Policy Memorandum

FISCAL RESEARCH CENTER

GEORGIA STATE UNIVERSITY
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FISCAL RESEARCH CENTER
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SUBJECT: Addressing Noncompliance in the Earned Income Tax Credit

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I. Structure of the EIC

A. Brief Description

The EIC is a refundable tax credit that operates through the federal individual income tax system. It is available to low-income, working taxpayers. The credit was originally designed to offset the impact of Social Security taxes. It has since evolved into a work incentive for low-income workers, a benefit for children of low-income workers, and an income supplement for low-income taxpayers without children. Each of these new roles has increased the complexity of the credit and compliance problems.

The most recent IRS study of EIC noncompliance estimates that there were $4.4 billion in EIC overclaims between January 15 and April 1, 1995. This is 25.8 percent of total EIC claims. EIC overclaims are claims by taxpayers who either were not eligible to take the credit or claimed a larger credit than they were eligible to claim.

B. Eligibility Criteria

Taxpayers with qualifying children are eligible to claim the EIC in 1998 if they:

(1) have earned income and modified adjusted gross income is less than $26,473 if they have one qualifying child (or modified adjusted gross income is less than $30,095 if they have more than one qualifying child);

(2) investment income is not more than $2,300;

(3) filing status is not married filing separately;

(4) they have a social security number;

(5) the qualifying child is not the qualifying child of another taxpayer who has a higher AGI. This situation may apply to intergenerational households. A child's mother and grandmother may live in the same household, for example. In such cases the AGI tiebreaker rule applies, and the taxpayer with the highest modified AGI can claim the child;

(6) the taxpayer or their spouse is not the qualifying child of another taxpayer;

(7) the taxpayer is not filing Form 2555 (*Foreign Earned Income*) or Form 2555- EZ (*Foreign Earned Income Exclusion*);

(8) the taxpayer is not a nonresident alien for any part of the year.

Taxpayers without children are eligible for the EIC in 1998 if:

(1) earned income and modified AGI is less than $10,030;

(2) the taxpayer or their spouse are at least age 25 but under age 65;

(3) neither the taxpayer nor spouse are claimed as a dependent on another person's return;

(4) their main home is in the U.S. for more than half of the year.

C. Filing Complexities

Federal tax regulations are complex, and the earned income tax credit is no exception. IRS Publication 596 on the Earned Income Credit consists of more than 20 pages of instructions, examples and tables. The Form 1040 instructions for the EIC consist of over four pages of instructions including three worksheets to determine a taxpayer's eligibility to take the credit and the amount of the credit. The EIC form is two pages. The first page requires information on up to two qualifying children. The second page supplies instructions and definitions.

The length of the documentation is further complicated by changes in the computation of qualifying income. Over the past few years, filers with interest, dividend, rent and/or royalty income in excess of a fixed threshold ($2,300 in 1998) were disqualified from taking the credit. Tax-free interest, nontaxable pensions, annuities and distributions from IRAs are included in AGI to calculate EIC. Net business losses in income that are disregarded at a 50% rate when calculating AGI are disregarded at a 75% rate when calculating EIC. These changes have been meant to clarify the code and/or reduce the tax expenditure attributable to EIC claims.

D. Economic Impact of the EIC

Empirical research examining the impact of the earned income tax credit has found that the credit has a positive influence on labor market participation and hours worked in many cases. The findings of a few of the more recent studies are summarized below.

- Liebman (1998) found that the EIC has increased labor force participation among single women with children and has offset a significant share of recent increases in income inequality.

- Meyer and Rosenbaum (1998) find that a large share of the increase in labor force participation of single mothers can be attributed to the EIC. The EIC explains 34 percent of the weekly increase in employment of single mothers between 1984 and 1996.

- Dickert, Houser and Scholz (1995) find that the EIC increases labor market participation for workers who were not in the labor force before 1993. A large portion (77 percent) of EIC recipients have incomes in the flat or phase out range of the credit which may reduce the hours worked by low-income workers. However, the increase in labor market participation more than offsets this reduction in hours worked.

- Burkhauser, Couch and Glen (1995) argue that the scheduled increases in the EIC through 1996 do more for the working poor than raising the minimum wage. Workers in non-poor households benefit from increases in the minimum wage while the EIC increases the wage of low-wage workers in low-income households with children.

- IRS (1997) reports that the amount of EIC overclaims has decreased over time. In 1988, 35 percent of EIC dollars were overclaimed. In 1996 this figure was reduced to just under 26 percent.

- Bureau of the Census (1997) estimates that in 1996 the EIC reduced the post-tax poverty rate from 22.3 percent to 19.1 percent.

II. Nature of Taxpayer Error/Fraud When Filing the EIC

Often it is hard to differentiate between taxpayer error and fraud. This section categorizes the different types of errors and/or fraudulent behaviors that may occur when filing for the EIC and offers some suggestions for correcting errors and discouraging fraud. In principle, these forms of errors and fraudulent reporting can occur for other aspects of income tax reporting. Some examples are underreporting taxable income, claiming nonexistent dependents, and claiming dependents for whom the taxpayer does not provide sufficient support. Thus, while the errors and fraud attributable to EIC filing may be more pervasive relative to these other aspects of tax reporting, the approach to eliminating errors and fraudulent behaviors for EIC filing are, in principle, no different than addressing tax fraud and errors in general.

A. *Qualifying child errors*. According to GAO (1998), the majority of EIC overclaims (56%) are due to taxpayers claiming children who do not qualify for the EIC either because the child does not meet the residency requirement or the AGI tiebreaker is not applied correctly. The residency requirement states that the child must have lived with the taxpayer for at least half of the year. With the AGI tiebreaker if a qualifying child can be claimed by more than one taxpayer, his mother and grandmother, for example, the taxpayer with the highest AGI is eligible to claim the child. To decrease these types of compliance problem, the IRS needs to be able to track where and with whom a child lives during the year.

B. *Misreported income*. According to GAO (1998), 16 percent of EIC overclaims were due to the following types of misreported income: (1) Taxpayers make arithmetic errors when calculating the various components of the income tax form, or (2) Taxpayers use the wrong filing status. Taxpayers who are married may file as head of household, single, or married filing separately. Such errors affect modified AGI and thereby the credit amount that the taxpayer claims. Taxpayers filing as married filing separately are not eligible to take the EIC. With these types of compliance errors, the IRS recalculates the credit and tax and notifies the taxpayer. (3) An additional problem is that in the phase-in range of the credit there is an incentive to overreport income to increase the credit. In the phase-out range, there is an incentive to underreport income to increase the amount of the credit. For workers with self-employed income, such manipulations may not be detectable.

C. *Errors due to changes in and definitions of eligibility requirements*. Taxpayers may not understand the definitions of various terms needed to file for the EIC. The list of eligibility requirements, for example, is long and complicated. There have been numerous changes in various components of the EIC. The types of income that are included in modified AGI, for example, have changed over the past few years. If a taxpayer is unaware of the changes, he may use previous years' rules to determine the EIC. With these types of compliance errors, the IRS recalculates the credit and notifies the taxpayer.

D. *Workers with no W-2 (Schedule C filers)*. This class of taxpayer was underrepresented in the IRS study. No statistics are available EIC overclaims for this filing class. Self-employed individuals are more likely to misreport their income since they are not subject to third party reporting of their wages. For example, the IRS estimates that sole proprietors, in general, report about 68 percent of their business income. Since the self-employed can more easily underreport their income, they may claim a higher EIC than their actual income would allow. Schedule C filers have traditionally been a troublesome income group for the IRS. Since they do not get W-2s, it is hard for the IRS to verify the amount of income that they earn. One way to improve compliance is to increase audits among this type of filer or to enact some sort of W-2 policy for them. This later option would be extremely hard to administer.

E. *Social Security Numbers (SSNs)*. False SSNs can be used in a couple of ways. Nonresident aliens may use a false social security number to claim the EIC. One way to prevent this type of noncompliance is to deny the EIC to taxpayers without a verifiable SSN. Taxpayers can use the SSN of children that do not belong to them to claim the EIC, or use false SSNs to claim nonexistent children. If the IRS is able to match child and parent SSNs and verify legitimate SSNs, this compliance problem can be reduced.

III. Current Initiatives to Reduce Noncompliance

The following initiatives are currently being utilized to reduce noncompliance.

A. Beginning in 1996, taxpayers without a valid SSN were denied the EIC.

B. In 1997 the IRS began to reduce or deny claims on returns filed with missing or invalid social security numbers for qualifying children. In this year the IRS began treating SSN errors as math errors.

C. TRA97 requires paid preparers to fulfill specific due diligence procedures. These procedures include completing an EIC eligibility checklist, completing the EIC worksheet and keeping a record of the EIC computation, maintaining these records for three years. Paid preparers may be fined $100 per return if due diligence procedures are not followed.

D. Taxpayers with fraudulent claims are denied EIC for ten years, and taxpayers that recklessly and intentionally disregard EIC regulations cannot claim the credit for two years. Taxpayers denied the EIC for the above reasons may apply to be recertified.

E. Under TRA97 the IRS is authorized to use two federal databases to improve compliance: the Social Security Administration's database linking parent and child social security numbers and the Health and Human Services Case Registry of Child Support Orders.

F. The IRS's EIC compliance initiative received $138 million in funding in 1998.

G. IRS customer service and outreach programs have been expanded to help taxpayers filing for the EIC.

H. In 1997 notices were sent to more than 383,000 EIC taxpayers informing them of a SSN problem on their return and reminding them to correct the problem when filing their next tax return.

I. The IRS staff dealing specifically with EIC noncompliance has been increased.

IV. Additional Options for Increasing EIC Compliance

Basic principles of tax analysis suggest two strategies for increasing tax compliance. The first is to provide incentives for taxpayers to accurately report the various types of information required on a tax form. Audits and penalties are the traditional mechanisms used to encourage honest reporting, Higher audit rates and penalties have been shown to increase compliance. Reducing the size of the maximum credit also reduces the incentive to misreport income. Losing the privilege of filing for the tax credit in subsequent years is another method of encouraging compliance.

A second strategy is to require an independent means (third party) to verify the information submitted on the tax form. For example, persons making charitable contributions receive a form verifying the amount and date of the contribution, and employers provide information on taxable wage and salary income for employees. In the case of the EIC, verification of appropriate information such as the length of residence of a child in a household may invade the privacy of the taxpayer. Use of the various federal datasets can potentially provide independent verification for some aspects of the EIC eligibility criteria.

The following are other actions that could be taken to increase EIC compliance. Many of these ideas, however may be politically unacceptable.

A. Advance EIC payments could potentially be used to increase compliance among wage earners. Taxpayers who qualify for the EIC and have at least one qualifying child can fill out the appropriate paperwork and receive advance EIC payments in each paycheck. Many employers, especially those that offer health benefits, may be able to easily identify qualifying children of a taxpayer. A disadvantage of this scheme is that it shifts much of the administrative burden of the EIC and associated costs to the employer. If such a program were implemented, employers should be subject to due diligence procedures.

B. An IRS representative could randomly visit the homes of taxpayers claiming the EIC to verify the presence and length of residence of qualifying children. This would reduce qualifying child errors.

C. The IRS could require additional proof of the presence of qualifying children. For example, the taxpayer could supply medical records, childcare receipts, school attendance records, birth certificates, adoption records, court custody rulings, etc. This would reduce qualifying child errors but would increase compliance costs for the taxpayer.

D. Tax returns of EIC claimants could be audited at a higher rate and higher penalties could be imposed. This should decrease fraudulent claims.

E. The EIC could be based solely on income and *not* consider the number of children. This would eliminate the problems associated with identifying qualifying children. In addition to the EIC, there are currently three tax credits --Credit for Child and Dependent Care Expenses, Child Tax Credit, Additional Child Tax Credit --based on children. If one of these credits were refundable, it would basically replace the child- benefit function of the EIC.

F. The definition of 'qualifying child' could be made to correspond more closely with the definition of 'dependent'. The major difference between the definitions is that the taxpayer must provide over half of total support for a dependent, and a qualifying child and taxpayer must share the same residence for over half the year. Another difference is that dependents can be any age while there is an age limit of qualifying children. A closer definition of these two terms may decrease noncompliance.

G. The EIC could be based solely on income reported on W-2 and 1099 forms. This option simplifies the definition of earned income and eliminates income earned by Schedule C filers. Persons that only earn Schedule C income would not be eligible for the credit. A disadvantage is that persons who earn both W-2 and Schedule C income would be able to claim a higher credit than if both types of income were considered. Depending on the distribution of income in each of these categories, this provision could lower total EIC payments.

H. For Schedule C filers, base the EIC on the amount of self-employment taxes paid. The amount of self-employment taxes paid is verifiable, and this would allow self- employed workers to get back a portion of income taxes paid.

A more comprehensive reform suggested by Yin (1996), Forman (1996) and Yin *et. al.* (1994) is to allow a $5,000 to $10,000 exemption of social security taxes. The original intent of the EIC was to offset the social security tax burden for low-income workers. This goal can be achieved more efficiently through the social security system. This reform removes the need for determining qualifying children and modified AGI. Since other tax credits within the federal personal income tax already target families with children, this aspect of the EIC can be shifted to one of these credits. Social security taxes are based on earned income, so the calculation of modified AGI is not necessary.

V. Other Tax Credits

Several new tax credits which may have compliance problems similar to the EIC have been added to the federal tax code during the past few years. Like the EIC, problems with these credits result in part from self reporting. These credits include: Credit for Child and Dependent Care Expenses, Child Tax Credit, Additional Child Tax Credit, and the Hope and Lifetime Learning Education Credits.

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