one would ask in assessing IRS' results is "how much has the EIC overclaim rate changed since the start of the initiative?" Although the results of the tax year 1994 EIC compliance study were the catalyst behind congressional funding of the compliance initiative, IRS does not plan to use those results as the baseline for measuring the initiative's impact on the EIC overclaim rate. Instead, it plans to measure the initiative's impact against the results of a tax year 1997 compliance study, which IRS has begun as part of the initiative.<sup>45</sup> However, by the time IRS completes the tax year 1997 study, which is to become the baseline, and a tax year 1998 study that can be compared with the baseline to measure change, IRS will be in the fourth year of its 5-year initiative. IRS' time frame for the tax year 1997 baseline study shows that the analysis will not be completed until fiscal year 2000. If the tax year 1998 study follows the same schedule, its results will not be available until fiscal year 2001—the fourth year of the initiative. It will be too late at that point to make substantive changes to the initiative.

Given the time frames associated with the broad compliance studies, it is important that IRS closely monitor the results of the initiative's individual components so that it can make more timely and better informed decisions about revising, deleting, or expanding those various components. For example, information on the results of the notices IRS sent users of duplicate SSNs in December 1997 would be useful in deciding whether to send similar notices in December 1998. As noted earlier, however, IRS does not plan to begin such an assessment until September 1998 and does not expect to have final results until well after December 1998.

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<sup>45</sup>By using tax year 1997 compliance as its baseline, IRS will not be measuring the impact of EIC changes implemented in tax year 1997 or earlier years.

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## Conclusions

Although minor methodological problems in IRS' tax year 1994 EIC compliance study could have led to some over- or understatement of total EIC overclaims, these issues do not affect the relevance of the study's findings. The study demonstrates that EIC noncompliance is a significant issue and that verifying qualifying child eligibility lies at the heart of EIC compliance problems. Targeting compliance efforts at qualifying child errors, however, presents IRS with a major challenge. IRS is not set up to systematically verify qualifying child eligibility. Doing so would basically require IRS to establish a process to verify eligibility before issuing a refund, similar to the processes used in EIC compliance audits.

IRS' EIC compliance initiative includes a broad array of customer service, enforcement, and research activities aimed at reducing noncompliance. Some parts, like special audits of head of household claimants and preparer due diligence requirements, are targeted specifically at areas of noncompliance identified in the tax year 1994 study. Others, like expanded walk-in and telephone assistance, are more broadly based efforts aimed at improving taxpayers' understanding of EIC rules. Although it is too early to judge the initiative's effect on noncompliance, we did identify some opportunities for IRS to improve future implementation efforts. For example, IRS did not offer Saturday walk-in assistance until late in the filing season when millions of EIC claims had already been filed. Also, for the TRA97 provisions allowing IRS to deny future EIC claims to act as a deterrent, taxpayers must be aware of the circumstances under which these penalties will be applied. IRS' income tax return instructions, however, did not alert taxpayers as clearly as they could have about these provisions and their implications.

IRS plans to do annual studies to measure the impact of its EIC compliance initiative on the overclaim rate. Based on IRS' time frame for these studies, however, useful data on impact will not be available until fiscal year 2001—the fourth year of the initiative. It will be too late at that point to make substantive changes. Absent timely data on the overall impact of IRS' efforts and given the need for IRS to ensure that available resources are used as effectively and efficiently as possible, it is important that IRS have immediate information on the results of individual components of that initiative. Evaluation plans that are not timed to provide data when data are most needed, as appears to be the case with IRS' planned evaluation of the notices on duplicate SSNs, are of limited value.

## Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner of Internal Revenue

- ensure that customer service efforts aimed at EIC claimants be available earlier in the filing season when most EIC claims are filed, and
- include prominent information regarding the 2-year and 10-year sanctions and the recertification process in the Form 1040 EIC instructions and Schedule EIC.

In addition, to provide a basis for continually improving and refocusing EIC compliance efforts, we recommend that the Commissioner develop evaluation plans for each compliance initiative component that will provide, in succeeding years of the initiative, timely data for decisionmakers.

## Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Commissioner of Internal Revenue and the Secretary of the Treasury, or their designees. The Commissioner of Internal Revenue responded in a July 2, 1998, letter generally agreeing with our recommendations (see app. I). On July 1, 1998, we met with IRS officials, including the Deputy Chief of Operations, the Acting Assistant Commissioner for Customer Service, and the Assistant Commissioner for Research/Statistics of Income, to discuss the Commissioner's comments. Treasury's Deputy Assistant Secretary (Tax Analysis) responded in a June 29, 1998, letter (see app. II).

In response to our recommendation that IRS provide customer service efforts earlier in the filing season, IRS said that it plans to publicize EIC awareness events early in the 1999 filing season and to hold EIC awareness activities beginning in January 1999. IRS officials told us that (1) Saturday service at walk-in assistance sites during the 1999 filing season will begin on January 16 and continue through the filing season, and (2) the first 6 Saturdays will be publicized as EIC help days. These actions, if effectively implemented, will be responsive to our recommendation.

In response to our second recommendation about more prominently displaying information on the 2-year and 10-year sanctions and the recertification process, IRS said that it will include such information in the tax year 1998 Schedule EIC instructions but will not revise the schedule itself. IRS said that it did not believe the Schedule EIC should be revised to address these issues because the issues do not affect the majority of filers and providing the information on the schedule may confuse filers who have not had their EIC claim disallowed. According to IRS officials,

taxpayers must go to the worksheet in the instructions to complete the schedule, and IRS' intent is to place the information so that persons using the worksheet will easily see it. Although inclusion of the information in the Schedule EIC instructions is an improvement, we continue to believe that something should also be added to the schedule. Because one of the purposes of this information is to alert potential EIC claimants to possible repercussions if they make erroneous claims, the information affects all filers. Also, although it is true that taxpayers who choose to compute their own EIC have to use the worksheet in the instructions, taxpayers who choose to have their returns prepared by someone else do not have to use the worksheet and thus would see only the Schedule EIC. We are not suggesting that all of the information on sanctions and recertification be included on the schedule. What we are suggesting is that a brief, but prominent, cautionary statement be added to the schedule alerting users to important information in the instructions that they should read before filing their returns.

Regarding our final recommendation, IRS said that it understood our concern regarding more timely delivery of research data for decisionmaking. According to IRS, it has developed an information delivery strategy that includes developing information systems that will allow more timely delivery of both interim and final tax return, audit, and research data. The strategy includes using interim reports to disseminate preliminary findings from various EIC projects. For example, IRS officials said that they hope to have, in October 1998, some preliminary findings from audits of taxpayers who had used duplicate qualifying child SSNs. IRS also noted that using interim data of this sort has limitations; it may not be adequate to measure revenue or provide a full understanding of taxpayer behavior. Although there are certain limitations associated with interim data, we believe, as IRS recognized in its comments, that such data can be of value to decisionmakers.

Treasury's letter addressed two statements in the draft report—our characterization of the EIC as an income transfer program and our statement that IRS cannot address a significant root cause of noncompliance. In response to our statement comparing the EIC to other income transfer programs, Treasury said that “unlike income transfer programs, the [EIC] makes work pay by reducing tax liabilities,” and that about 80 percent of the EIC's total costs offset individual income, Social Security, and other federal taxes. We clarified our reference to income transfer programs where appropriate.

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In response to our statement in a draft of this report that IRS cannot address a significant root cause of noncompliance (IRS' difficulty verifying qualifying child eligibility), Treasury said that issues of verifying family relationships and living arrangements are not unique to the EIC but also affect taxpayers' eligibility for dependency exemptions, filing status, the child credit, and the child and dependent care tax credit. Also, both IRS and Treasury said that they were hopeful that access to new data (an HHS registry of child support orders and SSA data linking parent and child SSNs) will allow IRS to detect some qualifying child problems during return processing. We modified our statement and related discussions in the report to acknowledge IRS' ability to identify some noncompliance related to qualifying children. Our report also recognizes the provision in TRA97 giving access to the HHS and SSA databases. However, IRS told us that it will not be testing use of these databases until late 1999 or 2000 and that the amount of information that can be initially expected is small.

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As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Ranking Minority Member, Committee on Ways and Means; the Chairmen and Ranking Minority Members of other interested congressional committees; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Major contributors to this report are listed in appendix III. If you or your staffs have any questions, please call me on (202) 512-9110.



James R. White  
Associate Director, Tax Policy  
and Administration Issues

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## Contents

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## Abbreviations

|       |   |
|-------|---|
| AGI   | adjusted gross income                   |
| EIC   | Earned Income Credit                    |
| HHS   | Department of Health and Human Services |
| IRS   | Internal Revenue Service                |
| OTA   | Office of Tax Analysis                  |
| QRP   | Questionable Refund Program             |
| SOI   | Statistics of Income                    |
| SSA   | Social Security Administration          |
| SSN   | Social Security number                  |
| TRA97 | Taxpayer Relief Act of 1997             |

# Comments From the Internal Revenue Service



COMMISSIONER

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

July 2, 1998

Ms. Lynda D. Willis  
Director, Tax Policy and Administration Issues  
United States General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Willis:

Providing the Earned Income Tax Credit (EITC) to eligible individuals, as well as minimizing noncompliance, continue to be our top priorities. We have reviewed the draft report titled "Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance." We are pleased that your review of the 1994 EITC Compliance Study found it accurate and representative of EITC claimants. We agree with your view that the increase in funding for EITC-related activities will allow us to better educate the public about the EITC and circumvent EITC noncompliance. We appreciate your efforts to help in this endeavor and are happy to have this opportunity to respond to the content and recommendations of the draft report.

For the sake of accuracy, we ask that you clarify several of the statements made in the report. The clarifications and the additional data you requested are included in the enclosure titled "Clarifications on GAO Report, IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance."

**Response to Recommendations:**

"We recommend that the Commissioner of Internal Revenue ensure that customer service efforts aimed at EIC claimants be available earlier in the filing season when most EIC claims are filed and include information regarding the 2-year and 10-year sanctions and the recertification process prominently in the Form 1040 EIC instructions and schedule EIC. In addition, to provide a basis for continually improving and refocusing EIC compliance efforts, we recommend that the Commissioner develop evaluation plans for each compliance initiative component that will provide, in succeeding years of the initiative, timely data for decisionmakers."

We agree that making information available earlier is essential. For the Walk-In Program, this issue has been addressed for the upcoming filing season. We are working to prepare, design, and disseminate publicity and information on EITC awareness events early in the filing season. EITC awareness activities are planned for early February 1999, to coincide with the receipt of Forms W-2 by taxpayers.

Taxpayer Education will continue to conduct local EITC events and activities, nationwide, throughout this upcoming filing season beginning in early January. These events are designed to educate taxpayers on EITC eligibility requirements and other related issues, as well as to offer tax return preparation assistance.

For telephone assistance, we will expand all telephone access for notice, tax law, and information issues by offering service 7 days a week, 24 hours a day, beginning January, 1999. This expanded service will be advertised in all tax packages, including Schedule EIC instructions and in Publication 596, the Earned Income Tax Credit information publication.

We concur, in part, with the second recommendation involving the sanctions and recertification for taxpayers whose earned income credit is disallowed. We agree to include guidance in the Schedule EIC instructions to advise taxpayers of the 2-year and 10-year sanctions and the need to provide the Internal Revenue Service (IRS) with additional information when they file for the credit in a subsequent year. The Tax Year 1998 instructions will be revised to include this guidance. However, we do not believe the Schedule EIC should be revised to address these issues, because they do not involve the majority of filers. Providing the information on the schedule may confuse the filers who have not had their credit disallowed.

With regard to your final recommendation, we understand your concern regarding the more timely delivery of research data for decisionmaking. We have developed an information delivery strategy that will provide information extracted from corporate databases earlier and will establish the information on pre-validated databases. For example, while the final report for the Tax Year 1997 Study will not be available until December 1999, an interim report of preliminary findings will be prepared. However, the constraints of tax timelines and the need for more valid data must be addressed if decisionmakers are to be provided information with a high level of reliability. There also must be a clear understanding by all parties of the limitations of early incomplete research.

For early analysis, the Compliance Research Initiative Tracking System will deliver information on research initiatives (not including audit data). Researchers are expected to be able to provide interim reports, containing limited analysis, to decisionmakers to plan for the following tax season. However, this quick response will not provide data adequate to measure revenue nor will it provide a full understanding of, or a description of, taxpayer behavior.

For the purpose of full analysis of initiatives, compliance analysis, and revenue estimates/measures, the Office of Research will work with Information Systems staff to leverage off existing research systems to obtain and accommodate data for pre-identified taxpayers.

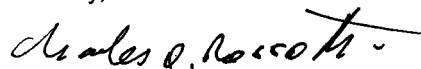
3

This will result in a system to capture data not only for the current year but for future years, as well. Thus, it is named the Subsequent Year Tracking System.

In addition, a database to receive data from audited returns and the accompanying checksheet information is being developed. Initially designed for the Baseline Study, the system is expected to be further developed to accommodate all EITC projects for which audit reports and/or checksheet information must be captured.

We look forward to meeting with you to discuss these important issues.

Sincerely,

A handwritten signature in cursive script, appearing to read "Charles O. Rossotti".

Charles O. Rossotti

Enclosure

# Comments From the Department of the Treasury



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

June 29, 1998

Mr. James R. White  
Associate Director, Tax Policy and Administration Issues  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. White:

Thank you for providing us with a copy of GAO's draft report entitled Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance. I am enclosing the Office of Tax Policy's technical comments on the report. Many of these comments were discussed in a conference call on June 17 between Deb Junod and members of my staff. Please let me know if you have any questions concerning our comments.

I would also like to address two statements that are found in the summary (pages 3 and 4) of the GAO report: first, the characterization of the earned income tax credit (EITC) as an income transfer program; and second, the statement that the IRS cannot address a significant root cause of noncompliance -- design of the EITC itself.

The EITC was designed to move families from welfare to work and to lift working families out of poverty, by making work pay. Recent research demonstrates that the EITC is achieving these goals. For example, several academic studies have shown that the EITC expansions of the past decade have contributed to an increase in labor force participation among single women and a reduction in welfare participation. In addition, Census Bureau data show that the EITC lifted 4.45 million persons out of poverty in 1996. Unlike transfer programs, the EITC makes work pay by reducing tax liabilities. About 80 percent of the total costs of the EITC offsets the individual income, social security, and other Federal taxes borne by the families receiving the credit. Thus, the EITC is an integral part of the Federal tax system.

Indeed, even if the EITC did not exist, nearly 95 percent of EITC filers would still be required or have a reason to file an individual income tax return, and the IRS would still have to process their returns and verify much of the same information regarding income, family relationships, and living arrangements. The issues of verifying family relationships and living arrangements are not unique to the EITC but also affect the determination of a taxpayer's eligibility for dependency exemptions, filing status, the \$500 child credit, and the child and dependent care tax credit. These provisions, like the EITC, make adjustments for ability to pay among taxpayers based on family responsibilities.

The IRS 1994 EITC compliance study shows (and the GAO report confirms) that 25.8

**Appendix II**  
**Comments From the Department of the**  
**Treasury**

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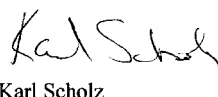
percent of the amount of EITC claimed in 1994 was in excess of the amount to which taxpayers were eligible. After accounting for IRS enforcement actions (including the extension, in 1996, of mathematical error procedures to more easily deny EITC claims to taxpayers who claim a child using an invalid social security number), the EITC overclaim rate was 20.7 percent.

The challenge for the Treasury Department is to improve EITC compliance, while still maintaining its high participation rate, relatively low administrative cost, and solid track record for reducing poverty and increasing workforce participation among low-income families. Over the past decade, the Treasury Department has worked together with Congress to design a number of compliance initiatives that meet these goals. The GAO report finds relatively few problems with the implementation of last year's legislation, but notes that it is too soon to know what effect these initial efforts will have on compliance.

I would like to emphasize that some of the most promising steps are still in the early stages, and the benefits may not be apparent for several years. For example, we supported legislation last year that would provide the IRS with access to two new data sets (the expanded Health and Human Services' Federal Case Registry of Child Support Orders and a Social Security Administration data file linking parent and child social security numbers) that would provide information regarding children's relationships and living arrangements. When available, these data will allow the IRS to better detect common qualifying child errors during return processing, thereby improving the accuracy of pre-refund audit criteria and the productivity of enforcement resources devoted to EITC compliance.

I appreciate the opportunity to comment on GAO's report.

Sincerely yours,



Karl Scholz  
Deputy Assistant Secretary (Tax Analysis)

Enclosure

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# Major Contributors to This Report

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## General Government Division

David Attianese, Assistant Director  
Deborah Parker Junod, Evaluator-in-Charge  
James Fields, Senior Social Science Analyst  
John Lesser, Senior Evaluator  
MacDonald R. Phillips, Economist  
Robert Dunsky, Economist

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## Kansas City Field Office

Doris Hynes, Senior Evaluator

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## San Francisco Field Office

Susan Mak, Evaluator





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# Related GAO Products

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Earned Income Credit: Noncompliance Relative to Other Components of the Income Tax Gap ([GAO/GGD-97-120R](#), June 13, 1997).

Earned Income Credit: Claimants' Credit Participation and Income Patterns, Tax Years 1990 Through 1994 ([GAO/GGD-97-69](#), May 16, 1997).

Tax Administration: Earned Income Credit Noncompliance ([GAO/T-GGD-97-105](#), May 8, 1997).

Earned Income Credit: IRS' 1995 Controls Stopped Some Noncompliance, But Not Without Problems ([GAO/GGD-96-172](#), Sept. 18, 1996).

Earned Income Credit: Profile of Tax Year 1994 Credit Recipients ([GAO/GGD-96-122BR](#), June 13, 1996).

Earned Income Credit: Noncompliance and Potential Eligibility Revisions ([GAO/T-GGD-95-179](#), June 8, 1995).

Earned Income Credit: Targeting to the Working Poor ([GAO/GGD-95-122BR](#), Mar. 31, 1995).

Earned Income Credit: Targeting to the Working Poor ([GAO/T-GGD-95-136](#), Apr. 4, 1995).

Tax Administration: Earned Income Credit—Data on Noncompliance and Illegal Alien Recipients ([GAO/GGD-95-27](#), Oct. 25, 1994).

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

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