# Management Advisory Report: Administration of the Earned Income Credit

**September 2000**

**Reference Number: 2000-40-160**

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 27, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

Pamela J Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Administration of the Earned Income Credit

This management advisory report presents the results of our review of the effectiveness of the Internal Revenue Service's (IRS) administration of the Earned Income Credit (EIC).[1] The objective of this review was to evaluate the history of the EIC, difficulties the IRS has faced involving the EIC in the past, and the problems the IRS faces in the future.

This is the first in a series of audits on the EIC. Currently, the Treasury Inspector General for Tax Administration has the following five audits in process involving the EIC:

- The EIC Recertification Process.
- Duplicate Dependent Claims.
- Revenue Protection Strategy on Improving Taxpayer Compliance.
- Educating and Assisting Taxpayers on the EIC.
- Administration of the EIC Appropriation.

[1] This program is also known as the Earned Income Tax Credit (EITC). All future references to this credit will be referred to as the EIC.

Once these audits are completed and the audit reports have been issued, we will issue a summary report that may also include results from other revenue protection audits.

For this management advisory report, the primary purpose of the IRS' response was to present an overview of the current status of the EIC compliance program. According to management's response, the IRS will soon release to the public the most recent EIC study: Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Tax Returns. This study will provide a starting point from which the IRS will be able to evaluate future IRS efforts.

The response also states that the IRS has recently launched new enforcement efforts to detect and prevent erroneous EIC claims before tax refunds are paid. The IRS has also implemented a program aimed at educating paid preparers and is continuing other outreach programs to state and local governments, faith-based organizations, community groups, business leaders, and low-income taxpayer advocates.

The full response is included in the report as Appendix XIV. Also, an attachment with specific comments is included in management's response and these comments have been considered for inclusion in the report where appropriate.

Our office plans to complete future work that will assess the progress the IRS' initiatives are making toward improving the administration of the EIC.

Copies of this report are also being sent to the IRS managers who are affected by the report. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

# Table of Contents

# Executive Summary

Due to continuing concerns about the efficient administration of the Earned Income Credit (EIC), the Treasury Inspector General for Tax Administration (TIGTA) performed a comprehensive assessment of the Internal Revenue Service's (IRS) administration of the EIC. The objective of this review was to evaluate the history of the EIC, difficulties the IRS has faced involving the EIC in the past, and the problems the IRS faces in the future.

## Background

The EIC is a refundable credit created by the Congress in 1975 to offset the impact of Social Security taxes on low-income families and to encourage low-income families to seek employment rather than welfare. This credit provides a major source of assistance to low-income families. The IRS has the responsibility for administering the EIC.

Since the inception of the EIC, laws and the administration of the credit have grown increasingly complex, and the dollars involved have increased significantly. For example, the IRS has gone from the use of a single line on the tax return for the EIC to a publication and schedule devoted to EIC instructions and computations. The amount of the allowable credit has expanded from a maximum amount of $400 in 1975, to $3,816 in 1999. The maximum amount of earned income or Modified Adjusted Gross Income allowed to qualify for the credit has expanded from $8,000 to $30,580 during the same time frame. In addition, the criteria for the credit has been complicated by qualifying EIC child rules, expanded phase-in (credit gradually increases with income) and phase-out (credit gradually decreases with income) levels, and the availability of receipt of advance payments of the credit throughout the tax year (advance EIC).

As the EIC has evolved, many more taxpayers have become eligible for the credit. Along with expansion has come growth in EIC noncompliance, both unintentional and fraudulent. The Congress has also been concerned with the effectiveness of the IRS to both achieve full participation[1] levels in the EIC among taxpayers who qualify for the credit and reduce EIC noncompliance. In 1997, the Congress authorized the IRS to spend a total of $716 million over a 5-year period for the improved administration of the EIC.

Although the EIC program is a highly visible and well-known source of noncompliance, it is not the most significant. In his May 8, 1997, testimony before the House Committee on Ways and Means, the Treasury Deputy Assistant Secretary for Tax

[1] The number of taxpayers eligible for the EIC compared to those actually receiving the credit.

Analysis stated that the IRS released a study that the gross individual income tax gap in 1992 was between $93.2 and $95.2 billion. The tax gap was largely attributed to underreporting of business income, underreporting of non-business income, and failure to file tax returns.

## Results

The EIC program and its implementation have changed dramatically since it was first enacted. The IRS has faced, and continues to face, problems with a complex processing structure, implementation of legislative changes, and a lack of reliable, current data on compliance and participation levels. As the IRS implements its new organizational structure and works to implement the Government Performance and Results Act of 1993 (GPRA),[2] now is an excellent opportunity to assess the program as a whole and make further improvements.

## Earned Income Credit Organizational Structure and Program Administration

The IRS uses a complex process to administer the approximately $30 billion in EIC claims received each year. The over 18 functions that process these claims have conflicting goals and different approaches for achieving full participation and compliance, both between and within functions. For example, one function's goal is to process paper tax returns and issue refunds within 45 days. Another function's goal is to identify fraudulent returns during processing of the returns and stop payment of the refunds.

Since Calendar Year (CY) 1993, the Government Accounting Office (GAO), IRS Inspection,[3] and TIGTA have issued numerous reports disclosing widespread and serious weaknesses in the IRS' administration of the EIC. The EIC program has been the subject of extensive review by the GAO, TIGTA, and internal IRS studies. The focus of these studies has centered on two competing problems, EIC full participation and EIC overclaims.[4] Yet, problems with ensuring EIC compliance and full participation still exist. In 1999, the GAO reported EIC fraud as a high-risk area.

---

[2] Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285.
[3] The IRS Restructuring and Reform Act of 1998 (Pub. L. No 105-206, 112 Stat. 685) eliminated the Office of the Chief Inspector within the IRS. A new independent office, the TIGTA, was created to provide oversight of the IRS.
[4] EIC overclaims involve both intentional and unintentional (mistakes) attempts to file returns with EIC claims that fail to meet eligibility requirements.

## Earned Income Credit Research Studies[5] and Initiatives

Studies that addressed the EIC participation rate showed significant differences in the estimates of the percentage of eligible taxpayers that claim the EIC credit. Two studies conducted outside the IRS on EIC participation, released between CYs 1994 and 1998, estimated 70 to 88 percent of eligible taxpayers received the credit.[6][7] In contrast, another private study conducted from CYs 1996 to 1997 estimated that only 65 percent of the eligible taxpayers nationwide claimed the credit.[8] The IRS is conducting a new study using 1996 tax return information.[9] While the new study will provide the IRS with a more current participation rate, it still will not provide data about today's EIC population so that a participation rate can be determined.

The EIC noncompliance has been a concern for a number of years. A root cause of EIC noncompliance is that taxpayers determine if they are entitled to receive the credit and the IRS has limited ability to verify entitlement before the refunds are issued. The EIC noncompliance studies conducted on Tax Years (TY) 1994, 1995, and 1997 returns, showed EIC overclaims remained high. The studies showed EIC overclaim amounts reached as high as $9.3 billion,[10] of the total returns with EIC claims for TY 1997, based on preliminary results. The EIC noncompliance studies have remained the only information the IRS has available to baseline EIC overclaims. However, none of these studies have been used by the IRS to establish baselines. Without studies that establish valid and reliable baselines, IRS management cannot accurately identify the population of all eligible EIC taxpayers, measure the extent of noncompliance, or determine if planned activities will achieve desired outcomes.

---

[5] The TIGTA did not validate the methodology or the results of these studies.
[6] Jeffrey B. Liebman, "The Impact of the Earned Income Tax Credit on Labor Supply and Taxpayer Compliance." Study estimated EIC participation ranged from 70 to 88 percent. Participation levels varied based on levels of income.
[7] John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," National Tax Journal (1994). Study estimated 80 to 86 percent EIC participation.
[8] Earned Income Credit Tax Credit Campaign Partnership, "$7 Million Extra to L.A. Workers." (1999) The estimated nationwide average participation rate reported in the publication was confirmed by TIGTA through correspondence with Dr. Richard H. Sander, Professor of Law, University of California, Los Angeles.
[9] The study will also use Survey of Income and Program Participation (SIPP) data, which contains a panel of detailed sample data tracking households and individuals. The SIPP data are available through CY 1996.
[10] Preliminary results from the IRS' draft report on Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (August 4, 2000).

The IRS has several EIC initiatives underway that include: (1) developing a new taxpayer compliance measure, (2) providing expanded customer service, (3) strengthening enforcement activities, and (4) enhancing research efforts. These efforts are intended to reduce overclaims and erroneous filings associated with the EIC. The IRS received from the Congress $144 million in Fiscal Year (FY) 2000 and will receive another $145 million in FY 2001 to fund these activities. Furthermore, the IRS is reorganizing, which will provide a great opportunity for the IRS to address the ongoing problems of improving compliance and identifying EIC-eligible taxpayers that do not claim the credit. However, plans for the new IRS structure do not improve the way IRS processes EIC returns.

Management Response: For this management advisory report, the primary purpose of the IRS' response was to present an overview of the current status of the EIC compliance program. According to management's response, the IRS will soon release to the public the most recent EIC study: Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Tax Returns. This study will provide a starting point from which the IRS will be able to evaluate future IRS efforts.

The response also states that the IRS has recently launched new enforcement efforts to detect and prevent erroneous EIC claims before tax refunds are paid. The IRS has also implemented a program aimed at educating paid preparers, and is continuing other outreach programs to state and local governments, faith-based organizations, community groups, business leaders, and low-income taxpayer advocates.

The full response is included in the report as Appendix XIV. Also, an attachment with specific comments is included in management's response and these comments have been considered for inclusion in the report where appropriate.

Our office plans to complete future work that will assess the progress the IRS' initiatives are making toward improving the administration of the EIC.

## Objective and Scope

Our overall objective was to evaluate the history of the Earned Income Credit (EIC), difficulties the Internal Revenue Service (IRS) has faced involving the EIC in the past, and the problems the IRS faces in the future. We analyzed various reports and statistics regarding the growth in the EIC between Tax Years (TY) 1975 and 1998. We also determined what action the IRS has taken and is planning to take to administer the EIC.

All audit work was done using National Office information and contacts during the period April to June 2000. Our analyses were made using data available through normal management reports. We did not conduct tests to verify the accuracy of the data in the reports.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

## Background

In 1975, the Congress authorized the Secretary of the Treasury to amend the Internal Revenue Code to provide a credit to taxpayers with certain earned income. The Bill, H.R.2166, became Public Law 94-12 on March 29, 1975. The credit, known as the EIC, was a refundable credit established to offset the impact of Social Security taxes on low-income families and encourage low-income families to seek employment rather than welfare.

Since the inception of the EIC, laws and the administration of the credit have grown increasingly complex, and the dollars involved have increased significantly. For example, the IRS has gone from the use of a single line on the tax return for the EIC to a publication and schedule devoted to EIC instructions and computations.

## Evolution of the Earned Income Credit Law

The EIC was originally established as a work bonus designed to offset Social Security taxes and was not designed to vary by family size; the taxpayer merely had to have at least one qualifying child.[1] This credit is a unique program in the IRS. The IRS processes are designed to address the traditional aspects of tax administration, where refunds are generally based on excess withholding of taxpayer's money. However, the EIC allows taxpayers to receive refunds in addition to their excess withholdings. Also, the EIC requires taxpayers to prove their eligibility in order to get the credit.

The amount of the allowable credit has expanded from a maximum amount of $400 in 1975, to $3,816 (maximum EIC allowed for claims with more than 1 EIC qualifying child) in 1999. The maximum amount of earned income or Modified Adjusted Gross Income (AGI) allowed to qualify for the credit has expanded from $8,000 to $30,580 (maximum modified AGI with more than 1 EIC qualifying child) during the same time frame. The EIC is also available to taxpayers without qualifying children. The maximum amount allowable for this credit for TY 1999 is $347.

Credit amounts depend on the number of qualifying children who meet age, relationship, and residency tests. The credit gradually increases with increasing income (the phase-in range), plateaus at a maximum amount (the plateau range), and then gradually decreases until it reaches zero (the phase-out range). For example, in TY 1999 for taxpayers with 2 children, the credit amount gradually increases until modified AGI reaches between $9,500 and $12,500. Once income reaches $12,500, the credit begins to gradually decrease.

[1] General Accounting Office. June 1996. "Earned Income Credit - Profile of Tax Year 1994 Credit Recipients." (GAO/GGD-96-122BR), p. 11.

Taxpayers with earned income or modified AGI exceeding the maximum qualifying income level are not eligible for the credit. Taxpayers with AGI falling in the credit's phase-out range receive the lesser amount resulting from using their earned income or modified AGI in calculating the credit.

Over the past 25 years, the credit has been subject to numerous legislative changes that both expanded taxpayer eligibility and complicated the application of the credit. In addition to complex qualifying child eligibility rules, the criteria for the credit has been complicated by the availability of receipt of advance payments of the credit throughout the tax year (advance EIC). Appendix IV provides detailed information on each legislative change since enactment of the EIC.

As the EIC has evolved, many more taxpayers have become eligible for the credit. Along with expansion has come growth in EIC noncompliance, both unintentional and fraudulent. In 1999, the General Accounting Office (GAO) reported on EIC fraud as a high-risk area. Subsequently, the IRS reported filing fraud in the EIC as a new Federal Managers' Financial Integrity Act (FMFIA)[2] material weakness. This identified the EIC as a national significant control deficiency that is required to be monitored and assessed. Due to this designation, the IRS is required to report its progress in correcting the EIC material weaknesses in its Annual Assurance Statement[3] to the Congress.

The Congress has also been concerned with the effectiveness of the IRS to both reduce EIC noncompliance and increase participation levels in the EIC among taxpayers who qualify for the credit and may not be claiming it. In 1997, the Congress authorized the IRS to spend a total of $716 million over a 5-year period

[2] Federal Managers' Financial Integrity Act of 1982, 31 U.S.C. §§ 1105-1106, 1113, and 3512 (1994).

[3] The FMFIA requires agencies to prepare an annual assurance letter or statement regarding the adequacy of their internal control for both financial and administrative programs.

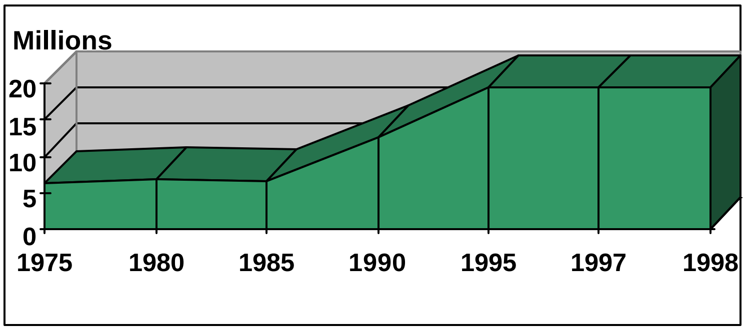
for the improved application of the EIC. The TIGTA is currently conducting a review of the IRS' administration of the EIC appropriation.

**Growth in the Earned Income Credit**

The EIC has grown steadily since it was created in 1975. The number of taxpayers claiming the EIC increased from approximately 6.2 million in TY 1975 to 19.4 million in TY 1998 ($1.25 billion in EIC claimed in 1975 to over $30 billion in 1998). During the same period, the average credit increased from approximately $202 to $1,577. See Figures 1 - 3 below.

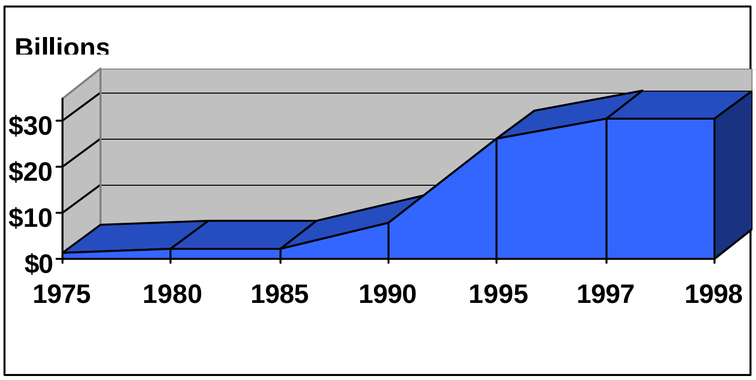
*This figure shows the number of taxpayers claiming the EIC in various years since its inception.*

**Figure 1**
**Number of Taxpayers Claiming EIC**




*This figure shows the total dollars of EIC claimed.*

**Figure 2**
**Total EIC Dollars Claimed**



*This figure shows the growth in average dollars claimed over the years since inception of the EIC.*

**Figure 3**
**Average EIC Dollars Claimed**

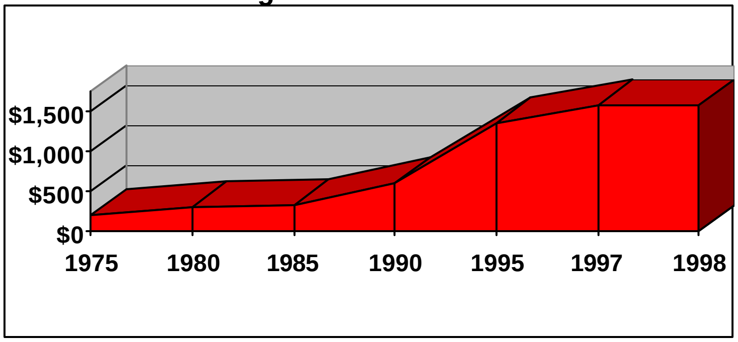
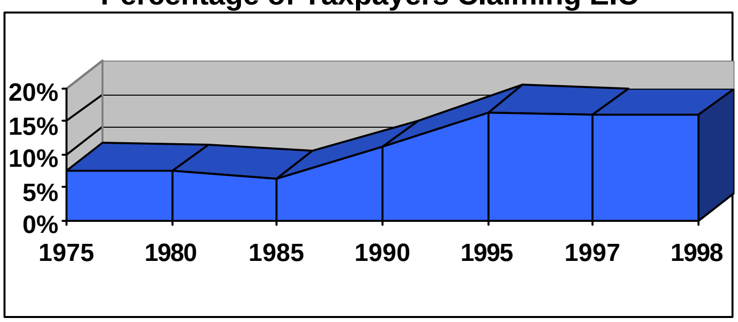



Figure 4 shows the percentage of taxpayers claiming the EIC compared to all individual tax returns filed for TYs 1975 through 1998.[4] Between TYs 1975 and 1985, the percentage of EIC claims remained relatively constant at around seven percent. However, by TY 1990, it had grown to 11 percent, and during the past few years has leveled out at around 16 percent.

*This figure shows the percentage of taxpayers claiming the EIC for various years.*

**Figure 4**
**Percentage of Taxpayers Claiming EIC**




## Electronic Filing and the Earned Income Credit

The advent of electronic filing (ELF) has also impacted the EIC. The IRS, in partnership with H&R Block,

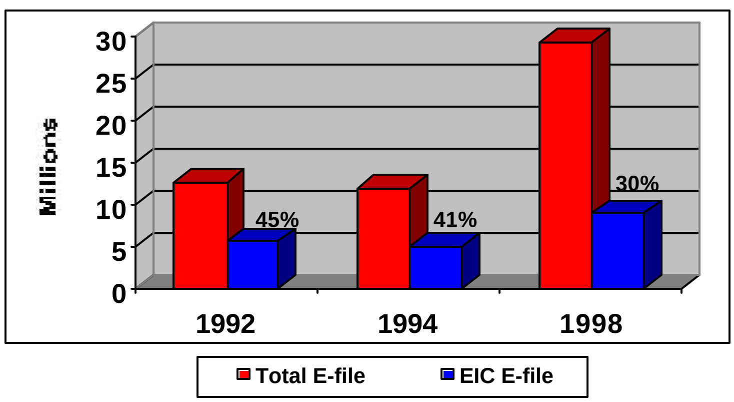
[4] Data for all taxpayers except TY 1998 were obtained from various IRS Statistics of Income bulletins and publications. The TY 1998 data were obtained from the IRS' Masterfile.

developed ELF, now called e-file, and brought it to the IRS in the 1980s. The IRS implemented e-file nationwide in 1990. Generally, taxpayers claiming the EIC have the option to file their tax returns using traditional paper forms or e-file methods. E-file benefits include more accurate and faster processing, resulting in taxpayers receiving faster refunds. With e-file, taxpayers receive their refunds in half the time of filing using paper. In TY 1992, approximately 5.6 million taxpayers claimed the EIC on e-file returns, compared to approximately 8.9 million in TY 1998.

While EIC claims filed using e-file have increased, the percentage of EIC e-file returns have declined when compared to the significant growth in total e-file returns. EIC e-file returns represented approximately 45 percent of electronically filed returns in TY 1992 and approximately 30 percent in TY 1998. Figure 5 shows a comparison of the total e-file returns filed to EIC e-file returns filed.

**Figure 5
Comparison of Total E-file Returns
to EIC E-file Returns**

*This figure shows the growth in e-file, both in total and for returns claiming the EIC.*

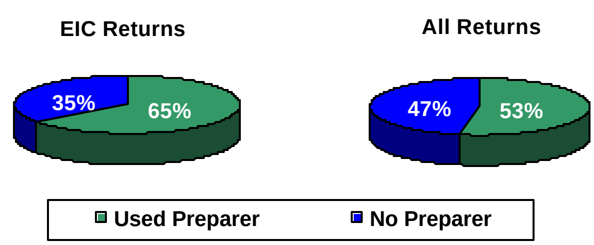



**<u>Preparers</u>**

A recent IRS study showed that approximately 65 percent of taxpayers claiming the EIC on TY 1997 returns used a paid preparer. However, the net benefit of this credit to these taxpayers is reduced by the costs associated with paying someone to prepare their return. Comparatively, only 53 percent of all individual taxpayers used a paid preparer during TY 1997. It would appear that the increasing complexity of EIC requirements may be a driving factor in the use of paid preparers.

The figure below depicts the numbers of EIC and total returns prepared by a paid preparer.

**Figure 6**
**Returns Filed Using Paid Preparers**[5]




Appendices V and VI provide detailed information on the EIC demographics for TYs 1997 and 1998.

## Results

The Congress legislated the IRS to administer the EIC. The IRS has defined this role as ensuring the efficient administration of the law; increasing the full

---

[5] The data for "EIC Returns" were obtained from the preliminary results of the IRS' EIC compliance estimate study for TY 1997 returns (February 2000). These data were dropped in a subsequent draft issued by the IRS in August 2000. The data for "All Returns" were obtained from IRS' Statistics of Income data by state for TY 1997.

participation[6] of eligible taxpayers; and reducing overclaims,[7] fraud, waste, and abuse.

Each year, the IRS allocates resources and implements activities designed to administer the EIC. However, IRS management cannot accurately identify the population of all eligible taxpayers, measure the extent of fraud, or determine if planned activities will achieve desired outcomes. The IRS also does not know if these efforts will increase EIC participation, improve compliance, and reduce inherent EIC vulnerabilities.

For the EIC program, the IRS has not established Government Performance and Results Act of 1993 (GPRA)[8] goals. The Congress enacted the GPRA, in part, to establish accountability over programs and activities and to improve the confidence of the American people in the Federal Government, by systematically holding Federal agencies accountable for achieving program results. The IRS' outcomes should be based, in part, on how its actions and activities effect the wage-earner taxpayer - the vast majority of the IRS' customers.

The ability of the IRS to establish GPRA goals and measures has been hampered by a lack of current reliable information. With the abolishment of the taxpayer compliance measurement program, the IRS has undertaken a number of studies to measure noncompliance in the EIC program. However, not all of these studies were considered reliable,[9] and they provide data that are several years old. In addition, no current data are available on the number of individuals who are eligible for the credit but do not claim it. Due to the

[6] The number of taxpayers eligible for the EIC compared to those actually receiving the credit.
[7] EIC overclaims involve both intentional and unintentional (mistakes) attempts to file returns with EIC claims that fail to meet eligibility requirements.
[8] Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285.
[9] The TIGTA did not validate the methodology or the results of these studies.

comprehensiveness of this assessment, this report has been formatted into two major sections:

- Earned Income Credit Organizational Structure and Program Administration (Page 10)

  This section discusses the roles and responsibilities of the various IRS functions for administering the EIC, the role of the GPRA, and the internal and external audit activities around the EIC.

- Earned Income Credit Research Studies and Initiatives (Page 26)

  This section summarizes the results of numerous internal and external studies, and the IRS' initiatives focused on the EIC.

## Earned Income Credit Organizational Structure and Program Administration

Modernization and reorganization efforts under way create a great opportunity for the IRS to address the ongoing problem of defining full participation and reducing noncompliance. Under the new reorganization, the EIC Project Manager will report directly to the Commissioner, Wage and Investment Division. However, no significant changes have been made to the roles and responsibilities of this project office under the new organization. Also, there are no significant changes planned for the way the IRS processes EIC returns.

Both taxpayers and the IRS face many difficulties in dealing with the complex legal requirements of the EIC. The IRS uses a complex process to administer approximately $30 billion in EIC claims received each year. This process crosses many functional lines, and includes conflicting goals and differing approaches for achieving full participation and reducing overclaims, both between and within functions. For example, one function's goal is to process paper tax returns and issue refunds within 45 days. Another function's goal is to identify fraudulent returns during processing of the returns and stop payment of the refunds.

Much of this complexity passes on to the over 19 million taxpayers who claim the credit. For example, the IRS has gone from the use of a single line on individual tax returns for the EIC to a separate publication and schedule devoted entirely to EIC instructions and computations.

### Roles and Responsibilities

Currently, there are over 18 submission processing, customer service, and IRS support functions that play a role in EIC processing. This organizational structure was designed to address the traditional aspects of tax administration where refunds are generally issued because taxpayers have excess withholding. Faced with administering this refundable credit, the IRS forced the EIC to fit by integrating administration of the credit into the existing processing structure.

To manage this process, the EIC Project Office oversees and coordinates the EIC activities. The IRS has established EIC partners, comprised of representatives from the affected functions, who work with the EIC Project Office to coordinate and implement EIC activities. Fifteen of these partners address EIC non-compliance and nine address full participation (with seven addressing both compliance and full participation.)

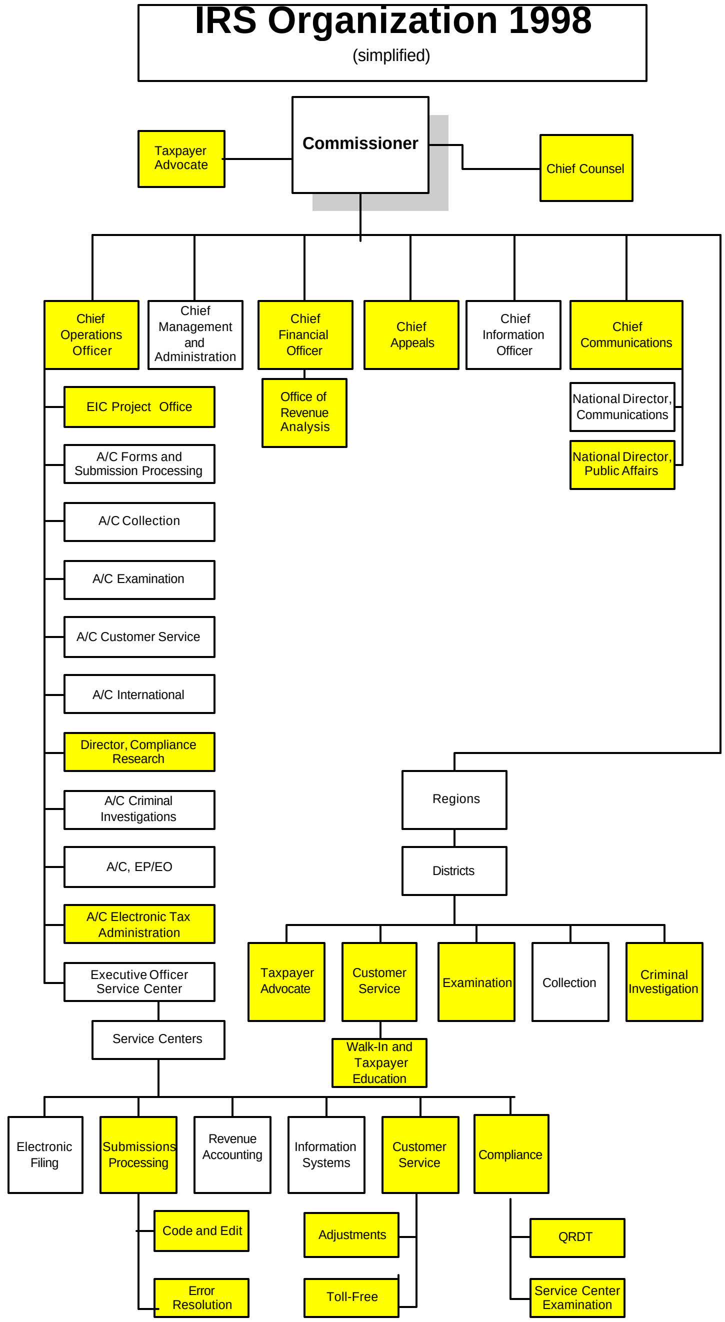
The EIC Project Office developed a strategy that covers Fiscal Years (FY) 1998 to 2002. The strategy contains planned actions that address outreach and education, assistance, prevention, and identification and research. However, the strategy does not contain measurable goals and objectives, or meaningful outcomes that are quantifiable and measurable. For example, the FY 2000 portion of the strategy contains a planned action to develop and implement an integrated strategy contacting EIC preparers for outreach, education, and compliance enforcement visits. The FY 2000 portion of the strategy did not contain time frames for completing the integrated strategy, and an expected outcome or a measure to define whether the activity achieved its goal.

The following pages are illustrations of the 1998 IRS organizational structure (Figure 7) and the proposed organizational structure after modernization (Figure 8); a table of the EIC partners and their roles and responsibilities as they relate to administering the EIC (Figure 9); and a high-level flow chart summarizing the process for EIC returns (Figure 10).

See Appendix VII for a more detailed description of the roles and responsibilities of the EIC partners.

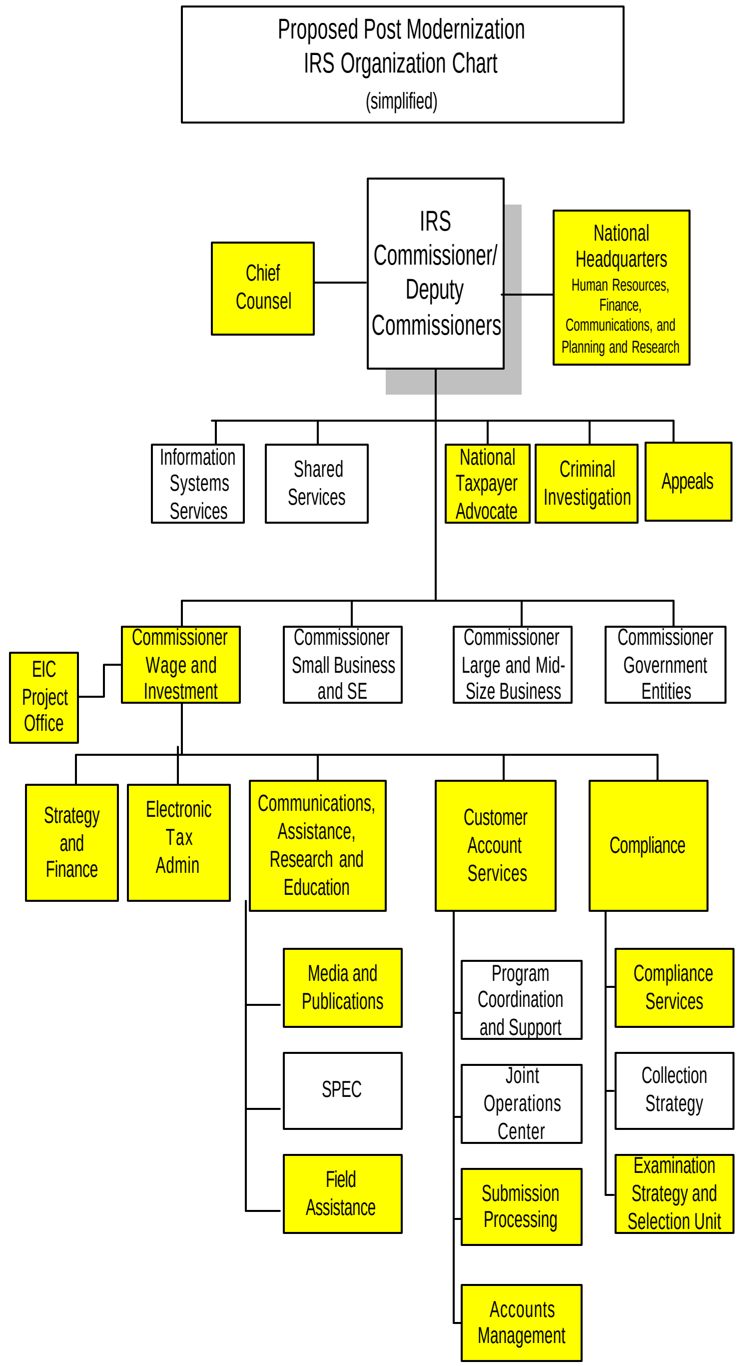
## Figure 7

*Figure 7: The areas shaded represent the organizational areas that are responsible for some role in administering the EIC.*



## Figure 8

*Figure 8: The areas shaded represent the organizational areas[10] that are responsible for some role in administering the EIC.*




[10] Source of shaded areas is the IRS Wage and Investment Network Tax – TV.

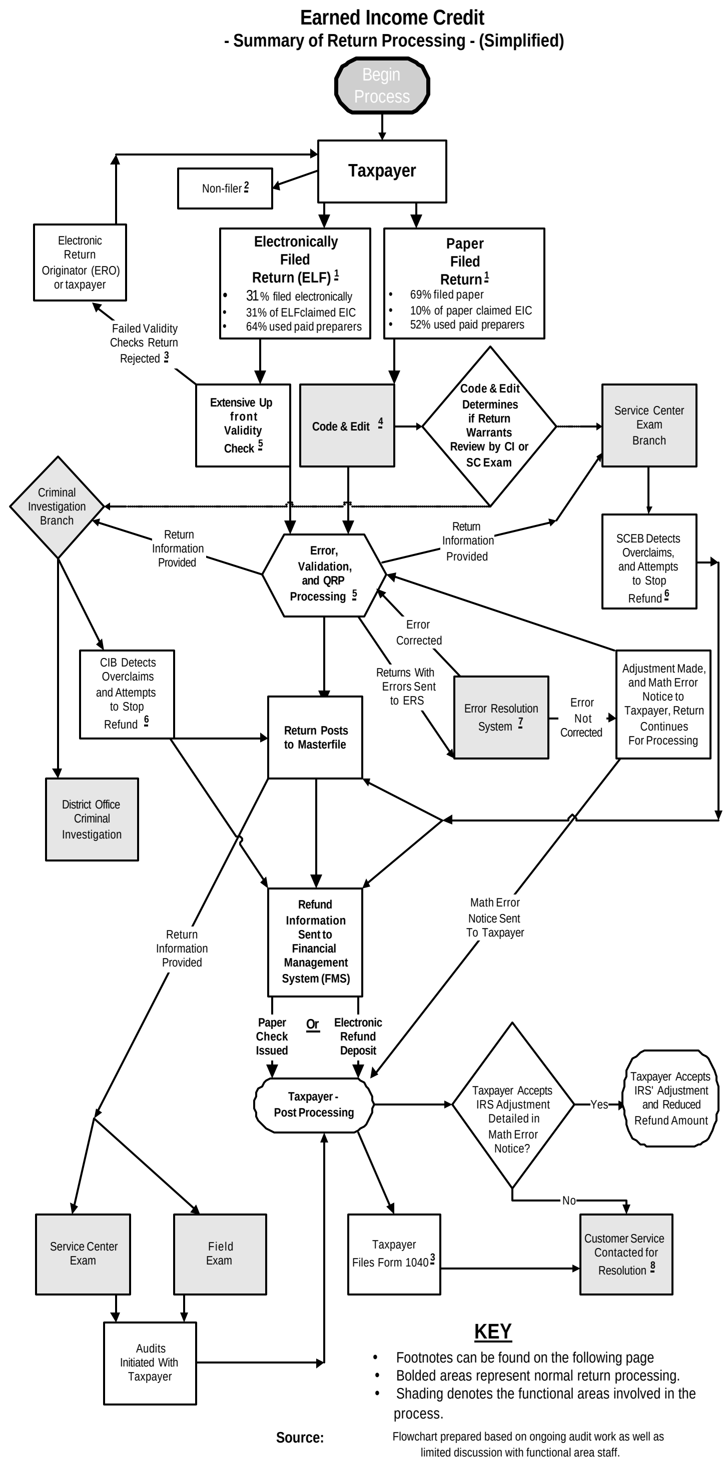
*Figure 9: Under the Responsibilities column, the following notations identify the role of each function:*

***C** = Compliance role*
***FP** = Full-participation role*

## Figure 9
## IRS Functional Roles and Responsibilities (Current)

| Function | Responsibilities |
|---|---|
| **Submission Processing Functions** | |
| Code and Edit | **C:** Identifies returns for review by the Criminal Investigations Branch or Service Center Examination. |
| Error Resolution | **C:** Performs math error processing to disallow questionable EIC during processing of returns. |
| **Customer Service Functions** | |
| Adjustments/Math Error | **C:** Works Math Error responses (written correspondence or calls received). |
| Service Center Examination | **C:** Resolves tax and return issues through correspondence versus face to face contact. |
| District Office Examination | **C:** Conducts examinations of returns and monitors compliance by return preparers. |
| Taxpayer Education | **FP:** Provides EIC return preparation assistance and education seminars at community locations. |
| Toll-Free | **C/FP:** Provides information and assistance to taxpayers that contact the IRS via 1-800 lines. |
| Walk-In | **C/FP:** Provides EIC assistance and conducts awareness campaigns. |
| Electronic Tax Administration- Channel Mgmt. and Marketing | **FP:** Prepares and places messages each year on IRS web sites, the Digital Daily, and on e-file bulletin board. |
| Public Liaison and Small Business Affairs | **C:** Communicates EIC messages and identifies partnering opportunities. |
| **Support Functions** | |
| Appeals | **C/FP:** Provides independent, impartial review of examination case after proposed audit action. |
| Chief Counsel | **C/FP:** Serves as legal advisor to the IRS; provides guidance to taxpayers in form of written regulations, publications, and forms review. |
| Chief Financial Office – Office of Revenue Analysis | Provides quarterly reports to the Congress on how funds have been expended and results generated by EIC efforts. **(This office is neither C nor FP).** |
| Communication Division Marketing and Taxpayer Information Branch | **C/FP:** Produces marketing products on EIC. Markets EIC to external stakeholders. |
| Compliance Research | **C/FP:** Conducts research to identify areas of EIC non-compliance and how to address them. |
| Criminal Investigation Division (CI) | **C:** Investigates potential criminal violations of the Internal Revenue Code. |
| Questionable Refund Detection Team (QRDT) | **C:** Identifies fraudulent returns, stops payment of fraudulent refunds, and refers identified fraudulent refund schemes to the CI. |
| National Taxpayer Advocate | **C/FP:** Intervenes in taxpayers' cases when IRS' normal processes for resolution fail. |

## Figure 10


Earned Income Credit
- Summary of Return Processing - (Simplified)
Begin Process
Taxpayer
Non-filer 2
Electronic Return Originator (ERO) or taxpayer
Electronically Filed Return (ELF) 1
31% filed electronically
31% of ELF claimed EIC
64% used paid preparers
Paper Filed Return 1
69% filed paper
10% of paper claimed EIC
52% used paid preparers
Failed Validity Checks Return Rejected 3
Extensive Up front Validity Check 5
Code & Edit 4
Code & Edit Determines if Return Warrants Review by CI or SC Exam
Service Center Exam Branch
Criminal Investigation Branch
Return Information Provided
Error, Validation, and QRP Processing 5
Return Information Provided
SCEB Detects Overclaims, and Attempts to Stop Refund 6
Error Corrected
Returns With Errors Sent to ERS
CIB Detects Overclaims and Attempts to Stop Refund 6
Return Posts to Masterfile
Error Resolution System 7
Error Not Corrected
Adjustment Made, and Math Error Notice to Taxpayer, Return Continues For Processing
District Office Criminal Investigation
Refund Information Sent to Financial Management System (FMS)
Math Error Notice Sent To Taxpayer
Return Information Provided
Paper Check Issued
Or
Electronic Refund Deposit
Taxpayer - Post Processing
Taxpayer Accepts IRS Adjustment Detailed in Math Error Notice?
Yes
Taxpayer Accepts IRS' Adjustment and Reduced Refund Amount
No
Service Center Exam
Field Exam
Taxpayer Files Form 1040 3
Customer Service Contacted for Resolution 8
Audits Initiated With Taxpayer
KEY
Footnotes can be found on the following page
Bolded areas represent normal return processing.
Shading denotes the functional areas involved in the process.
Source: Flowchart prepared based on ongoing audit work as well as limited discussion with functional area staff.

| Figure 10 Footnotes |
|---|
| [1]**Source of Statistics:** IRS Statistics of Income (SOI)-Taxpayer Usage Study for TY 1999 (4/21/00). All figures are estimates based upon samples of returns and are subject to sampling error. E-file statistics include all electronically filed returns (on-line, Telefile, regular e-file). |
| [2] **Non-Filer Population:** Estimated population of 55 million individual potential non-filers. |
| [3]**E-file Failed Validity Checks:** If a taxpayer files an e-file return that does not meet the e-file validity checks, the IRS rejects the e-file return. The taxpayer then has the option to correct the condition and refile electronically or on paper. |
| [4]**Code and Edit:** Manually identifies returns that require further review by the Criminal Investigations Branch (CIB) or Service Center Examination (SC Exam). For example, all returns filed with an Information to Claim Earned Income After Disallowance (Form 8862) are sent directly to SC Exam to be worked. Also, any returns that appear to meet a predefined (by CIB) scheme are removed from processing and referred to CIB for further review. |
| [5] **Tax Return Validity Checks:** The IRS performs various revenue protection related validity checks.<br><br>Math error processing has never been fully implemented for secondary Social Security Numbers (SSN) and the only math errors for year of birth are based on what the taxpayer puts on the return, not what is contained in the Social Security Administrations (SSA) records. |
| [6]**SC Exam and CIB Stop Refunds:** Employees in SC Exam and CIB input transaction codes to the Integrated Data Retrieval System to stop refunds on returns they determine warrant further review or verification.<br>Each service center has an Examination Section that conducts correspondence audits related to EIC claims that appear to be invalid. Each year, numerous projects are established to cover categories with an excessive EIC overclaim rate. These projects vary from year to year depending on where the major abuse occurs. Some problems encountered include incorrect filing status, erroneous qualifying child claims, and more than one taxpayer claiming the same qualifying child. The majority of EIC revenue protected by the IRS is due to the efforts of SC Exam. |
| [7]**Error Resolution System Tolerances:** To combat filing fraud, the Congress passed the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 [11] to help the IRS deal with questionable credits and deductions more effectively by using math error procedures. As a result, the IRS can disallow questionable credits, such as the EIC, during processing of returns when required SSNs are missing or invalid (i.e., do not match SSA records). |
| [8]**Customer Service:** When a taxpayer receives a math error notice, he/she can call Customer Service to provide a "corrected" SSNs or write a letter that includes this information. A limited validity check is performed (SSN matches name control from SSA records) before the Customer Service Representative adjusts the taxpayer's account. |

[11] Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193.

**Importance of Social Security Numbers**

*For the EIC to be claimed, a taxpayer and the qualifying child(ren) must have a valid SSN.*

The Congress amended the Internal Revenue Code of 1986[12] to prevent fraudulent claims for the EIC. This amendment required the IRS to disallow the EIC to any taxpayer without verification of the SSN. Taxpayers can claim the EIC only if they have valid SSNs that allow them to work. In addition, the taxpayer's spouse and qualifying child, if applicable, must have a valid SSN. If any of the SSNs are determined to be invalid, the EIC may be disallowed. During EIC processing, the IRS uses math error procedures to disallow credits when SSNs are invalid or do not match SSA records.

The IRS relies exclusively on the SSA to issue SSNs to United States (U.S.) citizens or to persons who have permission from the Immigration and Naturalization Service to work in the U.S. Social Security began in 1935, as a system to keep track of earnings and eventually the benefits of people who worked in jobs covered under the program. SSNs were first issued in November 1936.

Since its inception, the use of the SSN has grown from its initial purpose to include its current use for identification and record keeping purposes. There are about one billion possible SSN combinations, and since inception, the SSA has issued over 400 million. As of October 1999, about 217 million SSNs were active. In addition to this extraordinary number of SSNs in circulation creating unique challenges for the IRS in administering the EIC, there are also several types of SSNs assigned to individuals who cannot claim the EIC.

*To receive the EIC, the taxpayer's SSN must be valid for working in the U.S.*

Individuals having social security cards with an imprinted overstamp, "not valid for employment" cannot get the EIC credit. These numbers are issued to aliens who are not entitled to work in the U.S., but who need an SSN so they can get federally funded benefits such as

[12] Congressman Lehman introduced H. R. 4225 April 14, 1994, that amended the Internal Revenue Code of 1986.

food stamps[13] or supplemental security income.[14] An alien is an individual who is not a citizen or national of the U.S. As of October 1998, 7.9 million SSNs were issued to aliens not authorized to work.

Also, taxpayers using the Individual Taxpayer Identification Number (ITIN) or Adoption Taxpayer Identification Number (ATIN) cannot qualify for the EIC. The ITIN is a TIN issued to an alien individual by the IRS, upon application, for use in connection with filing requirements. The ATIN is issued for a child to adopting parents who cannot get a SSN for the child until the adoption is final.

Another common problem related to SSNs is duplicate usage. In some cases, this can occur because divorced parents both claim the same child as a dependent. However, the motive may also be fraud. (We are conducting additional audit work in this area.)

**Tax Law Complexity**

The IRS Restructuring and Reform Act of 1998 (RRA 98)[15] required the IRS to conduct an annual analysis of the sources of complexity in the administration of Federal tax laws and report these results annually to the Congress. The Office of Program Evaluation and Risk Analysis conducts the annual reviews, which report on reducing the complexity and modifying any provision believed to add undue and unnecessary burden to the administration of the Federal tax law.

The IRS issued the first IRS Annual Report on Tax Law Complexity in June 2000. In the report, the IRS noted, "Complexity adds to burden by increasing their (taxpayers) investment in these areas trying to figure out if and how specific provisions apply to them.

[13] A Federal entitlement program designed to help low-income people purchase food.
[14] A Federal program administered by the SSA that pays monthly checks to low-income people who are 65 and older, blind, or have a disability.
[15] Pub. L. No. 105-206, 112 Stat. 685.

Significant reductions in burden, as well as increases in compliance may be driven by a relatively small simplification change that affects many taxpayers." The report addressed three specific provisions in the IRS tax code that impacted individual taxpayers. One of the provisions, filing definitions, addressed the myriad definitions used to determine a taxpayer's eligibility to claim dependency exemptions and credits for qualifying individuals. The credits analyzed included the EIC.

Information analyzed from various sources both internally and externally surfaced inconsistent filing definitions for dependency exemptions and credits for qualifying individuals as a major contributor to tax law complexity. To reduce complexity associated with filing definitions, the IRS suggested that the Congress consider adopting one definition of relationship for dependents and qualifying individuals for tax credits including the EIC, and adopt one age criteria for the filing definitions addressed in the report. Currently, the dependency exemption for Head of Household,[16] and the Dependent Care[17] and Education[18] credits generally use the same relationship test. This test is different for both the Child Tax Credit and EIC eligibility. However, in the report, the IRS does not quantify the potential effect of its suggestion on reducing taxpayer burden or improving productivity.

[16] The filing status of an unmarried or considered unmarried individual taxpayer who paid more than half the cost of maintaining a home. The taxpayer must also have a qualifying person who lived in the home for more than half the year.
[17] An allowable credit for individual taxpayers having earned income who incurred expenses providing care for a dependent not able to care for himself or herself.
[18] An allowable credit for individual taxpayers having incurred qualified tuition and related expenses for the taxpayer, spouse, or dependent claimed as an exemption on the tax return.

## <u>The Government Performance and Results Act of 1993</u>

*The GPRA required that Federal agencies measure and report on their performance.*

In 1993, the Congress mandated that Government offices measure organizational performance. The GPRA requires Federal agencies to establish a hierarchy of performance measures and goals applicable to various organizational units within their agencies. These performance measures and goals should be expressed in objective, quantifiable, and measurable forms to define the level of performance to be achieved by a program activity. The IRS has adopted a number of performance measures that focus on various aspects of tax administration. However, these measures have not focused on the administration of the EIC.

In addition to GPRA requirements, the EIC appropriation for FY 1998 provided additional monies for funding essential compliance and error reduction initiatives and requested data on EIC compliance. The Conference Report[19] accompanying that appropriation bill stated that the IRS should establish a method to track the expenditure of funds and measure the impact of the additional funding on compliance. The Conference Report also required the IRS to submit quarterly reports that identify the expenditures and the change in the rates of compliance to the Committee on Appropriations. The IRS has reported to the Congress on the amounts of revenue protected or collected by various EIC compliance programs, but it has been unable to provide meaningful outcome data, such as the impact these funds have had on improving compliance.

In May 2000, the Chairman of the Senate Committee on Governmental Affairs requested that the GAO initiate a review of the Department of the Treasury's FY 1999 GPRA report and the FY 2001 GPRA performance plan. The review was to assess thoroughness, completeness, and reliability of the information in the FY 1999 performance report with respect to certain agency

[19] House of Representatives, *Conference Report No. 105-284*, (to accompany H.R. 2378), 105th Cong., 1st Sess. (1997).

outcomes, one of which is less fraud, waste, and abuse related to the EIC.

The GAO and TIGTA assessments of EIC activities indicate that the IRS is continuing to take steps that address the EIC process rather than meaningful outcomes. Without a meaningful outcome focus, as required by the GPRA, that would define both the levels of overclaims and EIC participation among eligible taxpayers, the IRS cannot ensure that expenditures of these resources effectively address EIC risks and vulnerabilities.

A GAO report[20] on the IRS' efforts to reduce EIC noncompliance stated, "The 5-year initiative could be into the fourth year before the IRS has TY 1997 and 1998 study data to compare in assessing the initiative's results. That would be too late for the IRS to identify and implement meaningful adjustments to the initiatives. 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."

Since the abolishment of the Taxpayer Compliance Measurement Program, the IRS has been somewhat hampered in its efforts to identify both overall compliance rates and EIC compliance rates. A GAO official told lawmakers on April 10, 2000, that the Congress must come to terms with the fact that a reliable measure of compliance needs to include at least some audits of a scientifically-selected random sampling of taxpayers.[21] Further, the GAO, in a recent assessment of the IRS' balanced performance measure system, stated that the IRS has no tool for reliably measuring taxpayer compliance. The IRS has also had mixed results in its attempts to measure EIC compliance. (This is discussed

---

[20] General Accounting Office July 1998. "IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance." (GAO/GGD-98-150).

[21] Amy Hamilton, "IRS Designs New Taxpayer Compliance Measure." *Tax Analysts*, (April 10, 2000).

in a later section of the report entitled Earned Income Credit Research Studies and Initiatives.)

**Audit Work Involving the Earned Income Credit**

Over the years, the GAO, IRS Inspection,[22] and TIGTA have issued numerous reports disclosing widespread and serious weaknesses in the IRS' ability to: (1) increase full EIC participation by eligible taxpayers, (2) ensure compliance through verification of the taxpayer's eligibility, and (3) reduce inherent EIC vulnerabilities.

The findings and recommendations have ranged from technical to programmatic implementation. The reports issued by the IRS Inspection and TIGTA made 50 recommendations that related to the EIC, of which 47 were implemented. Implementing these recommendations has resulted in improved compliance in certain areas and better fraud detection. However, because the IRS does not have reliable data to measure EIC compliance, the impact of these initiatives cannot be determined.

Problems with ensuring EIC full participation and reducing EIC overclaims continue to exist. For the first 18 years, the EIC received little attention or audit work and IRS Inspection efforts to assess the EIC were fragmented. Since the inception of the TIGTA in January 1999, audit work has become strategic and focused on high-risk EIC areas.

For the period 1993 through 2000, there have been nearly 40 final audit reports issued:

- From 1993 to January 17, 1999, there were 18 final reports issued by IRS Inspection related to the EIC.

---

[22] The RRA98 eliminated the Office of the Chief Inspector within the IRS. A new independent office, the TIGTA, was created to provide oversight of the IRS.

- From January 18, 1999, to the present, there have been five final reports issued by TIGTA related to the EIC.
- From 1994 to 2000, the GAO issued over 16 reports related to the EIC.

Examples of the recommendations made by the IRS Inspection and the TIGTA include:

- Refinements to Questionable Refund programming to detect EIC overclaims. For example:

  During a review of the 1993 Filing Season, IRS Inspection found that when the EIC was claimed on an e-file return, the absence of a valid dependent SSN was a strong indicator of fraud. In one sample, 67 percent of the dependents claimed on the fraudulent returns had either invalid SSNs or no SSNs listed for the dependents. IRS Inspection recommended that the IRS be provided the information necessary to identify fictitious dependents supporting fraudulent e-file EIC claims.
- Clarification of EIC instructions to ensure eligible, and only eligible, taxpayers claim the credit.
- Ways to verify eligibility of taxpayers and dependents claiming the EIC.
- Methods to ensure taxpayers are notified of errors concerning EIC eligibility.
- Availability of adequate resources to work the EIC specific cases, both in Customer Service and the Criminal Investigations Branch.
- Thorough testing of computer programming intended to identify and resolve incorrect and missing TINs. For example:

  The IRS implemented a new computer program intended to identify taxpayers who filed a return in 1998 and in the prior year with the same incorrect TIN. The TIGTA determined this program did not work as intended, as returns that met the criteria were not identified.

The overall concept presented in the GAO reports was that the EIC program has historically been vulnerable to high rates of invalid claims. For example:

- In 1996, the GAO reported that EIC claims for years have been the source of many errors identified during processing. According to the GAO report, in 1995, the IRS identified 1.6 million EIC-related errors involving about 8 percent of all returns with EIC claims. Of the 1.6 million errors, about 600,000 involved situations where the taxpayer claimed the EIC but was found not to qualify, and about 1 million cases where the taxpayer erred in computing the EIC.
- A report issued in 1999 discussed that during 1998, the IRS reported that it processed EIC claims totaling over $29 billion, including over $23 billion (79 percent) in refunds. Of the 290,000 EIC tax returns with indications of errors or irregularities that IRS examiners reviewed, $448 million (68 percent of $662 million claimed) were found to be invalid.

Many of these reports cited inadequate internal controls and difficulty in quickly verifying taxpayer's eligibility for the credit as factors contributing to noncompliance. The reports also presented data relating to the EIC overclaim rate and the profile of EIC recipients.

Recommendations made by the IRS Inspection and the TIGTA have improved the IRS' process to meet the goal of giving the EIC to qualified taxpayers. For example:

- In response to a recommendation by the IRS Inspection in 1993, the IRS rejected e-file returns that had an invalid SSN for a dependent.
- Another recommendation led to the IRS revising individual tax packages and taxpayer information publications to explain the importance of providing both correct SSNs and names for EIC-qualifying children, to avoid problems in processing.

- As a result of a recommendation in 1994, the IRS disallowed the use of "Applied for" in place of an SSN for dependents.

As part of the reorganization, as of March 2000, the IRS identified 5,290 recommendations from various sources such as task forces, prior year legislation, the GAO, IRS Inspection, and employee suggestions. These recommendations were prioritized into 157 primary short-term initiatives. The EIC was included as part of one of the primary initiatives. The IRS indicates that 80 of the 157 primary initiatives have been completed. However, the EIC-related initiative has not been completed. For more information on the TIGTA, IRS Inspection, and GAO audits and recommendations, see Appendices VIII - XI.

## Earned Income Credit Research Studies and Initiatives

The EIC has been the subject of numerous internal and external studies that addressed vulnerabilities and high-risk areas. However, none of these studies have been used by the IRS to establish baselines to assess the EIC program in terms of growth in noncompliance, levels of fraud, the number of individuals who should be claiming the credit but do not, and other aspects of the program that would be useful for effective administration. Not all of the studies have been considered reliable.[23] Nonetheless, all of the studies continue to show unacceptable levels of noncompliance and indicate that additional work needs to be done to improve full participation by eligible individuals.

### Earned Income Credit Entitlement Studies

The number of taxpayers who are entitled to the EIC compared to the number of taxpayers actually receiving the credit is referred to as the EIC participation rate. Two studies conducted outside the IRS on EIC participation, released between Calendar Years 1994 and 1998, estimated 70 to 88 percent of eligible taxpayers received the credit.[24] [25] However, another private study of the EIC indicates the participation rate may be much lower.

This private study performed in Los Angeles estimates only 65 percent of the taxpayers nationwide entitled to

[23]The TIGTA did not validate the methodology or the results of these studies.
[24] Jeffrey B. Liebman, "The Impact of the Earned Income Tax Credit on Labor Supply and Taxpayer Compliance." Study estimated EIC participation ranged from 70 to 88 percent. Participation levels varied based on levels of income.
[25] John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," National Tax Journal (1994). Study estimated 80 to 86 percent EIC participation.

receive the EIC actually claimed the credit.[26] In addition, a recent Washington Post news article cited that an estimated 250,000 Illinois families are losing up to $300 million a year by failing to apply for the credit. Not only does the EIC give money back to working people, it also pumps millions into the state's economy.[27]

There are many media examples of ways taxpayers use the EIC. In a few examples, the EIC enabled taxpayers to purchase a car and another to pursue a doctorate degree.[28] Another example is of a taxpayer that was a welfare mom, left with two babies by a former drug-addict husband. She used the EIC to buy shoes, clothes, and other necessities for her kids. This taxpayer is now an executive assistant and no longer qualifies for the EIC.[29]

The IRS has requested that the Office of Research perform another study of EIC participation using 1996 tax return information.[30] While the new study will provide the IRS with a more current participation rate, it will not provide data about today's EIC population due to the age of the data being used. The following table represents the results of eligibility studies conducted.

---

[26] Earned Income Credit Tax Credit Campaign Partnership, "$7 Million Extra to L.A. Workers." (1999) The estimated nationwide average participation rate reported in the publication was confirmed by TIGTA through correspondence with Dr. Richard H. Sander, Professor of Law, University of California, Los Angeles.
[27] Kari Lydersen, "Chicago Urges Poor to Seek Earned Income Tax Credit," Washington Post, March 24, 2000, Final Edition.
[28] Lydersen.
[29] Earned Income Credit Tax Credit Campaign Partnership, "$7 Million Extra to L.A. Workers" (1999). p. 4.
[30] The study will also use Survey of Income and Program Participation (SIPP) data, which contains a panel of detailed sample data tracking households and individuals. The SIPP data are available through CY 1996.

**Figure 11
EIC Eligibility Studies**

| Tax Year Returns | Year Study Conducted | Study Status | Results |
|---|---|---|---|
| 1990 | 1994 | Completed | 80-86% of eligible taxpayers nationwide claimed the EIC.[31] |
| 1990 | 1996 | Completed | 70-88% of eligible taxpayers nationwide claimed the EIC.[32] |
| 1995[33] | 1996-1997 | Completed | Only 65% of eligible taxpayers nationwide claimed the EIC.[34] |
| 1996 | | Underway | |

Without a process to identify these taxpayers, the IRS will continue having difficulty managing initiatives targeted at increasing EIC participation.

## Earned Income Credit Overclaim Studies

EIC overclaims have been a concern for a number of years and is a major factor underlying the GAO's designation of filing fraud as one of the Federal program areas at high risk because of vulnerability to waste, fraud, abuse, and mismanagement.  In the past, the IRS measured overall taxpayer noncompliance through its Taxpayer Compliance Measurement Program (TCMP). The last TCMP, involving audits of TY 1988 returns, found that about 42 percent of EIC recipients were not entitled to some or all of the credit claimed (representing about 34 percent of the EIC dollars paid that year).

---

[31] Scholz.
[32] Liebman.
[33] The data used were from the Census Bureau's Current Population Survey (CPS) for the Spring 1996 time period putting this data in the TY 1995 category.
[34] Sander.

However, these TCMP results may not represent current compliance levels because the EIC has changed substantially since 1988. For example, changes enacted in 1990 included a major redesign and simplification of the EIC eligibility rules that had accounted for many of the errors found in the 1988 TCMP.

In the absence of the TCMP and in an effort to understand the scope of EIC overclaims, the IRS and outside researchers have conducted several EIC studies. Figure 12 summarizes information about the EIC studies conducted since 1993.

**Figure 12**
**EIC Overclaim Studies**

| Tax Year | Year Study Conducted | Study Status | Results |
|---|---|---|---|
| 1992 | 1993 | Completed | 69.8% of 1,981 returns reviewed where no valid child's SSN was provided on the EIC schedule resulted in an average decrease of $1,197 in EIC claim. |
| 1994 | 1995 | Completed | Estimated $4.4 billion in EIC overclaims.[35] This overclaim amount was 25.8% of the EIC dollars claimed. |
| 1995 | 1996 | Not Released | Estimated between $8.4 and $8.9 billion in EIC overclaims. This overclaim amount was between 32% and 34% of the EIC dollars claimed. |
| 1996 | 1997 | Canceled | |
| 1997 | 1998 | Draft not Released | Estimated $9.3 billion[36] in EIC overclaims. This overclaim amount was 30.6% of the EIC dollars claimed. |
| 1999 | 2000 | Underway | |

The EIC noncompliance studies conducted between 1993 and 1998 used different methodologies but continue to show high levels of noncompliance.

---

[35] EIC overpayment rates are based on percentage of EIC dollars claimed.
[36] Preliminary results from the IRS' draft report on Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (August 4, 2000).

*Tax Year 1992 Returns Study*

A study was conducted at an IRS service center between January and May 1993 on a sample of EIC claims where no valid child's SSN was provided on the EIC schedule. Of 1,981 returns examined, 69.8 percent resulted in a change, with an average decrease of $1,197 in EIC claims.

*Tax Year 1994 Returns Study*

The IRS conducted a broader, more statistically reliable study of EIC returns filed electronically and on paper in 1995. The study showed that of the $17.2 billion in EIC claims on TY 1994 returns filed between January and April 1995, about $4.4 billion, or 25.8 percent, of total EIC claimed was estimated to be overclaims. The most common EIC error was taxpayers claiming qualifying children who did not reside with them for over half the year.

*Tax Year 1995 Returns Study*

The IRS conducted a study of TY 1995 returns. However, the methodology and related results were not considered to be reliable by the Department of the Treasury and the study was never released. This study suggested the overclaim rate to range between $8.4 and $8.9 billion.

*Tax Year 1997 Returns Study*

The IRS conducted a study of 2,221 EIC returns filed electronically and on paper between January 20 and May 29, 1998. The preliminary results of the study found that EIC overclaim amounts reached as high as $9.3 billion of the total returns with EIC claims for TY 1997. The study further showed that of the $29 billion in EIC claims paid, approximately $7.3 billion should not have been paid. This number represents overclaims reduced by underclaims and amounts prevented from being paid out or recovered through IRS enforcement activities.

This study also found the one of the most common errors was unqualified children being claimed.

## Earned Income Credit Initiatives

*Initiatives Prior to the Earned Income Credit Appropriation*

Some overclaims involve mathematical errors and other obvious mistakes made by taxpayers or their representatives in preparing the returns. Staff in the IRS' 10 service centers review each paper return when it is received to make sure it is accurate and complete (e.g., includes required supporting schedules and basic entitlement information, such as the SSN of qualifying children, etc.) for returns claiming the EIC.

The most serious form of overclaim involves deliberate attempts to defraud the Government (e.g., through phony refund claims). The Questionable Refund Program, established in the 1970s, is the IRS' primary effort to identify fraudulent refund claims, including those involving the EIC. An IRS computer program analyzes all returns to identify those that are potentially fraudulent. Then, fraud detection teams in the 10 service centers perform more in-depth reviews. If a return is considered fraudulent, the IRS attempts to stop the refund before it is issued.

*Earned Income Credit Initiatives After the Earned Income Credit Appropriation*

Responding to a TY 1994 study showing a 25.8 percent ($4.4 billion) noncompliance rate for EIC tax rules, the Congress enacted legislation that permitted budget authority for 5 years, and a new EIC appropriation to address EIC noncompliance.

The funding was to be appropriated as follows, not more than:

- $138,000,000 for FY 1998.
- $143,000,000 for FY 1999.

- $144,000,000 for FY 2000.
- $145,000,000 for FY 2001.
- $146,000,000 for FY 2002.

The following table (Figure 14) highlights EIC initiatives and results from 1993 - 1999. Details can be found in Appendix XII.

## Figure 14
## EIC Initiatives and Results

| Initiative | Results |
|---|---|
| 1993 Identified returns without EIC SSNs and if EIC was $1000 or more, EIC processed by Exam. | Approximately 350,000 taxpayer notices were issued and about $425 million in EIC refunds were stopped. |
| 1994 Additional unallowable codes developed (missing or invalid dependent TINS, etc.). | About 1.05 million notices were issued. |
| 1995 Several unallowable codes discontinued/modified. About 700,000 notices issued. 300 compliance visits made to businesses and tax preparers in the Southwest District. | Not Available. |
| 1996 Electronic returns rejected for missing/invalid SSNs. Paper returns subjected to math error procedures.<br>Over 1,800 compliance reviews of electronic return originators performed.<br>Questionable Refund Detection Team (QRDT) identified fraudulent schemes involving paper and electronic returns.<br>Criminal Investigation (CI) initiated investigations of return preparers. | 2.9 million e-file and 2.3 million occurrences of missing/invalid SSNs subjected to math error procedures prevented issuance of $1.4 billion in erroneous refunds.<br>322 warnings issued; 65 participants suspended for breaches of requirements.<br>2,500 schemes identified (25,000 returns); prevented $79 million in fraud refunds.<br>172 investigations conducted-107 forwarded for prosecution, resulting in 112 indictments and 84 convictions.<br>Examined 375,000 cases; over $612.9 million in assessments. |
| 1998 ($138 million) Increased staffing for QRDT, District CI, and Exam. Improved EIC education and assistance. Conducted research to understand scope and causes of erroneous EIC claims. Stepped up efforts to identify and stop inappropriate EIC claims. | Using math error authority, stopped 601,258 potentially erroneous EIC claims.<br>Expanded EIC toll-free assistance hours to 24 hours a day, 7 days a week.<br>Protected $977 million in revenue. |
| 1999 ($143 million) Improved EIC education and assistance. Conducted research to understand scope and causes of erroneous EIC claims. Stepped up efforts to identify and stop inappropriate EIC claims. | 72,000 taxpayers assisted with EIC questions through walk-in and EIC awareness days.<br>Toll-free assistance available 24/7; nearly 445,000 callers assisted on general line and 512,000 with specific notice questions.<br>Volunteers provided assistance to help taxpayers file 174,000 EIC returns.<br>Sent over 700,000 filers' soft notices[37] whose prior year return indicated a possible error.<br>Protected $1,123 million in revenue. |

[37] The IRS refers to these contacts as soft notices because the notices do not make demands. Instead, the notices provide information about the potential errors to the taxpayers involved and ask them to review their records and make corrections if necessary.

*Future IRS Earned Income Credit Initiatives*

The IRS has several EIC initiatives underway. For example, it is working to develop a new taxpayer compliance measure. Other initiatives include the following:

*Oversight*

To effectively address overclaims, the IRS plans to establish a compliance council to:

- Ensure a strategic, coordinated approach to compliance issues.
- Conduct high-level performance reviews of strategic compliance initiatives.

*Goals*

For FYs 2000 and 2001, the EIC appropriation provides for expanded customer service, strengthened enforcement activities, and enhanced research efforts to reduce overclaims and erroneous filings associated with the EIC.

Some examples of the IRS' plans to expand customer service include the following:

- Increased outreach activities.
- Improved promotional materials to better explain eligibility requirements.
- Increased toll-free assistor availability to EIC-eligibles.

Examples of the IRS' plans to increase enforcement activities include efforts to:

- Enhance computer identification and selection of questionable EIC claims.
- Expand Examination and Criminal Investigation activities.

Some examples of the IRS' plans to enhance research activities and projects include efforts to:

- Focus on EIC claimant characteristics and patterns of noncompliance that are designed to improve education and outreach products.
- Strengthen the IRS' abuse detection capabilities and measure the effects of agency-wide programs on compliance levels for the EIC-eligible taxpayer population.

Management's Response: For this management advisory report, the primary purpose of the IRS' response was to present an overview of the current status of the EIC compliance program. According to management's response, the IRS will soon release to the public the most recent EIC study: Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Tax Returns. This study will provide a starting point from which the IRS will be able to evaluate future IRS efforts.

The response also states that the IRS has recently launched new enforcement efforts to detect and prevent erroneous EIC claims before tax refunds are paid. For example, the IRS will:

- Partner with the Department of Health and Human Services and the Social Security Administration to permit the IRS to cross-check information reported on tax returns regarding the qualifying EIC child.
- Deny the EIC claim if the claim was denied the previous year and the taxpayer did not follow recertification requirements that were enacted in 1997.

The IRS has also implemented a program aimed at educating paid preparers, and is continuing other outreach programs to state and local governments, faith-based organizations, community groups, business leaders, and low-income taxpayer advocates.

The full response is included in the report as Appendix XIV. Also, an attachment with specific comments is included in management's response and these comments have been considered for inclusion in the report where appropriate.

Our office plans to complete future work that will assess the progress the IRS' initiatives are making toward improving the administration of the EIC.

## Conclusion

Each year, the IRS allocates resources and implements activities designed to administer the EIC. The IRS uses a complex process to administer the approximately $30 billion in EIC claims received from over 19 million taxpayers. Since its inception, the administration of the EIC has been forced to fit into the IRS' existing organizational structure. This has resulted in conflicting goals and approaches among functions that process EIC claims.

Despite the wide range of audit work and studies disclosing deficiencies in the administration of the EIC, problems with ensuring compliance and full participation continue to exist. The IRS has initiated or been subject to numerous internal and external studies that addressed EIC vulnerabilities and high-risk areas. However, some of these studies have not been reliable and the results are several years old. Also, despite problems with the inappropriate use of SSNs, the IRS has not yet implemented planned computer matches that will partially address this problem. As the IRS reorganizes and implements the GPRA, it should assess the EIC program as a whole to identify ways to further improve it.

## Appendix I

### Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the history of the Earned Income Credit (EIC), difficulties the Internal Revenue Service (IRS) has faced involving the EIC in the past, and the problems the IRS faces in the future.

To accomplish our objective, we completed the following sub-objectives and tests.

I. Researched the legislative and economic history of the EIC from the inception of the credit to the present.

   A. Reviewed various sources of EIC legislation, including Commerce Clearinghouse, Research Institute of America, and the Library of Congress to identify the law that created the EIC and the key legislative changes since 1975.

   B. Researched Statistics of Income quarterly and annual publications to determine the number of taxpayers claiming the EIC, the dollar amounts claimed, and the growth of electronic filing as it relates to the EIC.

   C. Researched the Congress' Joint Economic Committee web site.

   D. Obtained copies of research studies on EIC participation from 1994 and 1998.

II. Determined the audit work involving the EIC performed by the General Accounting Office (GAO), IRS Inspection,[1] and the Treasury Inspector General for Tax Administration (TIGTA).

   A. Researched the directory of audits performed by IRS Inspection from 1992 through 1998 and by TIGTA in 1999 and 2000, including audits in process, to identify EIC reviews and audit reports issued and recommendations made.

   B. Researched the GAO web site to identify GAO reports and testimony related to the EIC from 1994 to 2000.

III. Obtained the results of past and current IRS studies of EIC compliance.

---

[1] The IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, 112 Stat. 685) eliminated the Office of the Chief Inspector within the IRS. A new independent office, the TIGTA, was created to provide oversight of the IRS.

A. Researched GAO reports issued on EIC compliance to identify results of the last Taxpayer Compliance Measurement Program audit conducted in 1988 and on the IRS compliance study of 1994 returns.

B. Reviewed report issued in September 1993 by Dr. Malcolm K. Sparrow, "Fraud in the Electronic Filing Program - A Vulnerability Assessment prepared for the Internal Revenue Service."

C. Reviewed IRS Inspection notes from an August 1998 briefing by Dr. Sparrow to the IRS on EIC-Based Refund Fraud.

D. Reviewed an IRS draft report on EIC compliance for Tax Year (TY) 1997 returns (1998 EIC Baseline Study) to identify the latest research results on EIC compliance to date.

E. Researched IRS memorandums to identify plans for an EIC compliance study in Fiscal Year (FY) 2000.

IV. Determined the roles and responsibilities of the various IRS functions in administering the EIC.

A. Researched IRS internal web sites and EIC appropriation reports to identify the EIC internal partners and their roles in administering the EIC.

B. Obtained from the IRS Criminal Investigation Division the results of its work in identifying fraudulent refund schemes, including the amounts of refunds deleted by type of return filed (paper or electronic).

C. Researched IRS processing documentation to determine how EIC returns are processed (electronic and paper), including post processing activities.

V. Identified the IRS EIC initiatives, including those prior to the EIC annual appropriation (FY 1997 and earlier).

A. Reviewed IRS Revenue Protection Strategy results for TYs 1993 through 1996 to identify the results of IRS programs to identify invalid EIC claims.

B. Reviewed IRS EIC appropriation reports for FY 1998 and FY 1999 to identify IRS EIC initiatives and the results of those initiatives (e.g., revenue protected, number of taxpayers assisted, actual IRS resources expended, etc.).

VI. Determined what steps the IRS plans to take in the future to improve EIC compliance and expand EIC customer service.

A. Reviewed the IRS Criminal Investigation Modernization Blueprint to identify future plans for a Compliance Council and its roles and responsibilities.

B. Reviewed the IRS EIC FY 2001 Budget Justification and Budget in Brief to determine what plans the IRS had to improve EIC compliance and assistance efforts in FY 2000 and the plans for FY 2001.

C. Researched the Internet tax site "Tax Notes Today" to identify current IRS work on a National Compliance Survey.

D. Reviewed the June 2000 Annual Report from the Commissioner on Tax Law Complexity to determine the IRS' plans to address EIC administration complexity issues.

VII. Assessed the importance of the social security number (SSN) in EIC compliance.

A. Researched the Internet to obtain the history of the Social Security system.

B. Researched IRS publications on valid and invalid numbers for EIC eligibility (SSN, Individual Taxpayer Identification Number, and Adoption Identification Number).

## Appendix II

### Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage & Investment Income Programs)
Susan Boehmer, Director
Michael Phillips, Director
Stanley Rinehart, Director
Deann Baiza, Audit Manager
Donald Butler, Audit Manager
Bryce Kisler, Audit Manager
Patricia Lee, Audit Manager
Dan Adams, Senior Auditor
John Hawkins, Senior Auditor
S. Kent Johnson, Senior Auditor
Frank Jones, Senior Auditor
Edie Lemire, Senior Auditor
Bobbie Draudt, Auditor
Kathy Henderson, Auditor
Elizabeth Stout, Auditor
Tom Joyner, Computer Specialist

## Appendix III

### Report Distribution List

Deputy Commissioner Operations C:DO
Office of the Commissioner, Wage and Investment Division W
Earned Income Tax Credit Project Manager OP
Office of Management Controls M:CFO:A:M
Office of the Chief Counsel CC
Director, Legislative Affairs CL:LA
Director, Strategy and Finance, W:SF
Director, Office of Program Evaluation and Risk Analysis M:O
Audit Liaison, Earned Income Tax Credit Program Office OP
National Taxpayer Advocate TA

## Appendix IV

### Evolution of the Earned Income Credit Law

The Congress established the Earned Income Credit (EIC) in 1975 to offset the impact of Social Security taxes on low-income families and encourage low-income families to seek employment rather than welfare.[1] The EIC was originally established as a work bonus designed to offset Social Security taxes and was not designed to vary by family size; the taxpayer merely had to have at least one qualifying child. The EIC was a temporary 10 percent credit with a maximum value of $400. Over the past 25 years, the credit has been subject to legislative change. The revisions both expanded eligibility and complicated the application of the credit.

Today, the EIC is available to taxpayers who have earned income and meet Modified Adjusted Gross Income (AGI) thresholds. Credit amounts depend on the number of qualifying children who meet age, relationship, and residency tests. The credit gradually increases with increasing income (the phase-in range), plateaus at a maximum amount (the plateau range), and then gradually decreases until it reaches zero (the phase-out range). Taxpayers with earned income or AGI exceeding the maximum qualifying income level are not eligible for the credit. Taxpayers with AGI falling in the credit's phase-out range receive the lesser amount resulting from using either their earned income or AGI in calculating the credit.[2]

The following are key legislative changes since enactment of the EIC.

**1978 –** The EIC became a permanent credit. Required employers to make advance payments of the EIC to employees certified as qualifying for the credit during the current year. *[Revenue Act of 1978, P.L. 95-600]*

**1984 –** The credit increased to 11 percent with a maximum of $550. *[Deficit Reduction Act of 1984; P.L. 98-369]*

**1986 –** The credit increased to 14 percent and the earned income base was raised, resulting in an increase of the maximum credit from $550 to $800. The legislation increased the amount of income that could be earned (phase-out level) and still be eligible for the credit from $11,000 to $17,000. It provided for annual inflationary adjustments to the credit amount and the phase-out level. *[Tax Reform Act of 1986; P.L. 99-514]*

---

[1] General Accounting Office. Sept. 1996. "Earned Income Credit: IRS' 1995 Controls Stopped Some Noncompliance, But Not Without Problems." (GAO/GGD-96-172), p. 3.
[2] General Accounting Office. "Tax Administration: Earned Income Credit Noncompliance." May 1997 (GAO/T-GGD-97-105), p. 1.

**1990 –** The credit rate and phase-out levels were increased, a higher credit was provided if a taxpayer had two or more qualifying children, and the EIC was revised into three parts - basic credit, supplemental young child credit (for children under the age of one), and supplemental health insurance credit (for amounts paid for the children's health insurance). Also, this legislation required taxpayers to provide the IRS with the name and age of each qualifying child and a social security number (SSN) for those children age one or older. *[Omnibus Budget Reconciliation Act (OBRA) of 1990; P.L. 101-508]*

**1993 –** The EIC was increased by increasing credit rates, earned income base amounts, and phase-out levels. For Tax Year (TY) 1994, the credit maximum was $2,528 for 2 or more children. Provisions were made to continue increasing the credit rate annually until reaching a maximum of 40 percent (for 2 or more children) or 34 percent (for 1 child) for TY 1996 and later. This legislation eliminated the supplemental young child and health insurance components of the EIC.

This legislation also expanded the EIC to include a smaller credit for taxpayers without qualifying children. Single or married taxpayers could claim this credit provided at least 1 of them was between the ages of 25 and 64 at the end of the TY. The credit rate was 7.65 percent and the maximum credit for TY 1994 was $306. It limited the advance EIC to 60 percent of the maximum credit available for taxpayers with 1 qualifying child. Advance EIC allowed taxpayers to receive the credit during the year through their employer; however, it was not available for taxpayers without qualifying children. *[OBRA 1993; P.L. 103-66]*

Note: The credit rate percentages created by the OBRA 1993 are the current rates applicable for TY 1999.

**1994 –** This legislation required taxpayers to provide SSNs for each dependent qualifying child regardless of his/her age. This also applied to qualifying children claimed for the EIC if not their dependent. The EIC was extended to military personnel stationed outside the United States. It prohibited prisoner income from being used to compute the EIC and generally prohibited nonresident aliens from claiming the EIC. *[Uruguay Round Agreements Act of 1994; P.L. 103-465]*

**1995 –** This legislation denied the EIC for individuals having excessive "investment income." It provided that if the level of "disqualified income" was above $2,350, the taxpayer would not be eligible for the EIC. Disqualified or investment income includes interest (including tax-exempt), dividends, and net income from rents and royalties not derived in the ordinary course of business. *[Self-Employed Health Insurance Act of 1995; P.L. 104-7]*

**1996 –** This legislation expanded the definition of "math errors" to include the failure to provide a correct SSN for the taxpayer, his/her spouse, and any qualifying children when claiming the EIC. It revised the definition of AGI to include certain modifications when computing the phase-out level that affects the amount of the EIC. "Modified AGI" is the taxpayer's AGI without regard to certain losses, including 50 percent of net losses from trades or businesses.

This legislation also revised the definition of "investment or disqualified income" and lowered the threshold to $2,200. Taxpayers with investment income above $2,200 were ineligible for the EIC. Investment income includes items such as interest, dividends, and net capital gains. With the exception of individuals who had an EIC eligibility certificate for the TY beginning in 1996, the provisions were effective for TY 1996 and later. *[Personal Responsibility and Work Opportunity Reconciliation Act of 1996, also known as Welfare Reform Act; P.L. 104-193]*

**1997 –** This legislation provided stiff penalties for EIC noncompliance. No EIC would be allowed for 10 years to taxpayers who fraudulently claimed the credit (2 years if not fraudulent but the claim was due to reckless or intentional disregard of the rules). In other instances, if a taxpayer was denied the EIC as a result of deficiency procedures (examination), the taxpayer is required to recertify eligibility by providing qualifying information to the IRS before the credit could be claimed in the following year. It provided for a $100 penalty for each failure by a return preparer to follow due diligence[3] regulations to be established by the IRS on determining the taxpayer's eligibility and computation of the credit. This legislation also redefined "modified AGI" by increasing the percentage of business losses to be disregarded from 50 percent to 75 percent. *[Taxpayer Relief Act of 1997; P.L. 105-34]*

**1997 –** The Congress provided a separate 5-year appropriation for IRS enforcement initiatives related to the EIC, beginning with Fiscal Year (FY) 1998, of not more than $138 million per FY. The total appropriation is not to exceed $716 million. *[Balanced Budget Act of 1997; P.L. 105-33]*

**1998 –** This legislation clarified and expanded the IRS' treatment as a "math error" those returns where the IRS determined from the Social Security Administration that the taxpayer or his/her qualifying children makes him/her ineligible for the EIC. This change was also applicable to the dependent care and child tax credits. This provision was effective for TY 1998 and later. *[Tax and Trade Relief Extension Act of 1998; P.L. 105-277]*

---

[3] Due diligence requirements for the EIC preprarers include: (1) complete EIC eligibility checklist, (2) complete an EIC worksheet, (3) have no reason to believe any information used to determine eligibility is incorrect, and (4) retain for 3 years a copy of the completed checklist, worksheet, and record of how and when information was obtained and who provided the information.

**Appendix V**

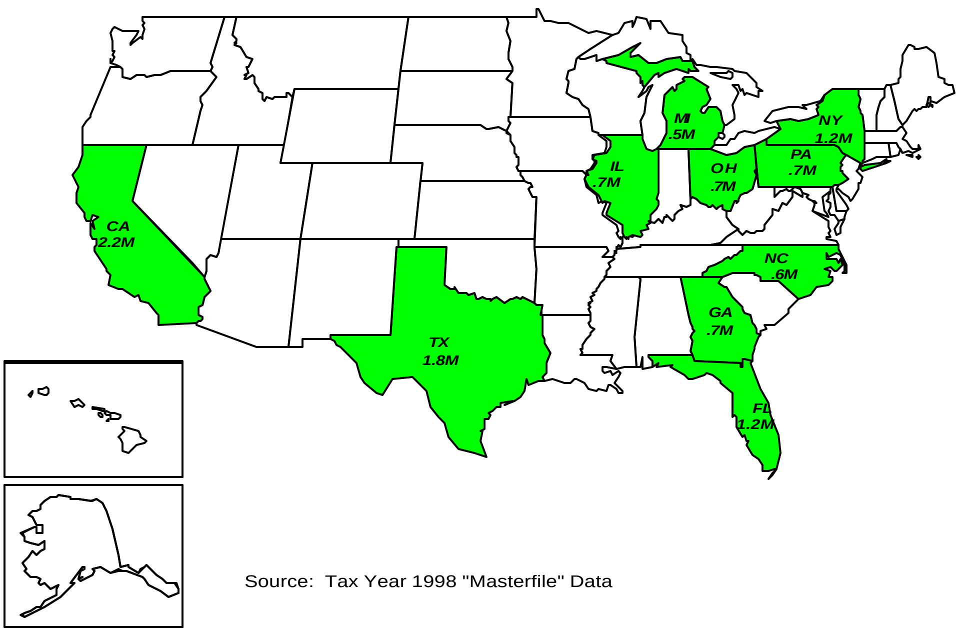
## Geographic Participation[1]

Tax Year (TY) 1998

The following maps and tables (Figures 1 - 4) show that for TY 1998, 10 states accounted for 56 percent of the number of Earned Income Credit (EIC) claims filed. Ten states also accounted for about 56 percent of the EIC dollars claimed for the same period. The states with both the highest volume of EIC claims filed and EIC dollars claimed were California, Texas, New York, and Florida.

**Figure 1**

**States With Highest Number of EIC Claims**




Source: Tax Year 1998 "Masterfile" Data

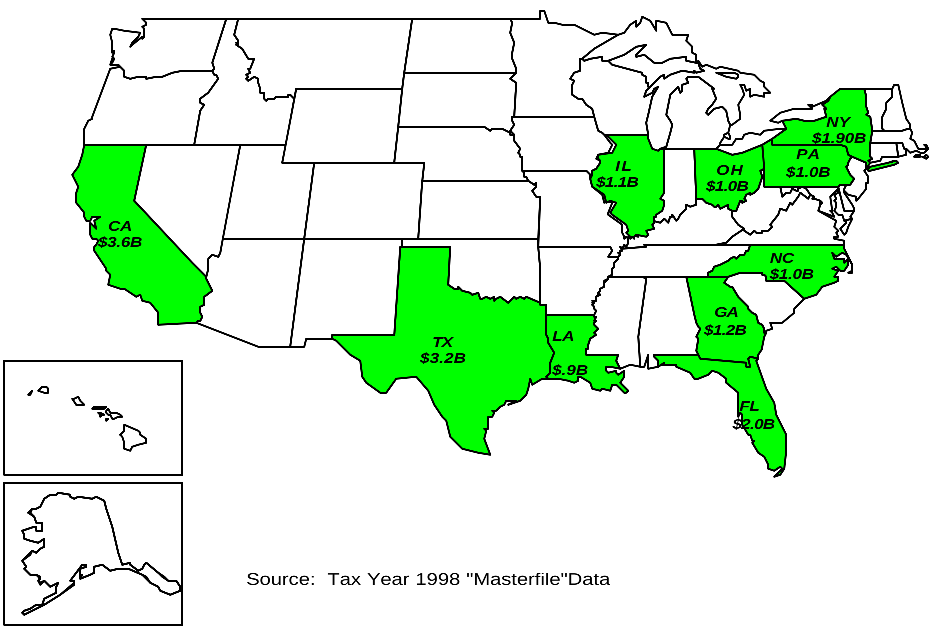
[1] Data for all taxpayers except TY 1998 were obtained from various IRS Statistics of Income bulletins and publications. The TY 1998 data were obtained from the IRS' Masterfile. At the time of our analysis, IRS data by state for TY 1998 were not available.

**Figure 2
States With the Highest
Number of EIC Claims**

| State | EIC Claims by State (in Millions) | % of Total Number of EIC Claims |
|---|---|---|
| CA | 2.2 | 13% |
| TX | 1.8 | 9% |
| NY | 1.2 | 6% |
| FL | 1.2 | 6% |
| IL | .7 | 4% |
| GA | .7 | 4% |
| PA | .7 | 4% |
| OH | .7 | 4% |
| NC | .6 | 3% |
| MI | .5 | 3% |
| Total | 10.30 | 56% |

**Figure 3**

**States With Highest
EIC Dollars Claimed**




Source: Tax Year 1998 "Masterfile"Data

### Figure 4
### Percentage of EIC Dollars Claimed by States With Highest EIC Dollars Claimed

| State | EIC Dollars Claimed by State (in Billions) | Percent of Total EIC Dollars Claimed |
|---|---|---|
| CA | $3.6 | 12% |
| TX | $3.2 | 11% |
| FL | $2.0 | 7% |
| NY | $1.9 | 6% |
| GA | $1.2 | 4% |
| IL | $1.1 | 4% |
| OH | $1.0 | 3% |
| NC | $1.0 | 3% |
| PA | $1.0 | 3% |
| LA | $.9 | 3% |
| Total | $16.90 | 56% |

## Appendix VI

### Selected Earned Income Credit Statistics by State[1]

| State | 1998 EIC Amount Claimed | 1998 Number of EIC Claims | 1997 Total Returns Filed | 1997 Number of EIC Claims | 1997 % of EIC Claims to Total Individual Returns Filed |
|---|---|---|---|---|---|
| AK | $ 38,338,964 | 28,970 | 343,154 | 30,442 | 9% |
| AL | $ 771,617,308 | 433,171 | 1,864,029 | 460,087 | 25% |
| AR | $ 417,953,017 | 243,864 | 1,081,085 | 257,224 | 24% |
| AZ | $ 538,085,370 | 327,818 | 1,966,894 | 347,168 | 18% |
| CA | $ 3,623,886,207 | 2,240,988 | 13,837,236 | 2,411,531 | 17% |
| CO | $ 326,733,083 | 225,715 | 1,898,354 | 241,770 | 13% |
| CT | $ 202,879,399 | 141,327 | 1,602,085 | 146,997 | 9% |
| DC | $ 78,977,733 | 50,245 | 267,591 | 53,616 | 20% |
| DE | $ 76,197,083 | 48,359 | 356,399 | 50,967 | 14% |
| FL | $ 1,992,520,570 | 1,235,173 | 6,898,458 | 1,309,902 | 19% |
| GA | $ 1,164,805,198 | 680,128 | 3,377,576 | 711,201 | 21% |
| HI | $ 85,106,591 | 64,397 | 552,105 | 66,480 | 12% |
| IA | $ 208,220,836 | 144,585 | 1,316,118 | 153,575 | 12% |
| ID | $ 124,623,499 | 80,617 | 520,936 | 84,111 | 16% |
| IL | $ 1,132,392,631 | 728,315 | 5,553,152 | 765,955 | 14% |
| IN | $ 545,048,282 | 356,018 | 2,724,201 | 374,273 | 14% |
| KS | $ 215,051,995 | 141,812 | 1,176,500 | 149,335 | 13% |
| KY | $ 459,676,690 | 297,957 | 1,665,227 | 308,909 | 19% |
| LA | $ 851,200,738 | 464,304 | 1,824,508 | 491,482 | 27% |
| MA | $ 375,597,838 | 270,006 | 2,958,740 | 285,476 | 10% |
| MD | $ 482,770,948 | 313,367 | 2,522,375 | 336,829 | 13% |
| ME | $ 112,863,930 | 78,850 | 574,272 | 82,894 | 14% |
| MI | $ 832,715,158 | 539,932 | 4,427,591 | 573,904 | 13% |

[1] Data for all taxpayers except TY 1998 were obtained from various IRS Statistics of Income bulletins and publications. The TY 1998 data were obtained from the IRS' Masterfile. At the time of our analysis, IRS data by state for TY 1998 were not available.

| State | 1998 EIC Amount Claimed | 1998 Number of EIC Claims | 1997 Total Returns Filed | 1997 Number of EIC Claims | 1997 % of EIC Claims to Total Individual Returns Filed |
|---|---|---|---|---|---|
| MN | $ 297,257,373 | 209,710 | 2,240,064 | 221,730 | 10% |
| MO | $ 588,621,373 | 374,136 | 2,451,886 | 393,452 | 16% |
| MS | $ 630,467,811 | 338,411 | 1,138,928 | 359,304 | 32% |
| MT | $ 95,539,796 | 63,837 | 404,283 | 66,766 | 17% |
| NC | $ 1,019,012,720 | 628,030 | 3,460,153 | 665,037 | 19% |
| ND | $ 52,061,494 | 36,080 | 300,134 | 38,142 | 13% |
| NE | $ 135,624,456 | 91,035 | 785,435 | 96,567 | 12% |
| NH | $ 75,430,058 | 54,337 | 586,297 | 58,487 | 10% |
| NJ | $ 653,450,496 | 427,548 | 3,861,555 | 455,475 | 12% |
| NM | $ 280,200,326 | 174,513 | 756,492 | 182,151 | 24% |
| NV | $ 177,030,522 | 119,130 | 837,719 | 124,595 | 15% |
| NY | $ 1,930,856,006 | 1,245,588 | 8,113,041 | 1,302,604 | 16% |
| OH | $ 1,023,573,877 | 673,009 | 5,430,932 | 702,487 | 13% |
| OK | $ 441,047,106 | 273,791 | 1,413,851 | 287,876 | 20% |
| OR | $ 286,349,380 | 191,573 | 1,501,235 | 204,819 | 14% |
| PA | $ 998,360,566 | 676,727 | 5,585,284 | 707,978 | 13% |
| RI | $ 82,113,409 | 56,794 | 463,759 | 60,085 | 13% |
| SC | $ 616,612,615 | 366,488 | 1,718,667 | 383,828 | 22% |
| SD | $ 70,530,939 | 47,116 | 340,181 | 49,296 | 14% |
| TN | $ 756,186,346 | 471,075 | 2,455,823 | 493,820 | 20% |
| TX | $ 3,201,209,563 | 1,822,873 | 8,456,037 | 1,907,725 | 23% |
| UT | $ 160,526,096 | 104,253 | 875,651 | 112,064 | 13% |
| VA | $ 673,167,778 | 428,094 | 3,030,210 | 448,041 | 15% |
| VT | $ 48,678,699 | 35,367 | 282,240 | 37,501 | 13% |
| WA | $ 432,362,077 | 297,844 | 2,608,639 | 307,805 | 12% |
| WI | $ 359,224,381 | 243,091 | 2,476,864 | 260,311 | 11% |
| WV | $ 207,013,778 | 136,533 | 729,612 | 139,600 | 19% |
| WY | $ 46,416,812 | 31,457 | 226,595 | 33,761 | 15% |
| Other | $ 2,799,075 | 1,752 | 1,216,700 | 22,223 | 2% |
| | $29,998,987,996 | 18,756,110 | 123,056,853 | 19,817,658 | |

## Appendix VII

### Earned Income Credit Roles and Responsibilities[1]

Managing the Earned Income Credit (EIC) process is a complex operation that crosses over 18 functional boundaries within the Internal Revenue Service (IRS). To improve management of this process, the IRS established partners comprised of representatives from submission processing, customer service, and support functions. The following is a detailed description of those partners, including their roles and responsibilities. The high-level flowchart (shown in Figure 10 of the report) shows the steps involved in processing tax returns where taxpayers claim the EIC.

**SUBMISSION PROCESSING INTERNAL PARTNERS**

Submission Processing processes tax returns, payments, and refunds; sends notices; and reconciles taxpayer accounts. It is responsible for identifying certain errors during tax return processing. The IRS currently has 10 service centers to process tax returns.

**Function: Code and Edit**

Code and Edit manually identifies returns that require further review by the Criminal Investigations Branch (CIB) or Service Center Examination (SC Exam). For example, all returns filed with an Information to Claim Earned Income After Disallowance (Form 8862) are sent directly to SC Exam to be worked. Also, any returns that appear to meet predefined scheme criteria (established by the CIB) are removed from processing and referred to the CIB for further review.

**Function: Error Resolution**

To combat filing fraud, the Congress passed the Personal Responsibility and Work Opportunity Reconciliation Act of 1996[2] to help the IRS deal with questionable credits and deductions more effectively by using math error procedures. As a result, the IRS can disallow questionable credits, such as the EIC, during the processing of returns when required social security numbers (SSNs) are missing or are invalid (i.e., do not match Social Security Administration records).

---

[1] A primary source of information presented here was the IRS' "Tax TV" web page, specifically the Earned Income Tax Credit Program Office web pages.

[2] Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193.

## CUSTOMER SERVICE INTERNAL PARTNERS

Customer Service answers tax law questions and provides taxpayer assistance in determining eligibility for the EIC. Customer Service assists taxpayers primarily through Toll-Free and Walk-In assistance.

### Function: Customer Service - Adjustments/Math Error

Each service center has an Adjustments Section that works math error responses from taxpayers, either by written correspondence or by calls received on the toll-free telephone number. Math error notices are issued for errors identified during tax return processing. Currently, math error notices are issued for the following discrepancies: 1) a missing or invalid primary Taxpayer Identification Number (TIN), 2) a missing or invalid secondary TIN, 3) a missing or invalid TIN for qualifying child(ren), 4) a missing or invalid date of birth for qualifying child(ren), 5) a primary or secondary TIN as an Individual Taxpayer Identification Number (ITIN), and 6)qualifying child(ren) TIN(s)as an ITIN(s).

National Office analysts are responsible for providing workplan projections, writing/updating instructions for processing math error responses, and monitoring resource utilization and workload volume.

### Function: Customer Service - Service Center Examination

Each service center has an Examination section that conducts correspondence audits related to EIC claims that appear to be invalid. Each year, numerous projects are established to cover categories with an excessive EIC overclaim rate. These projects vary from year to year depending on where the major abuse occurs. Some problems encountered include: incorrect filing status, erroneous qualifying child claims, and more than one taxpayer claiming the same qualifying child. The majority of EIC revenue protected by the IRS is due to the efforts of SC Exam.

National Office analysts work closely with the staffs of the Office of Refund Fraud, Assistant Commissioner (Examination), and District Office Research and Analysis to identify types of invalid EIC claims. In addition, analysts also develop workplans/schedules, write/update program instructions in the Internal Revenue Manual (IRM) 21, allocate resources, and monitor resource utilization and workload volumes.

Most cases are the result of soft notices[3] to taxpayers who claimed the EIC using duplicate TINs, referrals by the CIB, recertifications, unsubstantiated math errors, amended returns, audit reconsiderations, and problem resolution cases.

[3] The IRS refers to these contacts as soft notices because the notices do not make demands. Instead the notices provide information about the potential errors to the taxpayers involved and ask them to review their records and make corrections if necessary.

**Function: Examination - District Office**

Examination reviews EIC returns referred to district offices by SC Exam. The EIC work performed in district office examination includes examination of return preparers who are non-compliant with EIC procedures and development of fraud referrals on the EIC.

**Function: National Office Examination**

National Office Examination is involved in two major EIC programs: the EIC Compliance Study and the EIC Return Preparer Strategy. Both of these programs are joint efforts with the Office of Research. National Office Examination develops instructions, procedures, and training for field personnel conducting these programs and monitors progress for quality and timeliness.

In the field, revenue agents and tax auditors in district offices conduct examinations of EIC returns and monitor compliance by return preparers with EIC laws and regulations. Increasingly, agents and auditors will be devoting more of their time to activities related to the Return Preparer Strategy. Increased emphasis on return preparer education and outreach, coupled with increased penalty applications (especially the EIC due diligence penalties), may increase overall compliance with EIC requirements.

**Function: Customer Service - Taxpayer Education**

Since the inception of the IRS' EIC Initiative, Taxpayer Education has played a vital role in seeking to curb erroneous EIC claims through extensive community education and outreach activities. Each district office has established an EIC coordinator position. All around the country, these coordinators conduct local campaigns targeting individuals for whom English is a second language, low-income taxpayers, and organizations/advocacy groups of EIC-eligible taxpayers. Additional volunteer sites are being established throughout communities to assist EIC-eligible taxpayers with return preparation.

National Office analysts develop workplans/schedules and resource allocations and monitor resources utilization and workload volumes. Program guidelines are provided in IRM 21, Customer Service Handbook.

**Function: Customer Service - Toll-Free**

When a taxpayer receives a math error notice, he/she can call Customer Service to provide "corrected" SSN(s) or write a letter that includes this information. A limited validity check is performed before the Customer Service Representative adjusts the taxpayer's account.

Toll-Free provides 24 hours-a-day, 7 days-a-week coverage for the tax law, informant, and math error notice toll-free telephone numbers. Tax law inquiries are processed on

(800) 829-1040, informant calls on (800) 829-0433, and math error notice calls on (800) 808-4262. Calls are distributed based on historical weekly demand patterns and are routed to assistors. There are 25 call site locations throughout the country for the (800) 829-1040 line. The (800) 829-0433 hotline is located in 4 of the service centers, and the (800) 808-4262 line call sites are located in each service center. However, calls for all lines can be routed to any location based on the demand/need.

National Office analysts are responsible for developing workplans/schedules, allocating resources, monitoring workload volume and resource utilization, and providing instructions/guidelines in the IRM 21, Customer Service Handbook.

**Function: Customer Service - Walk-In**

Each district has at least one Walk-In Assistance site. Walk-In locations provide taxpayers the following types of EIC assistance: preparing tax returns claiming the EIC, resolving issues related to EIC math error notices, assisting taxpayers with the EIC recertification process, and answering EIC tax law questions. The Walk-In staff also conducts EIC awareness campaigns. These campaigns target low-income families and individuals most likely to be eligible for the EIC, educating them on eligibility requirements and the availability of the advance EIC.

National Office analysts develop workplans/schedules, allocate resources, and monitor resource utilization and workload volumes.

**Function: Electronic Tax Administration - Channel Management and Marketing**

The ETA's Office of Channel Management and Marketing prepares messages each year for placement on the IRS' website, "The Digital Daily," and on the e-file bulletin board. These messages inform e-file participants (return preparers) about the EIC, due diligence requirements, and the overall Revenue Protection Strategy.

**Function: Public Liaison and Small Business Affairs**

The Office of Public Liaison and Small Business Affairs maintains ongoing liaison relationships with national practitioner organizations, small business trade associations, IRS advisory committees, and other Federal agencies. This office communicates key EIC corporate messages, identifies partnering opportunities, and provides a forum for the introduction and discussion of new ideas. Their programs also serve as a "one-stop" communication vehicle to transmit EIC information between external stakeholders and IRS functions. The Office of Public Liaison and Small Business Affairs often identifies emerging EIC problems and operational issues and coordinates with IRS program owners to share information and resolve the problems.

## SUPPORT FUNCTION INTERNAL PARTNERS

### Function: Appeals

The Office of Appeals reviews taxpayer disputes, including EIC Examination actions taken by the IRS. If an EIC dispute cannot be resolved, the Appeals' role is to ensure a resolution that is fair and impartial for both the Government and the taxpayer. An appeal provides an independent, impartial review of the case after a proposed audit action and is the last opportunity for the IRS and the taxpayer to reach an agreement before the case may enter the tax court system. The goal is to resolve EIC controversies without litigation, in a way that enhances voluntary compliance regarding the rules of eligibility for the EIC and enhances public confidence in the IRS.

### Function: Chief Counsel

Chief Counsel provides advice to clients (SC Exam, Submission Processing, Taxpayer Service, and Criminal Investigation [CI]) on proposals and new legislation. It provides guidance to taxpayers in the form of publications, written regulations, and review of forms. It also handles tax litigation cases that arise and provides required litigation support. Field offices handle all EIC Tax Court matters while the National Office engages in the following EIC-related activities:

- Analyzes proposed legislation dealing with the EIC.
- Drafts regulations (e.g., due diligence regulations and "recertification" regulations).
- Drafts other formal guidance, such as revenue rulings (although no EIC revenue rulings have been issued for many years).
- Issues written determinations, such as private letter rulings, technical advice memoranda, and all forms of Chief Counsel advice. Chief Counsel has issued a number of Chief Counsel advice memoranda, primarily significant service center advice, on EIC issues.
- Reviews for technical accuracy: Earned Income Credit (Publication 596), Earned Income Credit (Schedule EIC), Information to Claim Earned Income After Disallowance (Form 8862), Paid Preparer's Earned Income Credit Checklist (Form 8867), Earned Income Credit Advance Payment Certificate (Form W-5), related instructions, and the U.S. Individual Income Tax Return (Form1040) instructions relating to the EIC. Chief Counsel has been actively involved in the redesign of the EIC documents.
- Reviews EIC documents prepared by other functions for distribution to the public.
- Reviews briefs prepared by field counsel offices in EIC Tax Court cases.

- Works with the Justice Department on EIC cases before courts other than the Tax Court.
- Assists the EIC Program Office as requested.

**Function: Chief Financial Officer (CFO) - Financial Analysis Division - Office of Revenue Analysis**

Along with the funding the IRS received to address EIC, the IRS is "required" (by Committee language, not statutorily) to submit a quarterly report to the Congress on how funds have been expended and the results generated by EIC efforts. The CFO's Office of Revenue Analysis is the office responsible for putting together the report and distributing it to certain interested stakeholders, including the Department of the Treasury, the Office of Management and Budget, the General Accounting Office, and the Senate and House oversight majority/minority chairs. The quarterly report summarizes the major initiatives the IRS has undertaken as part of the EIC Appropriation; the resources dedicated to and expended on each initiative; and the results, in terms of cases closed, enforcement revenue collected or protected, and compliance improvement generated.

**Function: Communications Division - Marketing and Taxpayer Information Branch**

The Communications Division is the IRS' focal point for planning, coordinating, and creating the IRS' communications activities and products. The Marketing and Taxpayer Information Branch is responsible for providing communications advice and counsel to the EIC Program Office. The Branch:

- Produces both print and electronic products on the EIC and advance EIC.
- Attends conferences and seminars to market the EIC to external stakeholders.
- Uses research to design the Fiscal Year (FY) 2000 campaign concept and FY 2001 communication strategy.

Products for the 2000 Filing Season will include brochures, payroll stuffers, posters, and other print materials, as well as a training video for taxpayer education. The Communications Division also produces a tax professional kit that contains due diligence[4] regulations, Information to Claim Earned Income After Disallowance (Form 8862), Paid Preparer's Earned Income Credit Checklist (Form 8867), and a CD-ROM.

---

[4] Due diligence requirements for the EIC preprares include: (1) complete EIC eligibility checklist, (2) complete an EIC worksheet, (3) have no reason to believe any information used to determine eligibility is incorrect, and (4) retain for 3 years a copy of the completed checklist, worksheet, and record of how and when information was obtained and who provided the information.

**Function: Compliance Research**

- Conducts basic research to identify and study areas of EIC noncompliance.
- Develops and tests potential means of addressing EIC noncompliance and provides assistance, where necessary, for nationwide implementation.
- Measures the EIC overclaim rate annually.
- Measures the impact of EIC activities initiated to address noncompliance.

**Function: Criminal Investigation**

In support of the overall IRS Mission, CI serves the American public by investigating potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law. The CI's Office of Refund Fraud is the owner of the Revenue Protection Strategy, which includes the EIC.

**Questionable Refund Detection Team (QRDT)**

The Questionable Refund Program (QRP), administered by the CI, is a nationwide multifunctional program established in January 1977. The QRP was designed to identify fraudulent returns, stop the payment of fraudulent refunds, and refer identified fraudulent refund schemes to CI field offices. The QRDT staff scans questionable returns to identify questionable EIC claims, refund schemes, and questionable EIC preparers.

**Function: National Taxpayer Advocate**

Generally, the National Taxpayer Advocate intervenes in taxpayers' cases, including EIC cases, when the IRS' normal processes and systems for resolution fail. The National Taxpayer Advocate also coordinates with the Citizen Advocacy Panels (CAPs); some CAPs have EIC subcommittees.

## Appendix VIII

### Treasury Inspector General for Tax Administration and Internal Revenue Service Inspection[1] Audits Related to the Earned Income Credit

| Reference Number | Issue Date | Report Title |
|---|---|---|
| 2000-30-076 | May-00 | The IRS Effectively Implemented a Tax Law That Disqualified Certain Taxpayers From the Earned Income Credit |
| 2000-40-006 | Nov-99 | The Internal Revenue Service Needs to Allocate Adequate Resources to Work Correspondence Cases Timely and Consistently |
| 199940062 | Sep-99 | The Internal Revenue Service Can Improve Its Electronic Return Preparer Fraud Activities |
| 091104 | Jul-99 | The Internal Revenue Service Should Improve Procedures to Identify and Resolve Incorrect and Missing Taxpayer Identification Numbers |
| 094106 | May-99 | Improving Internal Revenue Service Processes for Evaluating and Publicizing Walk-In Services |
| 091000 | Dec-98 | Follow-Up Review of Parent and Dependent Duplicate Exemption Claims |
| 085602 | Aug-98 | Review of Funding for Earned Income Tax Credit (EITC) Initiatives |
| 085408 | Aug-98 | On-Line Review of the 1998 Filing Season |
| 083705 | Jul-98 | Review of 1998 Filing Season Readiness |
| 083322 | May-98 | Math Error Processing for Revenue Protection Issues |
| 083105 | May-98 | Effectiveness of Invalid Primary SSN Processing |
| 081203 | Feb-98 | Revenue Protection Processing of Invalid and Duplicate Social Security Numbers |

[1] The IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, 112 Stat. 685) eliminated the Office of the Chief Inspector within the IRS. A new independent office, the TIGTA, was created to provide oversight of the IRS.

**Management Advisory Report:**
**Administration of the Earned Income Credit**

| Reference Number | Issue Date | Report Title |
|---|---|---|
| 081106 | Jan-98 | 1997 Tax Season On-Line |
| 075301 | Sep-97 | Review of the 1997 TeleFile Program Filing Season - Individual Master File (IMF) |
| 071502 | Sep-97 | Review of the 1996 Revenue Protection Strategy |
| 063502 | Apr-96 | Parent and Dependent Duplicate Exemption Claims |
| 060804 | Feb-96 | On-Line Review - Implementation of Processing Changes for the 1995 Revenue Protection Strategy |
| 055503 | Jul-95 | Review of the Tax Implications of the New Earned Income Credit Laws |
| 055104 | Jul-95 | On-Line Review - Preparing for 1995 Filing Fraud Initiatives |
| 051205 | Jan-95 | Review of the Questionable Refund Program |
| 050602 | Dec-94 | Tax Administration and Policies Relating to Illegal Aliens |
| 044509 | Aug-94 | Review of the Examination Earned Income Credit Unallowable Program |
| 040204 | Oct-93 | Electronic Filing of Fraudulent Returns |

## Appendix IX

### General Accounting Office Audits Related to the Earned Income Credit

| Report Number | Issue Date | Report Title |
|---|---|---|
| GAO/GGD-00-7 | Mar-00 | TAX ADMINISTRATION: IRS' Use of Non-Audit Contacts |
| GAO/GGD-00-83 | Mar-00 | TAX ADMINISTRATION: IRS' Low-Income Taxpayer Clinic Program |
| GAO/GGD-00-37 | Dec-99 | TAX ADMINISTRATION: IRS' 1999 Tax Filing Season |
| GAO/AIMD-00-10 | Oct-99 | FINANCIAL MANAGEMENT: Increased Attention Needed to Prevent Billions in Improper Payments |
| GAO/AIMD-99-75 | Mar-99 | FINANCIAL AUDIT: IRS' Fiscal Year 1998 Financial Statements |
| OCG-99-14 | Jan-99 | Major Management Challenges and Program Risks: Department of the Treasury |
| GAO/GGD-99-21 | Dec-98 | TAX ADMINISTRATION: IRS' 1998 Tax Filing Season |
| GAO/GGD-98-150 | Jul-98 | EARNED INCOME CREDIT: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance |
| GAO/AIMD-98-77 | Feb-98 | Examination of IRS' Fiscal Year 1997 Custodial Financial Statements |
| GAO/GGD-98-33 | Dec-97 | TAX ADMINISTRATION: IRS' 1997 Tax Filing Season |
| GAO/GGD-97-69 | May-97 | EARNED INCOME CREDIT: Claimants' Credit Participation and Income Patterns, Tax Years 1990 Through 1994 |
| GAO/GGD-97-25 | Dec-96 | IRS' 1996 TAX FILING SEASON: Performance Goals Generally Met Efforts to Modernize Had Mixed Results |

| **Report Number** | **Issue Date** | **Report Title** |
|---|---|---|
| GAO/GGD-96-172 | Sep-96 | EARNED INCOME CREDIT: IRS' 1995 Controls Stopped Some Noncompliance, But Not Without Problems |
| GAO/GGD-96-122BR | Jun-96 | EARNED INCOME CREDIT: Profile of Tax Year 1994 Credit Recipients |
| GAO/GGD-96-48 | Dec-95 | THE 1995 TAX FILING SEASON: IRS Performance Indicators Provide Incomplete Information About Some Problems |
| GAO/GGD-95-27 | Oct-94 | TAX ADMINISTRATION: Earned Income Credit-Data on Noncompliance and Illegal Alien Recipients |

## Appendix X

# Treasury Inspector General for Tax Administration and Internal Revenue Service Inspection[1] Recommendations Related to the Earned Income Credit

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| 2000-40-006 | The Internal Revenue Service Needs to Allocate Adequate Resources to Work Correspondence Cases Timely and Consistently | Customer Service management needs to ensure that adequate resources are allocated to timely work the Duplicate SSN EITC Repeater Project inventory. | **A (c)** | Completed 10/98 |
| 199940062 | The Internal Revenue Service Can Improve Its Electronic Return Preparer Fraud Activities | Ensure that adequate resources are provided for the identification and development of return preparer schemes. | **A (c)** | Completed 10/27/99 |
| 091104 | The Internal Revenue Service Should Improve Procedures to Identify and Resolve Incorrect and Missing Taxpayer Identification Numbers | The IRS should require more user involvement in the testing process for new computer programs to ensure the test criteria produce the desired results. | **R; A (c)** | Completed 4/23/98 |
| 094106 | Improving Internal Revenue Service Processes For Evaluating and Publicizing Walk-In Services | The IRS should consider planning special emphasis days at appropriate times during the filing season to help prevent problems from occurring. | **T** | Completed 1/99 |
| | | Customer Service management needs to ensure that adequate resources are allocated to handle the volume of PRP/ATAO cases generated by the Duplicate SSN EITC Repeater Project. | **A (c)** | Completed 1/99 |
| 085602 | Review of Funding for Earned Income Tax Credit (EITC) Initiatives | The EITC Project Office should establish a management oversight tool that can be used to track changes to planned initiatives and resource commitments. | **R** | Completed 7/7/98 |

[1] The IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, 112 Stat. 685) eliminated the Office of the Chief Inspector within the IRS. A new independent office, the TIGTA, was created to provide oversight of the IRS.
[2] **Legend: C** - Compliance with laws and/or policy; **P** - Protection of assets; **R** - Reliability of data; **A** - Achievement of objectives, either participation (**p**) or compliance (**c**); **T** - Taxpayer service.
[3] Status based on information in the Inventory, Tracking and Control (ITC) database. We did not verify the status of the recommendation reported in the ITC database.

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| | | The EITC Project Office should reassess the manner in which information is presented in the Program Plan Summary. These efforts should focus on ensuring that the Plan and its supporting action plans provide an adequate presentation of all the initiatives that will be funded, fully document planned EITC activities, and can be easily reconciled with AFS. | **R** | Completed 6/22/98 |
| | | Management should expedite its efforts to establish and staff the EITC Project Office to enhance the IRS' ability to oversee utilization of funds provided under the EITC appropriation. These efforts should include a clear delineation of the roles and responsibilities of personnel assigned to the Project Office. The Project Office should have oversight responsibility for all IRS EITC efforts. | **C; A (c); (p)** | Completed 7/6/98 |
| 085408 | On-Line Review of the 1998 Filing Season | Immediately advise taxpayers and tax return preparers through various media outlets, VITA and walk-in sites, and the EIC Awareness Day scheduled for March 28, 1998, of the necessity to include the income amounts from box 13 of their W-2 when calculating the earned income credit. | **C; T** | Completed 3/30/98 |
| | | For next filing season, stress in the individual tax return instruction booklets, forms, and taxpayer/preparer education venues the importance of including the appropriate income amounts when calculating EIC. Also, stress that improper calculation of the EIC could cause the taxpayer's refund to be decreased and delayed. | **C; T** | Completed 4/19/99 |
| | | Detailed taxpayer instructions for computing investment income, such as those in Publication 596, need to be included with Schedule EIC instructions in the tax return package. | **C; T** | Completed 10/21/98 |
| 083705 | Review of 1998 Filing Season Readiness | The IRS should request legislation for math error authority to use SSA information to disallow tax credits if the age of the taxpayers or their children disqualifies them. | **A (c)** | Completed 2/27/98 |
| | | The IRS should also strive to increase voluntary compliance by educating the taxpayer of the age requirements through publicity and, to the extent possible, through Compliance Programs. | **A (c);(p); T** | Completed 2/99 |
| 083322 | Math Error Processing for Revenue Protection Issues | Implement the remaining provisions of new laws designed to combat filing fraud by budgeting the resources needed to work invalid primary and secondary TIN cases. At a minimum, the IRS should ensure that taxpayers that use invalid SSNs for themselves or their spouses are not allowed to claim EIC. | **C** | Completed 2/98 |

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| | | Add information to tax packages and publications about the importance of providing complete name information for dependents and EIC qualifying children, as well as for the taxpayer and spouse. | **T** | Completed 12/98 |
| | | Change math error notices and Integrated Data Retrieval System (IDRS) correspondence dealing with invalid TINs for dependent and EIC qualifying children to alert taxpayers that the problems may be the result of incomplete or inaccurate name information. | **T** | Completed 1/21/00 |
| | | Send notices to taxpayers that used invalid TINs on their previous returns, including TINs for themselves and their spouses. | **T** | Still open on ITC |
| | | Develop programming to automate the research of prior year return data by Error Correction when dependent and EIC TINs are invalid or missing. | **P** | Delayed 5/1/00 |
| | | Modify programming to compute the number of EIC qualifying children by counting valid SSNs instead of Year-of-Birth fields. | **R; P** | Completed 1/1/98 |
| | | Create a new error code to identify cases that have not completed NAP validation. Suspend these cases in ERS until NAP validation can be completed. | **R; P** | Completed 1/1/98 |
| | | Modify programming to set the ERS Response Indicator for missing Schedule EIC error cases. | **P** | Completed 1/98 |
| | | Modify ERS programming to allow tax examiners to input the appropriate TPNCs at the time they review missing and invalid TINs (Error Codes 010 and 012), instead of at the error screen for taxable income. | **C** | Completed 1/99 |
| | | Modify service center and notice programming to include TPNC language about problems identified with dependent and EIC TIN in notices sent to taxpayers filing non-compute returns. | **C; T** | Completed 1/99 |
| | | Develop procedures for the Unpostables function to deny EIC when invalid primary SSNs on unpostable returns are changed to IRSNs or ITINs. | **P** | Completed 1/98 |
| 083105 | Effectiveness of Invalid Primary SSN Processing | All taxpayers using incorrect primary identification numbers should be properly notified when refunds and EIC are frozen. | **C; T** | Completed 3/5/97 |

## Management Advisory Report: Administration of the Earned Income Credit

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| | | Revise procedures to ensure that taxpayer accounts can be completely serviced by designated IRS functions. | **T** | Completed 1/1/98 |
| 081203 | Revenue Protection Processing of Invalid and Duplicate Social Security Numbers | Consolidate all information needed for EIC and dependent-related claims into one location on the tax return. | **T** | Still open on ITC |
| 081106 | 1997 Tax Season On-Line | The computer program to calculate disqualified income needs to be revised to include passive rental and royalty income. | **C** | Completed 1/2/98 |
| 075301 | Review of the 1997 TeleFile Program Filing Season - Individual Master File (IMF) | TeleFile returns could be more efficiently eliminated from consideration for a CP-27 notice. In addition, we recommended that both the primary and the secondary taxpayer birth years should be checked to determine EIC eligibility. | **A (c)** | Completed 2/97 |
| 071502 | Review of the 1996 Revenue Protection Strategy | Combine or eliminate multiple notices involving RPS issues to prevent taxpayer confusion and reduce taxpayer burden. | **T** | Completed 1/30/98 |
| 063502 | Parent and Dependent Duplicate Exemption Claims | Identify solutions that minimize both taxpayer burden and impact to the IRS. | **T; A (c); (p)** | Completed 11/14/97 |
| 060804 | On-Line Review - Implementation of Processing Changes for the 1995 Revenue Protection Strategy | Management should base 1996 computerized calculations on the actual amount of the unallowable Earned Income Credit. | **R** | Completed 3/1/96 |
| 055503 | Review of the Tax Implications of the New Earned Income Credit Laws | The IRS should devise and implement a plan to detect and resolve returns filed by prisoners who erroneously claim EITC. | **P** | Completed 4/19/96 |
| | | The IRS should clarify instructions for defining eligible individuals for EITC who do not have qualifying children and file married filing joint returns. | **T** | Completed 10/96 |
| | | The IRS should provide additional training to TPS employees to ensure they more clearly understand the eligibility requirements for filers without qualifying children. | **C** | Completed 7/15/96 |
| 055104 | On-Line Review - Preparing for 1995 Filing Fraud Initiatives | The IRS should reconsider its decision and inform the public about possible EIC refund delays during the 1995 filing season. | **T** | Completed 5/24/95 |
| 051205 | Review of the Questionable Refund Program | Develop procedures and specific computer criteria to select potential fraudulent returns during processing that claim EIC based on | **P** | Completed 1/1/96 |

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| | | business income. | | |
| | | Use computer databases to analyze the return information to identify multiple filer schemes. For other compliance problems, such as a taxpayer claiming EIC based on questionable business income, the returns should be referred to Examination for income and EIC verification. | **P** | Completed 1/22/96 |
| 050602 | Tax Administration and Policies Relating to Illegal Aliens | The IRS should seek clear legal guidance which would allow the IRS to not process returns and/or issue refunds of the EIC to aliens who are not legally in this country. | **A (c)** | Completed 10/21/94 |
| | | The IRS should follow the General Counsel Memorandum that allows the Service not to issue refunds when there is a name/number mismatch. | **C** | Completed 1/1/95 |
| | | The IRS should implement changes to the criteria for the Unallowable Code program to include returns with IRS Numbers and "Applied For" on the EIC schedule. | **A(c)** | Completed 11/1/94 |
| 044509 | Review of the Examination Earned Income Credit Unallowable Program | The IRS should reevaluate the initial decision to exclude "Applied For" returns from the EIC Unallowable Program. | **P** | Completed 2/94 |
| | | Management should evaluate the feasibility of developing notices exclusively for the UA88 program. Spanish versions of the notice should also be developed because of the large population of Spanish speaking taxpayers claiming the credit. | **T** | Completed 2/15/95 |
| | | The IRS should reinstate procedures requiring tax examiners to correspond with taxpayers to validate the source of "unidentified income" used to qualify for EIC before the credit is allowed. | **P** | Completed 4/1/94 |
| | | The IRS should automate the UA88 process for the 1995 filing season. | **A (c)** | Completed 1/1/95 |
| | | The current procedures for TPS and the PRO should be revised to cover more complete information on the program. | **A (c); (p)** | Completed 2/94 |
| | | IRS management should reemphasize the need to communicate information to all Taxpayer Service contact personnel so taxpayers are provided complete and accurate responses to their questions. | **A (c); (p)** | Completed 3/9/94 |
| | | The IRS should gather statistics on all EIC claims that met UA88 criteria as Adjustment Branch personnel identify them. | **R** | Completed 7/15/94 |

## Management Advisory Report:
## Administration of the Earned Income Credit

| Reference # | Title | Recommendation | Classification[2] | Status[3] |
|---|---|---|---|---|
| 040204 | Electronic Filing of Fraudulent Returns | The IRS should provide QRDT with the information necessary to identify fictitious dependents supporting fraudulent e-file EIC claims. QRDT should use this information to enhance their refund scheme detection capabilities. | **P** | Completed 1/1/94 |

## Appendix XI

## General Accounting Office Recommendations Related to the Earned Income Credit

| Report # | Title | Recommendation | Status [1] |
|---|---|---|---|
| GAO/GGD 00-37 | TAX ADMINISTRATION:IRS' 1999 Tax Filing Season | The Commissioner of the IRS should take steps to streamline the recertification process and avoid possible disparate treatment of taxpayers. | Open-response due by 12/15/00 |
| GAO/GGD 99-21 | TAX ADMINISTRATION: IRS' 1998 Tax filing Season | In conjunction with IRS' decision to revise the instructions for Schedule EIC to advise taxpayers of the 2-year and 10-year sanctions, add a brief, but prominent, cautionary statement to the Schedule EIC alerting taxpayers that they should read important information in the instructions before filing their returns. | Completed 10/14/99 |
| GAO/GGD 98-150 | EARNED INCOME CREDIT: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance | The Commissioner of the IRS should ensure that customer service efforts aimed at EIC claimants be available earlier in the filing season when most EIC claims are filed. | Completed 1/4/99 |
| | | The Commissioner of the IRS should include prominent information regarding the 2-year and 10-year sanctions and the recertification process in the Form 1040 EIC instructions and Schedule EIC. | Completed 10/14/99 |
| | | The Commissioner should develop evaluation plans for each compliance initiative component that will provide, in succeeding years of the initiative, timely data for decision makers. | Completed 7/14/99 |
| GAO/GGD 96-172 | EARNED INCOME CREDIT: IRS' 1995 Controls Stopped Some Noncompliance, But Not Without Problems. | The IRS should consider routinely reporting data, by tax year, on the results of Examination efforts to validate eligibility for benefits. | Completed 1/28/99 |

[1] Status based on information in the Inventory, Tracking and Control (ITC) database. We did not verify if recommendation was truly completed as stated in the ITC.

## Management Advisory Report:
## Administration of the Earned Income Credit

| Report # | Title | Recommendation | Status [1] |
|---|---|---|---|
| | | The IRS should consider tracking what happens to returns rejected by the Electronic Filing System. | Completed 7/15/97 |
| | | The IRS should consider distinguishing the results relating to EIC-qualifying children from the results relating to dependents. | No action noted on ITC |

## Appendix XII

## Earned Income Credit Initiatives

**Tax Year 1994/Processing Year 1995 (Paper Returns Only)**

The EIC initiative was broadened to include other issues and for a short while was known as "Refund Fraud." Soon after, the name was changed to the IRS Revenue Protection Strategy (RPS), additional unallowable codes were developed, including codes for missing/invalid dependent, EIC dependent Taxpayer Identification Numbers (TIN) and the fuel tax credit.

Approximately 1.05 million notices were issued; the majority of cases were closed by June 30, 1996. The following table presents the results of this initiative:

| **Category** | **Returns** | **Dollars (In Millions)** |
|---|---|---|
| Agreed | 171,421 | $250.59 |
| Default | 339,458 | $596.75 |
| No change | 517,997 | N/A |
| Unagreed | 3,790 | $7.21 |
| **Total Closed** | **1,032,666** | **$854.56** |

**Tax Year1995/Processing Year 1996**

For this initiative several unallowable codes were discontinued or their criteria modified. For example, the criteria were changed to require that the return had to reflect three or more invalid TINs before the Examination function would include the case in its inventory. (This decision was based on Tax Year (TY) 1994 results that indicated a high rate of audits resulting in no changes to the tax returns.)

Approximately 700,000 notices were issued. Also, during the 1996 Filing Season, more than 300 compliance visits were made in the Southwest District to businesses and tax preparers involved in electronic filing and paper returns to ensure compliance.

**Tax Year 1996/Processing Year 1997**

Approximately 2.9 million occurrences of missing or invalid uses of social security numbers (SSN) caused electronically filed tax returns to be rejected. Approximately 2.3 million returns were subjected to math error procedures that caused a refund reduction unless the taxpayer could provide correct information. As a result, the issuance of $1.4 billion of erroneous refunds was prevented.

Compliance reviews of 1,800 electronic return originators were performed. The IRS issued 322 warnings and suspended 65 participants for serious breaches of requirements. The Questionable Refund Detection Team (QRDT) identified 2,500 fraudulent schemes involving multiple returns for paper and/or electronically filed returns. It detected approximately 25,000 fraudulent returns and prevented the issuance of over $79 million in refunds.

- The Criminal Investigations Division initiated 172 criminal investigations involving return preparers. Recommendations for prosecution were forwarded on 107 cases. Indictments were obtained on 112 individuals and convictions made in 84 cases.
- For the Fiscal Year (FY) ending September 1997, the Examination Division closed approximately 375,000 cases with assessments exceeding $612.9 million.

**EIC Initiatives/Revenue Protection - Appropriation Spending**

Background

Responding to a study showing a 25.8 percent ($4.4 billion) noncompliance rate for EIC tax rules, the Congress enacted legislation that permitted budget authority for 5 years and a new EIC appropriation to address EIC noncompliance. The appropriation provided additional funding for the improved applications of the EIC. The funding was to be appropriated as follows. Not more than:

- $138,000,000 for FY 1998.
- $143,000,000 for FY 1999.
- $144,000,000 for FY 2000.
- $145,000,000 for FY 2001.
- $146,000,000 for FY 2002.

In addition to the funding, the Congress enacted the following six Department of the Treasury proposals in the Taxpayer Relief Act of 1997[1] to provide the IRS with new tools to combat EIC noncompliance.

[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 1 et seq. (1999).

1. Required paid preparers to fulfill certain due diligence[2] standards when preparing EIC returns.
2. Provided that taxpayers who fraudulently claim the EIC can be denied the credit for 10 years and those who recklessly or fraudulently disregard the rules and regulations can be denied the credit for 2 years.
3. Provided that taxpayers who are denied the EIC through the IRS' deficiency procedures are ineligible to claim the EIC in subsequent years unless they provide evidence of eligibility through the recertification process.

   *Note:* In response to this legislation, the IRS established the EIC Recertification Program. When the EIC is denied during an audit, a recertification indicator is placed on the taxpayer's account. Taxpayers are then required to submit an Information to Claim Earned Income After Disallowance (Form 8862) to claim the EIC after disallowance with their next return on which the EIC is claimed. After receiving this form, the IRS reviews the taxpayer's return information and either allows the EIC or begins an audit to determine if the taxpayer qualifies for the credit.
4. Allowed the IRS to levy up to15 percent of unemployment and means-tested public assistance and certain other specified payments.
5. Gave the IRS access to a Federal Case Registry of Child Support Orders, which could help identify erroneous EIC claims by non-custodial parents.
6. Required the Social Security Administration (SSA) to collect SSNs of birth parents and provide the IRS with information linking parents' with their child's SSN.[3]

**Report on the EIC Appropriation Expenditures for FY 1998 ($138 million)**

The IRS developed the following action plan to implement EIC initiatives for FY 1998:

<u>Action Plan</u>:

Communication and Assistance:

- Strengthen alliances with Volunteer Income Tax Assistance (VITA), Tax Counseling for the Ederly, and taxpayer advocacy groups for low-income taxpayers.
- Local offices to work with low-income workers to determine eligibility and assist with forms.

[2] Due diligence requirements for the EIC preprarers include: (1) complete EIC eligibility checklist, (2) complete an EIC worksheet, (3) have no reason to believe any information used to determine eligibility is incorrect, and (4) retain for 3 years a copy of the completed checklist, worksheet, and record of how and when information was obtained and who provided the information.
[3] Internal Revenue Service. Chief Financial Officer. 1999. "IRS Tracking - Earned Income Tax Credit Appropriation Annual Report - FY 1998." Document 9383, p. 3.

- The VITA volunteers to visit homeless shelters to explain credit and eligibility and help file tax returns.
- Work with employers of migrant workers, and volunteers visit work camps.
- Taxpayer Education Coordinators to identify low-wage industries in their areas and provide assistance and/or education.
- Expand low-cost and no-cost education and tax return preparation options for taxpayers so they get the best information regarding their EIC eligibility and the proper way to file a claim for the credit.
- Expand EIC toll-free assistance hours to 24 hours-a-day, 7 days-a-week.
- Contract with a market research firm to determine the effectiveness of current products.
- Use Math Error authority to stop over 600,000 potential erroneous EIC claims.
- Include instructions in materials sent to taxpayers of the importance of providing an accurate SSN.
- Increase staffing for the QRDT, and District Criminal Investigation and Examination Divisions to address potential fraud.

<u>Research Efforts</u>:

- Tax Year 1997 Study to baseline EIC noncompliance.
- A file of EIC taxpayers is being designed that will allow examination of changes in the filing characteristics of taxpayers over time.
- The Duplicate TIN Notices project measures the impact of non-enforcement approaches to changing taxpayer behavior, while the Duplicate TIN Repeater and Schedule C Audit projects will measure the impact of enforcement approaches.
- Develop a systemic way to distinguish between compliant and non-compliant taxpayers through use of the Department of Health and Human Services (HHS) and the SSA data made available to us in recent legislation.[4] (Although this is listed in the 1998 action plan, the database with HHS and SSA information has not been established. Limited testing will begin during FY 2000.)

[4] Internal Revenue Service, Document 9383, p. 3.

1998 Summary of Results:

- Resources: Overall, 2,358 Full Time Equivalent[5] (FTEs) (121 percent of planned 1,954 FTEs).
- Obligations: $135.9 million (98 percent of the $138 million).
- Revenue Protected: $977 million (81 percent of the projected FY 1998 total of $1.2 billion).

**Report on EIC Appropriation Expenditures for FY 1999 ($143 million)**

Action Plan:

Communication and Assistance:

- Outreach and Education Programs were the same as FY 1998.
- Use Math Error authority to stop 450,000 potential erroneous EIC claims.

Research Efforts:

- The TY 1997 EIC Baseline Study.
- Issued reports in 1999 include the Duplicate SSN Research Report and the Advance EIC Report. Reports on EIC Math Errors and EIC and Schedule C Filers are scheduled to be issued in early FY 2000.
- Database with HHS and SSA will be tested during FY 2000.
- Initiate studies on revised EIC forms, worksheets, and publications and a study of the population that appears to be eligible for the EIC, but do not claim the credit.

1999 Summary of Results:

Customer Service

- 72,000 taxpayers assisted with EIC questions and 174,000 returns filed for EIC taxpayers.
- Toll-free assistance was made available 24 hours-a-day, 7 days-a-week resulting in nearly 445,000 callers being assisted with general EIC questions and 512,000 callers helped with specific notice questions.
- The VITA Volunteers provided assistance to help taxpayers file 174,000 EIC returns.

[5] Full Time Equivalent is equal to the standard number of hours (2,088) one employee works in a year.

- The IRS sent out over 700,000 soft notices[6] to filers whose prior year return indicated a possible error with advice to correct the error before filing.
- Resources Overall: 2,358 FTEs (103 percent of planned 2,287 FTEs).
- Obligations: $140.5 million (98 percent of the $143 million).
- Revenue Protected: $1.123 billion (89 percent of the projected FY 1999 total of $1.26 billion).

[6] The IRS refers to these contacts as soft notices because the notices do not make demands. Instead the notices provide information about the potential errors to the taxpayers involved and asks them to review their records and make corrections if necessary.

**Appendix XIII**

## Bibliography


1. Earned Income Credit Tax Credit Campaign Partnership, “$7 Million Extra to L.A. Workers”. (1999)
2. General Accounting Office. June 1996. “Earned Income Credit - Profile of Tax Year 1994 Credit Recipients.” (GAO/GGD-96-122BR).
3. General Accounting Office. May 1997. “Tax Administration: Earned Income Credit Noncompliance.” (GAO/T-GGD-97-105).
4. General Accounting Office. September 1996. “Earned Income Credit: IRS’ 1995 Controls Stopped Some Noncompliance, But Not Without Problems.” (GAO/GGD-96-172).
5. General Accounting Office July 1998. “IRS’ Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance.” (GAO/GGD-98-150).
6. Hamilton, Amy. 2000. “IRS Designs New Taxpayer Compliance Measure.” Tax Analysts, April 10.
7. Liebman , Jeffrey B. “The Impact of the Earned Income Tax Credit on Labor Supply and Taxpayer Compliance.”
8. Lydersen, Kari. 2000.“Chicago Urges Poor to Seek Earned Income Tax Credit.” Washington Post, March 24.
9. Scholz, John Karl. 1994. “The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness,” National Tax Journal. (1994)
10. Sparrow, Dr. Malcolm K. 1993. “Fraud in the Electronic Filing Program - A Vulnerability Assessment Prepared for the Internal Revenue Service.”
11. Sparrow, Dr. Malcolm K. 1998. “EITC-based Refund Fraud: Briefing Notes” August 7.
12. Internal Revenue Service. Chief Financial Officer. 1999. “IRS Tracking - Earned Income Tax Credit Appropriation Annual Report - FY 1998.” Document 9383.
13. Internal Revenue Service. Chief Financial Officer. 1999. “IRS Tracking - Earned Income Tax Credit Appropriation Annual Report - FY 1999.” Document 9383.
14. House of Representatives, 1997. *Conference Report No. 105-284* (to accompany H.R. 2378). 105th Cong. 1st session.

## Appendix XIV

## Management's Response to the Draft Report

COMMISSIONER

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

RECEIVED
SEP 21 2000

September 21, 2000

**MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**

FROM: Charles O. Rossotti
Commissioner of Internal Revenue

SUBJECT: Treasury Inspector General for Tax Administration (TIGTA) Draft Management Advisory Report – Administration of the Earned Income Credit

Thank you for the opportunity to review and comment on TIGTA's Draft Management Advisory Report on the Administration of the Earned Income Credit (the Draft Report).

The primary purpose of this response to the Draft Report is to present an overview of the current status of the IRS' EITC compliance program. This overview should address some concerns raised in the Draft Report about how the IRS handles noncompliance in our administration of the program. Very soon, we will release to the public the IRS' most recent EITC compliance study: Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Tax Returns (1997 Study). This study is significant because it provides a starting point from which we will be able to evaluate future IRS efforts. Moreover, it describes recently launched enforcement initiatives, the results of which are not reflected in the studies cited by the Draft Report.

The 1997 Study's central finding is that of the estimated $30.3 billion in EITC claims, approximately $7.8 billion (25.6 percent) should not have been paid. The amount of overclaims before accounting for enforcement activities was approximately $9.3 billion (30.6 percent of the amount claimed). (The study does not include data relating to those who may have qualified for the credit but failed to claim it.) These results indicate that due to IRS enforcement practices, $1.5 billion of EITC overclaims for tax year 1997 were recovered or prevented from being paid. They also show that the IRS needs to continue to be innovative and aggressive in our compliance efforts.

We have launched promising new initiatives as a part of these efforts. For example, partnerships with the Department of Health and Human Services and the Social Security Administration will permit us to cross-check information regarding how the child is related to the taxpayer, the age of the child, and whether the taxpayer is the child's custodial parent against information contained on tax returns. Beginning in 2001, we will check all secondary social security numbers, in addition to primary and qualifying child social security numbers, on EITC returns. We will reject the returns if the names and numbers do not match Social Security records. Another initiative that improves the detection and prevention of erroneous EITC claims before tax refunds are paid permits us to deny EITC claims when a return is first received if the taxpayer's EITC claim was denied the previous year and the taxpayer did not follow recertification requirements that were enacted in 1997.

The last initiative that I would like to highlight here is aimed at educating paid preparers, who file about 60% of all EITC returns. Last fall, the IRS initiated a large-scale, multi-year outreach program aimed at thousands of preparers who had prepared at least 100 EITC returns during the previous filing season. During visits to these preparers, IRS employees provided one-on-one instruction on EITC compliance and on the preparers' due diligence responsibilities. These and other outreach programs to state and local governments, faith-based organizations, community groups, business leaders, and low-income taxpayer advocates are continuing.

The EITC program presents numerous challenges. We are committed to vigorously addressing these challenges and welcome your assistance in reaching this goal.

For your information, I also am attaching a document with more specific comments on the Draft Report. If you have any questions, please contact John Dalrymple, Commissioner, Wage and Investment Division, at (202) 622-6860.

**IRS Comments on Treasury Inspector General for Tax Administration (TIGTA) Draft Management Advisory Report – Administration of the Earned Income Credit**

Each of the following points relates to the identified section of the TIGTA Draft Report:

- *"advanced EIC"* should be changed to "advance EIC" (Treas. Reg. §31.3507-1(b)). (page i and throughout)

- *"In 1997, the Congress authorized the IRS to spend a total of $716 million over a 5-year period…."* (pages i, 4th par. and 4, at top) This statement is not accurate. In 1997, Congress enacted the Balanced Budget Act, which increased the discretionary spending caps by a certain amount each year (totaling $716 million over five years). This gives Congress the flexibility to fund additional annual appropriations up to the increase in the annual cap each year for EITC compliance initiatives. Congress must approve the EITC appropriation each year as part of the IRS appropriation.

- *Liebman and Scholz studies.* (pages iii, 1st par. and 26, 2nd par.) Dr. Liebman's study does not refer to the population of EITC-eligible taxpayers nationwide. Instead, what he found was that participation rates varied over incomes for taxpayers in his sample. For example, 70 percent of EITC eligible taxpayers whose income fell in the phase-in range of the credit claimed the credit. He did not estimate an overall participation rate. The IRS study on EITC participation is based on 1996 data for the initial phase because that is the last complete year available from Census. Data developed from this study, along with information from other sources, will be used to estimate subsequent year participation rates as well as to identify characteristics of people who may be eligible but do not claim the EITC.

- *"…another private study conducted from CYs 1996 to 1997 estimated that only 65 percent of the eligible taxpayers nationwide claimed the credit."* (pages iii, 1st par. and 26, 3rd par.) In correspondence Dr. Sander states that data from current studies on the effect of the impact of EITC marketing in Los Angeles "…throws into question the original methods I used in 1997 to estimate the underutilization of the EITC in Los Angeles." Dr. Sander has indicated that because he had to impute several critical data elements, he now feels less confident in his 1997 report results. We have found that many of the reasons that prevented finite findings from external researchers such as Dr. Sander also affect the IRS' ability to conduct these studies.

- *"A recent IRS study showed that approximately 65 percent of taxpayers claiming the EIC on TY 1997 returns used a paid preparer….only 53 percent of all individual taxpayers used a paid preparer during TY 1997. It would appear that the increasing complexity of EIC requirements might be a driving factor in the use of paid preparers."* (pages 6-7) The study to which TIGTA refers has been revised since TIGTA saw an early draft. The two numbers cited by TIGTA in this paragraph are not comparable. Comparable Statistics of Income data for 1997 indicate 59.6 percent of EITC claimants used paid preparers and 51.9 percent of all taxpayers used a paid preparer versus the 65 percent and 53 percent figures cited in your document. It is not clear what TIGTA's basis is for the conclusion that tax law complexity is the reason EITC taxpayers are using paid preparers to complete their tax returns.

We do not always know why EITC claimants use paid preparers. Complexity certainly may be one factor, but there are other factors to consider. Many may go to preparers in order to file electronically or to obtain a refund anticipation loan. Both of these are ways to obtain EITC refunds more quickly. (Note that EITC filers do not have to use a preparer to file electronically but they may not realize this.) Others may choose to use a preparer because they have more income (through the EITC) to do so.

- *"...IRS management cannot accurately identify the population of all eligible taxpayers, measure the extent of fraud...."* (page 8, top) The two key measures that are relevant for EITC purposes are the error and participation rates. The 1997 Study measures the error rate with reasonable accuracy. It is difficult, however, to tell how much of this error is attributable to fraud. Moreover, it is not necessary to make this distinction to meet our goal of reducing the amount of error. As stated above and discussed in the Draft Report, the IRS is currently conducting a study on participation rates.

- *Government Performance and Results Act of 1993 (GPRA)* (pages 8 and 20-21) The Draft Report fails to mention some of our most important measuring tools. The IRS will soon issue a report entitled "Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns." This report will provide an improved starting point from which to measure future compliance. In addition, IRS is also initiating the Subsequent Year Tracking Study, which follows the filing behavior of EITC claimants over a period of time after they have received a treatment that targeted inaccurate behavior. For example, taxpayers are sent notification that they are claiming an EITC qualifying child who is also being claimed by someone else. The taxpayer is asked to review his return, correct any error with an amended return, and not repeat the error in subsequent years. Taxpayer behavior is monitored in this situation as are taxpayers who have received an EITC math error correction notice during processing, as well as taxpayers who have their returns corrected by an examination.

- *Tax Return Validity Checks* (page 16, Footnote 5) Both changes identified in this footnote will be fully implemented for the 2001 filing season. During the 2000 filing season, both secondary TIN validation and Year of Birth validation were implemented in part. For example, secondary TIN validation was only partially implemented in order to allow the Social Security Administration to prepare for the taxpayer requests for record correction. This was a decision made in the interest of taxpayers who would need to interact with another government agency with some chance of success, and in the interest of government- wide cooperation not to present another agency with a task for which they were not prepared.

- *Issuance of Social Security Numbers* (page 18, 1st par.) The Social Security Administration, over many years, has issued a total of 7.9 million Social Security numbers (SSNs) to aliens not authorized to work. However, most of these SSNs are no longer valid or active. For example, the taxpayers have died, left the country, etc. An IRS District Office Research and Analysis (DORA) study of 1997 returns showed that approximately 535,000 primary, secondary, or qualifying children nonwork SSNs were reported on 471,000 individual returns. About 30 percent of these claimed the EITC.

- *"...in the report, the IRS does not quantify the potential effect of its suggestion on reducing taxpayer burden or improving productivity."* (page 19, last par., last sentence) The Office of Program Evaluation and Risk Analysis (OPERA) included EITC in its discussion of filing definitions in this report. EITC, however, was not among the issues selected for extensive analysis and discussion. Therefore, OPERA did not attempt to quantify the effect of differing definitions beyond pointing out that the definition of an EITC qualifying child is an illustration of such differences that Congress could change through revisions to the Internal Revenue Code.

- *Discussion of GPRA* (page 21, 1st par.) Regarding the need to focus on measurements, we believe the measures are extremely valuable and have established a bi-annual study of EITC compliance rates to measure the overall changes in compliance. Additionally, individual studies on the effects of programs such as the preparer strategy, "soft notices," etc. are being conducted to determine their effectiveness. Moreover, making needed improvements to IRS systems should help to achieve the measured overall goal of improving EITC compliance.

- *"Recommendations made by the IRS Inspection and the TIGTA have improved the IRS' process to meet the goal of giving the EIC to qualified taxpayers."* (page 24, 5th par.) Legislation passed as part of the Uruguay Round Agreement Act of 1994 provided the requirement that taxpayers provide a taxpayer identification number for each EITC qualifying child, regardless of age. This legislation was sought by IRS, phased in over a three-year period, and fully implemented with 1997 tax returns.

- *Expanded EITC Instructions* (page 24, last par.) The expansion of EITC instructions was actually dictated by the 1994 legislation. As a result, IRS included information on this new requirement, as with all new legislation, in the 'What's New for 1995' section of the 1040 and 1040A instructions.

- *"...the EIC-related initiative has not been completed."* (page 25, last par.) All EITC-related actions being tracked on the Taxpayer Treatment and Service Initiatives database that have come due have been completed. The remaining actions have not yet reached their due dates.

- *EIC Eligibility Studies* (page 28, Figure 11) As stated earlier in this document, both the 1990 and 1995 studies are not comparable to the 1990 study by Dr. Scholz.

- *EIC Overclaim Studies* (page 30, Figure 12) This figure implies that EITC compliance studies that have been performed over the years are comparable. To the contrary, these various studies are not comparable: selection methods differed, determination of claim accuracy differed, and the timing and size of the studies differed. The purpose of designing the tax year 1997 EITC Compliance Study was to provide a baseline against which future study results can be compared. Additionally, there was no planned study for tax year 1996 as shown in Figure 12.