

GAO

Briefing Report to the Chairman,
Committee on Governmental Affairs,
U.S. Senate

March 1995

EARNED INCOME CREDIT

Targeting to the Working Poor





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

General Government Division

B-260826

March 31, 1995

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This is our second report responding to your interest in the Earned Income Credit (EIC).¹ In this report, which follows our briefing for you, we present information on EIC noncompliance and assess changes and administrative issues that might result from potential changes to EIC eligibility criteria. These criteria would take into account (1) measures of taxpayer wealth and (2) more sources of income when determining who qualifies for the credit.² We also provide information on illegal alien recipients of the EIC and describe the administration's proposal, which is similar to your 1994 proposal, to exclude such aliens from eligibility.

Results in Brief

EIC noncompliance has been a continuing concern of the Internal Revenue Service (IRS). Current, reliable noncompliance measures do not exist for the entire EIC program. An IRS study of noncompliance for returns filed electronically during two weeks in January 1994 found that an estimated 29 percent of these recipients received too much EIC, and 13 percent intentionally claimed too much. The extent of such noncompliance for paper returns is unknown but also of concern to the IRS.

Concerned about EIC noncompliance and refund fraud generally, IRS has taken steps to detect and prevent erroneous refund payments. These include developing and applying improved criteria for detecting noncompliant returns and checking for the use of the same Social Security number (SSN) on multiple tax returns. These steps have resulted in many more taxpayers being asked to provide evidence of EIC eligibility and in delaying refunds to at least 2.9 million EIC claimants as of March 17, 1995. In addition, as of March 17, IRS had sent out almost 4.1 million notices primarily when returns did not appear to contain valid SSNs for dependents or, in the case of EIC, for qualifying children. Although these steps may

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

²As you requested, we initially assessed the magnitude of change likely to result from taking wealth and additional sources of income into account when awarding the EIC. On the basis of this work, you requested that the Joint Committee on Taxation (JCT) provide official revenue estimates. We present those estimates in this report.

inconvenience or burden taxpayers, if implemented effectively, they could help IRS improve EIC compliance.

Taxpayers' earned income, and in some cases their adjusted gross income (AGI), as well as whether they have children meeting certain age and residency tests, determine EIC eligibility and credit amounts. Unlike certain federal welfare programs, taxpayers' wealth (e.g., the value of property or other investments they own) does not affect EIC eligibility. In addition, the EIC does not consider certain forms of income in determining how much, if any, credit taxpayers will receive. EIC eligibility criteria could be changed to take into account wealth and additional forms of income.

The JCT estimates that denying the EIC to taxpayers who have some wealth, as indirectly measured by their asset-derived income, could yield \$318 to \$971 million in revenue savings in fiscal year 1997, depending on the wealth test design. These revenue savings represent potential reductions in EIC program costs resulting from changing EIC eligibility criteria. In addition, taking nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions into account in taxpayers' AGI for credit calculations could yield \$1.449 billion in revenue savings in fiscal year 1997, according to JCT estimates. Also, taking child support payments into account would increase revenues in fiscal year 1997 by \$686 million.

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

Although an indirect wealth test for the EIC that uses tax return data might be more practical than a more comprehensive test, it would have significant limitations in measuring potential EIC recipients' actual wealth. For instance, such a test would not measure the value of taxpayer assets like capital stock funds that yield little, if any, annual income. These limitations could raise concerns that taxpayers with similar wealth would be treated differently for the EIC.

Background

The EIC is a refundable tax credit available to low-income working taxpayers with children and, beginning in tax year 1994, certain taxpayers without children. Congress established the EIC in 1975 to achieve two long-term objectives: (1) to offset the impact of Social Security taxes on low-income workers with families and (2) to encourage low-income individuals with families to seek employment rather than welfare.

For tax year 1993, about 14.7 million taxpayers claimed about \$15 billion in EIC benefits. To be eligible for any EIC in tax year 1993, a taxpayer must have had earned income of less than \$23,050 and had one or more qualifying children who met the age, relationship, and residency tests. The Omnibus Budget Reconciliation Act (OBRA) of 1993 increased the number of taxpayers eligible for the EIC and the credit amount. These changes began in tax year 1994 and will be fully effective in tax year 1996. The maximum income qualifying for the EIC will rise to \$27,000 in tax year 1996, the maximum credit will rise to \$3,370 for tax year 1996,³ and total EIC cost in fiscal year 1996 is expected to reach nearly \$25 billion (in 1994 dollars).

Objectives, Scope, and Methodology

Our objectives were to (1) present information about EIC noncompliance and what steps IRS is taking to control such noncompliance and (2) review the impact on the amount of EIC paid that might result from potential changes to the EIC eligibility criteria that would reflect taxpayer wealth and additional sources of income and administrative issues which could arise due to these changes. In addition, we were asked to provide information about illegal aliens receiving the EIC and to describe the administration's proposal to exclude illegal aliens from eligibility.

To review the effects of possible changes to EIC eligibility criteria, we obtained and analyzed data from the IRS' Statistics of Income Division (SOI) and from the Bureau of the Census' Current Population Survey (CPS). For our various objectives, we also met with Treasury, IRS, JCT, and Congressional Budget Office officials; visited IRS Service Centers in Cincinnati, OH, and Fresno, CA; and reviewed relevant literature on the EIC. See appendix I for more details on our methodology.

We did our work from August 1994 through February 1995 in accordance with generally accepted government auditing standards. On March 21, 22, and 23, 1995, we discussed our draft report with Department of the

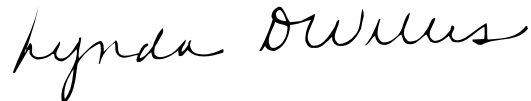
³All monetary figures are in 1994 dollars. Under OBRA 1993, amounts would be higher in 1995 and 1996 than shown here because of annual inflation adjustments.

Treasury and IRS officials who are responsible for administering the EIC, ensuring compliance, and analyzing potential policy changes. The officials generally agreed with the material in the report but offered updated data and suggestions for improving the clarity of presentation. We made appropriate changes to the report to reflect their comments.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute this report until April 4, 1995. At that time, we will send copies of this report to various interested congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix II. Please contact me on (202) 512-8633 if you have any questions about this report.

Sincerely yours,

A handwritten signature in cursive script that reads "Lynda D. Willis".

Lynda D. Willis
Associate Director, Tax Policy and
Administration Issues

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Abbreviations

AFDC	Aid to Families With Dependent Children
AGI	Adjusted Gross Income
CPS	Current Population Survey
EIC	Earned Income Credit
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
OBRA	Omnibus Budget Reconciliation Act
SOI	Statistics of Income
SSA	Social Security Administration
SSN	Social Security number
TIN	taxpayer identification number

Background

GAO Targeting the EIC

How can we better ensure that only the working poor receive the EIC?

- Reduce noncompliance
- Revise EIC eligibility
 - Wealth test
 - Income test
 - Illegal aliens

Ensuring That the Working Poor Receive the EIC

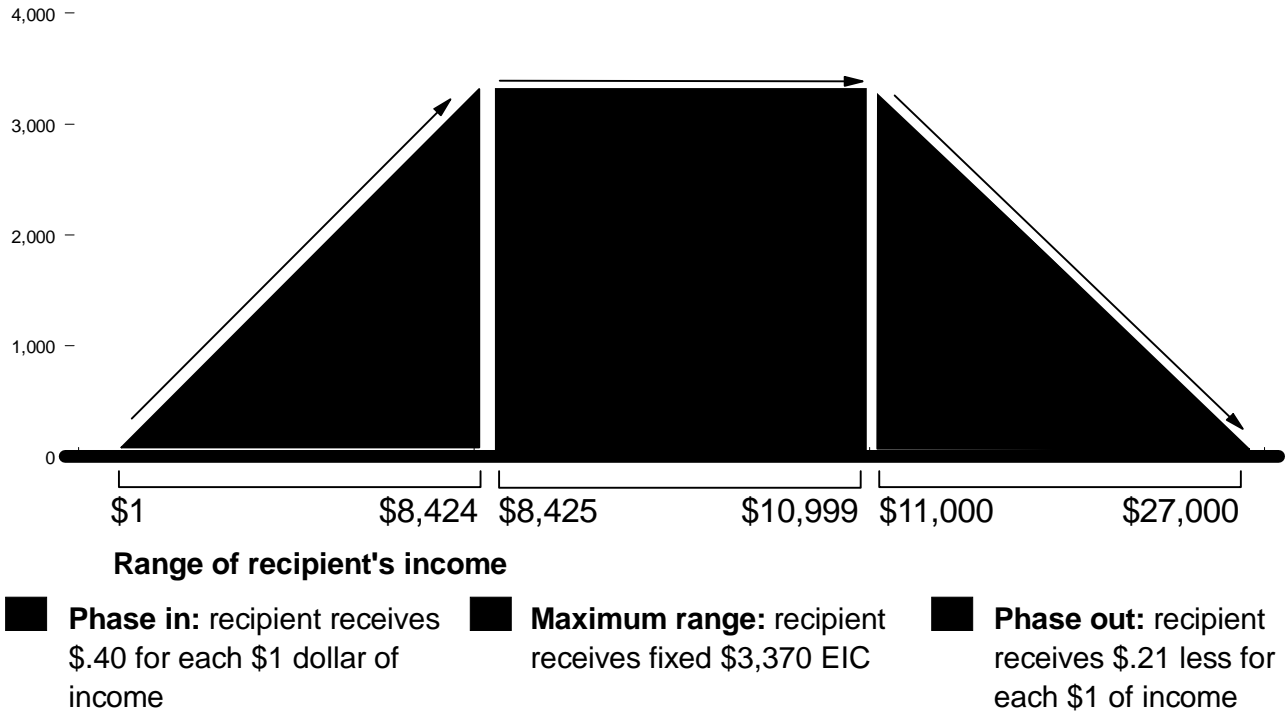
As requested by the Chairman, Senate Committee on Governmental Affairs, this report addresses how the federal government can better ensure that only the working poor receive the EIC. Specifically, the report

- presents information about noncompliance with the EIC and what the IRS is doing to increase compliance and thus exclude ineligible taxpayers from receiving the credit;
- assesses changes that may result from potential changes to the criteria used in determining EIC eligibility. These changes would take into account more of the resources that taxpayers could use to support themselves and their families (resources not taken into account when determining EIC eligibility include taxpayers' wealth and certain forms of income);⁴ and
- presents information about how many illegal aliens receive the EIC and discusses the administration's proposal, which is similar to Senator Roth's 1994 proposal, to exclude illegal aliens from eligibility.

⁴EIC recipients' wealth would include the value of assets like savings, stock or property that they may own. Additional income sources not taken into account in determining how much, if any, EIC to award include, for example, nontaxed Social Security income, tax-exempt interest income, and nontaxed pension distributions.

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

Earned income credit (1994 dollars)



Source: Congressional Research Service

How the EIC Is Awarded

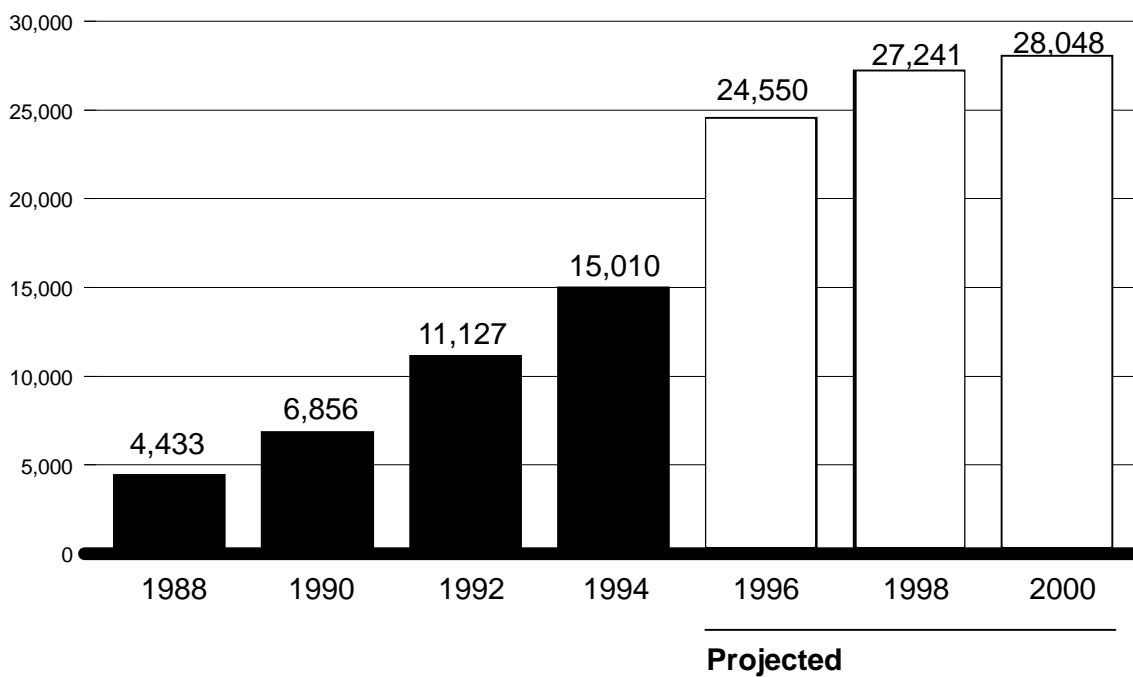
The EIC is a refundable tax credit available to low-income working taxpayers with children and, beginning in 1994, certain taxpayers without children. Congress established the EIC in 1975 to achieve two long-term objectives: (1) to offset the impact of Social Security taxes on low-income workers with families and (2) to encourage low-income individuals with families to seek employment rather than welfare.

EIC eligibility and credit amounts generally are determined according to the taxpayers' earned income and whether they have qualifying children who meet age, relationship, and residency tests. The credit gradually phases in, plateaus at a maximum amount, and then phases out until it reaches zero. If the taxpayers' earned income or adjusted gross income (AGI) exceeds the maximum qualifying income level, they are not eligible for the credit. When the taxpayers' AGI falls in the credit's phase-out range, they receive the lesser amount resulting from using their earned income or AGI in calculating the credit.

As the figure illustrates, when changes made in the 1993 Omnibus Budget Reconciliation Act (OBRA) are fully in effect in tax year 1996, taxpayers with two children and whose earned income ranges from \$1 to \$8,424 will receive \$.40 for each dollar earned. For taxpayers with incomes between \$8,425 to \$10,999, the amount of EIC received will remain stable at \$3,370. Taxpayers whose income falls between \$11,000 and \$27,000 will receive a declining amount of EIC, with the credit falling \$.21 for each additional dollar of income.

GAO Growth in EIC Program Costs (1988 - 2000)

Millions of dollars (1994)



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

Broader Coverage and Larger Credit Amounts Increase EIC Program Costs

Total program costs⁵ for the EIC have increased dramatically as Congress has broadened its coverage and increased the amount of credit available. The figure shows that between 1988 and 1996 total EIC program costs are estimated to increase over five fold in real terms, from \$4.4 billion in 1988 to an estimated \$24.6 billion in 1996. Congress has increased the coverage and amount of the credit for reasons such as to (1) ensure that EIC amounts would not fall in terms of purchasing power, (2) increase or maintain the progressivity of the tax system, and (3) better ensure that working individuals will have incomes above the poverty line.

The most recent change to the EIC, in the OBRA of 1993, increased the maximum credit available and the income level at which individuals can qualify for the credit, and made certain low-income taxpayers without children eligible. The maximum credit amount for a family with two children is rising from \$1,511 for tax year 1993 to \$3,370 in tax year 1996. The maximum income qualifying for the EIC is rising from \$23,050 in tax year 1993 to \$27,000 in tax year 1996. Finally, beginning in tax year 1994, individuals without a qualifying child are eligible for the credit if they (1) are at least 25 but less than 65 years old, (2) are not a dependent of another taxpayer, and (3) have earned income and AGI of \$9,000 or less. These taxpayers will be eligible for a maximum credit of \$306, adjusted for inflation.

⁵The EIC is a refundable tax credit. As such, the portion of the credit that offsets taxes owed by EIC recipients is considered a tax expenditure, i.e., a reduction in taxes due to a preferential provision in the federal tax law. The refundable portion of the EIC is considered a federal outlay. We totaled the tax expenditure estimate and the outlay estimate from appropriate versions of the President's Budget to arrive at "total EIC program costs."

Noncompliance

GAO IRS Studies

No comprehensive, reliable EIC data since 1988

IRS' 1994 2-week study

- Electronic returns only
- 29 percent received too much EIC (\$358 million)
- 13 percent were judged to have "intentional" errors (\$183 million)

IRS' ongoing study

Source: IRS data.

IRS Is Studying EIC Noncompliance

Currently, no reliable data exist on the extent of noncompliance among all EIC claimants. The most recent Taxpayer Compliance Measurement Program, from 1988, showed that about 42 percent of EIC recipients received too large a credit and about 32 percent were not able to show they were entitled to any credit. About \$1.9 billion (34 percent of the total EIC paid out) was awarded erroneously. However, the impact of the significant changes to the EIC since 1988 suggest that a new compliance

measurement is needed. For instance, in the intervening years, Congress has broadened the EIC coverage, increased the credit amount, and revised filing status and qualifying children criteria.

In response to concerns about EIC-related fraud, IRS studied a sample of those returns filed during a 2-week period in January 1994. Study results are only generalizable to electronic returns filed during this period. IRS' preliminary analysis of these returns showed that an estimated 29 percent of the 1.3 million EIC returns filed electronically during the period had claimed too large a refund and about 13 percent of the returns filed were estimated by IRS as having intentionally claimed too much EIC. Of the \$1.5 billion of EIC claimed in this period, an estimated \$358 million was erroneously claimed—about \$183 million, or 12 percent, was classified as intentional error. This intentional error category comes closest of any IRS category in the study to measuring EIC fraud.⁶ About 3 percent of taxpayers claimed a total of about \$7 million less EIC than they were entitled to receive.

In the fall of 1994, IRS began reanalyzing the electronic returns using additional income data that were not available earlier. The results of the additional analyses are not yet available. IRS officials expect the analyses to lead to a higher estimated error rate.

IRS is doing a 1995 study that will yield a noncompliance estimate for the entire EIC program. The study will include a random sample of EIC returns filed electronically and on paper throughout the 1995 filing season. Preliminary results may be available in June 1995.

⁶Determining whether a refund is fraudulent requires determining the taxpayer's intent, which is difficult to prove.

GAO 1994 Filing Season Enforcement
Results

Paper returns: Extent of EIC
noncompliance unknown

- 400,000 returns stopped in 1994 because they lacked SSN for child
- \$500 million in refunds delayed, most indefinitely

Paper and electronic returns

- 77,781 fraudulent returns in 1994
 - \$43 million in refunds incorrectly paid out; \$117 million in refunds stopped
 - 91 percent involved the EIC
-

Source: IRS data.

IRS' 1994 Enforcement
Efforts Address
Noncompliance

In addition to the 2-week electronic EIC return study, IRS detected noncompliance in its normal efforts to detect inaccurate or improper returns as they are processed. These data document noncompliance that IRS discovers while processing EIC returns but do not measure the universe of noncompliance.

In 1994, during initial manual reviews of tax year 1993 EIC paper returns, IRS personnel identified about 150,000 taxpayers who claimed the EIC although the return information indicated they were not entitled to it. Most problems resulting in disqualification related to qualifying children, such as a child exceeding the age limit. IRS' initial computerized reviews of about 6 million electronically filed EIC returns resulted in about 610,000 rejection notices being sent out. The rejections occurred when the qualifying child's Social Security number (SSN) did not match the Social Security Administration's (SSA) records.

Beginning in January 1994, IRS personnel also stopped the processing of returns that lacked an SSN for the qualifying child and had a tax refund exceeding a threshold. Following statutorily required notice procedures, IRS suspended the EIC refund and asked the taxpayer to submit proof of their EIC qualification. If proof was provided, the refund was released. If the taxpayer submitted insufficient proof or failed to respond, IRS' policy was to permanently deny the refund. As of September 30, 1994, IRS had delayed about \$500 million in potentially erroneous EIC refunds claimed on about 400,000 of about 8.7 million paper returns. IRS officials expected most of these refunds to be permanently denied because many taxpayers did not respond to requests for information or could not support their claims.

After electronic returns pass initial computer checks and paper returns pass manual checks, data is entered into IRS computers, which then identify returns that are potentially fraudulent. These potentially fraudulent returns are reviewed by fraud detection teams. The number of fraudulent returns detected has grown steadily over recent years. As of December 31, 1994, of the total number of returns reviewed, IRS had identified 77,781 as fraudulent—44,137 on paper and 33,644 electronic returns. About \$43 million in fraudulent refunds was not detected soon enough to stop the refund to taxpayers, but IRS stopped about \$117 million in refunds from being released. About 91 percent of the fraudulent returns claimed the EIC.

GAO 1995 Interim Enforcement Results

Delayed and rejected returns

- About 355,000 paper returns delayed
- About 3.7 million electronic returns rejected
- 2.9 million EIC returns delayed up to 8 weeks to check for duplicate SSN use

About 1 percent of new electronic return originator applicants rejected

Source: IRS data.

IRS' 1995 Countermeasures for Addressing Noncompliance

Verifying SSN accuracy is key to IRS' 1995 EIC enforcement efforts. For paper returns, IRS enters into computers the taxpayer's SSN and, starting this year, dependent and EIC qualifying children's SSNs. When returns have missing or invalid SSNs (i.e., do not match SSA records), IRS delays the return and contacts taxpayers to resolve the problem. As of March 17, 1995, IRS had delayed the refunds for about 355,000 paper returns that lacked a valid dependent or qualifying child's SSN.

IRS has added controls to prevent returns with missing or invalid SSNs, or SSNs already used by another taxpayer, from being filed electronically. All returns with these problems are to be rejected and returned for correction. As of March 17, IRS had sent out 3.7 million rejection notices⁷ principally for electronic returns with SSN problems related to a questionable refund. About 1.1 million notices were primarily due to the EIC qualifying child's SSN or year of birth not matching SSA records. The remaining 2.6 million notices were primarily due to dependent SSN problems.

In addition, IRS is working to identify uses of the same SSN on more than one tax return. Through a new tracking system, IRS intends to identify potentially problematic returns and trigger enforcement. Because of past EIC fraud problems, IRS is concentrating on EIC returns. IRS delays refunds up to 8 weeks from the time a notice is sent to taxpayers to allow staff time to identify duplicate SSN uses and fraud schemes—about 7 million EIC returns could be delayed. As of March 17, about 2.9 million EIC refunds had been delayed. As of March 17, IRS national office officials told us that initial problems with the duplicate SSN system were overcome early in the year. However, compliance personnel we spoke with said that problems with duplicate SSN data continued to impede their effective use of the system in mid-March.

IRS has begun checking criminal and credit histories of new return originator applicants who wish to file taxpayers' returns electronically. Due to these checks, IRS had rejected about 1 percent of applicants.

As of mid-March, statistics were not available on fraudulent returns detected this year.

⁷Because a return can be rejected for more than one reason, the number of notices may be exceed the number of returns.

Better Measuring EIC Filers' Resources

GAO Wealth

Comprehensive wealth test may be impractical

A narrower test, measuring income that is derived from taxpayers' assets, may be more practical

- Imperfect measurement
 - Fairness concerns
-

Options for Measuring Wealth

Congress requires income and wealth tests for certain welfare programs like Aid to Families With Dependent Children (AFDC). States use questionnaires to determine the welfare applicant's degree of need. A similar wealth test for the EIC likely would require additional IRS resources, or a diversion of current resources, to obtain and verify the data. Although states might administer a wealth test for IRS, such an arrangement likely would take time to perfect.

Alternatively, a test that uses income earned from assets as an indirect indicator of wealth is perhaps more immediately practical.⁸ Such a test could measure income reported on tax returns that is derived from taxpayers' assets and compare that income to an income threshold. This is the general approach proposed by the administration and incorporated in House and Senate versions of H.R. 831, a bill to permanently extend the health care deduction for self-employed individuals.

In evaluating an indirect wealth test, Congress might wish to consider several options. Asset-derived income is in several income categories. These include taxable interest and dividends, tax-exempt interest, estate and trust income, rental income, and capital gains. A wealth test that includes a broad array of asset-derived income might better measure taxpayers' wealth than a less inclusive test.

However, no wealth test relying on tax-return information can completely measure a taxpayer's wealth. For example, the value of a home,⁹ valuable collections, and stocks that appreciate but pay few, if any, dividends is not reflected on tax forms except when the assets are sold. Within the constraints of using data reported to IRS, broader income measures might come closest to measuring a taxpayer's overall wealth, but the measures nevertheless could incorrectly represent some taxpayers' wealth while more accurately measuring others' wealth. These limitations raise fairness concerns since taxpayers with similar wealth could be treated differently for purposes of the EIC.

⁸Taxpayers' wealth is somewhat taken into account through the present AGI rule since AGI includes some asset-derived income. The wealth test we discuss takes this approach an additional step by disqualifying taxpayers' whose asset-derived income, when summed, exceeds a threshold.

⁹The value of a recipient's home may not be included in wealth tests for welfare programs; for example, it is not considered for AFDC.

GAO Wealth Thresholds

Income realized from assets	Presumed value of underlying assets^a
\$1,000	\$16,700
1,500	25,000
2,500	41,700

^aThe relationship between income and wealth is based on the assumption of a simple 6-percent annual realized return on the value of the underlying assets.

Wealth Thresholds for Qualifying for the EIC

Congress will need to set a threshold amount above which taxpayers would be disqualified from receiving the EIC if it wishes to adopt an indirect wealth test for the credit. The House version of H.R. 831 proposes a \$2,500 threshold, indexed for inflation. The credit would phase out as asset-based income rose above \$2,500 and disappear when such income was at least \$3,150. The Senate version of the bill proposes a \$2,450

unindexed threshold with different income items and provides no phase out. One consideration in selecting a threshold amount could be the level of assets, or wealth, that a given level of income may represent. Possible thresholds could include, for example, amounts of \$1,000, \$1,500, and \$2,500. Assuming a 6-percent annual realized rate of return, about \$16,700 of assets would generate \$1,000 of income. About \$25,000 and \$41,700 of assets would generate \$1,500 and \$2,500 of income, respectively.

However, the relationship between asset-derived income and the underlying asset value may vary widely. For example, if a taxpayer reports \$1,000 of bank account interest, the average annual account balance likely would have been between \$10,000 (at a 10-percent interest rate) and \$30,000 (a 3.3-percent rate). If \$1,000 of interest was earned on a tradeable bond, the value of the underlying bond could lie outside those bounds because a bond's value rises or falls as interest rates change.

Associating income reported on tax forms with an underlying asset value is most problematic for capital gains income. For example, \$1,000 of reported gain could come from a successful \$1,000 investment in stocks that doubled in value. But, a \$1,000 capital gain also could come from a \$100,000 investment in stock that performed very poorly. The association between reported capital gains and underlying asset values also is complicated because the return on the assets could have been accumulated over many years.

It is difficult to say whether a goal of treating taxpayers of similar means similarly is better served by implementing a broad wealth test that combines income from assets with widely varying rates of return, or implementing a narrower test that ignores some assets completely. In considering a threshold amount for an indirect wealth test, lower thresholds may be more appropriate if the relationship between income and the value of underlying assets is less likely to vary widely among taxpayers.

GAO Wealth Test Results

Income derived from taxpayers' assets (wealth)	Option 1	Option 2	Option 3
Taxable interest ^a	•	•	•
Taxable dividends ^a	•	•	•
Tax-exempt interest ^a	•	•	•
Net estate and trust income		•	•
Net rental ^b income		•	•
Net capital gains ^c			•

Dollars in millions

Income threshold	Estimated revenue in FY'97 from reductions in EIC		
\$1,000	\$685	\$833	\$971
1,500	505	637	766
2,500	318	405	524

^aLess investment interest paid.

^bNet rental real estate income, net income from Real Estate Mortgage Investment Conduits, net farm rental income, and royalty income.

^cNet capital gains (Schedule D) and other gains (Schedule 4797).

Source: JCT estimates for Senator William V. Roth, Jr.

Lower Wealth Thresholds
and Broader Measures
Reduce EIC Program Costs

As more sources of income derived from taxpayers' assets are included in an EIC wealth test and as the test threshold is lowered, EIC program costs would be reduced further. Joint Committee on Taxation (JCT) revenue estimates illustrate this point.¹⁰ For example, option 3, including the broadest base of income derived from taxpayers' assets, coupled with a \$1,000 threshold, is estimated by JCT to raise \$971 million in revenue in fiscal year 1997. In contrast, option 1, including only taxable interest and dividends and tax-exempt interest, coupled with the higher \$2,500 threshold, is estimated to yield \$318 million in revenue in fiscal year 1997. JCT's latest published estimate for the EIC program's total cost in fiscal year 1997 is \$25.8 billion. Thus, \$971 million would represent about a 3.8 percent reduction in the total EIC program costs, and \$318 million would represent about a 1.2 percent reduction.

¹⁰Although figures provided by JCT are revenue estimates, these estimates can be thought of as "program cost" reductions. The EIC is a refundable tax credit. As such, the portion of the credit that offsets taxes owed by EIC recipients is considered a tax expenditure, i.e., a reduction in taxes due to a preferential provision in the federal tax law. The refundable portion of the EIC is considered a federal outlay. Since most EIC recipients owe no taxes, most of total EIC "costs" come from the refundable, or outlay, portion of the credit.

GAO Income

Income not included in AGI test

- Nontaxed social security income
- Tax-exempt interest
- Nontaxed pension distributions

AGI Criteria Could Be Expanded

Although the amount of EIC a taxpayer receives is based largely on earned income, the amount, if any, also depends in part on other sources of income. Taxpayers' AGI can limit their EIC payments. In addition to earned income, AGI includes income from other sources, such as investments, alimony received, and unemployment compensation. When taxpayers' AGIs fall within the EIC phase-out range, EIC payments are the lower of those resulting from using taxpayers' AGI or earned income. When AGIs exceed the top of the EIC phase-out range, taxpayers are ineligible for the credit regardless of their earned income level. Adding income elements to calculations of the AGI for the EIC, thus, would be an incremental change that would enable Congress, if it so desired, to take into account a fuller range of taxpayers' incomes in determining the amount of credit taxpayers would receive.¹¹

One alternative for expanding AGI could be to include nontaxed Social Security income, tax-exempt interest income, and nontaxed pension income. These income sources are excluded from AGI for purposes of calculating income tax liabilities but are sources of support available to individuals.¹² Of the three income items, Social Security is the largest income source to EIC recipients. Although most taxpayers eligible for the EIC do not receive Social Security income, several hundred thousand do.

¹¹AGI would be expanded to include those other income items only for purposes of the EIC and not for income tax liability.

¹²The taxable portions of Social Security income and pensions are included in taxpayers' AGIs.

GAO Expanded AGI Results

Expanding AGI would yield \$1.449 billion in FY'97.

Combining an expanded AGI and a wealth test would yield somewhat less revenue than the sum of the two.

Source: JCT estimates for Senator William V. Roth, Jr.

Results of Expanding AGI
to Include Nontaxed Social
Security Income,
Tax-Exempt Interest, and
Nontaxed Pension
Distributions

As requested by Senator Roth, JCT estimated the revenues that would result from including nontaxed Social Security income, tax-exempt interest income, and nontaxed pension income in taxpayers' AGI for purposes of EIC eligibility. It estimated that \$1.449 billion in revenue would be realized in fiscal year 1997 from this change. This would represent about a 5.6 percent reduction in the estimated \$25.8 billion cost of the EIC program for fiscal year 1997.

If both a wealth test and an expanded definition of taxpayers' AGIs were adopted simultaneously for the EIC, the net result in revenues would be somewhat less than the sum of savings from each test independently. This would occur because some of the taxpayers disqualified by one test would also be disqualified by the other; but these reductions resulting from the disqualified taxpayers should not be counted twice when estimating net revenue savings achieved by implementing both proposed changes.

GAO Additional Considerations

Wealth and income tests

- Increase complexity and burden
- May discourage EIC claimants

Wealth test-Broader measures may

- Capture more wealth
- Reduce incentives to shift investments
- Include some unverifiable income

Income test

- Most social security income is not reported on Form 1040
-

Complexity Increases With Wealth and Income Tests

A wealth test and an expanded AGI definition for credit determination purposes would have additional consequences besides reducing EIC program costs. Both changes would increase the complexity of the EIC and impose burdens on taxpayers in determining their eligibility and on IRS in ensuring compliance. Complexity has long been a concern of the IRS. Complexity contributes to taxpayer errors and the EIC's high noncompliance rate. IRS officials also expressed concern to us that a wealth test might discourage some legitimately qualified taxpayers from applying for the EIC—a longstanding concern. Some research suggests that

between 14 percent and 25 percent of eligible taxpayers do not claim the EIC.¹³

Complexity concerns might be alleviated, in part, because a small portion of EIC recipients have income that would be taken into account in either the wealth test or the expanded AGI. For example, in 1992 about 82 percent of EIC recipients had no income from any of the sources included in a broad indicator of wealth. Furthermore, about 50 percent of EIC recipients use paid preparers.

Specifically for a wealth test, broader measures may capture more sources of wealth and might reduce taxpayers' incentives to shift investments to maintain their EIC eligibility. However, IRS would be unable to verify tax-exempt interest income because it receives no third-party information reports to use in checking the accuracy of taxpayers' returns. Short of an audit, IRS also may be unable to verify the cost basis used in determining certain capital gains that could be included in a wealth test.

For the expanded AGI definition, tax-exempt income would, of course, be unverifiable. In addition, only taxpayers whose Social Security income is taxed report their Social Security income to IRS. IRS would have to collect Social Security income data for an expanded AGI test. The SSA provides all Social Security recipients with an annual Form 1099 that records their Social Security income and a computer tape containing this information is provided to IRS. However, under existing systems, according to the IRS, more than a year likely would elapse before IRS would be able to match taxpayers' claimed Social Security income to the SSA tape.

¹³Yin et al., Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, American Tax Policy Institute, Feb. 1994.

GAO Child Support Data Not Reported

Including child support in the expanded AGI may yield \$686 million in FY'97.

Administration would be difficult.

- Data on child support not reported to IRS
 - Verification of child support payments, if reported, may be difficult
-

Source: JCT estimates for Senator William V. Roth, Jr.

Including Child Support Payments in AGI Reduces Costs but Imposes Greater Administrative Difficulty

The AGI definition for EIC purposes could be expanded to include child support payments. Including child support payments would recognize that such payments are part of a family's support. As estimated by JCT, adding child support to AGI along with the other items discussed earlier would result in a savings of \$2.135 billion in fiscal year 1997 (about a 8.3 percent reduction in total EIC program costs for that year). This is \$686 million more than if the AGI definition did not include child support payments.

However, the administrative issues associated with incorporating child support payments in EIC eligibility criteria appear to be more formidable than for the other income items, such as Social Security payments, that could be added to AGI for determining the EIC. Although child support payments may be a factor in determining whether a divorced or separated parent may claim a child as a dependent for income tax purposes, child support income itself is not required on any IRS forms. Therefore, if child support were to be considered in determining EIC eligibility, IRS would need to begin collecting this information.

IRS' ability to ensure compliance is impeded when it cannot verify the accuracy of information reported on tax returns. Independent verification of child support payments could be difficult. In cases where child support agreements are overseen by a court or a state or local social services agency, the overseeing agency may be able to report to the IRS the amounts of child support paid. IRS could use such a report to verify the accuracy of child support data used by taxpayers claiming the EIC. However, systems would need to be developed to routinely report this data to IRS.

When courts or social service agencies do not oversee child support payments, third party verification of payments may be unavailable. Furthermore, the parents could have incentives to misreport the amounts paid. That is, a custodial parent might claim that payments were not made because such payments could affect their ability to claim the child as a dependent for tax purposes. Noncustodial parents who had not properly paid child support would have an incentive to claim they had paid it if for no other reason than to avoid child support enforcement procedures.

EIC Eligibility

GAO Illegal Alien Recipients

No reliable data on number of illegal aliens who received EIC

- IRS suspects that more than 160,000 received EIC in 1994

Many more may have received it

- Duplicate uses of SSNs
 - Temporary identification numbers
-

Some Illegal Aliens Receive EIC

The Internal Revenue Code does not prohibit illegal aliens from receiving the EIC if they meet the prescribed eligibility requirements. IRS forms do not require illegal aliens to identify themselves as such; therefore, IRS does not know how many illegal aliens may be claiming and receiving the EIC.

IRS needs an identification number, generally the taxpayer's SSN, to process a tax return. IRS assigns a temporary Taxpayer Identification Number (TIN) when any taxpayer files a return with an invalid SSN, a blank space, or the

code “205(c).”¹⁴ The designation 205(c) is often used by taxpayers to indicate they are not eligible to receive an SSN. Thus, IRS officials said taxpayers who enter this code are likely to be illegal aliens.

Limited data from manual reviews under the 1994 EIC Compliance Initiative show that a minimum of 160,000 taxpayers,¹⁵ out of about 8.7 million who filed paper returns claiming the EIC, entered 205(c) instead of an SSN for a qualifying child.¹⁶ Given use of the 205(c) code for qualifying children and their enforcement experience, IRS officials believe these returns likely were filed by illegal aliens. IRS expects most of these refunds to be denied because taxpayers will not be able to support their claims by verifying that the dependent met the age, relationship, and residency requirement.

Some unknown portion of returns filed with SSNs may also be filed by illegal aliens. For example, if illegal aliens use SSNs of other individuals when filing a return and IRS does not detect the SSN duplication, they may receive an EIC refund. IRS’ new efforts to detect duplicate uses of SSNs, if successfully implemented, should reduce the number of illegal aliens as well as U.S. citizens incorrectly receiving tax refunds.

¹⁴The designation 205(c) refers to section 205(c) of the Social Security Act as amended which specifies the rules for issuing SSNs. Most legal aliens can obtain an SSN if they meet the applicable requirements. Section 205(c) does not refer specifically to illegal aliens.

¹⁵In addition to the 160,000, an unknown number of illegal aliens would have received the EIC because the amount they claimed was below the Compliance Initiative’s dollar threshold.

¹⁶EIC claimants are required to provide a TIN for qualifying children.

GAO Excluding Illegal Aliens

Administration's compliance proposal

- Exclude illegal aliens from EIC eligibility
- Require recipient to have an SSN
- Allow IRS to use streamlined enforcement procedures

Administration estimates \$400 million in reduced EICs in fiscal year 1997

Proposals to Exclude Illegal Aliens From EIC Eligibility

A Senate bill introduced in 1994 by Senator Roth and the administration's Tax Compliance Act of 1995 (H.R. 981 and S. 453) introduced in 1995 would deny the EIC to illegal aliens. Illegal aliens cannot be employed lawfully in the United States. On the other hand, the EIC, which is intended in part to encourage employment, under current law, can be paid to illegal aliens. Thus, the EIC works at cross purposes with the prohibition on employment of illegal aliens.

The administration's proposal would require that all EIC recipients provide SSNs that are valid for employment in the United States for themselves, for their spouses, if applicable, and for qualifying children. Because illegal aliens cannot qualify for SSNs that are valid for employment in the United States, they would not be able to receive the EIC.

The SSA provides the IRS with a computer tape with names and SSNs of those individuals having SSNs. The data include codes indicating whether the SSN is for employment purposes or other purposes, such as qualifying for Social Security benefits. This data provides a tool for IRS to use in enforcing the administration's proposal. We have not assessed the adequacy of the information in the tape for enforcement purposes or the potential for illegal aliens to fraudulently receive work-related SSNs from the SSA.

Finally, the administration's proposal would permit IRS to use streamlined procedures to enforce the requirement that EIC claimants have valid work-related SSNs. The administration proposes that IRS be permitted to notify taxpayers who do not provide valid SSNs that they are not eligible for the EIC. Within 60 days, taxpayers would either have to provide valid SSNs or request that IRS follow deficiency procedures. Deficiency procedures protect taxpayers' rights through notices to the taxpayer and opportunities for rebuttal of IRS' concerns and petition to the Tax Court. Taxpayers who fail to respond within 60 days to IRS' proposed notice regarding lack of valid SSNs would be required to refile an amended return with correct SSNs to obtain the EIC.

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

Objectives, Scope, and Methodology

As requested, our objectives were to (1) present information about EIC noncompliance and what steps IRS is taking to control noncompliance and (2) review the impact on the amount of EIC paid that might result from potential changes to the EIC eligibility criteria that would reflect taxpayer wealth and additional sources of income and administrative issues that could arise due to these changes. In addition, we were asked to provide information about illegal aliens receiving the EIC and to describe the administration's proposal, which is similar to Senator Roth's 1994 proposal, to exclude illegal aliens from eligibility.

In responding to all of these objectives, we met with and obtained reports and data from officials with the Department of the Treasury and IRS' national office. Primarily in response to the objectives concerning noncompliance and illegal aliens receiving the EIC, we also met with officials and reviewed relevant procedures and data in IRS' Cincinnati, OH, and Fresno, CA, Service Centers.

Specifically for our objective of assessing the effects of certain revisions to the criteria used in determining the amount, if any, of EIC that is awarded, we

- reviewed relevant literature on the EIC to understand its requirements and to determine the results of others' analyses of EIC eligibility modifications;
- met with staff from the JCT to discuss advantages and disadvantages of using possible proxy measures of wealth to determine EIC eligibility;
- interviewed Congressional Budget Office analysts regarding their consideration of modifications to EIC eligibility requirements;
- met with Department of the Treasury Office of Tax Analysis staff to discuss policy and administrative issues associated with EIC eligibility modifications; and
- met with IRS national office officials, including the National Director of Submissions Planning; the Chief of Service Center Compliance; the Director of the Service's Tax Forms and Publications Division; and the National Director, Applications Design and Development Management, to discuss administrative issues associated with EIC eligibility modifications.

In addition, we performed statistical analyses to make preliminary estimates of the potential effects on the overall amount of EIC program costs and the number of EIC recipients of using measures of taxpayers' wealth and additional sources of their income when determining how much, if any, EIC would be awarded. After we determined the general magnitude of change that might result, we discussed our preliminary

results with Senator Roth and he requested revenue estimates, shown in our study, from the JCT.¹⁷

To do our analysis, we first determined how much EIC would have been awarded and to how many recipients had the EIC rules that will be in effect in 1996 actually been in effect in tax year 1992. Applying the 1996 rules, which increase the credit amount and the number of individuals who are eligible for the EIC, provided us with a more realistic indicator of the potential effects of changing the EIC eligibility rules.

Using this as a base measure, we computed the amount of EIC that would have been awarded and the number of recipients if (1) wealth measures of varying breadth coupled with varying cutoff thresholds had been used in determining EIC eligibility and (2) nontaxed Social Security income, nontaxed pension distributions, and tax-exempt income had been included in taxpayers' AGIs in determining how much, if any, EIC they would have received.

To assess the likely effects of changing the EIC eligibility criteria, we obtained and analyzed data from the Internal Revenue Service's (IRS) Statistics of Income Division (SOI) and from the Bureau of the Census' Current Population Survey (CPS).¹⁸ The CPS data was needed because SOI only has data that can be obtained from tax returns. Critically absent from SOI was data related to nontaxable Social Security income. (Social Security income is reported on Forms 1040 and 1040A, but only to the extent that some portion of the income is subject to tax.) We used tax year 1992 SOI data and March 1993 CPS data, which incorporates economic data for the calendar year 1992, because it conformed to the same period as the most recent SOI data available.

Using these data, we simulated the effect of broadening the definition of AGI to include nontaxed Social Security income as well as nontaxed private pensions and tax-exempt interest income. (The latter two items are reported on tax forms.) We used Census' simulation of EIC recipients on its CPS data set to estimate the Social Security income received by the actual SOI population. Overall, we believe that this simulation procedure yielded a

¹⁷Our methodology produces an estimate given the taxpayer income characteristics that existed in 1992 but assuming that the 1996 EIC rules had then applied. The result differs from a revenue estimate, which provides an indication of future changes in revenues due to changes in the EIC statute and also takes into account forecasted changes in interest rates and other economic factors.

¹⁸The Omnibus Budget Reconciliation Act of 1993 revised the EIC criteria, in part making certain taxpayers without children eligible for the credit. Our analyses did not include taxpayers without children.

Appendix I
Objectives, Scope, and Methodology

conservative estimate of the reductions in EIC program costs and the number of affected EIC recipients.

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Glossary

Income

Taxable Earned Income	For the EIC taxable earned income includes (1) wages, salaries, and tips, (2) union strike benefits, (3) long-term disability benefits received prior to minimum retirement age, and (4) net earnings from self-employment.
Nontaxable Earned Income	Among the earned income items that are nontaxable are (1) voluntary salary deferrals, such as 401(k) plans or the federal thrift savings plan, (2) pay earned in a combat zone, (3) basic quarter and subsistence allowances from the U.S. military, (4) housing allowance or rental value of a parsonage for the clergy, and (5) excludable dependent care benefits.
Unearned Income	Items that are not earned income include (1) interest and dividends, (2) Social Security and railroad retirement benefits, (3) welfare benefits (including AFDC payments), (4) pensions or annuities, (5) veterans' benefits, (6) workers' compensation benefits, (7) alimony, (8) child support, (9) unemployment compensation (insurance), (10) taxable scholarship or fellowship grants (not reported on Form W-2), and (11) variable housing allowance for the military.
Adjusted Gross Income	In addition to taxpayers' earned income, AGI includes their income from other sources, such as investments, alimony received, and unemployment compensation.
Qualifying Child	A qualifying child (1) is an EIC claimant's son, daughter, adopted child, grandchild, stepchild, or foster child, (2) is under age 19 or under age 24 and a full-time student or any age and permanently and totally disabled, and (3) lives in the claimant's home in the United States for more than half of the year (or all of the year if a foster child).
Working Poor	The term "working poor," while used in reference to the intended beneficiaries of the EIC, is not defined in statute. Generally, for purposes of this report, we use the term to refer to those individuals who meet the current EIC income criteria, or the revised criteria that we analyze. The revised criteria do not alter the basic EIC income criteria, but rather

Glossary

include a fuller range of potential EIC recipients' resources in determining whether basic eligibility criteria are met.

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