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INTERNAL REVENUE SERVICE'S 1995 EARNED INCOME TAX CREDIT COMPLIANCE STUDY

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

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INTERNAL REVENUE SERVICE'S 1995 EARNED INCOME TAX CREDIT COMPLIANCE STUDY

THURSDAY, MAY 8, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
May 1, 1997
No. FC–8

Archer Announces Hearing on the Internal Revenue Service's 1995 Earned Income Tax Credit Compliance Study

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to examine the Earned Income Tax Credit (EITC) Compliance Study released by the Internal Revenue Service (IRS) on April 21, 1997. The hearing will take place on Thursday, May 8, 1997, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include, among others, officials from the IRS, the Department of the Treasury, and the General Accounting Office. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Under present law, the amount of EITC that an eligible taxpayer may claim depends on whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout limit, no credit is allowed.

In recent years, Congress has enacted several changes to the credit's eligibility requirements in order to better target the program to low-income workers. In addition, changes have been enacted to enhance the IRS's ability to enforce compliance with the credit, including a provision authorizing the IRS to treat a taxpayer's failure to provide a valid Social Security number for EITC qualifying children as a mathematical error.

Despite these changes, noncompliance in the EITC program remains at high levels. Last week, the IRS released a study entitled "Study of EITC Filers for Tax Year 1994." This study was based on a sample of 1994 returns claiming the EITC and received by the IRS between January 15 and April 21, 1995. The study found that taxpayers erroneously claimed approximately $4.4 billion of EITC, which was 25.8 percent of the total EITC claimed in the 1995 filing season. Adjusting for changes in IRS enforcement practices made for the 1995 filing season, the net error rate would have been 23.5 percent. The study also found that had the procedural changes enacted in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104–193) been in effect during the 1995 filing season, the error rate would have been 20.7 percent.

In announcing the hearing, Chairman Archer stated: "The results of the IRS's EITC compliance study are extremely troubling. Despite the Government's best efforts, EITC fraud and errors are still shockingly high. We have an obligation to the

nation's taxpayers to ask whether the benefits of delivering the EITC through the tax system justifies the loss of $5 billion a year in fraudulent and erroneous payments."

FOCUS OF THE HEARING:

The Committee will receive testimony from Ted F. Brown, Assistant Commissioner of the IRS, Criminal Investigation, regarding the findings of the EITC Compliance Study and the types of fraudulent claims and errors identified by the IRS. The Committee will also hear Treasury officials regarding legislative options recently advanced by the Department for improving EITC compliance, and from the General Accounting Office regarding work they have done on EITC administration and compliance issues.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in WordPerfect or ASCII format, with their address and date of hearing noted, by the close of business, Thursday, May 15, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on a 3.5-inch diskette in WordPerfect or ASCII format.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including avail-

ability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. The Committee will come to order.

Good morning, everyone, on this beautiful spring day. We are not too far removed from April 21, when the IRS released a study it conducted during the 1995 filing session relating to the level of compliance in the Earned Income Tax Credit, EITC, Program. Their study concluded that the error and fraud rate for the EITC Program was an unacceptably high 20.7 percent and that we are paying out to people who are not legally entitled to it more than $5 billion a year.

The purpose of today's hearing is to learn more from the IRS and Treasury about the high level of fraud and errors associated with the EITC and what more can be done to address this problem.

I consider the EITC to be a very important program to help low-income working families. This program has long enjoyed bipartisan support, and deservedly so. To protect the long-term future of this helpful program, we have got to stop the fraud and the errors. Hardworking taxpayers will not support welfare programs like the EITC if we cannot get the errors and fraud under control. We have an obligation both to the credit's legitimate recipients and to the Nation's taxpayers to stop this waste.

This is not the first time that this Committee has addressed concerns about the IRS' vulnerability to tax refund fraud and the EITC noncompliance problems. In 1994, the Subcommittee on Oversight held two hearings to examine the issue. In part, due to concerns raised at those hearings, the IRS put into place a revenue protection strategy during the 1995 filing session which was designed primarily to identify returns with questionable claims for the EITC.

Congress has also enacted several changes to enhance the IRS' ability to improve compliance in the EITC Program, including a provision authorizing the IRS to treat a taxpayer's failure to provide a valid Social Security number for EITC qualifying children as a math error. Despite these changes, the EITC remains subject to massive leaks of money.

Treasury has advanced a package of eight legislative proposals for improving EITC compliance. However, until we know more about the root causes of the fraud and errors that were identified by the IRS, it is impossible for the Committee to assess whether the Treasury's proposals get at the real causes of noncompliance to actually make a difference.

For that reason, I have asked the Joint Committee on Taxation to request the Treasury Department to provide it with all of the underlying data and findings from the IRS study so that it can give this Committee its analysis of the problems and potential solutions. I encourage Treasury to comply as quickly as possible with that request.

Taxpayers have a right to know why EITC is so abused and prone to error. Fixing this valuable program should be a priority both for the Congress and for the administration.

[The opening statement follows:]

Statement of Hon. Bill Archer, A Representative in Congress from the State of Texas

On April 21st, the Internal Revenue Service released a study it conducted during the 1995 filing season relating to the level of compliance in the Earned Income Tax Credit program. The study concluded that the error and fraud rate for the EITC program is an unacceptably high 20.7 percent, and that we are wasting more than $5 billion a year. The purpose of today's hearing is to learn more from the IRS and Treasury about the high level of fraud and errors associated with the EITC, and what more can be done to address this problem.

I consider the EITC to be a very important program to help low-income working families. This program has long enjoyed bipartisan support, and deservedly so. To protect the long term future of this helpful program, we've got to stop the fraud and errors. Hardworking taxpayers won't support welfare programs like the EITC if we can't get the errors and fraud under control. We have an obligation both to the credit's legitimate recipients and to the nation's taxpayers to stop the waste.

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For that reason, I have asked the Joint Committee on Taxation to request the Treasury Department to provide it with all of the underlying data and findings from the IRS study so that it can give this Committee its analysis of the problems and potential solutions. I encourage Treasury to comply as quickly as possible with that request.

The taxpayers have a right to know why EITC is so abused and prone to error. Fixing this valuable program should be a priority with both Congress and the Administration.

[Prepared Text. Spoken Remarks May Differ.]

Chairman ARCHER. I now recognize Mr. Rangel for any statement he might like to make on behalf of the Minority, and without objection, all Members will have the right to insert written statements in the record at this point.

[The opening statements follow:]

Opening Statement of Hon. Barbara B. Kennelly, a Representative in Congress from the State of Connecticut

As a long-time champion of the EITC, and someone who has worked to simplify it as necessary over the years, I firmly believe in this program but fraud and abuse is unacceptable in any form.

Therefore, we must take two steps. First, we must insist that the IRS combat fraud and abuse—something they frankly have not been doing. When the IRS finds a taxpayer has made up a child or falsified income in order to increase the EITC, clear instances of fraud and abuse in anyone's mind, it should do three things—deny the credit, prosecute to the full extent of the law and, tag that return in the computer as a future fraud prevention measure.

Second, we need to get a better handle on where the fraud and abuse occurs. We have worked for years to simplify the credit. We still have an error problem. But for the moment, the outright fraud and abuse seems more serious. Treasury has

taken some steps administratively to address this problem. But there may be additional legislative steps we need to take. This is something I intend to work on. Perhaps we should conform the personal exemption and EITC to reduce fraud and abuse.

We must remember that this program only benefits working families. In 1995, the EITC lifted 3.7 million families out of poverty. In fact, there were 2.4 million persons over age 16 who lived in poverty and worked full-time year-round in 1995.

Opening Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for holding this critical hearing on the administration of the Earned Income Tax Credit.

The recent IRS study of EIC filers for the 1994 tax year revealed a startling and sobering level of fraud and errors in the EIC program. With the projected cost of the EIC program in FY 1997 at $25 billion, this could amount to between 5 and 6 billion dollars of waste. This is simply unacceptable.

The EIC program was intended to help the working poor, and we need to ensure the EIC meets this mission without costing taxpayers billions of dollars in fraud, abuse, error and waste.

I look forward to hearing about compliance issues from our panel of witnesses today, and to exploring solutions to the high level of fraudulent and erroneous payments in the EIC program.

Again, Mr. Chairman, thank you for your leadership in convening this important hearing.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Mr. Chairman, I would like to support your opening statement in its entirety. There is no program that I think that this Congress, or no policy has been adopted that has been more effective than the program we are talking about. This is a program about which liberals and conservatives agree, that people who work hard every day should not be getting less than those people who choose not to work or find themselves on welfare.

To encourage this work activity, we have this refundable tax that keeps people with their pride and their family, and encourages them to enter the mainstream without the stigma of having to go on welfare.

I do not think there is a better supporter of the Internal Revenue Service than I, and I think that a lot of accusations about the EITC have been unfair because nobody likes a tax collector. But this program is so vital. What are the reasons why we find so many mistakes? Why are you so prone to allow people to say that it is fraud and tax cheating? Are there other programs where we find this gap between effective collection of taxes due the U.S. Government? Do you find a large number of people in this particular category making mistakes, whether they are losing money or whether, in this case, they are gaining money?

If you cannot do this job, for God's sake, do not let everything fall on the recipient of the program. Let us know how we can be more effective. I am really concerned, and I have seen large tax shortfalls in other areas, why in this area the language is cheating and fraud, because if that is true, then we may have to take another look at the program. If it is not true, we should take another look at the IRS.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Rangel.

We do have with us today Michael Dolan, Deputy Commissioner of IRS, representing the Internal Revenue Service, Ted Brown, Assistant Commissioner of Criminal Investigation of the IRS, and John Karl Scholz, Deputy Assistant Secretary for Tax Analysis with the Treasury Department.

Mr. Dolan, I understand that you are our leadoff witness, so welcome to the Committee. We would be pleased to receive your statement.

STATEMENT OF HON. MICHAEL P. DOLAN, DEPUTY COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY TED F. BROWN, ASSISTANT COMMISSIONER, CRIMINAL INVESTIGATION, INTERNAL REVENUE SERVICE, AND JOHN DALRYMPLE, DEPUTY CHIEF, TAXPAYER SERVICE, INTERNAL REVENUE SERVICE

Mr. DOLAN. Thank you, Mr. Chairman. I am pleased to be here.

Knowing what an auspicious gathering this was going to be, I added a little more horsepower to my team. I have at my right John Dalrymple, who is essentially the Deputy Chief of Operations and who presides over the full spectrum of areas that I think the Committee will be interested in.

With your permission, I would like to have my formal statement submitted and maybe just recap a few of the points.

Chairman ARCHER. Without objection, your entire written statement will appear in the record, and if you will synopsize verbally and shorten the statement, we would appreciate it.

Mr. DOLAN. For starters, I would make the observation that the formal testimony that the Treasury Department is submitting does an excellent job of laying out the history of earned income credit, EIC, and this Committee does not need any kind of instruction from me on the various developments of EIC, so I am going to proceed from the background that the Internal Revenue Service essentially feels like it has a couple of missions in the area of the earned income tax credit.

On one hand, it is our responsibility to help those who are eligible know their rights and know how to claim the credit. On the other hand, it is our responsibility to ensure that only those who are eligible claim and are granted the credit. Some people have observed that this creates a tension or a dynamic that somehow is inherently dysfunctional.

I think this Committee understands that that is the inherent tension, a constructive tension, in the Internal Revenue Service mission in general: we typically worry about both components that create this tension. On the front end, we worry about education and outreach. We worry about our ability to inform taxpayers of their rights and their obligations so that those who are intent on complying with the law feel equipped to do so. And those who are inclined to game or scheme the system—hopefully—feel deterred from doing so.

On the back end, then, it is our responsibility to employ enforcement or compliance mechanisms that attempt to detect those instances where somebody erroneously claimed benefits under any

provision of the tax law and took an advantage to which they were not entitled.

My formal statement includes some particular references to the kinds of efforts we have made at outreach, and I think you will see some things in the statement with which you are quite familiar. Fortunately we have had the opportunity to work with a lot of civic groups, churches, and many of your offices. Many Congressional offices have helped us on outreach efforts to make sure that taxpayers know about EIC, how to qualify, what the rules of the game are, and, quite frankly, some of the issues that have surfaced over the last 3 or 4 years that have gotten all of the press attention.

The one area that I would say with respect to outreach on the earned income credit—with which we are less than satisfied and continue to look for ways to improve and to take all the help we can get—is in the area of the advanced earned income tax credit. That is a concept where we have found that we want to encourage people to take the advanced EIC. It not only is available to them year round but it also helps on the back end in some of the areas that have been most troublesome to us in the overclaims.

With respect to the enforcement, as this Committee is well aware, an earned income tax credit claim processes through the normal tax processing pipeline just like every other asset of the 100 million-plus individual tax returns that we receive every year. As a consequence, all of the filters and all of the processes of that pipeline work on the earned income tax credit claim just like they do the other provisions of the 1040 and the schedules that are attendant to it.

One of the things we did early on as a result of some experience we had with overclaim is we have done a reasonably vigorous attempt during the last four filing seasons to add to our detection and compliance process elements that we thought, in the first instance, identified the correct returns, because what we want to do is get the correct returns identified and get them through the system and not bog it down.

Second, we want to identify the returns that, on the face of them, look as if they raise questions.

Third, we want to mine those returns not only for what may or may not be erroneous claims but so we can use that data to establish filters and screens and systematic ways to detect in the future the issues that appear on the face of a return and allow us to deal with them quickly and process them.

Coming out of those efforts have been, by our lights, anyway, a number of enhanced abilities to do two things: Let the good returns flow through quickly and pay appropriate attention to returns that deserve more scrutiny.

Mr. Rangel, you made a comment, and I think inferred in your comment was we need to be careful about the language we use because people will, I think, sometimes talk about fraud and cheating and overclaim and lots of things in ways that do not actually distinguish the factual difference among returns.

So today, I would like to be very careful in suggesting that most of the data that we put before you in the form of our report and our testimony is characterized as overclaim, not because we are trying to be clever or cute with words, but because below the num-

bers that represent overclaim amounts there are a number of fairly important nuances and distinctions that become very misleading if somebody jumps to a conclusion that the overclaim amounts all represent fraud or jumps to the conclusion, quite frankly, that it all represents just innocent mistakes.

So there are some significant nuances below the level of the gross number of overclaims. Hopefully, our comments will elucidate and not obfuscate if we seem reticent to apply a label to the overclaims.

I know the Committee is particularly interested in the report that the Chairman mentioned in his opening comments. I would like to provide some context, of which I think the Committee may be aware. That report, as was pointed out, is 1994 tax year information. Those returns, for the most part, were filed between January and April 1995. There have been two filing seasons since then.

It was also a report that was drawn in the midst of the filing season, and again, I think as Chairman Archer mentioned, in the midst of a filing season where we had taken fairly substantial efforts to correct, particularly, the issue of invalid Social Security numbers. That also was the year, as many of you might remember since you experienced some of the frustration that came with people contacting your offices, that was the year in which we used an all-out campaign to do two things. There were many, many people who, just because of passage of time and reluctance or forgetfulness, did not correct their Social Security numbers. There were people who were married, still in the system with their maiden name. So a tremendous number of Social Security numbers were corrected that year for people for whom there was no ill intention or action at all.

Beyond that, there also were a number of people who, by our after-the-fact analysis, could have only intended to use a Social Security number incorrectly and a number of those cases have now disappeared in the wake of that 1994 campaign.

Subsequently, the 1995 and 1996 tax years have also been processed. In each of those years, we have made incremental improvements that would not be reflected in the 1994 test. Probably the most substantial thing that has occurred in that timeframe is an area that the Chairman referenced and an area where we have to thank Congress, because the technique that we are using this year, called math error technique, which allows us to avoid the long and arduous deficiency process and gives us a much quicker tool to deal with Social Security numbers that appear on their face to be invalid.

That is something we are using, for the first time this filing season. It is, at this preliminary stage, a tool that has been very useful in sorting out instances of erroneous use of Social Security numbers and in allowing us to deal with that much more quickly than under the old system.

Mr. Chairman, I will close with a couple of other comments. Since the 1994 report, as I mentioned, a number of incremental changes have been made that affect the actual base experiences that we were reporting on in 1994. A similar study is being done on the tax year 1995.

We are complementing that with a series of research efforts in five or six of our district offices. They are taking various subsets

of our experience in this and other areas and looking for further refinements to our process to assure us that the claims going through are appropriate.

In addition to the data that is in the report, you can also appreciate that there are other forms of analysis and there is other data that underlie the report. You, Mr. Chairman, make the point that you have asked the Joint Committee to look at that data. Clearly, like any report, there are cuts on that data that can be taken and have been taken in terms of systems changes in place. There are other cuts on that data that, quite frankly, if we were publicly to go into at any great lengths, would probably encourage those we want to discourage—that is, those who are out there who intend to scheme at the margins on this thing.

So I think you will find as the Joint Committee receives and analyzes that data that there are a number of ways to look at the data developed in 1995. Again, I would make the point, that data in the 1994 report was designed to assist us in improving the systems. It makes no pretense about being an authoritative work on EITC, and in point of fact, it is a report that has already generated a fair number of changes in the way we do business.

With that, I think that you will no doubt have some questions. My colleagues and I are quite prepared to respond, but maybe to get on with Karl's presentation and in the interest of the Committee's time, I would at this point close.

[The prepared statement and attachment follow:]

Statement of Michael P. Dolan, Deputy Commissioner, Internal Revenue Service; accompanied by Ted F. Brown, Assistant Commissioner, Criminal Investigation, Internal Revenue Service, and John Dalrymple, Deputy Chief, Taxpayer Service, Internal Revenue Service

Mr. Chairman and Distinguished Members of the Committee, I appreciate the opportunity to be here today to discuss the IRS' administration of the Earned Income Tax Credit (EITC). With me today are John Dalrymple, Deputy Chief Taxpayer Service, and Ted Brown, Assistant Commissioner for Criminal Investigation.

Congress enacted the EITC in 1975 as a refundable credit available to eligible low and moderate income workers. The amount of the EITC to which a taxpayer is entitled depends upon the taxpayer's earned income and whether the claimant has "qualifying children." The EITC phases out above certain income levels.

Since 1975, Congress has changed the EITC in several ways. These changes have included increasing the dollar amount of the EITC and the income levels at which EITC phases out. More recently, in the Omnibus Budget Reconciliation Act of 1993, Congress simplified the EITC by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. The available EITC amounts were also increased and EITC was made available to individuals who do not have children, but otherwise qualify based solely on earned income.

In 1994, Congress denied the EITC to nonresident aliens and prison inmates for any income received for services provided by the inmate while incarcerated. In addition, Congress required taxpayers to provide a social security number for each EITC qualifying child, regardless of the child's age. In the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Congress altered the income requirements for the EITC and denied the EITC to individuals who were issued taxpayer identification numbers solely for the purpose of receiving Federally funded benefits. Congress also authorized the IRS to treat a taxpayer's failure to provide a valid social security number as a mathematical error, which is a simpler and more efficient procedure than using the examination process.

The Treasury Department and the IRS have worked with Congress to develop measures designed to ensure that only those taxpayers eligible for the EITC actually receive it. The IRS has used education and publicity in administering the EITC to assure that taxpayers receive the benefits to which they are entitled. At the same

time, the IRS has also focused its efforts towards preventing taxpayers from receiving the EITC if they are not entitled to it.

A. Education and Publicity

It has been estimated that between 80 percent and 86 percent of all eligible families actually claimed the EITC in 1990. Through our education and publicity efforts over the past several years, the IRS has made a concerted effort to reach an even larger percentage of eligible families. For example, the IRS currently issues post-filing notices to taxpayers who appear to qualify for the EITC, but do not claim it on their returns. These notices advise taxpayers of their potential eligibility for the credit, and invite taxpayers to apply for the credit by returning the notices, along with certain requested information. In 1996, the IRS sent out over 1.2 million notices to taxpayers with a response rate of 38 percent. Of those responding, 99.7 percent received the credit.

Besides these notices, the Service also pursues other methods of educating taxpayers about EITC and their potential eligibility for the credit. The Service uses brochures, notices, press releases and direct mailings to publicize the EITC. Many of these products are available in Spanish, as well as English. Our publicity and educational efforts occur throughout the year, although we increase our outreach efforts during each filing season.

We are also taking steps to educate the public about the availability of the Advance Earned Income Tax Credit (AEITC) and to encourage employees to consider it. Although the percentage of taxpayers availing themselves of the EITC is high, a much smaller number takes advantage of the AEITC, which is paid out to employees in each paycheck. The IRS sends publications to employers describing both EITC and AEITC, as well as publications for employers to distribute to employees.

In addition, the IRS has sent Publication 1235, along with the necessary form to file with their employers, to employees who claimed EITC this year and would possibly benefit from the AEITC. This month, we will send out almost 4.7 million copies of Publication 1235. Additional mail-outs are planned for June and September.

To assist taxpayers in properly claiming the credit, the IRS will compute the EITC for a taxpayer upon request. The taxpayer merely writes "EIC" on the appropriate line of the yearly tax return and submits the Schedule EIC with the appropriate supporting information. The IRS will then calculate the proper amount of the taxpayer's credit, based on that information.

B. Enforcement Efforts

While we want to ensure that taxpayers receive the EITC if they are entitled to it under the law, we must also guard against ineligible taxpayers from receiving such benefits. To expand our understanding of EITC compliance, the IRS conducted a pilot study of the 1994 filing season of the electronically filed returns on which taxpayers had claimed the EITC. The study was designed to provide information needed to put controls in place quickly for the rest of the 1994 filing season so that the IRS could detect and prevent EITC compliance problems. The study, however, was not statistically valid for the entire EITC population and, therefore, the results were not representative of this filing population.

As a result of the issues identified by the 1994 filing season study, the IRS undertook a second study of EITC, which involved a statistically valid random sample of EITC returns filed throughout the 1995 filing season. A detailed report on the 1995 study is a attached as an Appendix. The sample included 2,046 returns, of which 1,250 were paper and 796 were electronically filed between January 15 and April 21, 1995.

Soon after the taxpayers filed their returns, agents from IRS Criminal Investigation Division made face-to-face contact with the taxpayers to validate their EITC claims. The agents also contacted other parties, such as employers, tax return preparers, family members and neighbors, if needed, to validate the EITC claims. The agents then made initial judgments about the legitimacy of the EITC claims, which were subject to review and to change, if the judgments were found to be in error.

The study results showed that EITC claims filed during the 1995 filing season contained errors that required adjustments, both upwards and downwards, in EITC. Of the total EITC dollars claimed in 1994, 25.8 percent of the EITC was overclaimed, while 1.7 percent of the EITC was underclaimed for both paper and electronically filed returns. The study further showed an overclaim rate of 26.1 percent for taxpayers claiming qualifying children and an overclaim rate of 15.7 percent for

taxpayers not claiming qualifying children.[1] Preliminary results from the study provided the IRS with a better understanding of EITC compliance prior to the 1997 filing season. The final study results provide a baseline from which to analyze further studies of the effectiveness of our EITC administration efforts.

Beginning with the 1994 filing season and continuing through this year's filing season, the IRS has developed and implemented numerous initiatives directed towards identifying and preventing erroneous refund claims, including EITC claims. These initiatives include increasing verification of taxpayer social security numbers, screening and monitoring of electronic return originators, delaying refunds in order to allow the IRS additional time to verify EITC claims before issuing refunds and dedicating enforcement resources to identifying fraudulent schemes, as well as examining questionable claims.

In FY 1995, IRS' Criminal Investigation Division identified more than 4,400 refund schemes involving almost 62,000 returns and prevented the issuance of $83 million in refunds. In addition, we initiated 491 criminal investigations involving refund schemes and return preparers. Prosecution recommendations were forwarded on 404 cases and we obtained indictments of 329 individuals and convictions in 300 cases.[2] Also in FY 1995, through pre-refund examinations, we prevented the issuance of an additional $425 million in refunds. Thus, in FY 1995, direct compliance efforts prevented $508 million in improper refunds from being issued.

In FY 1996, we continued our vigorous compliance efforts to identify and stop fraudulent refund schemes and to pursue questionable claims through pre-refund examinations. In FY 1996, we identified nearly 2,450 fraudulent refund schemes involving 24,000 returns and prevented the issuance of $46.8 million in refunds. We initiated 313 criminal investigations involving refund schemes. Prosecution recommendations were forwarded on 279 cases and indictments were obtained on 290 individuals and conviction in 304 cases.[3] Through pre-refund examinations, we prevented the issuance of an additional $864 million in refunds. Thus, last fiscal year, our direct enforcement efforts prevented $932 million in erroneous or fraudulent refunds from being issued.

In this time of declining resources, we must balance our use of enforcement resources to address a myriad of compliance issues, including EITC. However, I assure you that the IRS will continue its programs to detect, investigate and examine questionable EITC claims.

This concludes my prepared remarks. Thank you for allowing us the opportunity to discuss our efforts to improve administration of the EITC. I assure you that the IRS will remain vigilant in its efforts to ensure that only those taxpayers who are earned the credit receive it. My colleagues will be happy to answer any questions you or other Committee Members may have.

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[1] These overclaim rates include both paper and electronically filed returns.
[2] These totals include cases initiated in the prior fiscal year.
[3] These totals include cases initiated in the prior fiscal year.

Internal Revenue Service

Study of EITC Filers for Tax Year 1994

April 1997

APPENDIX

1995 Earned Income Tax Credit Compliance Study

I. Introduction

In June, 1995, the Internal Revenue Service released a study of taxpayers who had filed electronically during the last two weeks of January, 1994, and had claimed the earned income tax credit (EITC) on their 1993 tax returns. Although the initial scope of the study was focused on identifying apparently fraudulent or intentionally overstated claims for EITC, the results provided broader information on taxpayer understanding and compliance with EITC qualification requirements. The initial study did not include taxpayers who filed paper returns or any type of return filed after January. The results of the 1994 Study might not have been representative of all EITC recipients. Moreover, the 1993 tax returns included in the study were filed before the enactment of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) and subsequent tax legislation affecting the EITC.

To learn more about EITC claimants, the IRS conducted another study of EITC compliance during the 1995 filing season. This study included both paper and electronic returns for tax year 1994 accepted by the IRS through April 21, 1995. This study is representative of about 80 percent of the tax year 1994 EITC filing population. Using a sample of 1994 tax returns, the effects of the OBRA 1993 expansion (including the extension of the EITC to very low wage workers who do not have qualified children) can be examined. These data can also provide useful information regarding new IRS procedures in place during the 1995 filing season. As discussed below, the procedures for electronic and paper returns differed; therefore, separate EITC error rates for these types of returns as well as for the combined population are provided.

Information from this compliance study can also be used to evaluate the potential effectiveness of certain new legislation enacted in 1996. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 contains a provision which will authorize the IRS, beginning with the 1997 filing season, to treat a taxpayer's failure to provide a valid social security number for anyone associated with the EITC qualification process (primary filer, secondary filer, or EITC qualifying child) as a mathematical error. Information from the study can be used to estimate what the error rate would have been, had the IRS had similar authority during the 1995 filing season.

II. Sample Design

The study sample was drawn from 1994 tax returns claiming the EITC and accepted by the IRS between January 15 and April 21, 1995. During the 1995 filing season, electronic and paper returns were subject to the same filters but processed differently before being accepted by the IRS. The IRS rejected electronic returns if they did not include valid social security numbers for the taxpayers, dependents, and EITC qualifying children. Electronic returns were also rejected if IRS identified multiple prohibited uses of SSNs, e.g., the same SSN used for a dependent more than once; the same SSN used for an EITC qualifying child more than once, etc. The same checks were done on paper returns, but the IRS accepted paper returns with invalid social security numbers for dependents and EITC qualifying children. The IRS subsequently delayed the payment of refunds to four million taxpayers due to these omissions. In addition, a number of returns were referred to Examination for additional investigation.

The study used a two stage post stratified systematic sample design. In the first stage, .04 percent of electronic returns and .05 percent of paper returns claiming the EITC were selected from each service center. The returns were selected after the math errors had been corrected. In the second stage, the selected returns were classified into one of four subgroups based on filing status, gender, and the presence of EITC qualifying children. The sampling rates on the second stage were 100 percent for male head of household or single with qualifying children; 25 percent for female head of household or single with qualifying children; 10 percent for married filing joint or widow(er) with qualifying children; and 4 percent for filers with no qualifying children. The final sample consisted of 2,046 returns (1250 paper and 796 ELF). Stratified sample weights ensure that the weighted data are representative of the actual filing population for the period.

As noted previously, this sample was designed to provide representative data for most EITC filers during the 1995 filing season. The characteristics of the compliance study were compared to characteristics of EITC claimants in the 1994 Statistics of Income (SOI) data (Table 1 summarizes this data).

Sample characteristics – Between January 15 and April 21, 1995, the total number of returns filed claiming EITC was about 15 million. This consisted of 4.7 million through the electronic filing system and 10.3 million on paper. The average EITC claim was approximately $1,151. Head of household(HOH) claimants comprised about 54.2 percent of the total. Married filing joint(MFJ) filers accounted for 27.1 percent of the total and the remaining 18.7 percent was filed by single filers. The sample reflected the following number of EITC qualifying children; none was 19.9 percent; one was 43.8 percent; and two was 36.3 percent.

SOI Characteristics - For the 1995 filing season, 19,016,000 returns claiming EITC were filed according to the 1994 tax year Statistics of Income data. The average EITC claim was estimated to be $1,119. HOH Filers represented 50.5 percent of EITC claimants, MFJ and single filers accounted for 28.2 percent and 21.2 percent respectively. The distribution of the number of EITC qualifying children was – none was 21.4 percent; one was 42.8 percent, and two was 35.9 percent.

The sampled EITC returns filed during the January 15, 1995, through April 21, 1995, period differed from EITC claims filed during the entire filing season in the following categories:

>> During the filing season, paper returns accounted for 74.3 percent and ELF 25.7 percent of the EITC filing population compared to the samples 68.8 percent and 31.2 percent respectively.

>>During the filing season, the filing status of the EITC claimants were 50.5 percent for head of household and 21.2 percent single compared to the samples 54.2 percent and 18.7 percent respectively.

>> During the filing season, 92.5 percent of the EITC claimants had income from wages and salaries. The study figures reflect 97.9 percent with wages and salaries.

>> During the filing season, 15.3 percent of EITC filers claimed Schedule C income. In the EITC study, only about 6.3 percent of the filers claimed Schedule C income.

III. Methodology for Determining Errors

A. The initial step in building case files from the sampled returns was conducted in the service centers. Transcripts of the taxpayers' prior filings were obtained and associated with the sample return. The case file was then transmitted (usually within 3-5 days of the filing of the return) to a Special Agent (criminal investigator) for contacts to verify the EITC claim.

B. The Special Agent assigned the sample return was required to contact the taxpayer, the electronic return originator/transmitter, the tax return preparer (if different from the electronic return originator), and the employer (if W-2 wages were the source of EITC qualifying income). The agent was also instructed to contact other third parties if needed to validate the EITC claim. These contacts were made face-to-face at the residence or business location rather than requiring the taxpayer or witness to appear at IRS offices. The agent was required to complete his/her inquiries within 21 days.

The agent tested the accuracy of qualifying earned and adjusted gross income, the filing status of the taxpayer and the existence and qualifications of qualifying children (if there were any) reflected on the EITC schedule. If the agent believed the claim was incorrect, he/she also made a subjective assessment of the reason for the error (e.g., the error was part of a fraudulent refund scheme, the error was made intentionally or was due to unintentional error/misunderstanding). When the agent considered his/her inquiries complete, they telephoned an experienced agent who acted as the national coordinator on the study. This senior agent reviewed the findings to ensure completeness of the inquiry and consistency with the other inquiries being conducted across the country. If satisfied, the senior agent approved the return of the file to the Cincinnati Service Center.

C. After the file was returned to the Cincinnati Service Center, it was reviewed. If the return was deemed "part of a scheme," it was controlled at the originating service center as a fraudulent refund claim, and no refund was issued. If the claim needed adjustment (i.e., the claim was classified as having an intentional or unintentional error), a copy of the file was forwarded to the originating service center where it was referred to the Examination Division for a correspondence audit with the taxpayer. If the claims were viewed as correct, a copy of the file was forwarded to the originating service center where the refund was released. The taxpayer was then sent a no change letter.

D. All completed sample files were transcribed into a database for analysis. Subsequently, tax examiners reexamined the case files to determine the reasons for taxpayers' errors. Based on this more comprehensive review of the facts reported in the case file, the tax examiners changed their assessments in some cases. The database also contains this information.

Over the following months, data inconsistencies and errors were identified and corrected. Additional comparative information was added to the database as it became available. For example, information reports (W-2s and 1099s filed with the Service) were matched to the sample files during the fall of 1995. Returns were also matched to the duplicate use SSN file to identify cases where other persons had also claimed the qualifying child.

Lastly, all cases were reviewed to assign "best and final" codes to the case file. The tax examiner made a "best and final" determination on the basis of the available evidence. These determinations were used for the purposes of the study only and did not affect the taxpayer's receipt of the refund.

IV. Calculation of EITC Claim Error Rates

Overclaim rates are shown for total EITC returns filed during this period, and for electronic and paper returns separately. IRS enforcement efforts during the 1995 filing season may have affected overclaim rates in at least two ways. First, because these enforcement efforts were well publicized, it is possible that some taxpayers were discouraged from applying for the credit initially and thus are neither in the claimant population nor reflected in the overclaim rates. Second, electronic returns accepted by the IRS (and included in the sample) were subject to up-front verification which did not allow for the processing of returns with invalid, missing or duplicate SSNs. The sample and the overclaim rates generally do not include electronic returns with invalid, missing, or a duplicate social security number for an EITC qualifying child because these returns were not accepted by the IRS.[1] In contrast, paper returns with similar issues were accepted by the IRS and are thus reflected in the sample returns claiming the EITC and the overclaim rates.

A. *Overclaims -- Total EITC, ELF, Paper (Dollars)* The following results represent the estimated amount of EITC dollars and the amount of overclaimed EITC dollars on returns in the sample period population. The overclaim rates are reported as percentages of dollars. These statistics are weighted figures.

PERCENTAGE OF OVERCLAIMED EITC DOLLARS

TYPE	TOTAL EITC $ CLAIMED	AMOUNT OF OVERCLAIMS	PERCENTAGE of AMOUNT OVERCLAIMED
PAPER	$10,698,000,000	$2,795,000,000	26.1 %
ELF	$ 6,537,000,000	$1,654,000,000	25.3 %
TOTAL	$17,235,000,000	$4,448,000,000	25.8 %

Totals may not agree due to rounding.

[1] A few electronic returns with invalid SSNs are included in the sample, apparently because certain validity checks had not been uniformly checked.

B. *Overclaims for EITC Claimants with Qualifying Children, Total, ELF, Paper*
The following results represent the estimated amount of EITC dollars and the amount of overclaimed EITC dollars on returns claiming EITC qualifying children in the sample period population. The overclaim rates are reported as percentages of dollars. These statistics are weighted figures

PERCENTAGE OF OVERCLAIMS ON RETURNS CLAIMING QUALIFYING CHILDREN

TYPE	TOTAL EITC $ CLAIMED	AMOUNT OF EITC OVERCLAIMS	PERCENTAGE of AMOUNT OVERCLAIMED
PAPER	$10,248,000,000	$2,726,000,000	26.6%
ELF	$ 6,474,000,000	$1,642,000,000	25.4%
TOTAL	$16,722,000,000	$4,368,000,000	26.1%

C. *Overclaims for EITC Claimants without Qualifying Children, Total, ELF, Paper* The following results represent the estimated percentage of overclaimed dollars in the sample period population. The error rates are reported as percentages of dollars. These statistics are weighted figures. This was a new category in 1995 with a maximum amount of EITC of $306 if the qualifying criteria were met.

OVERCLAIMS (OC) ON RETURNS NOT CLAIMING QUALIFYING CHILDREN

TYPE	TOTAL EITC $ CLAIMED	AMOUNT OF EITC $ OC	% OF EITC $ AMOUNTS OC
PAPER	$449,000,000	$69,000,000	15.3 % *
ELF	$ 63,000,000	$12,000,000	19.0 % *
TOTAL	$513,000,000	$81,000,000	15.7%

* These are based on small sample size and should be used with caution.

D. *Underclaims -- Total EITC, ELF, Paper* The following results represent the estimated amount of dollars underclaimed in the sample period population. The error rates are reported as percentages of dollars. These statistics are weighted figures.

UNDERCLAIMS

TYPE	TOTAL EITC $ CLAIMED	AMOUNT OF EITC UNDERCLAIMS	PERCENTAGES OF AMOUNT OF EITC UNDERCLAIMED
PAPER	$10,698,000,000	$240,000,000	2.2 %
ELF	$ 6,537,000,000	$ 53,000,000	0.8 %
TOTAL	$17,235,000,000	$293,000,000	1.7 %

V. Estimate of "Net" Overclaim Rate

The estimates shown in Section IV provide information on the amount of EITC *claimed* erroneously by taxpayers whose 1994 tax returns were accepted by the IRS during the 1995 filing season. In some cases, the IRS would have subsequently detected erroneous claims by using conventional enforcement techniques (e.g., matching of returns to information reports). These estimates also do not reflect the direct effects of administrative changes which were implemented during the 1995 filing season in order to reduce erroneous payments. During the 1995 filing season, the IRS delayed refunds for three million returns that contained either a missing or invalid social security number for the dependent child or EITC qualifying child. The IRS delayed refunds for an additional four million returns because the EITC claim appeared questionable on the basis of other criteria. Of these seven million returns, one million were referred to examination for further investigation.

The EITC overclaim rate can be adjusted to reflect the full effects of IRS enforcement activities which were in effect during the 1995 filing season. Adjustments for these actions reduces the estimated amount of overclaims by $392.9 million to $4,055.5 million, reducing the dollar overclaim rate from 25.8 percent to 23.5 percent.

The "net" estimate does not reflect subsequent legislative or administrative actions which will take effect during the 1997 filing season. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 contains a provision which will authorize the IRS to treat a taxpayer's failure to provide a valid social security number for EITC qualifying children as a mathematical error. If the IRS had comparable authority during the 1995 filing season, the estimated amount of overclaims would have been reduced by an additional $489.0 million to $3,566.5 million reducing the dollar overclaim rate to 20.7 percent.[2]

[2] The estimates in this section assume that the total amount of EITC claims (the denominator in the error rate calculations) is not changed by the enforcement action. In this way, we can best isolate the impact of the various enforcement actions on compliance. However, EITC claims are generally observed after returns have been processed for mathematical errors. During the 1997 and subsequent filing seasons, the net overclaim error rate calculations will reflect the impact of the expanded mathematical error authority on both the amount of overpayments and total claims. For example, the 1994 net overclaim error rate (taking into account the reduction in observed overclaims after processing for mathematical errors) would be estimated to be 21.7 percent instead of 20.7 percent.

APPENDIX

TABLE 1

Comparison of Weighted Sample Characteristics of 1994 EITC Claimants

Category	EITC Compliance Study		1994 Statistics of Income	
	Number of Returns	% of Total	Number of Returns	% of Total
TOTAL RETURNS	14,970,000	100.0%	19,016,000	100.0%
PAPER	10,305,000	68.8%	14,120,000	74.3 %
ELECTRONIC	4,665,000	31.2%	4,896,000	25.7%
FILING STATUS				
Married, Filing Joint 1/	4,052,000	27.1%	5,368,000	28.2%
Head of Household	8,116,000	54.2%	9,609,000	50.5%
Single	2,802,000	18.7%	4,039,000	21.2%
NUMBER OF QUALIFYING CHILDREN				
None	2,986,000	19.9%	4,061,000	21.4%
One	6,557,000	43.8%	8,131,000	42.8%
Two or more	5,428,000	36.3%	6,824,000	35.9%
ADJUSTED GROSS INCOME				
LESS THAN $5,000	2,847,000	19.0%	3,829,000	20.1%
$5,000 - $10,000	4,240,000	28.3%	5,583,000	29.4%
$10,000 - $15,000	3,114,000	20.8%	3,975,000	20.9%
$15,000 - $20,000	2,932,000	19.6%	3,293,000	17.3%
Greater than $20;000	1,837,000	12.3%	2,336,000	12.3%
SOURCE OF INCOME				
Wages and Salaries	14,654,000	97.9%	17,583,000	92.5%
Schedule C (Business)	950,000	6.3%	2,900,000	15.3%
Interest	2,789,000	18.6%	3,904,000	20.5%
Unemployment Compensation	1,721,000	11.5%	2,177,000	11.4%
NUMBER OF BALANCE DUE	*	*	1,119,000	5.9%

(*) Estimate is not statistically reliable because of small sample size
1/ Includes qualifying widow(er)s

Chairman ARCHER. Thank you, Mr. Dolan.

Mr. Scholz, would you like to give us your statement on behalf of the Treasury.

STATEMENT OF JOHN KARL SCHOLZ, DEPUTY ASSISTANT SECRETARY, TAX ANALYSIS, U.S. DEPARTMENT OF TREASURY

Mr. SCHOLZ. I certainly would. Mr. Chairman and Members of the Committee, I am very pleased to have the opportunity to discuss the administration's proposals to improve the earned income tax credit.

Since I have not testified before the Full Committee, let me tell you a little bit about my background. For the past 9 years, I have been an economics professor at the University of Wisconsin-Madison and a Research Associate at the Institute for Research on Poverty. My academic research has, in part, focused on the effectiveness of the EITC and I look forward to working with the Committee on improving the credit.

The administration is strongly committed to the goals of the EITC and will oppose any proposals that reduce the EITC and raise taxes on millions of working families who play by the rules. The credit provides a clear message that work pays——

Chairman ARCHER. Mr. Scholz, if you will suspend for a moment, I would hope that we do not get into political rhetoric in this hearing today. We are here to determine why there is a fraud and error rate in the program, and I would hope that the witnesses and the Members of the Committee will not let this turn into a hearing that involves political rhetoric. You may continue.

Mr. SCHOLZ. Mr. Chairman, my testimony addresses important sources of noncompliance and I have worded my testimony very carefully to make sure that we do not want to raise taxes on working families who play by the rules.

Mrs. JOHNSON. Will the gentleman yield?

Chairman ARCHER. The gentlelady from Connecticut is recognized.

Mrs. JOHNSON. No one here is interested in raising taxes on the working poor. No one is interested in undermining the EITC. We are interested in the fact that $5 billion is going out every year to people who are not qualified. So for you to start your testimony that way is to say that we have to defend this program against you. You do not. We are for this program, but we want it honest. We do not want to waste $5 billion and we do not want a 25-percent error rate. I think that is the point that we are trying to make to you, and if you will get to how you are going to reform this, that would be useful.

Mr. LEWIS. Mr. Chairman.

Chairman ARCHER. Mr. Lewis.

Mr. LEWIS. If you invited the gentleman here to testify, to speak, he should be given that courtesy and not muzzled and not censored on what he has to say.

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. I would simply reiterate what I said, which is not political. I do not want these hearings to fall into political rhetoric. I do not want these hearings to be involved in how are we going to increase people's taxes. I do not want these hearings to be involved in even how we are going to solve the problem. We want to know what the problem is and why it is what it is, as the gentleman from New York said in his opening statement, and I would encourage all the witnesses and the Members of the Committee to stick to the purpose of this hearing.

You may proceed, Mr. Scholz.

Mr. RANGEL. Mr. Chairman? Mr. Chairman, may I be recognized?

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Might this not be the appropriate time for us to go vote and then come back?

Chairman ARCHER. I think that is an excellent suggestion. The Committee will stand in recess while we vote, and let us return as quickly as we can.

[Recess.]

Chairman ARCHER. The Committee will come to order.

Mr. Scholz, you may continue.

Mr. SCHOLZ. Thank you very much, Mr. Chairman.

The EITC provides a clear message that work pays and so plays a critical role in public policies directed toward low-wage labor markets. While the U.S. economy has become the envy of the world, labor markets for low-skilled workers in the United States have not performed well over the last 20 years. Between 1979 and 1992, the earnings of a male without a high school degree has declined by more than 23 percent in real terms. Among male workers with a high school degree, real earnings have declined by 17 percent over this period.

The EITC helps the operation of low-wage labor markets by increasing the returns to work and, hence, labor force participation for low-skilled workers. In addition, it helps close the poverty gap by increasing disposable incomes of families. The Census Bureau reports that the EITC lifted 3.7 million persons out of poverty during 1995. The EITC will play an increasingly important role over time in making welfare reform work.

In the public dialog regarding the EITC, some have raised the question of whether the credit is a nontax function of the IRS. Let me be clear. The EITC belongs in the Internal Revenue Code. The credit was created and expanded to offset the overall tax burden of low- and moderate-income families. It continues to play this role as about 85 percent of EITC costs offset the combined Federal income, Federal excise, and Federal payroll tax burden of families receiving the credit.

In addition, 95 percent of EITC recipients would still file an individual income tax return even if there were no EITC and the IRS would still have to verify much of the same information regarding their filing status, number of children, and income.

Because most EITC claimants would file a tax return even if the credit did not exist, the costs both to the taxpayers and to the IRS of administering the EITC are very low compared to the corresponding administrative costs of other programs. For example, in

1995, the Food Stamp Program cost $3.7 billion to administer. The Aid to Families with Dependent Children, AFDC, Program cost $3.5 billion to administer. Even with these large administrative outlays, the overpayment rates of these programs were between 6 and 7 percent. These figures point to a clear tradeoff between administrative costs and noncompliance in the design of programs targeted to any specific group of taxpayers.

Another advantage of administering the EITC through the tax system is that participation by taxpayers eligible for the credit is higher than participation in many other assistance programs targeted to low-income families. For the EITC to meet the role that Congress and the administration envision, the credit must reach those it is intended to serve. The EITC meets this standard.

Today's hearing has been called in response to the recent release of new IRS data on EITC noncompliance. Deputy Commissioner Dolan has described the major findings of this study. Let me add a couple additional words.

The results provide both good news and bad news. The good news is there has been a significant improvement since the last comparable compliance study, when the IRS found that the EITC error rate was 35.4 percent in 1988. The improvement in EITC compliance to 25.8 percent in 1994 represents the implementation of several sensible compliance initiatives.

Taking into account only one of the steps that has been enacted since 1994, that is the use of the math error procedures Deputy Commissioner Dolan referred to for most children, the net error rate in 1994 would have been 20.7 percent. Other compliance initiatives adopted since 1994 cannot be examined using the data from the study but would bring the noncompliance rate down still further.

While the EITC error rate has fallen sharply over time, the bad news from the compliance study is clear. The EITC error rate is too high. The administration and Congress recognize that the EITC can best meet its goals of making work pay and lifting families out of poverty by ensuring that only those who are eligible receive the credit.

To better understand the remaining sources of noncompliance, the Treasury Department has conducted its own analysis of the data. We have found the most common EITC error is caused by taxpayers claiming qualifying children who do not reside with them for over half the year.

The second most common error is due to misreporting of filing status among married taxpayers.

The third most common error results from complicated living arrangements, where at least two taxpayers are eligible to claim the child. In such cases, there is an adjusted gross income, AGI, tie-breaker—that is tax law esoterica—where the taxpayer with the higher income is supposed to claim the child. Mistakes in meeting the tie-breaker test result in errors.

Given the insights that arise from the current compliance study, Treasury and the IRS have designed a set of proposals to provide the IRS with new tools to identify erroneous EITC claims while minimizing additional administrative costs to the Federal Government. Our eight-point plan consists of six legislative proposals and

two administrative actions. These proposals will help reduce EITC errors by increasing error detection before EITC refunds are paid, by imposing new, more effective penalties on EITC claimants, and by reducing the risk of unintentional errors by well-meaning taxpayers. Very briefly, let me list these initiatives.

To reduce EITC errors by increasing error detection before refunds are paid, we are proposing new due diligence requirements on paid tax preparers. We are asking taxpayers who have lost their EITC through a deficiency procedure to file an expanded schedule EITC to be recertified by the Service. We are proposing that four States be selected for demonstration projects to investigate alternative mechanisms for delivering the credit and determining the effect of those alternative mechanisms on compliance. And last, the IRS has committed resources, significant resources during the 1998 filing season to investigate EITC claims.

We are increasing penalties for intentional noncompliance by imposing penalties for intentional and fraudulent errors that would result in a taxpayer not being able to receive the credit in subsequent years. We are proposing to institute a continuous levy, so a portion of unemployment compensation and certain means tested public assistance could be levied to bring back part of outstanding tax liabilities, including overpayments of the EITC. Last, to simplify the credit, we have proposed to simply foster child definitions and improve access to the Tax Volunteer Assistance Program.

These eight steps build on our previous efforts that have thus far reduced the EITC error rate from 35.4 to 20.7 percent or less, and I want to emphasize previous efforts, not all from this administration. We ask for your support in enacting these six new legislative proposals which are necessary to further improve noncompliance.

Mr. Chairman, thank you once again for providing me with the opportunity to testify and I will be happy to answer any questions that you or others on the Committee have.

[The prepared statement follows:]

Statement of John Karl Scholz, Deputy Assistant Secretary, Tax Analysis, U.S. Department of Treasury

I am pleased to have the opportunity to discuss the Administration's proposals to improve the earned income tax credit (EITC) and look forward to working with the Committee on this issue.

The Administration is strongly committed to the goals of the EITC and will oppose any proposals which reduce the EITC and raise taxes on millions of working families who play by the rules. The goals of the EITC are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs.

ECONOMIC CONDITIONS AMONG LOW-WAGE WORKERS

To understand the role of the EITC, a couple of facts about the labor market for low-skilled workers in the United States are useful.

There has been a striking drop in real wages for unskilled workers, beginning in the 1970s and accelerating over the 1980s. Between 1979 and 1992, the earnings of full-time male workers who had not graduated from high school declined by more than 23 percent in real terms. Among full-time male workers with a high school diploma, real earnings fell by 17 percent over the same period.

This decline in the real wage for many unskilled workers has serious implications. In the United States, it is still possible for a family, containing a worker, to live in poverty. According to the Census Department, there were 2.4 million persons, over the age of 16, who lived in poverty and had worked year-round at full-time jobs in 1995.

EFFECTIVENESS OF EITC IN MAKING WORK PAY AND REDUCING POVERTY

The ETC makes work pay in two ways. Unlike many assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases—rather than decreases—for each additional dollar of earnings. As a consequence, the EITC is different from many low-income assistance programs that are characterized by a reduction in benefits for each additional dollar of earnings. In my work prior to coming to Treasury, I—together with Stacy Dickert-Conlin and Scott Houser—examined the net impact of the OBRA 1993 expansion of the EITC on labor supply. We found that the EITC has a modest, positive effect on labor supply by encouraging individuals to enter the workforce. The EITC also directly increases the disposable income of working families. According to the most recent Census data, the EITC lifted 3.7 million persons out of poverty during 1995.

By making work pay, the EITC increases the probability that some parents may enter the workforce and perhaps leave the welfare rolls. The EITC, then, plays a key role in our efforts to reform welfare.

ADMINISTERING THE EITC THROUGH THE TAX SYSTEM

The EITC achieves the goals of making work pay and relieving poverty by reducing the tax liabilities of low and moderate-income families. Thus, it is improper to characterize the EITC, as some have done recently, as a "non-tax function" of the IRS. The EITC was created and expanded to offset the overall tax burden of low and moderate-income families and should not simply be measured as an offset to income and SECA taxes. About 85 percent of EITC costs will offset the combined Federal tax burden of families receiving the credit in 1998.

As these numbers suggest, EITC claimants are taxpayers. If the EITC did not exist, almost all EITC filers would still file an individual income tax return (in addition to paying payroll and excise taxes), and the IRS would still have to process their returns and verify much of the same information regarding their filing status, number of children, and income. In 1998, about 69 percent of EITC claimants will be required to file a tax return because they have an individual income tax liability (before the EITC), owe special taxes, have self-employment income in excess of $400, or their gross income will exceed the filing threshold. In addition, over 25 percent of EITC claimants will file a tax return in order to obtain a refund for overwithheld taxes paid throughout the year.

Because most EITC claimants would be filing a tax return even if the credit did not exist, the direct budgetary costs of administering the EITC are significantly lower than if the credit were provided through another means. The IRS cannot easily disentangle the costs of administering one line on the Form 1040 from other lines on the tax return, and we thus do not have estimates of the costs of administering this particular tax provision through the tax system. We can safely say, however, that the costs are lower than those associated with certain government expenditure programs. For example, in FY 1995, the food stamp program cost $3.7 billion to administer, while AFDC administrative costs were an additional $3.5 billion—nearly 14 percent of the combined costs of these two programs. For these administrative costs, the AFDC program served, on average, about 4.9 million families in a given month, while over 10 million households received food stamps. By way of comparison, the entire IRS budget in FY 1995 was $7.6 billion, and the IRS served over 116 million individual taxpayers and 15 million corporations.

Taxpayers also benefit from obtaining the EITC through the tax system. Many low-income workers learn about the EITC when they file a tax return to obtain a refund. By claiming the credit on tax returns, EITC claimants do not have to take time off from work to apply for the credit at a government office.

Not surprisingly, then, participation in the EITC tends to be higher than many other assistance programs targeted to low-income families. In my research prior to joining Treasury, I found that 80 to 86 percent of those eligible received the credit in 1990. This high participation rate is striking when compared to the AFDC participation rate of 62 to 72 percent and the food stamp participation rate of 54 to 66 percent. International comparisons also confirm this finding. The United Kingdom has an EITC-like program called the Family Credit. It is administered through the transfer system and directed toward families with children. Official estimates place the participation rate of the Family Credit at around 50 percent. Thus, both compared to cash and in-kind transfers in the United States and comparable work-related benefits in the United Kingdom, the EITC is much better at reaching those who are eligible for the credit.

Notwithstanding these benefits, there are costs associated with operating the EITC, as with other tax provisions, through the tax system. A system based largely

on self-assessment will have lower administrative costs than a more bureaucratic approach, but it will also lead to higher noncompliance. Many of us were very concerned when EITC compliance data, from the 1980's, first became available. The Taxpayer Compliance Measurement Program (TCMP), last conducted in 1988, showed that 35.4 percent of the EITC claimed ($2 billion) exceeded the amounts to which taxpayers were eligible.

But the same TCMP also places the problems of the EITC in perspective. Last April, the IRS released a study, based on the 1988 TCMP, showing that the gross individual income tax gap in 1992 was between $93.2 and $95.2 billion. The IRS estimated that the total "true" individual income tax liability was between $550.2 and $552.3 billion for tax year 1992. Over 40 percent ($39.1 to $39.9 billion) of the gross tax gap for 1992 was attributable to the underreporting of business income (including self-employment income, partnership income and rents and royalties). About 20 percent ($18.1 to $18.7 billion) of the gross tax gap was due to the underreporting of non-business income. Over 14 percent ($13.5 to $13.8 billion) of the gross tax gap was due to persons who failed to file tax returns. These problems exceed any noncompliance problems associated with the EITC.

Nonetheless, the Administration and Congress have recognized that the EITC can best meets its goals—of making work pay and lifting families out of poverty—by ensuring that only those who are eligible and deserving receive the credit. Congress took a first step in this direction during the consideration of OBRA 1990, when data from the 1985 TCMP became available. The TCMP data suggested that EITC errors were linked to complicated and unverifiable support and household maintenance tests. OBRA 1990 replaced the support and household maintenance rules for EITC eligibility with simpler age, residency, and relationship tests, lowered the age requirement for reporting a taxpayer identification number for EITC qualifying children, and created a separate schedule to claim the EITC.

This Administration, with the support of Congress, has taken 17 additional legislative and administrative actions to further improve the targeting and operations of the credit. First, Congress has enacted stricter reporting requirements proposed by the Clinton Administration, and the IRS has tightened enforcement of these requirements. Since 1995, the IRS has transcribed the social security numbers of *all* EITC qualifying children and most dependents, and it has intensified its examination of returns with missing social security numbers. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (the welfare reform act) contains a Clinton Administration proposal which will enable the IRS to use the simpler and more cost-efficient mathematical error procedures to deny both the EITC and dependent exemptions to taxpayers who fail to provide valid social security numbers. As a consequence of the Uruguay Round Agreement Act of 1994, taxpayers will also be required to provide social security numbers for all dependents and EITC qualifying children without regard to their age on their 1997 tax returns.

Other reporting requirements have also been strengthened. The Uruguay Round Agreement requires the Department of Defense to report to both the IRS and military personnel nontaxable earned income used in the computation of the EITC. The 1996 welfare reform act also authorizes the IRS to treat the omission of self-employment taxes as a mathematical error, if the taxpayer claims eligibility for the EITC on the basis of self-employment income.

The IRS, with the support of Congress, has also intensified scrutiny of "questionable" EITC claims and preparers. For the last several years, the IRS has conducted studies of EITC compliance and has used this information to better identify questionable returns. In addition, the IRS increased scrutiny of electronic return originators (EROs), instituted fingerprint and credit checks on certain new ERO applicants, and eliminated the direct deposit indicator.

Finally, the Administration has consistently supported provisions that would simplify the EITC, opposed provisions that would add significant complexity to the EITC, and has striven to ensure that EITC reforms can be administered. In 1993, the Administration proposed the repeal of two supplemental credits (for children under the age of one and for the purchase of health insurance for qualifying children), arguing that the IRS could not enforce the eligibility criteria for them, and these supplemental credits were subsequently repealed. In 1995, the Administration opposed, on administrative grounds, proposals to base EITC eligibility on child support payments and hours of work. The Administration's proposal to deny the EITC to undocumented workers, included in the welfare reform act, was also designed in a manner which could be administered by the IRS.

ANALYSIS OF EITC COMPLIANCE STUDY FOR TAX YEAR 1994

The combined effects of these efforts cannot be fully measured at this time, since several key steps did not take effect until the 1997 filing season and another step—the requirement that all children, regardless of their age, have a social security number—will not be fully implemented until the 1998 filing season. Today's hearing, nonetheless, has been called in response to the recent release of new IRS data on EITC noncompliance for tax year 1994.

The Criminal Investigation (CI) Division of the IRS conducted this study of compliance among 2,046 taxpayers who claimed the EITC on tax returns filed and accepted by the IRS between January 15 and April 21, 1995. CI Special Agents visited a random sample of EITC claimants, shortly after they filed their paper or electronic tax returns. Taxpayers (and often their employers, tax return preparers, family members, and neighbors) were interviewed at length and asked to produce verification that they met the EITC eligibility criteria. While the Special Agents made initial judgements about the legitimacy of the EITC claim, these judgements were reviewed—and sometimes changed—in subsequent review by Examination staff who had access to other sources of independent information (such as the Forms W–2 and 1099 sent by employers and other payers).

The study found that of the $17.2 billion claimed in EITC between January and April 1995, $4.4 billion, or 25.8 percent of total EITC claimed, exceeded the amount to which taxpayers were eligible. The overclaim rate among EITC claimants was slightly higher among paper filers (26.1 percent) than for electronic returns accepted by the IRS (25.3 percent). Noncompliance was found to be much higher among filers who claim EITC qualifying children than for those EITC claimants without qualifying children. Among those who claimed EITC qualifying children, the overclaim rate was 26.1 percent, while the overclaim rate was 15.7 percent for those who did not reside with a qualifying child. IRS enforcement practices, in place during the 1995 filing season, reduced the estimated net overclaim rate from 25.8 percent to 23.5 percent. If the IRS had been able to treat a taxpayer's failure to provide valid social security numbers for EITC qualifying children over the age of one as a mathematical error on 1994 tax returns, the net overclaim rate would have been reduced further, to an estimated 20.7 percent.

While EITC noncompliance remains at unacceptably high levels, the study's results do show significant improvement since the late 1980s, the last time that the IRS examined a comparable group of taxpayers as part of the TCMP. The improvement in EITC compliance since 1988 reflects the implementation of many, but not all, of the steps described earlier.

To better understand the remaining sources of noncompliance, we have conducted an analysis of the data. We have found that the most common EITC error is caused by taxpayers claiming qualifying children who do not reside with them for over half the year. Among taxpayers with children, such errors account for about 39 percent of overclaimed EITC amounts. Under current law, taxpayers are required to reside with their qualifying children for at least six months or a full year, depending on the relationship of the child. Taxpayers fail the residency test for many different types of reasons. For example, divorced parents who share the custody of their children might both claim the EITC because they both feel the child lived with them for over half the year. At the other extreme, a taxpayer may claim a child with whom he or she has never resided.

A second common error is due to misreporting of filing status among married taxpayers. Filing status errors account for about 31 percent of overclaimed EITC amounts among taxpayers with children.[1] Sometimes, separated couples do not understand that they must still file as married persons if they have not yet obtained a legal separation. In other cases, married couples, who are still living together, do not file either a joint return or a "married filing separate" return.

The third most common error results from complicated living arrangements. In such situations, a child lives with more than one adult who appears qualified to claim him or her for EITC purposes. However, about 18 percent of overclaimed EITC amounts result when, in such households, the caregiver with the lower AGI claims the child. In some cases (although it is difficult to quantify), the other caregiver was, in fact, qualified to claim the EITC but did not. The study does not account for the offsetting errors which occur because the taxpayer's relative, with the higher AGI, did not claim the EITC when he or she was eligible.

Even among EITC claimants without qualifying children, many errors are caused by the misreporting of family structure. Among these taxpayers, about 40 percent

[1] Some taxpayers misreport their filing status and also claim children who did not reside with them. They are included in both error categories.

of overclaims are attributable to the misreporting of filing status among married taxpayers. However, most errors among EITC claimants without qualifying children are due to the misreporting of income.

While we can identify the sources of EITC errors in this study, we do not know from the study the extent to which the EITC, itself, is the root cause of the noncompliance on the part of the taxpayers. By misreporting filing status, child dependents, and income, taxpayers may be able to reduce their tax liability through other provisions in addition to the EITC. Because this study focused only on EITC claimants, it does not isolate the effect of the EITC on noncompliance, or the extent to which higher income taxpayers are benefiting from misreporting their income or family circumstances.

The study does provide evidence that the refundable nature of the credit does not induce ineligible individuals to enter the tax system simply to claim the credit. As I have discussed, 95 percent of EITC claimants have a reason other than the EITC to file a return. The overclaim rate among those with a positive pre-EITC tax liability is nearly three times larger than the rate among those who did not have a tax liability. The data thus suggest that noncompliant EITC claimants do not enter the tax system merely to claim the credit.

While the results of this study are not fully applicable to the current EITC, the study does point to the need for new approaches. Many types of EITC errors are difficult to detect with the current IRS enforcement tools, such as matching of information reports and Social Security Administration records to tax returns. Our proposals are designed to provide the IRS with new tools to identify erroneous EITC claims while minimizing additional administrative costs to the Federal government.

LEGISLATIVE AND ADMINISTRATIVE PROPOSALS

The Treasury Department's eight-point plan contains six legislative proposals and two administrative actions. These proposals will help reduce EITC errors by increasing IRS's ability to detect errors before EITC refunds are paid out, by imposing new, more effective penalties on EITC claimants, and by reducing the risk of unintentional errors by law-abiding taxpayers.

PROPOSALS TO IMPROVE THE FLOW OF INFORMATION PRIOR TO RELEASE OF EITC CLAIMS

Due diligence requirements for preparers—About half of earned income tax credit (EITC) claimants use a paid preparer to complete their income tax returns. As a consequence, tax preparers can play a key role in helping working families file accurate tax returns. While there is little significant difference among returns prepared by the taxpayer and those prepared by a paid preparer, the error rate does differ depending on the type of preparer consulted by the taxpayer. Noncompliance was much lower among taxpayers who went to a preparer who was either a certified public accountant, lawyer, enrolled agent, or a representative of one of the large nationally-recognized organizations. It was higher among those who sought other types of preparers.

Under our proposal, the responsibilities of paid preparers, with respect to potential EITC claimants, would be clarified. Preparers who do not fulfill certain due diligence requirements would be subject to cash penalties ranging from $50 to the full amount of an EITC overclaim. The proposed penalties would be in addition to the penalties imposed on preparers and taxpayers under current law. The proposal would be effective for taxable years beginning after December 31, 1997.

Recertification—When questions arise about EITC claims, the IRS generally must follow deficiency procedures to determine the accuracy of the taxpayer's return. While deficiency procedures protect taxpayers' rights, they can be time-consuming and relatively expensive when compared to the amount of tax at issue.

Under the proposal, a taxpayer who has been denied the EITC as a result of deficiency procedures would be ineligible to claim the credit in subsequent years unless he or she provides evidence of his or her eligibility for the credit. To demonstrate current eligibility, the taxpayer would be required to meet evidentiary requirements established by the Secretary of the Treasury. Failure to provide this information when claiming the EITC would be treated as a mathematical or clerical error. If a taxpayer is recertified as eligible for the credit, he or she would not be required to provide this information in the future unless the IRS again denies the EITC as a result of a deficiency procedure. Ineligibility for the EITC under the proposal would be subject to review by the courts. The proposal would be effective for taxable years beginning after December 31, 1997.

Demonstration Projects—The Treasury Department is seeking legislation permitting it to select four states to experiment with alternative ways of providing the

EITC throughout the year. Under the proposal, the four states could provide advance payments of the EITC to wage earners through state agencies rather than employers for a three year period. States would be required to verify eligibility for the EITC before paying out the credit. Effects on advance payment participation and compliance would be studied by Treasury. Applications would be submitted by the states to the Treasury Department during 1998 for demonstration projects to begin in January, 1999.

Earmarking of IRS Resources—Using information from the EITC compliance studies and other ongoing pilot projects, the IRS will continue to develop and use profiles of potentially erroneous EITC claimants. These profiles will be used to identify questionable EITC claims during the 1998 filing season. The IRS will expand the number of questionable EITC claims that it investigates during the 1998 filing season. Refunds associated with these claims will be delayed until the investigation is complete. Out of its current appropriations request, the IRS is earmarking 550 full time equivalent staff persons for this intensified effort during the 1998 filing season.

INCREASING THE PENALTIES FOR INTENTIONAL NONCOMPLIANCE

New Penalties for Intentional and Fraudulent Errors—Existing civil penalties have a limited deterrence effect against ineligible taxpayers repeatedly claiming the EITC. Denying subsequent eligibility to claim the EITC to taxpayers who have recklessly, intentionally, or fraudulently claimed the EITC in the past should help ensure that only those who are eligible for the credit receive it.

Under the proposal, any person who fraudulently claims the EITC would be ineligible to claim the EITC for a subsequent period of ten years. In addition, any person who erroneously claims the credit and such error is due to the reckless or intentional disregard of rules or regulations would be denied eligibility for the EITC for two subsequent years. The sanction under the proposal would be in addition to civil and criminal penalties imposed under current law. In addition, the sanction would be subject to review by the courts. The proposal would be effective for taxable years beginning after December 31, 1997.

Continuing Levy—The IRS does not generally find it cost-effective to recoup overpayments of the earned income tax credit (EITC) or impose monetary penalties on noncompliant claimants. To some extent, these efforts are hindered by the exemption from levy of certain types of income prevalent among EITC claimants. By removing these exemptions, this proposal would make it more likely that the IRS would recapture overpayments.

In our FY 1998 budget, the Administration proposed that certain exemptions be partially lifted from the levy. Under the budget proposal, Federal workers' compensation payments, annuity or pension payments under the Railroad Retirement Act, and benefits under the Railroad Unemployment Insurance Act would no longer be fully exempted from levy. The proposal would change the exempt amount of Federal wages, salaries, and other income to a flat 85 percent exemption. The proposal would provide for "continuous" levy on non-means tested, recurring Federal payments.

Under the EITC initiative, unemployment benefits and means-tested public assistance would no longer be fully exempted from levy for any purpose. Up to 15 percent of these benefits would be subject to levy. The proposal would also provide for the option of a "continuous" levy on these payments. Treasury would work with affected Departments and state agencies to design the mechanisms appropriate for each program. If necessary, conforming changes would be made to the laws and regulations governing public assistance to ensure that there would not be offsetting changes in these benefits to compensate for the levy. The proposal would apply to levies issued after December 31, 1997.

As under current law, taxpayers would be allowed to apply for relief from a levy if they can demonstrate that they are suffering significant hardship as a consequence.

REDUCE UNINTENTIONAL ERRORS

Simplification of Foster Child Rule—Under current law, a taxpayer is eligible to claim the earned income tax credit (EITC) if he or she resides with a son, daughter, or grandchild for over half the year. EITC qualifying children also include individuals who reside with taxpayers for a full year and for whom the taxpayers "care for as the taxpayers' own children." All EITC qualifying children (including foster children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled.

The foster child" rule is confusing to both taxpayers and the IRS. Clarifying the definition would eliminate unintentional errors by taxpayers and provide better guidance to the IRS. In addition, the definition of a foster child for EITC purposes would be conformed to the dependency exemption definition proposed as part of the Administration's simplification package.

Under the proposal, a foster child would be defined as a child who (i) is under the age of 19 (24 if a full-time student), (ii) is cared for by the taxpayer as if he or she were the taxpayer's own child, and (iii) either is the taxpayer's niece, nephew, or sibling or was placed in the taxpayer's home by an agency of a state or one of its political subdivisions or a tax-exempt child placement agency licensed by a state. The proposal would be effective for taxable years beginning after December 31, 1997.

Improve Access to Taxpayer Assistance—In 1996, 1.9 million low-income taxpayers receive assistance preparing their tax returns from over 47,000 volunteers in IRS-sponsored VITA (Volunteer Income Tax Assistance) facilities. The IRS provides training materials and tax forms to 8,300 sites. The IRS also provides software for electronic filing and lends computer hardware to selected sites. These VITA efforts will be continued and strengthened as part of the Administration's commitment to volunteerism. The Treasury Department is contacting businesses and tax professional organizations to make sure that they are aware of the need for VITA volunteers, computers, facility sites, and outreach assistance. By improving access to free taxpayer assistance and electronic filing, these efforts will help reduce the risk of unintentional errors.

This concludes my remarks. We look forward to working with you toward the enactment of these provisions. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer any question that the Committee may have.

Chairman ARCHER. Thank you, Mr. Scholz, and thank you, Mr. Dolan. Thank you for also being here, Mr. Dalrymple and Mr. Brown.

Mr. Dolan, I would like to try to get a little better understanding of the parameters of your study. The study indicates that your sample was selected from returns that were actually accepted by the IRS. However, the IRS electronic screens are designed to automatically reject electronic returns with invalid or missing Social Security numbers or mismatches between the qualifying children's Social Security numbers and their dates of birth. Do you know what percentage of the returns were rejected during the time period that this study was conducted?

Mr. DOLAN. Mr. Chairman, I am going to ask Ted Brown to comment. But you are exactly right. There were a number of returns that would have been rejected electronically. We do not have a way to systematically follow each of those rejected returns to see when or if they came back in on paper.

However, based on the parameters of the study, the fact that the study did, encompass returns filed through April 15, our assumption is that one of three things happened. Somebody corrected the Social Security number and it came back in electronically, they were bogus and did not come back in at all, or they attempted to come back in on paper. If they had come back in on paper, the statistical sample would have accounted for that population as a part of the group that was studied in 1994.

As to your specific question on a percentage, I am not sure whether Ted has that or not.

Mr. BROWN. Mr. Chairman, we do not count the number of returns that are rejected, so I cannot give you a percentage, because

returns can be resubmitted repeatedly. We count occurrences, how many times we have a reject. That would run about 14 to 15 percent of the attempts to file a return electronically during 1995.

Chairman ARCHER. And you had no flag or tickler placed on the electronic rejections to determine whether they came back on paper filings, is that correct, or did you have such a thing?

Mr. BROWN. No, sir. We cannot track an electronic return that is rejected and comes back in on the paper side.

Chairman ARCHER. And as I understand, Mr. Dolan, what you said preliminarily, if a return that had been rejected electronically did come back in writing on paper during the window of your sampling, you would have picked that up, is that correct?

Mr. DOLAN. It would have been part of the universe from which the sample was drawn, correct.

Chairman ARCHER. But if it came back after that window closed, then you would not have any data on that?

Mr. DOLAN. That is an accurate statement. However, I think if we showed the demography of the return filing patterns, I think there is a reasonably good inference that most EIC refund claimants are going to come in on or before April 15.

Chairman ARCHER. There were a rather significant number of electronic returns that were rejected and not taken into consideration in this study, are you confident that the results of the study capture the full level of potential errors in the EITC?

Mr. BROWN. Yes, sir, other than the group that might have decided not to refile and that is your only exposure to something that would not be included in the sample.

Chairman ARCHER. But this 14 percent that you mentioned, would that not possibly have augmented the number of errors?

Mr. BROWN. The first issue, Mr. Chairman, is that that is an occurrence count. So, for example, the taxpayer submits a return and it is rejected for an error. They think they have corrected it. They try it again. It is rejected again. So we can have multiple occurrences from the same taxpayer, so that tends to make that number higher than it is in reality.

Chairman ARCHER. Mr. Brown, I am going to move on to a little different approach. Can you elaborate on exactly what types of erroneous claims your study identified and can you give us a breakdown of the types of fraud and error that the IRS detected by their root cause?

Mr. BROWN. Mr. Chairman, we have a lot of different data about the makeup of this sample. Sometimes when you get down to very specific subcategories, the statistical validity of the sample falls away because the numbers get very small, so that is one caveat.

Beyond that, we have tried to analyze the data to look at and determine if there are patterns based upon filing status, based upon income levels, based upon the number of children that were claimed, and based upon the types of income that were reported. We have used that data to attempt to redirect our enforcement efforts, our audit programs, as well as our screens.

My concern is if I get too specific, I may disclose some of our capabilities as well as some of our vulnerabilities. For that reason, perhaps the Joint Committee, after they have analyzed the data, may have better answers than I could give you today. If that is not

sufficient, I would be willing to come back in and give you some of the examples.

Chairman ARCHER. Inasmuch as we have asked the Joint Committee to look at the raw data and to develop the kind of responses for us that my question solicits, it might be best not to do that here publicly today. However, I will say that it is my common sense opinion, not backed by any technical expertise, that if someone wants to commit fraud on this program, that there is an underground grapevine that most clearly permits them to understand how to do it without your giving them a road map. That has been the experience that we have seen in an awful lot of programs, but I will not push that any farther.

Mr. BROWN. Thank you.

Chairman ARCHER. Mr. Brown, what are the qualifications of the special agents who conducted the investigation in this study?

Mr. BROWN. Most of our special agents, they are all college graduates. The majority of them are accountants by training, but we also have attorneys and former revenue agents, former law enforcement officers. After they are hired, they are sent through about 6 months of training at our Federal Law Enforcement Training Center in Brunswick, Georgia, where they get an introduction to law enforcement techniques as well as specialized training on our techniques to prove tax fraud and money laundering.

The agents that were selected, my work force is very experienced. Most of them are very experienced agents around the country, so they are experienced investigators.

Chairman ARCHER. So they are experienced in investigating fraud issues?

Mr. BROWN. Yes, sir. These are criminal investigators.

Chairman ARCHER. Based on their training and experience, did the special agents who conducted this study and investigation reach a conclusion in each case in which erroneous payments were identified about whether the mistakes were simply errors due to the complexity of the Code or whether they were intentional fraud?

Mr. BROWN. We asked the agents during their field contacts to categorize each case and to make a subjective assessment as to their reaction to the facts as they identified them. The first and the simple one was that the return was correct, and at the other extreme was that they simply could not develop enough information, they could not locate the taxpayer, they could not locate appropriate witnesses to make a determination.

In those cases in between, we asked them to classify that the error either was due to misunderstanding, error, or some mistake by the taxpayer or that, in their opinion, subjectively, that the error was due to an intentional nonadherence to the law.

Chairman ARCHER. And based on your training and experience, what percentage of the overclaims were simply error and what percentage were intentional fraud?

Mr. BROWN. Again, as Mr. Dolan mentioned earlier, we did not use the term "fraud" during this study. We did use the term "intentional," because as a criminal investigation——

Chairman ARCHER. Let us take fraud out of it and say intentional.

Mr. BROWN. In the classification of the cases, it was about 50 percent due to error and about 50 percent classified as intentional by the investigators.

Chairman ARCHER. Thank you very much. I have one last question for Treasury and then I will yield to my colleague, Mr. Rangel.

Mr. Scholz, in your new proposals, what you are suggesting is that they would help to reduce the amount of overpayment. If enacted, what level of error rate would this bring the noncompliance down to?

Mr. SCHOLZ. It would bring the noncompliance down a significant amount. It is a very difficult question to answer that you asked because we do not know what the current error rate is because of steps that have been adopted since the 1994 has been taken. In particular, we have new math error procedures for primary and secondary taxpayers and the Social Security number requirement and math error procedures for children under one. So this makes it very difficult to know what the current noncompliance rate is.

What adds to and compounds the difficulty is at least two of our significant noncompliance proposals are directed at tax preparers and are deterrence proposals for taxpayers and there is very little out there in existing academic or policy literatures that would allow us to base an estimate.

We, Congress and the administration, do have a track record, though, when we say that these proposals will reduce the noncompliance rate significantly and the track record is bringing the noncompliance rate down from 35.4 percent to the current 20.7 percent that would be the noncompliance rate if the math error procedures that we could model were incorporated.

Chairman ARCHER. So you believe that if your current proposals were adopted, that there would be an additional significant amount of reduction in the error rate, is that correct?

Mr. SCHOLZ. I do, Mr. Chairman.

Chairman ARCHER. And how would you define significant? What percent would you put on the term "significant"? What range of percent, if you cannot be totally accurate?

Mr. SCHOLZ. I can bound the effect. I can tell you that I have a strong feeling that it is going to be lower than 20.7 percent, and beyond that, it would be inappropriate for me to hazard a guess for the reasons that I just said. We do not know what the existing noncompliance rate is. We do not have any objective basis upon evidence from the policy literature or the academic literature on the effects of these noncompliance rates. So it is very, very difficult. It would be, in fact, irresponsible for me to give you a point estimate of what I think the effect of these proposals would be.

Chairman ARCHER. I assume that you have looked carefully at the study that has been done by Mr. Brown under Mr. Dolan's supervision——

Mr. SCHOLZ. Yes, sir, we surely have.

Chairman ARCHER [continuing]. And that you have the benefit of all of that analysis.

Mr. SCHOLZ. That is correct.

Chairman ARCHER. You, therefore, know probably more than we do at this time. Have you seen the raw data, also?

Mr. SCHOLZ. Yes, sir, we have.

Chairman ARCHER. So you have even more information than the Members of this Congress have or that we will even have at the end of this hearing today but which will be turned over to the Joint Committee for their evaluation.

Based on that information, which is not even available to us today, at this moment, you have no ability to determine what your proposals will do to reduce that error rate other than to say that it will be significant?

Mr. SCHOLZ. We certainly do, because we have designed the particular proposals with the knowledge that we have from extensive analysis of the data that underlies the IRS study. So we know, for example, that tax returns prepared by the large national tax preparation community have lower noncompliance rates. Our proposaal to require due diligence on EITC claims among professional tax preparer proposal was generated by this fact, and we are asking other tax preparers to take the same kinds of steps that the large national tax preparers take.

Every single one of our six legislative proposals and two administrative proposals is generated by the knowledge that we have gained from looking at this noncompliance study. That is why I am confident when I sit here and tell you that there will be a significant reduction in the error rate as a consequence of adopting our proposals.

Chairman ARCHER. After saying all that, I was hoping I could get you to draw a conclusion from that. Significant, then, might be one-half of 1 percent, is that correct?

Mr. SCHOLZ. Significant—that would not be significant, Mr. Chairman.

Chairman ARCHER. That would not? What about 1 percent?

Mr. SCHOLZ. That probably would not be significant, either.

Chairman ARCHER. What about 2 percent?

Mr. SCHOLZ. That would probably not be significant, either, Mr. Chairman.

Chairman ARCHER. What about 3 percentage points?

Mr. SCHOLZ. It starts to get hard.

[Laughter.]

Chairman ARCHER. So that is beginning to enter the range of what you would consider significant, 3 percent. So we would be able to anticipate that if your proposals were enacted, that we would at least reduce the rate to 17.7 percent, at a minimum.

Mr. SCHOLZ. As you know, Mr. Chairman, the world does not stop when you adopt some proposals, so there are lots of other things happening in the economy. There are lots of other things happening with IRS enforcement efforts. The EITC is getting larger because of the steps that you and the administration took in 1993 and all of those things make it very, very difficult to make the statement that you have just made. We do not know what the noncompliance rate is right now. The credit has gotten somewhat larger. That would tend to possibly increase——

Chairman ARCHER. No. I understand that it is not easy to do this, but you have an expertise that no Member of this Committee has, both from your academic background and the fact that you have done an intensive study of this investigation report. I am simply asking you to try to give us the benefit of that expertise and

that study and tell the Committee what we might expect if these proposals are adopted.

If we are only going to get 1 percentage point, we have not made a whole lot of progress. I am trying to understand what you mean by significant, and I think that the record will show now that you think significant is a minimum of a 3-percentage point reduction. I appreciate your giving us the benefit of that conclusion.

Now, let me further ask you, and then I am going to yield to the gentleman from New York, what do you believe is a reasonable target for EITC compliance? What would you accept as a reasonable error rate?

Mr. SCHOLZ. Compliance initiatives——

Chairman ARCHER. Please, just give me your opinion as to a number that you would accept. I know that you have all this background of knowledge, but I want to know what you would accept as a reasonable target for EITC compliance, where you could rest easy and say, now this program is one that we think has got an error rate that is acceptable.

Mr. SCHOLZ. Mr. Chairman, I, like you, have a goal of trying to reduce the EITC noncompliance rate as far as we possibly can with sensible, cost-effective steps.

Chairman ARCHER. But where would you rest easy? What would your target be, where you would rest easy and say, now we have a program that is defensible and an error rate that is defensible and I am satisfied with it?

Mr. SCHOLZ. Just as with my professional career, I never rest easy, Mr. Chairman. I am always trying to improve, and compliance initiatives have to be the same.

Chairman ARCHER. Mr. Scholz, you are not answering my question.

Mr. SCHOLZ. I am trying to, Mr. Chairman.

Chairman ARCHER. You are saying that you want it to be as good as possible, and that is very vague, but with your background and your experience and your knowledge on this subject, what would you personally accept as a target for noncompliance that you believe would be defensible? Just give me a percentage figure.

Mr. SCHOLZ. It is a number that does not——

Chairman ARCHER. If it is zero, say zero and we will keep working toward that goal, but——

Mr. SCHOLZ. We will always strive to zero, Mr. Chairman. There is no question about that.

Chairman ARCHER. No. But what do you——

Mr. SCHOLZ. But it requires a careful balancing of the benefits of the program with the costs, and the costs are part of this noncompliance problem that we are all so frustrated about.

Chairman ARCHER. Clearly, there is some point where you believe we need to get before you will be comfortable that we have an error rate that is acceptable.

Mr. SCHOLZ. To be honest, Mr. Chairman, I will never be comfortable when taxpayers are receiving dollars——

Chairman ARCHER. We cannot get to zero. We know that.

Mr. SCHOLZ [continuing]. When taxpayers are receiving dollars that are inappropriate, and so noncompliance initiatives are an evolving thing. They are incremental. You always find problems

and you go and attack them and you try to attack them in a sensible, cost-effective manner. That process will never stop. It has not stopped in any single area of the Tax Code. I am sure my colleagues from the IRS would assure you of that. There is not one single area——

Chairman ARCHER. Let me see if I can just synthesize this. You would not be satisfied with the significant reduction that you say your proposals would give the country.

Mr. SCHOLZ. Those would be a major policy achievement and then there would be new compliance initiatives. We would continue to study the problem and we would continue to do it better.

Chairman ARCHER. So you would not be satisfied with what your proposals will produce?

Mr. SCHOLZ. I would call it a major policy achievement and one that we should seek because the proposals are low cost and they promise to do a lot of good.

Chairman ARCHER. I yield briefly to the gentleman from Florida.

Mr. SHAW. Mr. Chairman, I just want to inject here that, you are trying to get an answer from an economist. Economists do not give answers.

Chairman ARCHER. I thank the gentleman for his observation.

Mr. Rangel.

Mr. RANGEL. Dr. Scholz, when you described your background, you indicated that you were new in testifying in front of Committees?

Mr. SCHOLZ. I have testified a couple of times, but never with so many Members present.

Mr. RANGEL. Most of your background has been academic?

Mr. SCHOLZ. That is correct.

Mr. RANGEL. As an economist, have you ever heard the expression, dynamic scoring?

Mr. SCHOLZ. I certainly have.

Mr. RANGEL. That is pretty creative, is it not?

Mr. SCHOLZ. Dynamic scoring?

Mr. RANGEL. Yes.

Mr. SCHOLZ. I suppose it depends on what context, Mr. Rangel.

Mr. RANGEL. But it is subjective. It allows economists to reach conclusions that we want to reach here. You are new, but we have to do better in our assumptions because they are based on things that are not in your control, are they?

Mr. SCHOLZ. The best and most capable scoring would be based on things that are objective and do come from, either the academic or policy literature.

Mr. RANGEL. Let us see, now, Mr. Dolan, you have been around a long time. Can we do better in our assumptions as to bringing this rate down more than 2 or 3 percent?

Mr. DOLAN. I liked it better when you were asking Mr. Scholz a question like that. [Laughter.]

Is your question whether we think these proposals can bring it down or what it would take to bring it down?

Mr. RANGEL. Who is in charge of administering this program at the IRS?

Mr. DOLAN. The Commissioner and I are.

Mr. RANGEL. I mean, directly hands on, you are?

Mr. DOLAN. I am sorry?

Mr. RANGEL. Are you hands on, directly involved?

Mr. DOLAN. Well, I think the accountability clearly is with me, Mr. Rangel.

Mr. RANGEL. The accountability is with the President of the United States. I am trying to find out——

Mr. DOLAN. I am not trying to obfuscate.

Mr. RANGEL. No. No. I am just trying to find out. The recommendations have come from Treasury. You have evaluated them. I assume you agree. Both of you are reading from the same page as to what can be done to correct a situation that looks like a hemorrhaging of overclaims. You have targeted it. On your own, you figured something was wrong, so you had your study. You evaluated somehow whether it was fraud or mistakes and you created some way that you think you can close this gap in order to save what many of us believe is a very, very good program. Is that correct?

Mr. DOLAN. That is correct.

Mr. RANGEL. So with all of your creativity and all of the safeguards, are we suggesting that the best we can look forward to is bringing this down from 25 to 23?

Mr. SCHOLZ. May I answer that, Mr. Rangel? As I mentioned in my oral statement, with just the math error procedures that the Committee and Congress and the administration supported in last year's welfare reform law, the error rate would be 20.7 percent. The error rate has come down from 35.4 percent in 1988 to 20.7 percent with the 1994 data. More initiatives have already been adopted. We have proposed another set and we think those error rates will come down further, significantly.

Mr. RANGEL. Well, we have a problem with the word significantly, but what do you tolerate with other taxpayers' groups? Is there a group identified as individual self-employed proprietors that you categorize as having specific problems in overclaims? Mr. Dalrymple.

Mr. DALRYMPLE. Mr. Rangel, I can answer that. We have a 17-percent overall tax gap. That is the overall tax gap, roughly. Wage earners are basically in the 98-percent turnstile. They are 98-percent compliant. When you start talking about sole proprietors, which I think you asked the question about, it is in the range of 56- or 57-percent compliant. I hope that answers your question.

Mr. RANGEL. So the noncompliance is what is left?

Mr. DALRYMPLE. The noncompliance would be about 42 percent.

Mr. RANGEL. Did you do a study on that?

Mr. DALRYMPLE. We have done several TCMP studies around that.

Mr. RANGEL. Are you doing things to correct it?

Mr. DALRYMPLE. We are doing all kinds of things to try to correct that.

Mr. RANGEL. Do you have any assumptions to what improvement is going to be made in that? Are you an economist?

[Laughter.]

Mr. DALRYMPLE. I do have a degree in economics, yes, sir. I am almost sorry to have said that, Mr. Rangel.

[Laughter.]

Mr. RANGEL. Well, you never can be wrong with this Committee. Everyone needs their own economists and I thought they sent the wrong team here.

Mr. DALRYMPLE. Part of the $405 million revenue initiative several years ago was to address specifically that particular market segment.

Mr. RANGEL. We are constantly trying to improve the system, and in order to have confidence in the system, people have to believe that they cannot beat it. It is very important that you try to evaluate this overclaim problem as to which people are deliberately cheating on the U.S. Government and which are not educated enough to understand the complexity in the 39-page information sheet that some people have to read in order to take advantage of it. We ought to find out how many people are so frightened of the darn thing that they do not even apply for it, as well.

I think it would help us in our thinking if you could tell us the delivery of services or benefits to poor people. It is my understanding, since the delivery administration system is already locked in with these working people, that the overall cost of the program is dramatically lower than the delivery of food stamps and other benefits. If you find reason to be so tolerant of the 42 percent, then we ought to have the same type of understanding with the EITC. We have to constantly report to this Committee and the Congress and the American people what we are doing, how can the Congress assist you to make certain that programs and the tax collection system and a voluntary system works.

I want to thank the IRS for initiating their own study to see how they could do better and I join with the Chairman and Mrs. Johnson in saying, the program is not in jeopardy. The program is good. But in order for the program, which costs a lot of money, to continue to succeed, it cannot carry the political burden of having people believe that either people are deliberately cheating or the IRS cannot do the job or come up with a solution.

I gather that the complexity of the lives of hard working, low-income people, the taking the credit for children that may be living with grandmothers and other people, have caused a great problem. I, for one, think that we have to, if we cannot explain the complexity of the problems because the Tax Code is really something that is designed for lawyers and not taxpayers, that we should spell out in no uncertain terms that those people who intend to take advantage of this credit better know what they are doing under penalty and they had better have some pamphlets in the community.

I do not have anything in my Congressional offices except the regular forms. We have to do a better outreach job. All of the Congressional offices, especially those with large numbers of poor people, should have special people assigned with literature to let our people know. We will attempt to help you prior to income tax day. We can help those people that are locked into the system. Please ask the Congress to help you to resolve this program and not allow it to fall victim to criticism, some deserved and a lot not deserved.

Dr. Scholz, before you come back to the Committee, let us discuss some of the things earlier about how we make assumptions around this place. Thank you.

Chairman ARCHER. Thank you, Mr. Rangel.

Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to go back to Dr. Scholz. He seems to be a favorite target this morning. I would like to ask you in the questions that I am going to ask you, as painful as it might be, if you could give me brief yes or no answers, as would be appropriate to the question.

The first matter that I want to go into, according to the Congressional Budget Office, CBO's, latest figures, we expect the total cost of the credit to be $25.7 billion in 1997. Do you agree with that figure?

Mr. SCHOLZ. Yes, I do.

Mr. SHAW. Second, the IRS study shows the 25 percent of the benefits paid by this program are wasted in the sense that they are paid either in fraud or in error. Now, this was the study, I believe, that Mr. Dolan referred to, is that correct? This is the 1994 study?

Mr. SCHOLZ. What year are you talking about?

Mr. SHAW. I know you want to try to get this back to 20.7 percent, but the only study that has been completed with fresh data is 25 percent, is that correct?

Mr. SCHOLZ. So you are talking about filing season 1994?

Mr. SHAW. That is the latest study that has been completed.

Mr. SCHOLZ. Yes, sir.

Mr. SHAW. I hope the error rate is less than that, and I am sure you do, too, but this is the latest study that we have.

Mr. SCHOLZ. Correct.

Mr. SHAW. If we take the projections from the Congressional Budget Office on the EIC and calculated the total revenue and outlays scored for the 5-year period, according to CBO figures, the total EIC cost over the next 5 years would be $144.5 billion. Do you have any reason to disagree with the Congressional Budget Office on that, $144.5 billion over the next 5 years?

Mr. SCHOLZ. That sounds reasonable.

Mr. SHAW. Based upon the figures that we agree on, we know that we will waste over $36 billion in this program during a period when we are trying to balance the budget, and everyone is trying to balance the budget. We are working hard toward that goal. But let me repeat that figure, because this is quite dramatic. This is a waste of $36 billion on the income credit over the next 5 years.

Thirty-six billion dollars would pay for Head Start for a decade. Thirty-six billion dollars would pay for the WIC Program, which we are currently debating, which provides nutrition for children, also for a decade. This is $36 billion, and under any system, whether you are an accountant or an economist, we can all agree, this is a lot of money and it is a lot of money that is being wasted at this time. I am sure you agree with that.

Mr. SCHOLZ. Mr. Shaw, $36 billion is clearly a lot of money. The calculations that you have made are not appropriate, though. The reason is that 25.8 percent cited in the IRS study is a percentage of overclaims and not overpayments. So 25.8 percent was not paid out. The net overclaim rate after IRS enforcement efforts was around 23 percent. Then, as I said, this 20.7 figure that I have mentioned, that is not made up. That is the law that you passed

as part of the Welfare Reform Act—that is the math error procedure that corrects a lot of overpayments.

Mr. SHAW. Even using your figure, Dr. Scholz, we still have over $25 billion being wasted. We can sit here for the rest of the day and argue between $36 billion and $27 or $28 billion, but the bottom line is that we are wasting money that can be used for many worthwhile projects that help the poor.

Mr. SCHOLZ. Mr. Shaw, that is why we are all here today, to try to improve that noncompliance rate for this important program.

Mr. SHAW. Mr. Chairman, I look at this and I look at what we are doing and how we are using the Internal Revenue Service and all of these things and I think that all of us agree. I think you have made the point, Mrs. Johnson made the point, and Mr. Rangel made the point that if you continue these programs with these high figures of wasted money, you are endangering the programs, and none of us wants to do that. We want to be sure these programs work.

We want to be sure the money is getting to the people so that we are helping the people not be the working poor. We are helping the people that are working to put the extra money into their paychecks.

The problem of the abuse in this program and the fraud and abuse and waste, however, is scandalous and I think that we need in a very bipartisan way and in cooperation with all involved to work together to try to see that this program is not used as a stepping stone for receiving all of this money that is taxpayer money being paid out. Eighty percent of it is being paid out. It is not a question of coming out of the taxes. It is a question of this money being paid out of the U.S. Treasury by the U.S. taxpayers to a group of people and the fraud and waste level is far too high. I think we all agree with that and I would hope we could work together.

Chairman ARCHER. The gentleman's time is expired.

Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I have two questions I want to ask, so I do not want to get bogged down on either one, but on this 42-percent noncompliance, let me just pursue that for a moment, if I may. That is, for the most part, underpayment, so it is people paying their taxes but not enough, and on audit, auditors going back and saying, according to the rules and regulations, we do not think you paid enough.

When you look at how many of the audits are sustained when they are appealed, what is that rate, the sustention rate?

Mr. DALRYMPLE. Mrs. Johnson, I do not have the sustention rate with me on sole proprietorships. I could have that document given to you.

Mrs. JOHNSON. I am interested that you do not. I would be interested in that, because the sustension rate overall is 25 percent. So if you apply that to the 40 percent, what you really have is an error rate of 10 percent, and I think that ought to be clear, because we are kind of comparing apples and orange here. In our welfare program, where we provide direct payments, the error rate is 6 percent in welfare and 8 percent in food stamps.

This is a tax program that provides direct payments, and while we are unlikely to ever get down to that rate, frankly, because we do not put the money into the administrative superstructure that the direct payment programs do, nonetheless, the current error rate of the program is totally unsustainable. But to compare it to the error rate in the sole proprietorship area is really misleading because you are comparing it to audits, and only 20 percent of the audits are found to be accurate and payments needing to be made and that is 20 percent of 40 percent, so you have a 10-percent error rate.

What I want to go to on——

Mr. DOLAN. Mrs. Johnson, not to prolong this at all or to be argumentative, the TCMP data that John referred to would have accounted for the results through appeal. So you are exactly right on the normal appeal for a particular strata. I would like to give you some more specific data so we do not mislead you on——

Mrs. JOHNSON. I would be interested, because, of course, the TCMP audits, those auditors are not permitted to take into account judicial precedents or even the probability that the positions will be asserted in audit on appeal.

Mr. DOLAN. Like I said, I am not interested in being argumentative as much as not misleading you on that fact.

Mrs. JOHNSON. OK, because I do not think we should leave that standing on the record that there is that great noncompliance among sole proprietorships, and especially when it is underpayment as opposed to nonpayment.

I do want to, though, get to Mr. Scholz, and any one of you, Mr. Dolan, who wants to address this. You have made some proposals to bring down the error rate. Now, we know a lot about the source of this error rate. We know that 65 percent of the errors are the result of joint return filing, inappropriate return filing, married taxpayers improperly filing separate returns, claiming single or head of household status. That is 30 percent of the EIC overclaim returns, $1.4 billion. We know that 2.3 million men file EIC benefits claiming head of household status and 59 percent of them were ineligible to file for $1.7 billion.

So these are big groups where noncomplying in filing is a big issue. How are the recommendations that you are proposing going to get to these groups specifically? I know you are making these recommendations about the tax preparers, but you really are going to have to be able to tell whether people filing as single heads of households are filing accurately and whether men claiming deductions are doing it accurately and how are your screens going to determine that.

Mr. SCHOLZ. The largest source of taxpayers' mistakes is the failure to meet the residency test. That accounts for about 39 percent of overclaims by our calculations. So this may be a case where a couple may have split up. Both taxpayers are spending time with the child, both think they are entitled to claim the child, and the noncustodial parent claims the child, and that is inappropriate.

A second type of very common error are these so-called filing status errors. There can be two cases. One could be clearly intentional, where both a husband and wife go ahead and file as heads of households and claim the credit. Another might be that there is

a married couple who have separated, and they are living in different places now. They are supposed to file as a married couple until they are legally separated, but they do not, and that would account for a filing status error.

The third kind are these complicated intergenerational families, where grandma is living with mother and her daughter, and they make a mistake on the AGI tie-breaker rules.

The proposal to modify the foster child definition gets at exactly that last kind of case, where you have an unmarried man and woman living together, both of whom think that they might be able to claim the child under the foster child provisions, but that definition is not clear because it talks about caring for a child as if it is your own, and that, of course, is an inherently subjective kind of thing.

Mrs. JOHNSON. Then how are you addressing these?

Mr. SCHOLZ. We are having very definitive rules about what is a foster child. That is, it has to be appointed by a court or meet narrow relationship tests.

Mrs. JOHNSON. What about the problem of an individual parent, in the case of the large number of men who claim inappropriately? How are you going at that problem?

Mr. SCHOLZ. Right. The men claiming inappropriately come up in the first two examples that I gave, where often, the noncustodial parent is a male claiming the credit inappropriately. The case where a married couple is both filing as head of household could both be a woman and a man filing in error.

So what is going to happen in those cases is the due diligence requirement on tax preparers—as you know, at least half the EITC recipients are using professional tax preparers, and there will be a series of questions that are already being asked in many of the better tax preparation offices about living arrangements, a child that might qualify someone for an EITC.

In addition, there is the checking that my colleagues at the Internal Revenue Service do on Social Security numbers. They are developing new ways of identifying duplicate children, children that are claimed by taxpayers twice, and the powers that we are proposing to grant the IRS in investigating those cases should help in that kind of problem. Both of those would directly lower the noncompliance associated with male heads of households, the problem that you spoke to.

Mrs. JOHNSON. Thank you, Mr. Chairman. My time is expired.

Chairman ARCHER. The gentlelady's time has expired.

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Scholz, at the beginning of your testimony, you said you were new to all of this and new to us. I am not new to Mr. Dolan. I was one of the original advocates of the earned income tax credit. I was there when nobody used it because they did not know about it. I was there when it was so complicated, nobody applied for it. And now I am here today at a hearing about waste and abuse, so I do not know what the IRS means by waste and abuse, I do not know the difference, but the good news is, people are using the earned income tax credit. The bad news is that we have this high error rate.

Having been with the program from the very beginning, I would say we are on two tracks. The first track is, if, in fact, somebody has abused the credit, they should not get the credit. They should be prosecuted, and if not, at least their tax return should be checked or tagged that they have been abusive.

Having said that, I want to thank the Chairman very much for saying today that the reform of EITC would not be used as political football in the whole budget situation. It relieved me greatly.

Having said that, I want to join with the Chairman in reforming this program that I have put so much of my time into, but I cannot do it and this Committee cannot do it without the information from Treasury and without the cooperation of IRS. I have known from the very beginning of this program that IRS did not want to get into this, but unfortunately, they have had to.

I read your report and I see a root cause of the noncompliance is the self-determination of eligibility by taxpayers with then limited ability by IRS to verify the taxpayers' eligibility before the check goes out. So I think that is where we are right now. We have got to figure out how, in fact, the check does not go out before the eligibility is verified, and if, in fact, that does happen, we are going to have to put a great deal of effort to make sure, that people do not think they can just get away with it.

I think we need some new legislative approaches. One issue that I have looked at and I want to ask you gentlemen about, one I have looked at for the last couple of years is conforming the personal exemption and the EITC. I would like to know if you have any comments on that. Is that an avenue we should pursue, and if not that avenue, what other legislative avenue can we pursue to make a program that is intended to keep people out of poverty and off welfare work?

It looks like it can work. It has a huge error rate that is unacceptable, but, my heavens, I just have to tell you, we need you to help us figure out what to do next and I would ask for your suggestions.

Mr. DOLAN. Mrs. Kennelly, let me, first of all, tell you that we have appreciated your support and your willingness to invite us into the equation. While it might have been your perception that we were not anxious to be in EIC when it was created, I think what we have tried to do is be as diligent as we know how to be in helping manage the program to produce the outcome Congress intends, the nonpartisan outcome Congress intends.

You put your finger on a point that I think frequently is lost on others, that one of the underlying explanations for the complexity of the EIC is clearly not limited to earned income tax credit. The entire functioning of the Tax Code turns on filing status classifications—head of household, married filing jointly, married filing separately. Similarly, the same dependent that is at issue in an EITC claim is at issue in a tax return that is filed without any EITC claim.

Neither of those lend themselves to some silver bullet classification. They are both highly personal, highly subjective, and no computer made is going to sort out all those personal relationships in an absolute pristine way in advance of an action.

So, as a consequence, what we have tried to do in EIC is the same thing we do in other areas. We look for probabilities; we look for hallmarks that would cause us to question a particular return or a particular set of returns. I think our best hope of continuing on the path that Karl talked about of incrementally bringing this down is to continue to refine the way we look at the returns that have the greatest likelihood of question.

I do not think there is a silver bullet, no more than there is a silver bullet to reduce a 17-percent overall noncompliance rate to zero. That 17 percent was worth $95 billion last year, and if we could find some tonic to wipe that out, I think we would all be happy.

I will let Karl speak to any additional legislation. I think, in large part, the course we are on, which has demonstrated a continued step downward in the risk that that program represents, is probably the only practical way in the short run to improve it.

Mrs. JOHNSON. Mr. Dolan, do we have a problem with personal exemption claims?

Mr. DOLAN. Certainly.

Mrs. JOHNSON. We have been talking and we will continue to talk. Would you like to respond quickly?

Mr. SCHOLZ. The legislative and administrative steps that we have offered, are the most sensible next steps in this evolving fight against EITC noncompliance. We certainly share your concerns. We want to bring this error rate down.

Mrs. JOHNSON. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. The gentlelady's time has expired.

Mr. Collins.

Mr. COLLINS. No questions, Mr. Chairman.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and thanks to the witnesses for all the good testimony.

Mr. Scholz, you said you had not testified much. When you get down to this level, most of the big picture questions have been asked, so then you start to roll up your sleeves and get into more of the detail. It is not as much fun sometimes, but that is our role down here. I have a number of questions relating to the IRS role and a number of questions related to the program itself and to some of the data you have presented today in your testimony.

First, Mr. Dolan, as you know, this Restructuring Commission that is due to report in about 1 month that I cochair and that Mr. Coyne is also a member of has done some pretty extensive surveying of IRS employees, and I am just following up on Mrs. Kennelly's questions as to the IRS support of this program, whether it makes sense to do this within our tax structure.

We have interviewed 300 online IRS employees, and it is interesting what we found, which is that more than half of those employees have told the Commission—these are your people—that the EITC is the greatest source of difficulty in administering the tax law. I assume you have that data from your own internal communications with your employees and you understand that they are very frustrated by this program. Have you taken their views into account in putting together your advice to Treasury on Treasury's proposals?

Mr. DOLAN. Mr. Portman, the specific survey that the Restructuring Commission has overseen has not directly been a function in the advice and the consultation we have done with Treasury. I think the characterization that the Restructuring Commission would make of the attitudes of IRS employees is probably not wide of the mark. Those who have been directly involved in trying to improve the administration of EIC, I think have been frustrated by the continuing presence of overclaims, erroneous claims.

I think it might be a leap, at least in my mind, and I will not speak for the half of the group of the IRS employees surveyed who told you what was in their minds, it might be a leap for me to call that the single biggest frustration or concern in the tax administration. I think there are clearly, as I think you probably well know, along that whole spectrum of compliance and noncompliance, I can think of some areas that probably would be at least as vexing, both as to the dollars involved and as to the basic structure of the tax system.

Mr. PORTMAN. It is interesting you mention that, because I think the data will speak for itself and I think that it will show that it is the greatest frustration, at least in an absolute sense, but as you say, the dollars involved might be very different.

That is one of the reasons that we ask, based on what we have learned from your report and what we have learned from independent surveys, such as this one that the Restructuring Commission did, is it the appropriate role of the IRS to be increasing its compliance in this area? Is it something that your people are capable of doing?

A lot of what Treasury is recommending involves some pretty difficult work in the trenches, and levying unemployment compensation and levying people's welfare benefits. Is this what you all want to do and can do effectively and efficiently? Is it appropriate?

Mr. DOLAN. Those are both tough questions—what we want to do and what we can do appropriately. I think what we want to do is certainly a whole lot more collegial and deliberate a process than just the IRS deciding what it wants to do. Part of what you, the Congress, I think, in consultation with the administration have to tell us is, is that the——

Mr. PORTMAN. But I think what has been missing in this debate in my 4 years here, which is a short period of time, I realize, is the IRS is not at the table, whether it is helping to direct Treasury in terms of policy or helping to direct this Committee in terms of tax administration and we need to hear from you. You are the ones who are supposed to administer this program.

You did not answer my earlier question as to whether you are taking the views into account of those frustrated employees as to how to fix the program. But even as we are talking about this program and how it could work better, does it make sense to crank up the compliance side, as you said, on the relatively low dollar program?

Mr. DOLAN. It really is a mixed bag, just from my vantage point, because while we could both sit here and call it low dollar, if you look at the——

Mr. PORTMAN. The aggregate, as we have said earlier, is very, very high. We are talking about $5 billion, maybe $6 billion a year.

But when you are looking at the individual problems and the resources the IRS has and where the IRS should devote its resources, I am taking your side, really, Mr. Dolan, saying that this may not be the most efficient use of your resources.

Mr. DOLAN. It is an observation that is clearly fair for discussion and debate among people who have investment in the tax system. There are only 100 pounds of us and there are 200 pounds of challenge out there, and I think at the end of the day, the issue is where is the best place to put that 100 pounds. That is, I think, an issue that involves more than just the IRS for the ultimate determination.

Mr. PORTMAN. Mr. Chairman, I have some additional questions for Mr. Scholz. Maybe we can get to those later, if we have time.

Chairman ARCHER. The gentleman may continue if Mr. Collins or Mr. English would like to yield him any time, and then we will go to questioning on the Minority side.

Mr. ENGLISH. Mr. Chairman, I would like to yield my time to Mr. Portman.

Mr. PORTMAN. Mr. Scholz, just briefly, your testimony, I have read some of it and certainly listened to all your oral testimony. You talked about the cost to administer the program being very low compared to other programs. What is the cost to administer the EITC, and maybe Mr. Dolan and Mr. Dalrymple or others can jump in here. What is the cost? I do not know what it is and we have been trying to find out through various means. It is very difficult.

Mr. SCHOLZ. I believe the entire IRS budget is on the order of $7 billion, slightly over $7 billion.

Mr. PORTMAN. Seven-point-six.

Mr. SCHOLZ. Seven-point-six billion, very good. They handle well over 100 million tax returns and the 15 million tax returns of the corporate——

Mr. PORTMAN. Two-hundred-million paper returns alone.

Mr. SCHOLZ. So the incremental costs of administering the quarter-page, three-quarters of a page schedule EIC and a line on the 1040, I would argue, are quite small.

Mr. PORTMAN. You would argue they are quite small but you do not know what the cost is. And I notice in your testimony you said you think it is probably around 1 percent, and then there was a footnote that said, this estimate is for return and refund processing only and does not include the cost of IRS enforcement.

Mr. SCHOLZ. Mr. Portman, that is the GAO testimony.

Mr. PORTMAN. Then you compare it in your testimony to AFDC and AFDC does include those noncompliance costs. I mean, Mr. Dolan, when he looks at the EITC, he has to look at not just that form, putting in that form, but the data collection and the enforcement, the fraud detection, and those numbers are not in your 1 percent, I guess, because your footnote says they are not, whereas in AFDC, you use the 3-percent figure, I guess——

Mr. SCHOLZ. Mr. Portman, you are not reading my testimony, sir. That is the GAO testimony that cites a 1 percent figure. That is not a figure that we understand how they came up with.

Mr. PORTMAN. So you do not know what the number is but you know that it is a lot lower than it is in other programs.

Mr. SCHOLZ. Yes.

Mr. PORTMAN. Based on——

Mr. SCHOLZ. The incremental costs of administering one line of form and a three-quarter page schedule has to be vastly lower——

Mr. PORTMAN. I guess my only point is, if we are going to——

Mr. SCHOLZ [continuing]. When the entire budget was $7.6 billion in fiscal year 1995, as you said.

Mr. PORTMAN. Right. If we are going to solve this problem, whether it is within the tax system or whether it is without the tax system, we should certainly get a handle on what the problem is and what the costs are. For you to say from Treasury that the costs are very low compared to other programs, which was your oral testimony, $3.5 billion for AFDC, that is about 12 percent of program costs. Food stamps is roughly the same, as I understand it.

Mr. SCHOLZ. That is right.

Mr. PORTMAN. Then on the error rate, we talked earlier about a 6- to 7-percent error rate in those programs. The error rate, as we know, here is somewhere between 20 and 25 percent. You said the EITC meets your standards of participation, that it is a much better participation rate. What is the participation rate on food stamps?

Mr. SCHOLZ. Around 54 to, say, 66 percent.

Mr. PORTMAN. AFDC?

Mr. SCHOLZ. Slightly higher by about 5 percentage points.

Mr. PORTMAN. What is the participation rate on EITC?

Mr. SCHOLZ. Between 80 and 86 percent, is the best evidence.

Mr. PORTMAN. What is that based on? How do you know that?

Mr. SCHOLZ. Scholarly work and the literature, some of which I have done.

Mr. PORTMAN. Because one of the things that we are hearing out there, and Mr. Rangel talked about it, is the lack of communication and marketing and evidence. You have this tremendous problem of error and there is some significant fraud, but then you also have a lot of participation that is probably not what it should be because people are not aware, and it is so darn complex to do it for many taxpayers.

My only point is that I do not think we have the numbers yet on what it costs to administer, and I do not think we have analyzed the problem thoroughly. Your own report really does not give us any sense of the problem, which is why now the Joint Tax Committee has to go back and look at your raw data and try to figure out what the problem really is to be able to analyze whether your solutions make any sense.

I just wish that the Treasury Department would be able to provide us with some more data to be able to properly analyze it and now simply say, this is a great program because the error rate is much better than it was 5 years ago and because participation is relatively high and because it does not cost much to administer. We need to know what the numbers are.

Mr. SCHOLZ. My testimony contains the numbers for the three most common errors, and in my oral responses, I have given you, sir, a flavor of what those errors are, as well. We certainly want to be forthcoming, Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Scholz.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Dolan, do you think that the EITC constitutes the largest compliance issue for your agency today?

Mr. DOLAN. No. I do not think I would characterize it that way.

Mr. COYNE. How does the EITC compliance rate compare, then, with the error rate for individual and corporate taxpayers?

Mr. DOLAN. I think that was sort of the road we began down before, and maybe the best way to answer that is to suggest that the most recent tax gap would have spread, and I do not have it at my fingertips, but it spreads basically that $95 billion, the annual significance of the tax gap, and basically, that amount that is not paid voluntarily, it spreads it——

Mr. COYNE. I want to talk about percentages. We are talking about a 20- or a 25-percent rate here. How does that compare with individuals' error rates on other returns, individual returns and corporate returns?

Mr. DOLAN. I think, as Mr. Dalrymple said earlier, on one end of the spectrum is the individual taxpayer for whom all of his or her income is both withheld and reported on. That is a compliance rate that is very high, and it is, as John said, in the 98th percentile.

You go to the other end of the spectrum where the person's income could be in any number of endeavors and it is not withheld and not reported on either in whole or in part. That is clearly the most chronic part And that is where you get into the 40-plus percentage range that John had talked about earlier.

Mr. COYNE. So that is clearly a larger compliance problem for the IRS than the EITC program.

Mr. DOLAN. It is complex, because it is impossible to capture one root cause or one answer to it. So it is very complex, yes.

Mr. COYNE. I would like to ask you, should the problem that exists here with EITC compliance, should it be an error rate problem or is it a fraud problem? What would you describe it as, error or fraud?

Mr. DOLAN. I think I would have to say it has some of both. In all——

Mr. COYNE. It has some of both, but I would like for you to be able to distinguish, can you, how much of it is fraud and how much of it——

Mr. DOLAN. Ted, I think, took a crack at that initially, Mr. Coyne, and I think it is really hard to get much past the characterization he made. A group of special agents looked at a set of cases by a standard that is, by definition, subjective, and declared some of them to be intentional and some mistakes.

To take it the next step, to put it through a rigor of deciding that some subset of the intentional are fraudulent is beyond any analysis that has actually been applied and really would be far more rigorous than the study set out to be. I am not trying to equivocate rather, I do not want to be sloppy about jumping from intentional to fraud.

Mr. COYNE. You have been dealing with the figures, though.

Mr. DOLAN. Correct.

Mr. COYNE. You have looked at it. You have looked at this study. What is your judgment? Is it a fraud problem or is it an error problem?

Mr. DOLAN. I do not know any other way than to say it has some of both in it. As we said at the outset, it has got everything from the most obvious error, that people made claims because they did not understand the rules——

Mr. COYNE. Maybe Mr. Brown could answer that question. Is there anything you could add to that?

Mr. BROWN. No, sir. The study was not designed to answer that question and we do not have that kind of data in the study. The resource commitment and the requirement of proof to satisfy a special agent that he can prove fraud would be beyond a reasonable doubt and we certainly did not invest that kind of rigor into this test.

Mr. COYNE. What about Mr. Scholz? Could you answer that? Do you have any thoughts on that?

Mr. SCHOLZ. A lot of the errors you see come up because of the complexity of family living situations and the like, and so surely there is some of both. Because it is impossible to be into the mind of the taxpayer, it is very, very difficult to say that *x* percentage was intentional or fraudulent.

Mr. COYNE. Thank you.

Chairman ARCHER. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Before I ask you to comment on future tax proposals relevant to this hearing, I would first like to ask a couple of questions about present tax reporting. When an ordinary taxpayer, no matter where they are in the income scale, reports that they have a child, what verification is there that they have, in fact, got a child living with them? Is there any verification done at all on that issue?

Mr. DOLAN. The principal verification would be the Social Security number verification that indicates that the child and the Social Security number belong together. What is only susceptible to after-the-fact validation is the reality of where that child lived during the filing season, so——

Mr. MCDERMOTT. On the average taxpayer making $100,000, is there anything where you check to see if that child is actually living with that person or not?

Mr. DOLAN. It would be checked only to the same extent it is in EIC, either through correspondence audit programs, through various compliance efforts that identify a set of returns and go in for that kind of validation.

Mr. MCDERMOTT. Have you ever done a study on all taxpayers in terms of compliance about where kids actually live?

Mr. DOLAN. Not that I am aware of.

Mr. MCDERMOTT. So this is just——

Mr. DOLAN. What I would like to do is give you for the record, a report that I am told that we did some years ago on what we call a deferred tax consequences study that would offer some insight into that area.

Mr. MCDERMOTT. My point is that in this day when children live with a mother or father after a divorce and they live 5 months with the mother one place and 7 months with the father, it is possible

for people making $75,000, both parents to take credit for those kids and you would never know it, is it not?

Mr. DOLAN. I think you make both points. One is that complexity of living circumstances or personal circumstances are not confined to a particular strata on the income ladder——

Mr. MCDERMOTT. So it is not only people making less than $15,000, where the kids might live with the father, the mother, or the grandmother, or an aunt?

Mr. DOLAN. I think you are exactly right.

Mr. MCDERMOTT. That could happen at any level of society, but you made no check. You have nothing in place that checks that today.

Mr. DOLAN. Only with respect to what I mentioned before, that is, we do have ways in which we identify a return for further scrutiny and in that further scrutiny that issue, in some instances, would be examined.

Mr. MCDERMOTT. Now, as we move forward to the future, there is a proposal on the table that we have a nonrefundable $500 tax credit for children. You are aware of that, right?

Mr. DOLAN. I am.

Mr. MCDERMOTT. There will be no verification, except sort of in the general way. We could have the fraud go all the way up to $200,000 under that proposal because there is no way you are going to know whether the kid is living with the father or the mother or the aunt or the uncle or the grandpa.

Mr. DOLAN. In that case, the one governor that you would have, I think, Mr. McDermott, that would be helpful to you is an ability to ensure that the child only appears one place. We do not have an ability to——

Mr. MCDERMOTT. How would you know that if you cannot computer check?

Mr. DOLAN. Well, we can——

Mr. MCDERMOTT. My number is "*x*," and if my name is put down by my mother and my father, one living in Kansas City and one living in New Hampshire, how would anybody ever know that my name was put down twice and I was claimed twice?

Mr. DOLAN. We can check that.

Mr. MCDERMOTT. You cannot check that?

Mr. DOLAN. We can.

Mr. MCDERMOTT. You can?

Mr. DOLAN. We can, and we do.

Mr. MCDERMOTT. You can electronically, or you do on paper?

Mr. DOLAN. We can get—irrespective of whether the return was electronic or paper, the data is either captured electronically or transcribed manually. It is in the system. We do the check and we can satisfy ourselves that the dependent was only claimed once, or if it was claimed twice, we can work the contention between the duplicate claims.

Mr. SHAW. Would the gentleman yield?

Mr. MCDERMOTT. I will yield in just a second. If you can do that for me at my income level, why can you not do it for people down at the lower level?

Mr. DOLAN. We can. We can and we do. What that does not answer, though, is the question that you posited in the first instance.

I can ascertain whether the child showed up in one or two places——

Mr. MCDERMOTT. So you can get the duplicates.

Mr. DOLAN. Correct.

Mr. MCDERMOTT. But what you cannot get is the one who is claiming it who did not actually have it, is that correct?

Mr. DOLAN. As between the two, the one may have been entitled and the other may have claimed on——

Mr. MCDERMOTT. But if you have a divorce decree that says that the child can be claimed by the father although the child lives with the mother, how do you know that one?

Mr. DOLAN. At the moment, and you are probably taking me as deep or deeper than I would like to be in a public setting, but what we have, in that particular instance, we have right now under exploration with the Social Security Administration the use of a data base. They are still trying to determine whether it is legally acceptable for us to take and routinely use some of that information that would, at least in some of those factors, help sort out who is the legal custodial parent and be able to use that.

Mr. MCDERMOTT. I would yield to my colleague from Florida.

Mr. SHAW. If the Chairman would indulge me just for another second, because you are on an interesting line of questioning. You said you can catch whether the same Social Security number is used twice on two returns for the same child. The question is, would that automatically pop up or is it something that you can do but do not routinely do?

Mr. DOLAN. No. We can do and do routinely do.

Mr. SHAW. So if the mother and father separated and use, or if anybody uses the same Social Security number for a dependent on the return, the chances of picking it up is almost certain, is that correct?

Mr. DOLAN. The answer to that is yes. I guess what I would really like to do with maybe Mr. Shaw's and the Chairman's permission is we are at a point now where to go much more into what exactly is done and how it is done, while I would like to meet your information needs, I would sure like to take it in a closed session.

Mr. SHAW. That would be of interest to the Committee, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired and we would very much like to pursue that with you. We do not want to hinder your ability to enforce as a result of these hearings——

Mr. DOLAN. I appreciate that.

Chairman ARCHER [continuing]. But we do want to get as much information as we can out so that we have an understanding of the root cause of the fraud and mistakes which will put us in a position to evaluate this program as we move on. I do not want to cross that line, to get into information that would be adverse to our desired goals, but I do want to ask you a couple of additional questions to followup on, an excellent line of questioning from the gentleman from the State of Washington.

Do you have access to all Federal information that would be helpful to you in doing your enforcement job?

Mr. DOLAN. That is a good question. The only reason I hesitate to say yes is I am not sure I know what I do not know. What we have——

Chairman ARCHER. I know that is a very broad question, but it seems to me that that is one of the things that we should consider, is that you should be able to have access to whatever information is held by other Federal agencies in order to be able to do your job of enforcement.

Mr. DOLAN. I would say, Mr. Chairman, in the main, that has not been a problem. As you know, we do the prisoner matches and we do a fairly wide range of other information matches, and I mentioned to Mr. McDermott the issue is now between the IRS and Social Security on using this custodial parent database. So there may be another source of information out there——

Chairman ARCHER. Because the Treasury, to my knowledge, has made no recommendation in that regard and it seems to me that you should look at that.

Let me ask you about the individual without children who now qualifies for the EITC. I would like to ask Mr. Brown, is the error rate the same there as it is generally for the entire cohort?

Mr. BROWN. No. It is lower.

Chairman ARCHER. What would the error rate be in that category?

Mr. BROWN. About 15 percent.

Chairman ARCHER. That is not the amount that is due to fraud. That is the total error rate——

Mr. BROWN. That is the total overclaim.

Chairman ARCHER [continuing]. Including fraud and mistakes?

Mr. BROWN. The total overclaim rate, right.

Chairman ARCHER. What is the root cause of that? You do not have to match any Social Security numbers for children and you do not have the complexities that Mr. McDermott spoke of in his line of questioning.

Mr. BROWN. It is usually an income adjustment. Somebody has either not reported all of their income, moving them down in the higher ranges of the earned income tax credit, or they have created income to move themselves into higher credit payoffs.

Mr. SCHOLZ. A lot of it, Mr. Chairman, as well, is filing status mistakes, where a married couple are both filing separate returns and one of them who is filing as a single person would have an income low enough to get the EITC. So it is a combination of some of the filing status errors and income errors.

Chairman ARCHER. Thank you for that input, because that is another aspect of this that is going to be awfully difficult to come to grips with. If it has not been asked, where you have two taxpayers married filing separately and they have two children, is there any way that you can prescreen or know whether or not they are entitled to get this credit because each one of them applies with one of the children? Is there any way at all that you can enforce that?

Mr. BROWN. If they file married, filing separate, disclose the other taxpayer on the form properly and follow the instructions properly, there would not be a problem. The problematic area is when they both claim to be heads of household. That is the area that is problematic for us.

Chairman ARCHER. But if they do not claim to be heads of household and the one files claiming one child and the other claiming the other child, that is not a problem?

Mr. BROWN. We would be able to identify that.

Chairman ARCHER. Do you identify it today? You would be able to, but do you?

Mr. BROWN. It has not been an area of high emphasis in our screens, no, currently.

Chairman ARCHER. Maybe that is something that you ought to try to put in place administratively. I know that your resources are limited in trying to do the massive job that this very arcane, complex, counterproductive Tax Code puts upon you, but I will leave that for another time, to talk about what we ought to do to rectify the overall Tax Code.

Let me ask you, Mr. Dolan, and see if I can get a little better answer from you than I got from Dr. Scholz, and I apologize for calling you Mr. Scholz, but that is what is on your nameplate in front of your desk there. What would you accept as a tolerable target for an error rate in this program and feel like you have done your job?

Mr. DOLAN. If I change my nameplate, would you ask me an easier question? [Laughter.]

Mr. Chairman, I think the way I would try to think about that is in the context of, again, this discussion we were having about what does the spectrum look like of tax compliance in general and where might most of the EIC claimants fit on that spectrum. Then what I guess I would like to say is to the extent they fit on the end of the spectrum that is largely a wage-earner population, I would hope that, ultimately, the characteristics of wage-earner returns that have an EIC claim would fit into that kind of a compliance pattern, which would take us down into the low noncompliance——

Chairman ARCHER. So you think, depending upon the nature of the law and the job that is assigned to you, that it might not be possible to have a target that is much below 18 percent? Would that be——

Mr. DOLAN. No. No. The 18 percent, 17 or 18 percent is when you comb it across the whole spectrum. I am trying not to give you a number because I do not know how to select a number with accuracy. But I would say there is a spectrum that up here is 40 and 50 percent and down here is under 10 percent, and what I guess I would like to do over time is see us moving it down here because these are the returns and the compliance patterns of wage earning, wages withheld, wages reported Americans, which for the largest part of the EIC population would be their demographics as well. So that is why I say, I would try to push it into that range of compliance with the incremental security improvements.

Mr. PORTMAN. Mr. Chairman, would you be willing to yield on that answer? I do not want to interrupt you, but are you moving on? Could I ask one followup on that question?

Chairman ARCHER. I yield to the gentleman from Ohio.

Mr. PORTMAN. Thank you, Mr. Chairman.

Mr. Dolan, to put them in that part of the spectrum does not take into account the fact that the externals of this program are

entirely different. How can you say that the wage earner who is paying taxes should be compared in terms of the ultimate error rate to an EITC recipient, because you are talking about a withholding program that essentially the private sector does for you.

You are talking about whether people are going to be paying the appropriate amount of taxes, and you talked about the concern, as an example, with the single individual without children having this 15-percent error rate, that it is income often that is overreported rather than underreported. It is a whole different phenomenon. Plus, you have a refundable credit. It is a refundable credit.

So I do not know how in your analysis you are thinking about it. I know you have been at this a long time and you know the different taxpayer groups that might have various error rates, but how could you lump those two groups together? Is it not a very different kind of a scenario with regard to compliance?

Mr. DOLAN. Mr. Portman, you make a series of very good points. I guess what I was trying to do is rise to the Chairman's question of what would I accept. I was trying, without giving you anything precise, I was trying to tell you that where my thinking would take me is, because——

Mr. PORTMAN. But how would your thinking take you there, because the answer to the Chairman's question I think you gave him is it should be in the 10 percent or under range because that is where it is with the wage earners, but this is a different program.

Mr. DOLAN. Let me go on.

Mr. SCHOLZ. There is no evidence that taxpayers are overreporting income to maximize their EITC claims in the data in our study.

Mr. PORTMAN. Say that again?

Mr. SCHOLZ. There is not evidence——

Mr. PORTMAN. There is no evidence that any taxpayers are overreporting income——

Mr. SCHOLZ. That that is a major——

Mr. PORTMAN [continuing]. To claim the EITC?

Mr. SCHOLZ. That that is a major problem among taxpayers claiming the EITC.

Mr. PORTMAN. There is no evidence? The Treasury Department makes that statement?

Mr. SCHOLZ. That that is a major——

Mr. PORTMAN. That is amazing to me.

Mr. SCHOLZ. Please.

Mr. PORTMAN. I yield back, Mr. Chairman.

Mr. SCHOLZ. The statement is that there is no evidence that that is a major problem in the IRS compliance data.

Mr. PORTMAN. Mr. Brown just said it was.

Mr. SCHOLZ. He was talking about for childless taxpayers. He was saying——

Mr. PORTMAN. Right, overreporting income to claim the EITC.

Mr. SCHOLZ. Some portion of——

Mr. PORTMAN. And you just said there is no evidence of it. There is either evidence of it or there is not.

Mr. SCHOLZ. I said there was no——

Mr. PORTMAN. You said there was no evidence——

Mr. SCHOLZ. I said there was not——

Chairman ARCHER. I believe we understand.

Mrs. Thurman. The Chairman's time has expired. Mrs. Thurman.

Mrs. THURMAN. Hello. It has been fun already, has it not? Maybe we can let people answer questions now for a little bit.

Let me ask, first of all, have any of you seen the Certified Public Accountant, CPA, testimony that was put before this Committee to be put into the record on this issue?

Mr. DOLAN. I have not.

Mrs. THURMAN. Let me ask a couple of questions, because I think it is kind of pertinent to particularly where there has been some consideration on the paid preparers who have actually suggested that about one-half of theirs have had problems. They suggest—let me see where it is—that part of this problem, and again, I always think that we always hit the agencies and, quite frankly, we make the laws, that part of the problem has been because the credit has been changed 12 times and in that 12 times, actually, starting from 1976, 1977, 1978, 1979, 1984, 1986, 1988, 1990, 1993, 1994, 1995, and 1996.

Within that, the computation of that credit currently requires the taxpayer to consider, now you need to tell me if these are true, nine eligibility requirements; the number of qualifying kids, taking into account relationship, residency, and age tests; the taxpayer's earned income, taxable and nontaxable; the taxpayer's adjusted gross income; the taxpayer's modified adjusted gross income, AGI; threshold amounts; phase-out rates; and varying credit rates. Are all those part of compliance, where they would have to fill this all out? How much time does that take them to do? What does that require from this taxpayer?

Mr. DOLAN. I do not know that we can give you today the time implications. Your point, Mrs. Thurman, though, is an accurate one. Clearly, between some of the changes and then at the end of the day the actual calculations a taxpayer has to make, they are significant.

Mrs. THURMAN. But if I were claiming this, and I am sure that we have changed Tax Codes all the time, so these are not the only people that are being confused, but could this be a part of the problem for compliance? I mean, if the people that are being paid to make these claims and then the person who might do it on their own, to take all of this information that is required and then change the procedure almost every year since 1976, I mean, is that a part of our problem with compliance?

Mr. DOLAN. I would say it certainly is a part of it but it is a story that is not totally bleak. I think that the Congress and a series of administrations have tried to counter that complexity. When I first entered this picture back in, I guess it would have been 1993, I actually appeared before a body on the other side that was concerned that we were going to ask taxpayers to use a schedule to try to figure out their EITC and people were just kind of reading directions and putting on the face of the return.

I think what Congress has done with a series of administrations is try hard to take things out of the mix that do not make sense and get schedules that make sense and——

Mrs. THURMAN. So you are thinking that it makes it a little bit easier?

Mr. DOLAN. I think it has been everybody's objective to try to rationalize something that is supposed to be——

Mrs. THURMAN. With that, then, in mind, we have talked in the Subcommittee a couple of times about what kind of information we give to taxpayers in being able to fill these out. What are we doing with that today? I can tell you, 2 years ago, I did a television show that I sent out to my cable television programs specifically on the earned income tax person so that they could understand how they could apply for this, what the qualifications were to try to help give them some good information. What are you doing in that area to help these folks?

Mr. DOLAN. We have a series of initiatives, some of which take advantage of exactly the kind of generosity that you have extended in terms of using Congressional outreaches. We work with an awful lot of churches and civic groups. We also—somebody made the point, and I forget which of the Members made the point earlier on, at the end of a filing season, we actually go through the filings looking on the face of the return for filing patterns that look like the person would have otherwise been eligible. I think it was Congressman Portman that made the point that there are people out there that do not know about it and are not claiming it.

I am doing this from memory, but I think in the last one of those cycles we sent out about 1.2 million of those notices and something like 38, 40 percent of the people came back and said, gee, having gotten your notice, here is my factual circumstance, and then a high percentage of those people actually qualified. So that was a way we got people in.

We are now also trying to use, as I said, the advanced earned income publicity and we are going with a new wave of that to bring people in.

Mrs. THURMAN. I have just one quick question. In some cases where there are two adults, an example would be a grandma and a mom, in the household and the wrong person claims the credit, the rule is, as I understand it, that the one with the higher AGI should claim the EITC, but we understand that the entire erroneous payment is counted by the IRS as an error, even when the mom in this case would have legitimately have gotten the EITC. Does that then overstate the issue of error?

Mr. BROWN. I guess it does not hurt. I do not know what percentage of the sample——

Mrs. THURMAN. But there is that out there, and that does get counted twice, then, so an error——

Mr. BROWN. No, it would not be counted twice, because in our study, it is unlikely we picked up both the daughter and the mother in that example.

Mrs. THURMAN. So one.

Mr. BROWN. If our random sample had picked one or the other, then that would be the party. Then in the sample, we would have adjusted that person's return. We would not show a corresponding change to say there was another person that was entitled to the credit.

Mr. SHAW [presiding]. The time of the gentlelady has expired.

Mrs. THURMAN. Thank you.

Mr. SHAW. We have two more Members that have not had a chance to inquire, Mr. Jefferson and Mr. Levin. Mr. McDermott has stated that he has another question. We will recess long enough for the Committee to vote and we will be back and finish up. Thank you.

[Recess.]

Mr. SHAW. If we could resume. The Chair now recognizes Mr. Jefferson, the gentleman from Louisiana.

Mr. JEFFERSON. Thank you, Mr. Chairman, and good afternoon.

I want to follow up a little bit on what Congresswoman Thurman was asking, to talk about the issues of complexity and the solution for that, which is some simplification. Why is it that you made some recommendations, some of you have in your testimonies, I think Dr. Scholz has for sure, why do we not in this program define earned income as taxable wages and self-employment income from line 12 of the 1040 form instead of all of these myriad ways we define it here, which are terms which are not commonly used in that same context and some of them actually include some idea of nontaxable earnings. They do not include taxable income for most of it, so we are using it in a very different way.

Why do we not just take the earned income definition on the tax form and use that one? Would that not simplify this process tremendously and cut down on the errors?

Mr. DOLAN. We are very anxious to take steps to further simplify the EITC or other areas of the Tax Code to reduce differences between tax treatment of some income items and family status of the EITC and elsewhere in the Tax Code. For instance, we have a simplification proposal that would move the definition of dependent a lot closer to the EITC definition.

Your suggestion sounds like one that ought to be taken very seriously, and I can certainly say from the Office of Tax Policy at Treasury, we would be interested in speaking further with you about these things and seeing whether there are constructive steps that can be taken to make the credit work better.

Mr. JEFFERSON. The other point is, not only in this area but in every other area where you have references in Tax Code about thresholds that provide definitions, they ought not be different in the EITC area because it just adds to the complications of it——

Mr. DOLAN. Right.

Mr. JEFFERSON [continuing]. Which is why the preparers, the paid preparers, have a difficult time keeping up with it as well as the folks who work on it themselves.

Mr. DOLAN. We agree, and that is why our simplification initiative is so important, to try to conform the definitions or more closely conform the definition of dependent with the qualifying child and the EITC.

Mr. JEFFERSON. I would urge that in addition to the recommendations we have talked about already, just simply tie these things into current Tax Code provisions so everybody can understand it. It would be a whole lot simpler and we could get this form down to a few pages that ordinary people can have a chance to work with. You compare this to the short form of the Internal Revenue Service reporting form and it is no comparison. You have got a short form to report your regular taxes and you have this huge

thing to do the EITC calculation. It is just almost impossible to do it and to not make a mistake on it, really.

But in any event, that is my editorial comment on it, and I think a great reason for the problems we are having is it is just too complex.

This whole issue of——

Mr. SCHOLZ. Mr. Jefferson, would it be inappropriate? Could I add one more thing to what you have just said?

Mr. JEFFERSON. Yes.

Mr. SCHOLZ. That is, for millions of taxpayers who have wage and salary income, have standard living situations, the EITC really is not complex. It is not horribly complex and millions of taxpayers are easily able to comply with the credit. The particular form is about three quarters of a page and it is very simple and the Congress and the administration have worked very hard to make that form simple.

It is when you get these unusual living situations, the three-generation family, the couple that has split up, and that kind of thing, or have unusual sources of income, that the credit gets very complex. But for the vast majority of EITC recipients, the credit really is not overly complex.

Mr. JEFFERSON. For the vast majority? What percentage is that?

Mr. SCHOLZ. Oh, no. I got into this again.

[Laughter.]

Mr. JEFFERSON. I am just asking. Is it——

Mr. SCHOLZ. Around 18 million taxpayers claim the EITC and, let us say 13 million, 12 million of them have very common standard living arrangements.

Mr. JEFFERSON. And so 5 million have these other complicated things?

Mr. SCHOLZ. This is just a wild guess, at the encouragement of Mr. Rangel.

Mr. JEFFERSON. It falls in the range of the errors and problems that you have, is what I am talking about. I am sure everyone does not have a problem and most folks get it right. Twenty percent of them do not and those are the ones we are talking about and those are the ones who, I think, have fallen victim to some of the problems here, who have these complicated issues. So that is the same point.

My time is quickly passing, and already gone, but I wanted to deal with this other issue that I did not understand from, and I am glad she is back, Congresswoman Johnson's question earlier today when she reduced the 42-percent noncompliance rate with self-employed folks down to 10 percent. Now, that is not the way I read it and it did not seem to me to be correct, so I want you to clarify that for me just so I will be sure that either she is right or the reading of this thing is right.

When you talk about the 42-percent compliance, this is after the TCMP has been completed and that is how you come out. So you have taken everything into account that you should have taken into account in that examination and you come out with a 42-percent noncompliance rate. Is that right, or is it 10 percent, as she was suggesting this morning?

Mr. DALRYMPLE. No, you are right. It takes into account the entire process, so the 42-percent noncompliance rate would be applicable. The sustension rate that is described is the sustension rate across all tax returns. Sole proprietors, especially at the lower level, have a much higher sustension rate in our appeals process, also. So there are a number of different factors there.

Mr. JEFFERSON. So it takes into account underpayment and nonpayment and every other consideration that creates this gap that we are talking about.

Mr. DALRYMPLE. That is right.

Mrs. JOHNSON. Would the gentleman yield on that?

Mr. JEFFERSON. Sure, if I have any time.

Mr. SHAW. Go ahead with this, and then we will move on.

Mrs. JOHNSON. The gentleman from Louisiana asked you, does the TCMP rate take everything into account. It is my understanding that TCMP audits are not permitted to take into account judicial precedents or even the probability that the positions that they are asserting in the audit level would be upheld by litigation, is that not true?

Mr. DALRYMPLE. Yes, that is true.

Mrs. JOHNSON. Then in this audit category across the agency, only 25 percent of the audits are sustained, correct?

Mr. DALRYMPLE. The sustension rate varies for different——

Mrs. JOHNSON. But across the agency, is it not 25 percent?

Mr. DALRYMPLE. I really do not have that number with me, Mrs. Johnson, but——

Mrs. JOHNSON. That is what we were told——

Mr. JEFFERSON. But reclaiming my time——

Mrs. JOHNSON [continuing]. But in sole proprietors, the sustension rate is even higher, is my understanding, in this audit business.

Mr. DALRYMPLE. It is much higher than 25 percent.

Mrs. JOHNSON. Right, the sustension, the rate at which people are sustained that they were right and the agency was wrong.

Mr. DALRYMPLE. No. No. That the IRS was sustained and that the—it is just the reverse, Mrs. Johnson.

Mrs. JOHNSON. OK. Sorry. So 25 percent, the IRS is sustained that the IRS is right. Seventy-five percent of the time, they are wrong?

Mr. DALRYMPLE. In certain categories, that is true.

Mrs. JOHNSON. Right. Overall, the agency——

Mr. JEFFERSON. Let me reclaim my time.

Mrs. JOHNSON. I just want to get this——

Mr. JEFFERSON. It is going to get more and more confusing.

Mr. SHAW. I am about ready to say the time has expired.

Mrs. JOHNSON. I will give you back time.

Mr. JEFFERSON. Across the board sustensions, and I am dealing just in the context of sustensions kind of across the board. It is very hard to isolate that into this area, if you want to kind of use a gross percentage figure. But in any event, Mr. Chairman, we will never finish this conversation in the time that I have.

Mr. SHAW. The time of the gentleman has definitely expired.

Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Some of the discussion related to targets, and I believe that most everybody, and I think, really, yourselves believe that the target for noncompliance should be zero, that we should aim for everybody complying, because that is surely my position. I want to pick up what Mr. Rangel raised and has now just been discussed between several other colleagues and yourselves. You mentioned the sole proprietor noncompliance. Do you have figures on noncompliance in any other area?

Mr. DALRYMPLE. Yes, Congressman Levin, we do. In fact, we discussed them earlier. The overall tax gap is at about 17 percent——

Mr. LEVIN. OK, but how about other specific areas.

Mr. DALRYMPLE. I was just going to break that down for you. In the people who are normal wage earners who have——

Mr. LEVIN. You covered that earlier.

Mr. DALRYMPLE [continuing]. About 98 percent, and when you get down to our least compliant area would be in sole proprietors and that compliance rate is around 58 percent.

Mr. LEVIN. How about some other area in between? Are there any other categories?

Mr. DALRYMPLE. I did not bring breakdowns with me but we do have those and I can certainly supply them to you.

Mr. LEVIN. Would there be any other area besides sole proprietors that would be as high as the noncompliance for EITC filers?

Mr. DALRYMPLE. Like I said, Mr. Levin, I would have to get that data for you. I did not bring it with me.

Mr. LEVIN. You do not remember? Do you happen to have that information available?

Mr. SCHOLZ. It looks like the answer is no, Mr. Levin, not right now. We would be happy to provide it to you. We would be happy to try to provide it to you.

Mr. LEVIN. I take it, though, if the average is 17 percent, that there probably are other categories where the noncompliance rate would be over 20 percent besides sole proprietors. That is logical, is it not, likely?

Mr. DALRYMPLE. That is a fair statement, Mr. Levin.

Mr. LEVIN. I would hope, Mr. Chairman, that our Committee would look into these other areas of noncompliance. We have focused on EITC. The record there is not acceptable, though it has been an improvement, and I think the word "substantial" has been used, a substantial improvement since 1988. By the way, were any of you involved in enforcement in 1988?

Mr. DALRYMPLE. No, sir.

Mr. LEVIN. It was a different cast of characters? But anyway, there has been some substantial progress since then, but we still have a considerable ways to go. Go ahead. Somebody was saying something.

Mr. SCHOLZ. We actually do have results from the IRS tax gap study, Mr. Levin, that business income in general is the area with the largest net misreported percentage, and then there are several categories within business income.

Mr. LEVIN. What is the overall for business income?

Mr. SCHOLZ. It ranges overall between 29 and 30 percent.

Mr. LEVIN. Twenty-nine what?

Mr. SCHOLZ. And 30 percent.

Mr. LEVIN. Thirty percent? You mentioned sole proprietors. What are some of the other categories?

Mr. SCHOLZ. These would be separated into nonfarm proprietors——

Mr. LEVIN. And what is that figure?

Mr. SCHOLZ. Between 31 and 32 percent.

Mr. LEVIN. Keep going.

Mr. SCHOLZ. Informal supplier income, around 81 percent.

Mr. LEVIN. Eighty-one percent what?

Mr. SCHOLZ. Is misreported. These are informal suppliers.

Mr. LEVIN. Informal suppliers, 81 percent noncompliance?

Mr. SCHOLZ. The underground economy, Mr. Levin.

Mr. LEVIN. And what else?

Mr. SCHOLZ. Farm income.

Mr. LEVIN. And what is that?

Mr. SCHOLZ. Thirty-one, 32 percent.

Mr. LEVIN. Thirty-one to 32 percent. Give me a few others, if you would.

Mr. SCHOLZ. Capital gains would be between 6 and 7 percent.

Mr. LEVIN. Mr. Chairman, I would hope that this Committee, trying to further our efforts to crack down on noncompliance, would hold some hearings in these other areas.

Mr. SHAW. I think we should, but I would be very quick to point out to the gentleman that this is taxpayers' money. Eighty to 85 percent of it is taxpayers' money that is being paid to people as part of a welfare program. If you compare it with some of the other welfare programs, according to the green book, AFDC only has an error rate of 6 percent. Food stamps only has an error rate of 7 percent. I think it is always important in all of these areas to get compliance, but this is a question of Federal money being paid out. It is not a question of income being reported.

Mr. LEVIN. But, Mr. Chairman, all of this is taxpayers' money, all of it. Noncompliance——

Mr. SHAW. No, but this is a welfare——

Mr. LEVIN. I understand. I do not think EITC is a welfare program, but——

Mr. SHAW. So I think when you are——

Mr. LEVIN. No, let me just——

Mr. SHAW. No, wait a minute. I have the floor. I think when it is a question of what you compare this to, I think it is important that we look and see how are we doing in other welfare programs. This is a welfare program and I think it is a question of—now, I am not trying in any way to diminish the statistical data for noncompliance in the payment of income tax. I think that is also very important and I agree with you. I think we, as a Committee, have a constant obligation to look at this.

But I think to compare a welfare program with a question of reporting of income is not entirely fair, and particularly when you are talking about in the cases of the percentages. We are talking about the dollars and how they are reflected in the compliance.

Mr. LEVIN. Let me just finish by saying, I do not think EITC is a welfare program, but noncompliance, no matter where it is, needs to be examined, and there are Federal subsidies in some of these areas. For example, the farm area has considerable Federal sub-

sidy. So I think we need to be strict and stringent about compliance in every single area and I think the testimony today has indicated that there is a shortfall in a number of these areas that we had better look into.

Mr. SHAW. I do not think there is any question about that.

Mr. Becerra is recognized.

Mrs. JOHNSON. Mr. Chairman, would you just yield on that for 1 minute?

Mr. SHAW. Yes, I will yield to you.

Mrs. JOHNSON. I think one of the problems here is that the percentages that were named are a percentage of data that GAO has told us has not been adjusted for appeals, so it is just the amount of money that IRS thinks is owed. When you adjust that for appeals, 25 percent is what they really get paid out of the whole amount.

So apparently there is some dispute between IRS and GAO as to whether this is adjusted for appeals or not, and so we should come back to that subject, but that is certainly—I am taking my comments from GAO testimony.

Mr. LEVIN. Twenty-five percent is a huge amount.

Mr. SCHOLZ. Mrs. Johnson, the same point would apply with the EITC compliance study, as well. Some of the noncompliance that we are talking about in this study today might be overturned on appeal, as well.

Mrs. JOHNSON. That is true, but it was not a TCMP audit kind of study. It was a different kind of study with screens and rather more focused on just EITC actions.

Mr. SCHOLZ. It was not an entire TCMP——

Mr. SHAW. Mr. Becerra is recognized.

Mr. BECERRA. Thank you, Mr. Chairman.

Let me ask a question. I know we have been talking generally in the Committee about the issue of noncompliance, and, of course, the focus today is on the EITC. I believe the child tax credit that is being proposed by both the President and the Congressional leaders in both the Senate and the House would give us a tax credit of somewhere, I think it is about $40 billion. Can you comment, and perhaps, Mr. Dolan, we could start with you, whether you believe that the $500 child tax credit will result in any noncompliance?

Mr. DOLAN. It is hard to make a categorical estimate of that. I suspect we will see the typical gamut of everything from needing to appropriately inform and educate and make sure that instructions and the forms all coincide to what it is the taxpayers are trying to do. I have no doubt that when you introduce a new provision, there will be some of that. I have no reason to expect any kind of runaway problem with it.

Mr. BECERRA. So it is unclear at this stage what type of noncompliance there may be, but certainly, as you just mentioned, when you add any new component to the tax structure, there is a good chance that you will have some form of noncompliance, whether it is intentional or not.

Mr. DOLAN. I think, as the Congress has often said, when there is the volatility that there is in the Tax Code, the process of absorb-

ing the change is substantial year to year, whether I am an individual filer or a practitioner.

Mr. BECERRA. Do you have any way of gauging of what type of noncompliance we have out there, whether it is by business or individuals, whether it is on a credit or some other matter, is there some way to try to get a sense of how much noncompliance there is out there?

Mr. DOLAN. Part of what was just going on with Mrs. Johnson is that we have data that we put together in something that we publish as a tax gap estimate and that would probably at this point be our best calibration of that, and I would be happy to be sure that we furnished you those materials. That is probably the best product we have today that would attempt to break down some of those. That is actually the document from which Dr. Scholz was reading, as well.

Mr. BECERRA. You or Dr. Scholz, do you happen to remember offhand what some of those estimates might have indicated in terms of noncompliance?

Mr. DOLAN. I think probably what will meet your needs best is maybe to give you the document and walk you through it. We talked about an overall average of 17. The wage-earner end of the spectrum is 2 or 3 percent; the other end of the spectrum is up in the 40-plus percent, a lot of it depending on characteristics of the income and whether the income is reported upon and withheld. I think that the document we will show you breaks that down to unreported income, unfiled returns, returns that are filed and reported correctly but unpaid at the point, so it is calibrated in a number of different ways.

Mr. BECERRA. Dr. Scholz, do you have anything?

Mr. SCHOLZ. I think the overall tax gap for 1992 was estimated to be around $90-some-odd billion, about $39 billion accounted for by business kinds of incomes, which would be the largest source of the tax gap.

Mr. BECERRA. Mr. Dolan, do you have any other studies or examinations underway with regard to noncompliance beyond what you did here with the EITC?

Mr. DOLAN. We have a fairly wide range. I mentioned, perhaps before you came in, we have an actual research capacity, both in our National office and in our district office, where we are constantly looking at various pieces of the compliance gap and trying to through those studies identify both sort of wholesale prescriptions that could influence compliance as well as looking for ways to influence where we spend our compliance resources.

Mr. BECERRA. Can you give us a sense of what types of studies you are doing at this time on compliance?

Mr. DALRYMPLE. I guess, specifically, I would address a couple that we have going on that we are looking at around EITC, because that is the subject of the hearing.

Mr. BECERRA. But beyond EITC, because, obviously, we know——

Mr. DALRYMPLE. Beyond EITC, we have looked at tip reporting, we have looked at advance payment agreements, we have——

Mr. BECERRA. Not what you have done, I am asking what you have underway, any other examinations you have underway.

Mr. DALRYMPLE. Actually, I have a number, and I could get you a list back, would be the best thing to do. But we have a number of studies underway.

Mr. BECERRA. It sounds from your response that you have too many to articulate.

Mr. DALRYMPLE. That is right.

Mr. BECERRA. Maybe, then, if you could provide the Committee with those various projects that you have underway.

Mr. DALRYMPLE. Sure.

Mr. BECERRA. I appreciate that.

[The following was subsequently received:]

List of Research Projects Dealing with Taxpayer Compliance:

Construction Industry
Duplicate Use of Social Security Numbers
Fishing Industry
Schedule C Unallowable Expenses
Use of Accounting Methods
Automotive Industry
Form 2119 Compliance (Sale of Residence)
Tax Effect of Income Verification by Mortgage Companies using IRS data
Earned Income Credit Compliance
Research on Nonfilers
Self Employment Tax Compliance
Passive Activity Losses
Government nonfilers of Form 1099
Capital Gain Basis
Wholesale and Retail Industry
US Source Income/1042 Credits
Health Care Industry Compliance
Tax Protesters
Tax Return Preparer Compliance
Alternative Ways of Filing
Profiles of Accounts Receivable Taxpayers
Form 1040 Filing Characteristics

Also:

As part of our modernization efforts, IRS is in the later stages of development of a research database (Compliance Research Information System-CRIS) which allows a researcher to answer questions about individual return compliance or filing characteristics. This database currently contains 1600 data elements and will be expanded to 2600 elements in October 1997. No individual identifiers are accessible through the system.

Mr. BECERRA. Thank you, Mr. Chairman. Thank you very much.

Mr. SHAW. Mr. Portman, do you seek recognition?

Mr. PORTMAN. Just very briefly, Mr. Chairman. Thank you for your patience here among our witnesses.

Just quickly, with regard to Mr. Becerra's comments, I think he makes a very good point. When you look at the current situation, and Mr. Dolan, I guess I would ask you, you have the personal exemption, we have the deduction for dependents, we have the standard deduction. We now will have a tax credit, which obviously will create, as you indicate, more problems for you in enforcement, in not just communicating it but in enforcing that, because there is more of an incentive for people to claim a child and claim a credit.

Are you looking at some ways to simplify that from an enforcement point of view, or an administration point of view collapsing

those or coming up with ways that would make it easier, that would relate to EITC but also to the other exemptions, deductions and credits?

Mr. DOLAN. I can tell you, in the arena of credits per se, Mr. Portman, that we have a compliance strategy underway. We are anticipating and watching quite carefully where the proposed legislation might take us, so that, when given the opportunity, we would offer our opinion as to what will or will not work—both from the point of view of simplicity for the taxpayer and from the point of view of our being—to followup and corroborate.

Mr. PORTMAN. My only point is, I think what your data apparently shows, we do not have the raw data yet but when we get it and look at it, is that this is one of the major problems in terms of current EITC but also future problems with compliance.

Let me just back up to where Mr. Shaw was. I think he is right. We are talking about apples and oranges here. We are talking about a program that is a cash benefit. Eighty to 85 percent of it, whether you call it welfare or not, is a nonrefundable credit and that is a cash benefit program. You all keep talking about the tax gap. This is not part of the tax gap, folks. This is not taxes that are not being collected or paid. This is whether we are paying out too much or not. It is an entirely different parameter.

Second, this TCMP analysis that the IRS keeps bringing up today, I mean, it is not the same study. What Mrs. Johnson is trying to say is that the auditors put their estimation on the table and that is what TCMP is based on. That is what they are putting on the table and there is only a 25-percent rate of sustaining overall in the system. Let us at least compare apples to apples, and maybe that is something Treasury can give us so that we can answer some of the questions Mr. Becerra and Mr. Jefferson and others have as to the compliance, because we are not comparing the same numbers here.

Finally, I just have to make the comment that when you are talking about comparing, again, this program, EITC, with our other noncompliance problems, we cannot collect taxes from sole proprietors any other way than through a tax collection system, can we? Is there another program out there that enables us to collect revenue from people?

Mr. DOLAN. No. I think your point is——

Mr. PORTMAN. Whereas with EITC, we have lots of other programs. We have a Food Stamp Program. We have public subsidies in the housing area. We are talking about it on the floor right now. We have the AFDC Program. We just sent block grants to the States. We have welfare-to-work programs.

There are some inherent flaws in a voluntary tax system that are going to lead to noncompliance, whether it is sole proprietors, or elsewhere. This is not the fault of the IRS. It is not the fault, frankly, of the public at large. It is just a function of human nature and the tax collection system. We do not have any choice on sole proprietors, but we do with regard to providing appropriate subsidies to get people from welfare to work and to keep them there.

Thank you, Mr. Chairman.

Mr. SHAW. Thank you, and I know this panel will be very glad to wish us a nice weekend, as we certainly wish you a nice week-

end. Thank you for being with us. I think we received a lot of information.

Mr. RANGEL. We thank them. Let me thank you, too. I hope that you reach out to this Congress and feel comfortable in reaching out to Members to let us know what you need to support this program, because the statistical data could cause us political problems and because it is so expensive when you are trying to balance a budget, some people may target it for the wrong reason. So I enjoyed your testimony and want you to know that you have to reach out a little more because I did not know you were having these kind of problems until you did your survey. Thank you.

Mr. SHAW. Thank you. The next panel will be Lynda Willis, Director of Tax Policy and Administration Issues, General Government Division of the U.S. General Accounting Office.

There is a series of votes on the floor now and I have checked with Ms. Willis and I understand that she would be willing to try to get her testimony behind her before we go to vote, so we do have a few minutes.

Ms. Willis? Ms. Willis, we are in receipt of your testimony and it will be placed in the record. Proceed as you wish.

STATEMENT OF LYNDA D. WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. WILLIS. Thank you, Mr. Chairman.

In the interest of time, I will not even summarize my written statement. I recognize that most of the Members here have had an opportunity to read what we had to say. There are just a couple of points that I would like to emphasize in our statement that I think are cogent to the discussion that has gone on here.

One is that a great deal of the difficulty with the credit and noncompliance with the credit is the conflict between how the credit is designed and IRS' ability to administer it, and that gets back to the quote that someone made of IRS having to determine eligibility before the refund goes out, and that is very, very difficult for IRS to do.

The second point that I would emphasize is that we have some concerns about the proposals put forth by Treasury. There are a number of issues that need to be pursued, not the least of which is if we put additional resources into administering the earned income credit, where we are going to take those resources from.

IRS, like most Federal agencies, is facing declining or stagnant budgets between now and 2002 and if we move resources into the EIC enforcement program, we have to move them out from somewhere else and those sorts of tradeoffs need to be very carefully considered and evaluated, particularly in light of the difficulty in enforcing this credit and in light of the other topics of noncompliance that we have discussed here today.

Having said that, I would be happy to answer any questions.

[The prepared statement follows:]

Statement of Lynda D. Willis, Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office

Mr. Chairman and Members of the Committee

We are pleased to be here today to participate in the Committee's inquiry into noncompliance surrounding the Earned Income Credit (EIC)—a refundable tax credit available to low-income, working taxpayers. As used in connection with the EIC, "noncompliance" occurs when persons either claim credits to which they are not entitled or claim credits in excess of the amount to which they are entitled. This statement is based on our past work on the EIC,[1] a review of limited data on the results of IRS' study of EIC filers for tax year 1994,[2] and a review of various Department of the Treasury proposals to reduce EIC errors.

Our statement makes the following points:

- EIC noncompliance has been a concern for a number of years and is a major factor underlying our designation of filing fraud as one of the federal program areas at high risk because of vulnerability to waste, fraud, abuse, and mismanagement.[3] Through design changes and administrative actions, noncompliance (expressed as a percentage of total EIC dollars paid out) has been reduced since 1988 but, because of increases in the number of claimants and changes in credit amounts over the past few years, the amount of dollars erroneously paid out has increased dramatically. A root cause of EIC noncompliance is the self-determination of eligibility by taxpayers combined with IRS' limited ability to verify eligibility before the refund is issued.
- IRS has undertaken, with some success, a variety of efforts to reduce EIC noncompliance in recent years. While the impact of IRS' efforts cannot be precisely quantified, it is reasonable to expect that recent declines in the noncompliance rate were in part the result of IRS' efforts. How much further it can be reduced with available resources is uncertain.
- It will not be easy to significantly reduce EIC noncompliance because of the nature of the credit and the design of IRS' systems. Treasury has announced eight proposals, six of which would involve legislation, to reduce EIC noncompliance. Those proposals provide a starting point for deliberations on what can reasonably be done to address this difficult problem. Various questions need to be answered in assessing those proposals, the most significant being whether they get at the real causes of noncompliance.

BACKGROUND

Congress established the EIC in 1975 to (1) offset the impact of Social Security taxes on low-income families and (2) encourage low-income families to seek employment rather than welfare.

EIC eligibility depends on taxpayers' amount of earned income[4] or, in some cases, adjusted gross income (AGI).[5] 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 their earned income or AGI in calculating the credit.

EIC coverage and benefit rules have been modified several times since 1990. In the Omnibus Budget Reconciliation Act (OBRA) of 1990, Congress made two major changes to the EIC that took effect in tax year 1991. These changes (1) adjusted the credit structure to grant different credit amounts to taxpayers with one qualifying child and taxpayers with two or more qualifying children and (2) added two sup-

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[1] A list of related GAO products is at the end of this testimony.

[2] We did not assess IRS' study methodology or the reliability of its reported results.

[3] *High-Risk Series: IRS Management* (GAO/HR–97–8, Feb. 1997).

[4] Earned income for calculating the EIC includes both taxable and nontaxable earned income. For the EIC, taxable earned income includes (1) wages, salaries, and tips; (2) union strike benefits; (3) long-term disability benefits received prior to minimum retirement age; and (4) net earnings from self-employment. Nontaxable earned income includes (1) voluntary salary deferral such as 401(k) plans or the federal thrift savings plan, (2) pay earned in a combat zone, (3) basic quarter and subsistence allowances from the U.S. military, (4) housing allowances or rental value of a parsonage for the clergy, and (5) excludable dependent care benefits.

[5] In addition to taxpayers' taxable earned income, AGI includes their taxable income from other sources such as investments, alimony, and unemployment compensation. Beginning in tax year 1996, taxpayers are to use a newly defined "modified AGI" that excludes certain losses to determine EIC eligibility and to calculate the credit.

plemental credits—one for taxpayers with a child under 1 year of age and another for taxpayers who paid health insurance premiums on policies covering their children. OBRA 1990 also allowed taxpayers with a filing status of single to claim the credit, as long as they had a qualifying child, and specified a general increase in credit rates that was to be phased-in over 4 years (the planned increase for 1994, however, was superseded by 1993 legislation).

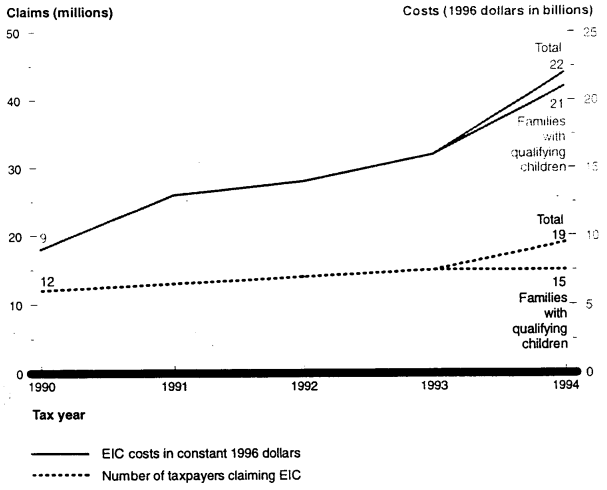
OBRA 1993 made two changes in the credit's structure that went into effect in tax year 1994. First, to simplify EIC filing, the act repealed the supplemental young child and health insurance credits. Second, the act expanded EIC eligibility to include certain taxpayers without qualifying children or "childless adults."[6] OBRA 1993 also increased, over a 3-year period beginning in tax year 1994, the maximum credit for families with children.

The maximum basic credit amount for EIC families with two or more children was $953 in tax year 1990, $1,511 in tax year 1993 (reflecting OBRA 1990), and $3,556 in tax year 1996 (reflecting OBRA 1993). The maximum credit for childless adults in tax year 1996 was $323.

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 made three additional changes to the EIC. First, beginning with tax year 1996 returns, the act made taxpayers with certain investment income greater than $2,200 ineligible for the EIC, regardless of their earned income or AGI. Second, the act created a "modified AGI" to be used in calculating the credit. Modified AGI disregards certain losses from investments and businesses. And third, the act denied the EIC to filers without valid Social Security Numbers (SSN).[7] Taxpayers were already required to provide valid SSNs for qualifying children.

As shown in figure 1, both the number of taxpayers claiming the credit and EIC program costs (in 1996 dollars) increased steadily from tax years 1990 through 1994. In large part, this growth reflects the impact of either eligibility or benefit expansions implemented in tax years 1991 and 1994, as discussed earlier.

Figure 1: EIC Costs and Number of Claims, Tax Years 1990 Through 1994



Source: GAO analysis of IRS Statistics of Income data.

[6] Although referred to as "childless adults," these taxpayers may be noncustodial parents or may live with a child who, for some reason, cannot be claimed as an EIC qualifying child.

[7] A valid SSN is one that matches Social Security Administration records.

EIC Noncompliance and IRS' Efforts to Control it

Despite efforts over time to change design and administration of the EIC, it is still a major source of noncompliance. That continuing noncompliance is one reason why refund fraud remains on our list of high-risk federal program areas.

IRS' study of tax year 1994 EIC filers showed that of $17.2 billion in EIC claimed, 25.8 percent ($4.4 billion) was overclaimed. While that percentage of noncompliance is an improvement over the level identified in the 1988 Taxpayer Compliance Measurement Program (TCMP), the dollars involved have increased significantly.[8] The 1988 TCMP showed that about $1.9 billion, or 34 percent of the total EIC paid out, was awarded erroneously.

The lower rate of noncompliance since 1988 may be due, at least in part, to legislative changes since the 1988 TCMP. In that regard, IRS data indicated that taxpayers who claimed the wrong filing status were the most frequent source of EIC error in the 1988 TCMP. Legislative action in 1990 simplified the rules for qualifying for the credit by eliminating different eligibility rules for different filing statuses. Even with that change, eligibility-related compliance issues remain. For claimants of the credit for families with children, eligibility for the credit is still self-determined by the taxpayer using a three-part test based on the relationship of the child to the taxpayer, the length of time the child lived with the taxpayer, and the child's age.

Congress has long been concerned about the high level of EIC noncompliance. However, reducing it to more acceptable levels will be difficult. Many of the noncompliance problems identified by IRS are the result of a process whereby taxpayers self-determine their eligibility for the credit and/or the amount of credit they are due. These erroneous claims frequently related to qualifying children or choosing the wrong filing status.[9] In both instances, IRS faces difficulty in verifying the information on the return without using field resources to determine taxpayer eligibility in a fashion similar to that used by organizations administering welfare programs.

The reported level of EIC noncompliance is much higher than the reported level of noncompliance in some other federal outlay programs but those other programs also have much higher administrative costs. For example, according to the Committee on Ways and Means 1996 Green Book, about 6.1 percent of the dollars paid out under the Aid to Families With Dependent Children (AFDC) program was overpaid in fiscal year 1993 and 7.3 percent of the dollars paid out in the Food Stamp program was overpaid in fiscal year 1995. As we noted in June 1995 testimony before the Senate Finance Committee, those programs not only have lower noncompliance rates than the EIC program but also have administrative costs that likely are many times higher than those of the EIC program.[10] Data available at that time showed AFDC and Food Stamp administrative costs of about 12 percent of total program expenditures in 1993. In comparison, we estimated EIC administrative costs to be about 1 percent of EIC program costs.[11]

Causes of EIC Noncompliance

Before deciding on how to reduce EIC noncompliance, it is important to know the major causes of that noncompliance. Data IRS made available on the results of its study shed little light on that question. According to an analysis of IRS' study by Treasury's Office of Tax Analysis, however, the three most common causes were (1) taxpayers claiming qualifying children who did not reside with them for over half the year, (2) taxpayers claiming the wrong filing status, and (3) complicated living arrangements involving more than one custodial caregiver.

It seems clear that a major share of the problem can be traced back to the nature of the credit, as explained by an IRS consultant in 1993. According to the consultant, the EIC, and other tax credits, have historically caused problems for IRS because IRS' systems were designed and, for the most part, are operated with the

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[8] Before IRS' study of tax year 1994 EIC filers, the 1988 TCMP provided the most current comprehensive data on EIC noncompliance. IRS did a study of tax year 1993 EIC filers, but that study only covered returns filed electronically during the last 2 weeks of January 1994.

[9] A change in filing status, per se, will not necessarily disqualify a taxpayer from claiming the EIC. Only taxpayers who use the married-filing-separately status are ineligible for the credit. However, reporting an incorrect filing status has implications for correctly reporting income. For example, taxpayers who file as a head of household when they should have filed as married may underreport income, by excluding their spouse's income, and thus overclaim, in whole or in part, the EIC.

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

[11] This estimate is for return and refund processing costs only and does not include the cost of IRS enforcement efforts related to EIC noncompliance.

overriding objective of enabling anyone who wants to pay their taxes to do it. The distribution of EIC is philosophically different from the issuance of traditional refunds, where the government returns the taxpayer's own money after excess withholding. The consultant noted that payment of the EIC has much more in common with government distribution of welfare benefits through other agencies but that the standards of proof required to prove eligibility for EIC are not comparable to the standards of proof required for receipt of welfare benefits. As he pointed out, establishing eligibility for benefits delivered through other agencies normally requires the claimant to deal with government employees face to face; to produce proof of identification; and to prove the existence of, and relationship with, any relevant dependents. These types of controls are foreign to traditional IRS modes of operation.

A Treasury Task Force on Tax Refund Fraud made similar observations in 1994. According to the Task Force, (1) every refundable credit provides some incentive for the filing of problematic returns, and the incentive rises as the amount of the refundable credit rises and (2) the incentive to file problematic returns is likely to increase as IRS' capability to verify information on the return decreases. With the EIC, there are various important pieces of information, such as filing status and the existence of qualifying children, that IRS cannot easily verify. The relationship between verifiable information and compliance is not unique to the EIC. Throughout the tax system, noncompliance tends to be higher whenever there is an absence of easily verifiable data.

IRS Efforts to Control EIC Noncompliance

IRS took several steps in the past few years to combat EIC noncompliance, with some success. Although the impact of IRS' efforts cannot be precisely quantified, it is reasonable to assume that those efforts contributed to the recent decline in the rate of EIC noncompliance.

Improved verification of SSNs was a key objective of IRS' recent efforts. For electronic returns, IRS increased the number of automated filters that are designed to identify and reject submissions that involve missing, invalid, or duplicate SSNs. Through those filters, IRS identified 4.1 million SSN problems on tax year 1994 returns, 1.3 million of which involved the EIC. This year, as of April 24, the filters identified about 3.2 million SSN problems, of which 1.1 million involved the EIC.

IRS also emphasized SSN verification on paper returns. For tax year 1994, it identified 3.3 million paper returns with missing or invalid SSNs (how many involved EIC returns is unknown) and followed up on 1 million of those cases (it did not have sufficient resources to follow up on all 3.3 million). IRS continued that effort, but at a reduced level, for tax year 1995 paper returns. According to IRS, these verification efforts resulted in recommended changes to taxpayers' refunds or tax liabilities of about $900 million in fiscal year 1996. Starting with tax year 1996 returns filed this year, IRS was authorized to treat missing or invalid SSNs on filed returns as math errors. As such, IRS can automatically reduce or deny the taxpayer's EIC claim, if there is any.

Also for tax year 1994, IRS (1) improved the Questionable Refund Program, (2) strengthened the process for checking the suitability of persons applying to participate in the electronic filing program as return preparers or transmitters, and (3) eliminated the direct deposit indicator.[12]

Despite the various changes discussed above, IRS' study of tax year 1994 EIC filers indicates that much more needs to be done. For example, even with the many electronic filing filters, which are intended to keep erroneous returns from being submitted electronically, the percent of tax year 1994 electronic returns with EIC overclaims, according to IRS' data, was almost as high as the percent of paper returns (25.3 compared with 26.1). Also, IRS determined that even if its study results were adjusted to reflect the impact of its enforcement efforts in 1995 and the new math-error procedure being used this year, the overall noncompliance rate would still be about 21 percent.

It is also interesting to note, as shown in table 1, that the number of fraudulent returns detected by the Questionable Refund Program has declined since 1994, with a dramatic decrease in 1996.

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[12] The direct deposit indicator gave return preparers a quick signal from IRS that a taxpayer was going to receive a refund check and was relied on by providers of Refund Anticipation Loans. IRS' objective in eliminating the indicator was to give providers of Refund Anticipation Loans greater incentive to check the eligibility of EIC claimants before approving the loans.

TABLE 1: Questionable Refund Program Data for 1993 Through 1996

Calendar year	Number of fraudulent returns detected	Amount of fraudulent dollars detected (in millions)	Percent of fraudulent returns that involved the EIC
1993	77,840	$136.8	98
1994	77,781	160.5	91
1995	62,309	131.7	73
1996	24,919	82.5	72

Source: IRS data.

According to program officials, a major reason for the decline in fraudulent returns and dollars detected in 1996 was a staffing reduction from 553 full-time equivalent staff in 1995 to 379 full-time equivalent staff in 1996.

WHAT MORE CAN BE DONE?

It will not be easy to significantly reduce EIC noncompliance without somehow addressing the basic underlying problem—the self-determination of eligibility by taxpayers and IRS' limited ability to verify that eligibility before issuing the refunds. On April 23, 1997, Treasury announced eight proposals, six of which would require legislation, that it believes will help reduce noncompliance.

The six proposals requiring legislation would (1) deny future EIC claims from persons who are found to have claimed the EIC fraudulently or through reckless or intentional disregard of the rules and regulations; (2) require taxpayers who have had an EIC claim denied after an audit to prove their eligibility to IRS before being allowed future credits; (3) allow IRS to place liens and execute levies on a portion of unemployment compensation, welfare benefits, and other types of assistance in order to recapture EIC claims that were found to be erroneous after IRS had paid them; (4) penalize preparers who did not meet certain due diligence requirements; (5) clarify the definition of a foster child; and (6) conduct state tests of new ways to provide the EIC and to verify eligibility. The other two proposals would (1) increase IRS' enforcement efforts and (2) expand access to volunteer return preparation services.

There are not enough details in IRS' study and Treasury's announcement to identify the major causes of EIC noncompliance or to assess the costs, benefits, and administrability of Treasury's proposals. However, based on available information as well as our past work on the EIC specifically and tax administration in general, we have identified several issues that Congress needs to consider in deliberating on those proposals.

The most important issue is whether the various proposals get at the real causes of noncompliance. According to IRS' data, for example, a disproportionate segment of the noncompliant returns involved incorrect filing status. However, IRS' report provides no information that helps explain what it is about those claims that made them noncompliant, and none of Treasury's proposals directly addresses that issue.

On the other hand, three Treasury proposals address issues that do not seem, on their face, to be major causes of noncompliance. Those proposals call for (1) clarifying the definition of a foster child; (2) testing alternate ways to provide advance EIC payments and, at the same time, to verify the eligibility of persons receiving the advance payments; and (3) increasing the availability of volunteer return preparation assistance. Although each of those actions probably has some merit, IRS' report and Treasury's proposals provide no evidence that the benefits, in terms of reducing EIC noncompliance, would be of any consequence.

Specifically,

- IRS' report provides no information on the extent to which noncompliance can be traced back to confusion over the definition of a foster child or even how many EIC claims involve foster children,
- only about 1 percent of all EIC recipients have historically used the advance payment option, and
- IRS has provided no data comparing the noncompliance rate for returns done without the help of a preparer and those done by preparers, much less volunteer preparers.

A second issue relates to administrability. Much more information is needed on the proposals and how they will be implemented in order to determine if they can be easily administered. The proposals that most need attention in this regard, because they would apparently involve major operating changes, are the ones that would (1) automatically deny the EIC for several years to anyone who is found to have claimed the credit fraudulently or due to reckless or intentional disregard of

the rules and regulations, (2) require taxpayers who had an EIC claim denied after an audit to prove their eligibility for future credits, and (3) penalize preparers who did not meet certain due diligence requirements.

To assess the administrability of the preparer penalty proposal, for example, we would want to know what preparers would have to do to demonstrate due diligence and what IRS would have to do enforce those requirements. Our interest in this proposal is heightened by the results of our past work on preparer penalties. In a 1991 report, we said that IRS' examiners and supervisors were reluctant to pursue return preparer penalties because of the low dollar amounts of the penalties.[13] We wonder whether the new penalties proposed by Treasury would be viewed similarly.

In assessing administrability, it is also important that Congress consider whether the action being proposed is the most appropriate given the facts. In explaining its proposal that certain EIC claims be automatically denied, for example, Treasury says that "existing civil penalties do not appear to be an effective deterrent against ineligible taxpayers repeatedly claiming the [EIC]." We saw nothing from IRS' study related to the effectiveness of penalties. Nor have we seen any information on the extent to which IRS, in the past, has asserted available civil and criminal sanctions for fraudulent or reckless EIC claims and the extent to which penalized parties have submitted fraudulent claims afterwards. Such information would help determine if the answer lies in better administering existing procedures or establishing new procedures.

A third issue surrounding Treasury's proposals involves the need to ensure that any legislative or administrative change include adequate controls to protect taxpayer rights. For example, Treasury is proposing that IRS be allowed to place liens and execute levies on a portion of unemployment compensation, welfare benefits, and other types of assistance in order to recapture EIC claims that were found to be erroneous after IRS had paid them. Those types of income are now exempt from levy. It is for Congress to decide whether there is now sufficient reason to revise those exemptions. But, it is important in doing so that any such change include adequate controls to protect taxpayers' rights.

A final issue involves tradeoffs. It is important that concern about EIC noncompliance not become so encompassing that other areas of noncompliance are neglected. In that regard, one of Treasury's proposals calls for aggressive IRS action to prevent the payment of erroneous EIC claims. While we support the first part of that proposal—the development of new profiles to help IRS better target its enforcement efforts—we cannot support the second part—earmarking substantial resources for an intensified EIC compliance effort—without knowing the tradeoffs. IRS, like most of the federal government, is facing stagnant or declining resources through 2002. Consequently, knowing where the resources will come from is critical. Equity and financial concerns have already been raised about IRS reducing its audit coverage of high income individuals in order to target EIC returns.

To assess tradeoffs, it is important to know what the return on investment is for EIC-related enforcement efforts compared with other programs. In fiscal year 1995, for example, all examinations done by tax auditors (those IRS staff who would normally do EIC-related audits) resulted in average additional recommended taxes of about $3,500 per return, compared to the average EIC refund that year of less than $1,500.

Finally, as IRS becomes more and more involved in determining whether taxpayers are eligible to receive the EIC, the benefits of delivering income assistance to low income taxpayers through the tax code may erode. Specifically, administrative costs will increase and participation rates may fall. In addition, IRS employees will be faced with new job responsibilities traditionally more related to welfare programs than tax administration.

In conclusion, Mr. Chairman, many questions remain about EIC noncompliance and the most effective ways to reduce it. IRS efforts have reduced the level of noncompliance but it still remains above 20 percent, with several billion dollars in overclaimed credits annually. How much further it can be reduced with available resources is uncertain.

As I noted earlier, it will not be easy to significantly reduce EIC noncompliance without somehow addressing the basic underlying problem—the self-determination of eligibility by taxpayers and IRS' limited ability to verify that eligibility.

Treasury's proposals provide a starting point for deliberations on what can reasonably be done to address this difficult problem. Much more information is needed on the proposals and IRS' study findings before any overall judgment can be made on how much the proposals will contribute to reducing noncompliance.

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[13] *Tax Administration: Effectiveness of IRS' Return Preparer Penalty Program Is Questionable* (GAO/GGD–91–12, Jan. 7, 1991).

It is important, in further deliberations on Treasury's proposals or those made by others, that Congress and the administration consider whether (1) the actions being proposed are feasible; (2) potential benefits justify expected costs, especially in light of tighter budgets and other compliance problems facing IRS; and (3) adequate procedures are built in to protect taxpayers' rights.

That concludes my statement. We welcome any questions that you may have.

PAST GAO PRODUCTS RELATING TO THE EIC

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

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

Earned Income Credit: Noncompliance And Potential Eligibility Revisions (GAO/T–GGD–95–179, June 8, 1995)

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

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

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

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

Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD–92–26, Feb. 19, 1992).

The New Earned Income Credit Form Is Complex and May Not Be Needed (GAO/T–GGD–91–68, Sept. 17, 1991).

Mr. SHAW. Mr. Rangel, do you have any questions of the witness?

Mr. RANGEL. Does your report have any specific recommendations as how we can cut down the error rate?

Ms. WILLIS. Our testimony today does not make any specific recommendations regarding the proposals made by Treasury beyond their being more fully analyzed and evaluated. We do have on the books a recommendation similar to the administration's regarding the qualifying child and the exemption, making those more similar.

Mr. RANGEL. You testified that the Treasury recommendations, in your opinion, are inadequate, so that means you evaluated it and you probably had some thoughts of what should be done to make them adequate.

Ms. WILLIS. I think I testified that they deserve more scrutiny and that we have concerns about them. One where there is definitely more information needed that has potential is in the development of profiles of taxpayers who are noncompliant, but until we have more data and we know more about who these people are and how they are noncompliant, it is going to be hard to design programs to identify them.

Mr. RANGEL. Can you get that data so that you could really come up with some positive recommendations that you think are better than what Treasury has come up with?

Ms. WILLIS. We will be looking at the data, the study, and everything that IRS has done for this Committee with exactly that in mind.

Mr. RANGEL. Throughout my political career, when I have had to deal with complex legislation and people ask me questions, one answer fit it all. I said, it is good in concept but it just did not go far enough, and I kind of think that that is the response you are giving the Treasury recommendations.

Ms. WILLIS. They did not go far enough in terms of being developed with the details. A number of the other proposals that Treasury has on the board we think are not particularly well targeted

to the noncompliance. It is hard to argue with additional assistance to taxpayers. But, I do not know how much noncompliance you are going to eradicate with additional assistance to taxpayers.

Mr. RANGEL. Who were you working with in Treasury as relates to this?

Ms. WILLIS. We will be working with the people who were here at the witness table today as well as with IRS. We——

Mr. RANGEL. Before you made your report, who were you working with? Did you assist them in putting together their recommendations?

Ms. WILLIS. No, we did not.

Mr. RANGEL. Does that violate the General Accounting Office rules? I mean, it is all one government.

Ms. WILLIS. We were never approached in terms of working with Treasury on any of the recommendations. We have done quite a large body of work related to the earned income credit and noncompliance that——

Mr. RANGEL. I am just asking, would it violate any principles if you say, we have studied this problem as well as you and these are the recommendations we would make.

Ms. WILLIS. No.

Mr. RANGEL. Did you do it?

Ms. WILLIS. No, we have not.

Mr. RANGEL. Will you do it?

Ms. WILLIS. Yes, we will.

Mr. RANGEL. You are a great body. I depend on you a lot because you do good work, but good work, unless we can put the results into action, is just an academic experience. I will ask you, and maybe I have to do it in writing, to try to get together with the Treasury people because they are looking for answers and you may have some that they need and then we can come together and hope that we can reduce the underclaim or whatever it is. Thank you so much.

Ms. WILLIS. Thank you.

Mr. SHAW. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman. I will just ask one or two quick questions.

I note that in the report, which, again, I want to emphasize what Mr. Rangel says, we appreciate the good work that is done by the GAO, in the report, you mention that throughout the tax system, noncompliance tends to be higher whenever there is an absence of easily verifiable data.

Ms. WILLIS. Yes.

Mr. BECERRA. Is the data that you need for the purpose of certifying an EITC claim by a filer, a tax filer, easy to come by?

Ms. WILLIS. No.

Mr. BECERRA. What makes it difficult to come by that data?

Ms. WILLIS. Because the data are not filed in any central location that you can match to, in essence, determine whether someone is eligible or has eligible children under the EIC. You have to go through many of the same procedures that a welfare agency would have to go through, and that is face-to-face contact where you are being provided documentation that the children are eligible and

that you have some way of documenting that they do, indeed, reside with you.

Mr. BECERRA. So it seems it is an issue for the IRS of access to that data. You have to go track it down somehow.

Ms. WILLIS. You have to do field enforcement.

Mr. BECERRA. Is there another level of nonverifiability in that the data may never really exist except as produced by that filer? In other words, I may tell you I generated $100,000 in income but you have really no way to verify that short of looking through every receipt and expense that I have, which makes it perhaps more difficult than finding out if someone has a child or not.

Ms. WILLIS. Yes.

Mr. BECERRA. So in your comment that noncompliance tends to be higher whenever there is an absence of easily verifiable data, on that spectrum, it would seem that if we could come up with some mechanisms of enforcement, you are more likely to improve your compliance within the EITC than you might ever be able to get, say, within the business field because you know if he is entitled or not.

Mr. SHAW. If the gentleman would suspend. If you do want to continue this line of questioning, we are going to have to come back. There is a series of votes and we are going to be lucky to make this first vote.

Mr. BECERRA. We are at less than 5 minutes now, Mr. Chairman?

Mr. SHAW. Yes.

Mr. BECERRA. Then let me just pose that question and maybe later on we can get the response. I do not wish to hold the witness up just for that.

Thank you, Mr. Chairman.

Mr. SHAW. We are adjourned. There is one thing. I think the point has been made that this is a program that is somewhat out of control. The taxpayers are getting ripped off. We are losing billions and billions of dollars. It has been a valuable program, one that we want to preserve but one that we have got to bring under control. Despite all the spin that both sides have tried to put on it today, it is a big problem that we need to work together to solve and I thank you.

I would like to place into the record a document prepared by the staff of the Joint Committee on Taxation with respect to the EITC.

[The prepared statement follows:]

Statement of Joint Committee on Taxation

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on May 8, 1997, on the Administration's proposals relating to the earned income credit. On April 23, 1997, the Department of Treasury released eight proposals to reduce errors on tax returns with respect to the earned income credit ("EIC").[1]

[1] The Administration proposals also include two administrative actions to be undertaken relating to EIC compliance. These actions are continued IRS efforts to improve: (1) compliance by providing additional IRS personnel to work on EIC issues and, (2) awareness of, access to, and resources for volunteers in the IRS-sponsored Volunteer Income Tax Assistance ("VITA") program.

This document,[2] prepared by the staff of the Joint Committee on Taxation in connection with the May 8 Committee hearing, provides a description of present-law earned income credit provisions (Part I), a brief legislative background (Part II), a summary description of the April 1997 IRS compliance study (Part III), and a description of the Administration's legislative proposals (Part IV).

I. Description of Present-Law Earned Income Credit Provisions

In general

Certain eligible low-income workers are entitled to claim a refundable earned income credit (EIC) (sec. 32 of the Internal Revenue Code of 1986 ("Code")). A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the individual's earned income[3] up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of alternative minimum tax ("AMT") the taxpayer owes for the year. The EIC is phased out above certain income levels. For individuals with earned income or modified adjusted gross income ("modified AGI"), in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. Modified AGI means AGI, but for this purpose does not include the following amounts: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 50 percent of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. Amounts attributable to a business that consists of the performance of services by the taxpayer as an employee are not taken into account for purposes of (4).

The parameters for the EIC for 1997 are given in the following table:

Earned Income Credit Parameters (1997)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	$9,140	$6,500	$4,340
Maximum credit	$3,656	$2,210	$332
Phaseout begins	$11,930	$11,930	$5,430
Phaseout rate (percent)	21.06	15.98	7.65
Phaseout ends	$29,290	$25,760	$9,770

Under present law, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,250. Disqualified income is the sum of: (1) interest (taxable and tax-exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income (if greater than zero) that is not self-employment income. The $2,250 threshold is indexed for inflation.

The earned income amount and the phaseout amount are indexed for inflation.

Earned income

Under present law, earned income means the sum of (1) wages, salaries, tips, and other employee compensation, and (2) the amount of the taxpayer's net earnings from self employment for the taxable year, determined without regard to the deduction for one-half of the taxpayer's self-employment taxes (Code sec. 164(f)). For purposes of this definition, earned income is computed without regard to any community property laws, pension and annuity payments are not treated as earned income,

[2] This document may be cited as follows: Joint Committee on Taxation, *Description of the Administration's Proposals Relating to the Earned Income Credit* (JCX-14–97), May 7, 1997.

[3] In the case of a married individual who files a joint return with his or her spouse, the income for purposes of these tests is the combined income of the couple.

certain amounts relating to nonresident aliens are disregarded, and no amount received by inmates for services in penal institutions is treated as earned income.

Eligible individual

Under present law, an individual is an eligible individual entitled to claim the EIC for a year if

(1) the individual has a qualifying child for the taxable year, or

(2) the individual does not have a qualifying child, but satisfies the following requirements:

(i) the individual's principal place of abode is in the United States for more than ½ of the year,

(ii) the individual (or, if the individual is married, either the individual or the individual's spouse) has attained age 25, but has not attained age 65 before the close of the year, and

(iii) the individual is not a dependent for whom a dependency exemption is allowed on another taxpayer's return for a taxable year beginning in the same calendar year as the taxable year of the individual.

An individual is not an eligible individual for the year if the individual (1) is a qualifying child of another taxpayer, (2) claims any exclusion from income under Code section 911 for citizens or residents living abroad, (3) is a nonresident alien individual for any portion of the year unless the individual is treated as a U.S. resident for the year under Code section 6013, or (4) does not include the individual's taxpayer identification number ("TIN") or the individual's spouse's TIN on the tax return.

Qualifying child

A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. Under the relationship and age tests, an individual is eligible for the EIC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); and (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled. Also, if the qualifying child is married at the close of the year, the individual may claim the EIC for that child only if the individual may also claim that child as a dependent.

To satisfy the identification test, an individual must include on their tax return the name, age, and TIN of each qualifying child.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United States for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty.

Advance payment

An individual with qualifying children may elect to receive the credit on an advance basis by furnishing an advance payment certificate to his or her employer. For such an individual, the employer makes an advance payment of the credit at the time wages are paid. The amount of advance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to an individual with one qualifying child.

TIN requirement

Under present law, for purposes of determining who is an eligible individual and who is a qualifying child, a TIN means a social security number issued to an individual by the Social Security Administration other than a social security number issued pursuant to clause (II) (or that portion of clause (III) that relates to clause (II)) of section 205(c)(2)(B)(i) of the Social Security Act relating to the issuance of a Social Security number to an individual applying for or receiving Federally funded benefits.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the

taxpayer an opportunity to petition the Tax Court. If an individual fails to provide a correct TIN, such omission is treated as a mathematical or clerical error. Also, if an individual who claims the EIC with respect to net earnings from self employment fails to pay the proper amount of self-employment tax on such net earnings, the failure is treated as a mathematical or clerical error for purposes of the amount of EIC claimed. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

II. Legislative Background

The EIC was enacted in 1975 as a means of targeting tax relief to working low-income taxpayers with children, providing relief from the Social Security payroll tax for these taxpayers, and improving incentives to work. As originally enacted, the credit equaled 10 percent of the first $4,000 of earned income (i.e., a maximum credit of $400). The credit began to be phased out for taxpayers with earned income (or AGI, if greater) above $4,000, and was entirely phased out for taxpayers with income of $8,000.

The Revenue Act of 1978 increased the maximum credit to $500 (10 percent of the first $5,000 of earned income). Also, the income level at which the phaseout began was raised to $6,000, with a complete phaseout not occurring until an income level of $10,000. The Deficit Reduction Act of 1984 increased the maximum credit to $550 (11 percent of the first $5,000 of earned income) and the credit was phased out beginning at $6,500 of income and ending at $11,000.

The Tax Reform Act of 1986 increased the maximum credit to $800 (14 percent of the first $5,714 of earned income), beginning in 1987. The maximum credit was reduced by 10 cents for each dollar of earned income (or AGI, if greater) in excess of $9,000 ($6,500 in 1987). These $5,714 and $9,000 amounts (stated above in 1985 dollars) were indexed for inflation.

The Omnibus Budget Reconciliation Act of 1990 ("OBRA 1990") substantially increased the maximum amount of the basic credit and added an adjustment to reflect family size. OBRA 1990 also created two additional credits as part of the EIC: the supplemental young child credit and the supplemental health insurance credit. Both of these supplemental credits used the same base as the basic EIC.

OBRA 1990 also modified the definition of taxpayers eligible for the EIC. Under prior law, taxpayers were required to file a joint return or file as a head of household or surviving spouse in order to be eligible for the EIC. OBRA 1990 generally broadened the set of eligible taxpayers and set out uniform requirements for qualifying children. The definition of "qualifying child" enacted in OBRA 1990 is described in the present-law section.

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") expanded the EIC in several ways. For taxpayers with one qualifying child, the EIC was increased to 26.3 percent of the first $7,750 of earned income in 1994. For 1995 and thereafter, the credit rate was increased to 34 percent. In 1995, the maximum amount of earned income on which the credit could be claimed is $6,160 (this is a $6,000 base in 1994, adjusted for inflation). The phaseout rate for 1994 and thereafter is 15.98 percent.

For taxpayers with two or more qualifying children, the EIC was increased to 30 percent of the first $8,425 of earned income in 1994. The maximum credit for 1994 was $2,527 and was reduced by 17.68 percent of earned income (or AGI, if greater) in excess of $11,000. The credit rate increases over time and equals 36 percent for 1995 and 40 percent for 1996 and thereafter. The phaseout rate is 20.22 percent for 1995 and 21.06 percent for 1996 and thereafter.

OBRA 1993 also extended the EIC to taxpayers with no qualifying children. This credit for taxpayers with no qualifying children is available to taxpayers over age 24 and below age 65. Finally, OBRA 1993 repealed the supplemental young child credit and the supplemental health insurance credit.

The implementing legislation for the General Agreements on Tariffs and Trade, enacted in 1994, made a number of modifications to the EIC. First, it denied the

EIC to inmates for any amount received for services provided by the inmate in a penal institution. Second, it generally made nonresident aliens ineligible to claim the EIC. Third, it deemed that a member of the Armed Forces stationed outside the United States while serving on extended active duty would satisfy the test that the principal place of abode be within the United States. Fourth, it required that members of the Armed Forces receive annual reports from the Department of Defense of earned income (which includes nontaxable earned income such as amounts received as basic allowances for housing and subsistence). Fifth, it required a TIN for each qualifying child regardless of the dependent's age. Prior to the legislation, taxpayers had to provide a TIN only for qualifying children who attained the age of one before the close of the taxpayer's taxable year.

Under the Self-Employed Person's Health Care Reduction Extension Act of 1995, effective for taxable years beginning after December 31, 1995, a taxpayer is not eligible for the EIC if the aggregate amount of disqualified income (i.e., taxable and tax-exempt interest, dividends, and (if greater than zero) net rent and royalty income) of the taxpayer for the taxable year exceeds $2,350 ("the disqualified income test").

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 included several changes to the EIC. First, it modified the disqualified income test by adding capital gain net income and net passive income (if greater than zero) that is not self-employment income to the definition of disqualified income, and by reducing the threshold above which an individual is not eligible for the EIC from $2,350 to $2,200 (indexed for inflation). Second, it modified the definition of AGI used for phasing out the earned income credit by disregarding certain losses. The losses disregarded are: (1) net capital losses (if grater than zero); (2) net loses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 50 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. Third, it applied mathematical and clerical error treatment to the failure to provide a correct Social Security Number (SSN) or to pay the proper amount of self-employment tax on net self-employment earnings on which an EIC is claimed. Finally, it denied the EIC to individuals whose SSNs were issued solely for purposes of the individual applying for or receiving Federally funded benefits.

III. Internal Revenue Service Compliance Study

In April 1997, the Internal Revenue Service ("IRS") released a study of EIC filers for tax year 1994. This study based on a final sample of 2046 tax returns examined both paper and electronic returns that were accepted by the IRS through April 21, 1995; this represents about 80 percent of the EIC filing population for that tax year 1994. The study found that the total amount of erroneously overclaimed and accepted EIC amounts for tax year 1994 amounted to $4.44 billion (25.8 percent of the total EIC claimed and accepted for that tax year 1994). The study determined that the overclaim rate should be adjusted down to $4.05 billion (23.5 percent of the total EIC claimed and accepted for tax year), to reflect the full effects of IRS enforcement activities which were in effect during the next tax year 1995, Also, certain EIC legislation enacted after tax year 1994, (i.e., mathematical and clerical error treatment for the failure to provide valid TINs for qualifying children), was estimated to reduce the overclaimed amount by an additional $489 million down to $3.56 billion. This would have lowered the overclaim rate to 20.7 percent for tax year 1994 had the mathematical and clerical error rule been in place for the year.

IV. Description of Administration Propsals

A. Deny EIC Eligibility for Prior Acts of Recklessness or Fraud

Present Law.—The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement (sec. 6662). Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud (sec. 6663).

Neither the accuracy-related penalty nor the fraud penalty is imposed with respect to any portion of an underpayment if it is shown that there was a reasonable

cause for that portion and that the taxpayer acted in good faith with respect to that portion.

Description of Proposal.—A taxpayer who fraudulently claims the EIC would be ineligible to claim the EIC for a subsequent period of 10 years. In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations would be ineligible to claim the EIC for a subsequent period of two years. These sanctions would be in addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations would be made in a deficiency proceeding (which would provide for judicial review).

Effective Date.—The proposal would be effective for taxable years beginning after December 31, 1997.

B. Recertification Required When Taxpayer Found to be Ineligible for EIC in Past

Present law.—If an individual fails to provide a correct TIN and claims the EIC, such omission is treated as a mathematical or clerical error. Also, if an individual who claims the EIC with respect to net earnings from self employment fails to pay the proper amount of self-employment tax on such net earnings, the failure is treated as a mathematical or clerical error for purposes of the amount of EIC claimed. Generally, taxpayers have 60 days in which they can either provide a correct TIN or request that the IRS follow the current-law deficiency procedures. If a taxpayer fails to respond within this period, he or she must file an amended return with a correct TIN or clarify that any self-employment tax has been paid in order to obtain the EIC originally claimed.

The IRS must follow deficiency procedures when investigating other types of questionable EIC claims. Under these procedures, contact letters are first sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made and the EIC is denied.

Description of Proposal.—A taxpayer who has been denied the EIC as a result of deficiency procedures would be ineligible to claim the EIC in subsequent years unless evidence of eligibility for the credit is provided by the taxpayer. To demonstrate current eligibility, the taxpayer would be required to meet evidentiary requirements established by the Secretary of the Treasury. The evidentiary requirements have not yet been specified. Failure to provide this information when claiming the EIC would be treated as a mathematical or clerical error. If a taxpayer is recertified as eligible for the credit, the taxpayer would not be required to provide this information in the future unless the IRS again denies the EIC as a result of a deficiency procedure. Ineligibility for the EIC under the proposal would be subject to review by the courts.

Effective Date.—The proposal would be effective for taxable years beginning after December 31, 1997.

C. Establish IRS Continuous Levy and Improve Debt Collection

1. CONTINUOUS LEVY.

Present Law.—If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[4] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[5] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[6]

In general, a levy does not apply to property acquired after the date of the levy,[7] regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure is insufficient to satisfy the liability.[8] The only exception to this rule is for salary and wages.[9] A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

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[4] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (sec. 6303).

[5] Sec. 6331.

[6] Secs. 6335–6343.

[7] Sec. 6331(b).

[8] Sec. 6331(c).

[9] Sec. 6331(e).

A minimum exemption is provided for salary and wages.[10] It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which the taxpayer is entitled, divided by 52.[11] For a family of four for taxable year 1996, the weekly minimum exemption is $325.[12]

Description of Proposal.—The Administration's budget proposal would amend the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are subject to levy under present law, would become subject to continuous levy.

In addition, the Administration's budget proposal would provide that this levy would attach up to 15 percent of any salary or pension payment due the taxpayer. This rule would explicitly replace the other specifically enumerated exemptions from levy in the Code. Under the Administration's budget proposal, the continuous levy could apply to the entire amount of a Federal payment that is not salary or a pension payment. Under the Administration's EIC proposal, a continuous levy of up to 15 percent could also apply to unemployment benefits and means-tested public assistance.

Effective Date.—The Administration's budget proposal would be effective for levies issued after the date of enactment. The Administration's EIC proposal would be effective for levies issued after December 31, 1997.

2. MODIFICATIONS OF LEVY EXEMPTIONS.

Present Law.—The Code exempts from levy workmen's compensation payments,[13] annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act[14] described above, unemployment benefits[15] and means-tested public assistance.[16]

Description of Proposal.—The Administration's budget proposal would provide that the following property is not exempt from levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

(1) workmen's compensation payments,[17] and

(2) annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act.

The Administration's EIC proposal would provide that the following property is not exempt from levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

(1) unemployment benefits, and

(2) means-tested public assistance.

Effective Date.—The Administration's budget proposal would apply to levies issued after the date of enactment. The Administration's EIC proposal would apply to levies issued after December 31, 1997.

D. Due Diligence Requirements for Paid Preparers

Present Law.—There are several penalties that apply in the case of an understatement of tax that is caused by an income tax return preparer. First, if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position and such position was not disclosed or was frivolous, then that return preparer is subject to a penalty of $250 with respect to that return or claim (sec. 6694(a)). The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith.

In addition, if any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of rules or regulations by an income tax return preparer, then the income tax return

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[10] Sec. 6334(a)(9).

[11] Sec. 6334(d).

[12] Standard deduction of $6,700 plus four personal exemptions at $2,550 each equals $16,900, which when divided by 52 equals $325.

[13] Sec. 6334(a)(7).

[14] Sec. 6334(a)(6).

[15] Sec. 6334(a)(4).

[16] Sec. 6334(a)(11).

[17] Many workmen's compensation payments are made by States. The heading of the new subsection of the Code (but not the text of the subsection itself) refers to "Federal" payments. A clarification of this matter may be desirable.

preparer is subject to a penalty of $1,000 with respect to that return or claim (sec. 6694(b)).

Also, a penalty for aiding and abetting the understatement of tax liability is imposed in cases where any person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result (sec. 6701).

Additional penalties are imposed on return preparers with respect to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy or list of the returns prepared, and (5) file a correct information return (sec. 6695). The penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000.

Description of Proposal.—Return preparers would be required to fulfill certain due diligence requirements with respect to returns they prepare claiming the EIC. The due diligence requirements have not yet been specified. The penalty for failure to meet these requirements would range from $50 to the full amount of the EIC overclaimed. This penalty would be in addition to any other penalty imposed under present law.

Effective Date.—The proposal would be effective for taxable years beginning after December 31, 1997.

E. Simplification of Foster Child Definition

Present law.—For purposes of the EIC, qualifying children may include foster children who reside with the taxpayer for a full year, if the taxpayer "cares for the foster children as the taxpayer's own children." (Code sec. 32(c)(3)(B)(iii)(I)). All EIC qualifying children (including foster children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled. There is no requirement that the foster child either be: (1) placed in the household by a foster care agency or (2) a relative of the taxpayer.

Description of Proposal.—A foster child would be defined as a child who (1) is under the age of 19 (24 if a full-time student), (2) is cared for by the taxpayer as if he or she were the taxpayer's own child, and (3) either is the taxpayer's niece, nephew, or sibling or was placed in the taxpayer's home by an agency of a State or one of its political subdivisions or by a tax-exempt child placement agency licensed by a State.

Effective Date.—The proposal would be effective for taxable years beginning after December 31, 1997.

F. Advance Payment Demonstration Projects

Present law.—Qualifying individuals can claim the EIC when filing their tax returns at the end of the year. Alternatively, qualifying individuals with children have the choice of obtaining a portion of the EIC in advance through their employers, and claiming the balance of the EIC upon filing their income tax returns at the end of the year. The annual advanced EIC payment cannot exceed 60 percent of the maximum full-year EIC for a family with one child ($1,326 for 1997).

Description of Proposal.—The Secretary of the Treasury could select four States to provide advance payments of the EIC to wage earners through State agencies rather than employers for a three-year period. The four States would be selected from those States applying for participation in the demonstration project. States would be required to verify eligibility for the EIC before paying out the credit. Effects on advance payment participation and compliance would be studied by the Treasury Department.

Effective Date.—Applications would be submitted by the States to the Treasury Department during 1998 for demonstration projects to begin in January 1999.

Mr. SHAW. I would also like to include in the record a written statement from the American Institute of Certified Public Accountants.

[The prepared statement follows:]

Statement of the American Institute of Certified Public Accountants

INTRODUCTION

The American Institute of Certified Public Accountants (AICPA) is the national professional organization of CPAs, with more than 320,000 members. Many of our members are tax practitioners who, collectively, prepare income tax returns for millions of Americans.

The AICPA urges that simplification of the tax system be made a legislative priority. In particular, the earned income tax credit (EITC) is an area in critical need of simplification.

We strongly urge the Committee and Congress to re-write the EITC rules to be understandable and usable by the taxpayers that this provision is intended to benefit—low-income wage earners. This group of taxpayers generally lacks the ability to deal with complex tax laws and is unable to pay for tax preparation assistance. The AICPA welcomes proposed changes to make the credit more effective and offers several suggestions.

BACKGROUND ON THE EITC

The refundable EITC was enacted in 1975 with the policy goals of providing relief to low-income families from the regressive effect of Social Security taxes, and improving work incentives among this group. According to the IRS, EITC rules affect almost 15 million individual taxpayers.

Over the last few years, the number one individual tax return error discovered by the IRS during return processing has been the EITC, including the failure of eligible taxpayers to claim the EITC, and the use of the wrong income figures when computing the EITC. The frequent changes made to the EITC over the past twenty years contribute greatly to the credit's high error and noncompliance rates. In fact, the credit has been changed 12 times (1976, 1977, 1978,1979, 1984,1986, 1988 ,1990, 1993, 1994, 1995, and 1996). The credit now is a nightmare of eligibility tests, requiring a maze of worksheets. Computation of the credit currently requires the taxpayer to consider:

- 9 eligibility requirements;
- the number of qualifying children—taking into account relationship, residency, and age tests;
- the taxpayer's earned income—taxable and non-taxable;
- the taxpayer's adjusted gross income (AGI);
- the taxpayer's modified AGI;
- threshold amounts;
- phase out rates; and
- varying credit rates.

As part of the Self-Employed Health Insurance Act of 1995, a new factor was added for determining eligibility—the amount of interest (taxable and tax-exempt), dividends, and net rental and royalty income (if greater than zero) received by a taxpayer, even if total income is low enough to otherwise warrant eligibility for the EITC. A threshold of this type of disqualified income was set at $2,350 in 1995, but was then altered as part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 to be $2,200. In addition, in 1996, capital gain net income and net passive income (if greater than zero) that is not self-employment income were added to this disqualified income test.

In 1996, the credit computation became even more complicated, with the introduction of a modified AGI definition for phasing out the credit, wherein certain types of nontaxable income need to be considered and certain losses are disregarded. Specifically, nontaxable items to be included are: tax-exempt interest, and nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if rolled over into similar vehicles during the applicable rollover period). The losses that are to be disregarded are:

- net capital losses (if greater than zero);
- net losses from trusts and estates;
- net losses from nonbusiness rents and royalties; and
- 50 percent of net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses—but amounts attributable to businesses that consist of the performance of services by an individual as an employee are not taken into account.

In addition to the prior requirement that a taxpayer identification number (TIN) be supplied for each qualifying child, starting in 1996, the taxpayer must be authorized to be employed in the U.S. in order to claim the credit, and failure to provide a correct TIN is now treated as a mathematical or clerical error.

To claim the credit, the taxpayer may need to complete:

- a checklist (containing 8 complicated questions),
- a worksheet (which has 9 steps),
- another worksheet (if there is self-employment income),
- a schedule with 6 lines and 2 columns (if qualifying children are claimed); and
- Usually, the normal Form 1040 (rather than Form 1040A or Form 1040EZ).

For guidance, the taxpayer may refer to 7 pages of instructions (and 39 pages of IRS Publication 596). The credit is determined by multiplying the relevant credit rate by the taxpayer's earned income up to an earned income threshold. The credit is reduced by a phaseout rate multiplied by the amount of earned income (or AGI, if less) in excess of the phaseout threshold.

While Congress and the IRS may expect that the AICPA and its members can comprehend the many pages of instructions and worksheets, it is unreasonable to expect those individuals entitled to the credit (who will almost certainly NOT be expert in tax matters) to deal with this complexity. Even our members, who tend to calculate the credit for taxpayers as part of their volunteer work, find this area to be extremely challenging. In fact, we have found that the EITC process can be a lot more demanding than completing the Schedule A—Itemized Deductions, which many of our members complete on a regular basis for their clients.

Our analysis suggests that most of the EITC complexity arises from the definitional distinctions in this area. While each departure from definitions used elsewhere in the Code can be understood in a context of accomplishing a specific legislative purpose, the sum of all the definitional variances causes this Code section to be unmanageable by taxpayers and even the IRS. We recognize that many of the additions and restrictions to the credit over the years were for laudable purposes. However, the rules are so complex that the group of taxpayers to be benefited find them incomprehensible and are not effectively able to claim the credit to which they are entitled.

Summary of Our Legislative Recommendations

We recommend that Congress adopt the following changes to the EITC:

1. Simplify definitions and the calculation. (See Appendix for specific administrative proposals that we intend to pursue with the IRS).
2. Define "earned income" as taxable wages (Form 1040, line 7) and self employment income (Form 1040, line 12).
3. Modify the "qualifying child" rules.

A. Replace the "qualifying child" definition with the already existing dependent child definition.

B. Increase the incremental amount of credit provided for two children versus one child.

C. Use the dependency exemption rather than the EITC to provide benefits for children.

4. Combine and expand the denial provisions.

A. Deny the credit for taxpayers with: foreign earned income, alternative minimum tax liability, and AGI that exceeds earned income by $2,350 or more.

5. Modify the EIC Table or provide a percentage rate instead of the table.

Specific Legislative Recommendations

1. Simplify definitions and the calculation.

The current rules for the EITC, as previously noted, provide different rules depending upon the number of qualifying children the taxpayer claims. The many rates, thresholds, limitations, and classifications regarding this credit are confusing. For the 1994 tax year, the parameters are as follows:

	1 Child	2 or more Children	No Children
Credit rate (%)	26.30	30.00	7.65
Phaseout rate (%)	15.80	17.68	7.65
Earned income threshold	$7,750	$8,425	$4,000
Phaseout threshold	11,000	11,000	5,000
Phaseout limit	23,755	25,296	9,000
Maximum credit	2,038	2,528	306

RECOMMENDATION:

Congress should simplify the definitions and the calculation of the credit. Specifically, as detailed below, we suggest the definitions of qualifying child and earned income be modified. The many rates, thresholds, limitations, and classifications regarding this credit should be referenced to other similar thresholds and classifications throughout the Code. These changes, and the changes listed below, would reduce the number of pages needed for the worksheets, Schedule EIC, EIC Table, and instructions. (See Appendix for specific administrative proposals that we intend to pursue with the IRS to simplify the definitions and calculation.)

2. Define "earned income" as taxable wages (Form 1040, line 7) and self-employment income (Form 1040, line 12).

The current EITC definition of "earned income" needs to be simplified. Currently, to calculate the credit, the taxpayer must take into account all earned income, including amounts not otherwise reported on the tax return or not taxed. This is one area where numerous errors are made. As GAO states in its September 1993 report GAO/GGD–93–145, Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved, "determining the amount of income that should be included in calculating the credit poses a problem for taxpayers and IRS."

Currently, potentially eligible recipients must take into account:

- Taxable earned income (wages, salaries, and tips; union strike benefits; long-term disability benefits received prior to minimum retirement age; and net earnings from self-employment), PLUS
- Nontaxable earned income (defined in the instructions as: contributions to a 401(k) plan and military housing and subsistence, excludable dependent care benefits, pay earned in a combat zone, the value of meals or lodging provided by an employer for the convenience of the employer, housing allowance or rental value of a parsonage for clergy, voluntary salary reductions such as under a cafeteria plan, and "anything of value that is not taxable which you received from your employer for your work").

Furthermore, because taxable scholarships and fellowship grants are reported on Form 1040 line 7, taxpayers are instructed to subtract taxable scholarships or fellowship grants not reported on the Form W–2. This one exception complicates the calculation and is not verifiable, as it is not on the Form W–2.

In addition, as discussed in our administrative recommendations in the Appendix, the earned income calculation does NOT include various other forms of income not on line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). The exclusion of these items is mentioned in IRS Publication 596, but is not mentioned in the worksheet or instructions. Since these items are taxable, but are not wage income (line 7 of the Form 1040), taxpayers may inadvertently include these items as "earned income."

Currently, the calculation of "earned income" involves a detailed knowledge of tax terminology, such as: "excludable," "taxable," "for the convenience of the employer," and "voluntary salary reductions." The definition of taxable income includes many items not commonly thought of as earnings. In addition, the definition of "nontaxable earnings" is unique to the EITC and is defined in different ways in the instructions and IRS Publication 596 (as addressed in our administrative recommendations in the Appendix). Most people think that "earned income" is wages. Omissions are likely to happen when uncommon terms are used to cover many items that normally are not treated as earnings.

RECOMMENDATION:

Congress should define earned income as wages appearing on line 7 of Form 1040, plus self-employment income from line 12 of the Form 1040.

Earned income should only include taxable income, as the statute originally provided when it was created in 1975. As the GAO points out, much of "this (nontaxable) income is not reported to recipients or to IRS," and IRS has no way right now of verifying the nontaxable amounts. GAO states, "we do not see a need to provide space on the tax return for nontaxable earned income since less than 3 percent of eligible taxpayers claim (report) this type of income." Therefore, nontaxable income should be removed from the EITC definition of "earned income" to make the process simpler for the majority of taxpayers who need to complete this worksheet.

We also believe that there should be no exceptions to this taxable earned income definition. If Congress wants to treat taxable scholarships and fellowships different from taxable wages, taxable scholarships and wages should not be reported on in line 7 of the Form 1040. Alternatively, if taxable scholarships are to be treated as

taxable wages (line 7 of Form 1040), the current EITC subtraction for scholarships and fellowship grants should not be allowed.

3. Modify the "qualifying child" rules.

According to a GAO analysis, most EITC errors have been linked to issues involving filing status and qualifying children. The qualifying child test is complex. Taxpayers are confused by the "qualifying child" definition and the different definition for a dependent. The definition of "eligible child" complicates the EITC instructions for determining eligibility. The IRS attempts to communicate that a "qualifying child" usually does not have to be a dependent. However, there are a few exceptions that confuse taxpayers. For example, if one divorced parent has custody of the child, but the other parent claims the child as a dependent, the parent with custody can claim the child as a "qualifying child" for the EITC, but can not claim the child as a dependent. Also, if a child is married, the child must be a dependent (i.e., over half of the child's support is provided by the taxpayer) to claim the child as a "qualifying child" for the EITC. This married child exception confuses taxpayers.

Additionally, the different EITC treatment for different taxpayers—depending on the number of children—seems unnecessarily complex, especially for the minor additional benefit derived. The maximum additional credit for more than one child is only $490. The minor additional benefit is illustrated by an eligible taxpayer with $4,000 of earned income receiving a credit for one child of $1,059, while for two or more children, the taxpayer's credit is $1,208, a difference of only $149. What is this differential meant to reflect? Clearly, the difference cannot be cost. In addition, there is no EITC difference between taxpayers with two children and taxpayers with three or more children.

Also, taxpayers with and without children are treated differently with regard to their eligibility for the advance EITC. The advance EITC is available only to taxpayers with qualifying children. There does not appear to be any reason for this difference. The EITC should focus on one goal—earned income.

RECOMMENDATION:

The rules throughout the Code, and especially in this area, could be simplified if just one definition was used consistently. Congress should eliminate the distinction between "qualifying child" and "dependent child." Section 32(c)(1)(A)(I), which currently allows the EITC to certain taxpayers with non-dependent children, should be changed. If the term "eligible children" is restricted to dependent children, section 32(c)(1)(A)(I) could be cross referenced to section 151. This definition would provide an easy reference to information already on the Form 1040, line 6, and would eliminate the need for the additional information currently required on the Schedule EIC. We also suggest that the married dependent child test, which is rarely applied, be removed. Alternatively, if Congress deems that the "qualified child" is a better definition than "dependent child," then the "qualified child" test should be used for the dependency exemption as well. Either way, there should be just one definition of child in the Code.

RECOMMENDATION:

The spread in the amount of credit for one child and two children should be made more significant than under the current EIC Table. The difference between one and two children in the current table is so small that it could not possibly reflect a cost differential and it is too incomprehensible for it to be a motivating factor in individual conduct.

RECOMMENDATION:

Even greater simplification would result if there was no EITC differential based on the number of children. The current three classes of EITC recipients and three considerations at each point in the process are cumbersome. If just one class of EITC recipient existed, the "qualifying child" versus dependent child confusion would be eliminated, making the credit process much easier. In addition, if this recommendation is adopted, all EITC recipients would be able to claim the advance EITC.

As stated previously, an objective of the credit is to remove the regressivity of the Social Security tax for lower-income individuals. This objective applies to all lower income taxpayers, regardless of the number of children in the home. Thus, eliminating the incremental amount of the credit based on the number of children would not detract from the stated objectives of this provision. The calculation and the EIC Table would be simplified, and the additional information on age and social security numbers of children (currently required on a separate Schedule EIC) would not be needed for the EITC.

RECOMMENDATION:

Congress should coordinate all of the Code's tax provisions related to children. These child-based tax provisions include: the incremental child EITC, the child tax credit, the dependency exemption deduction, and the proposed family tax credit in H.R. 1215. All of these child tax benefits should be provided through one mechanism—the dependency exemption. The dependency exemption takes into account the total number of children in the household, versus the EITC, which only accounts for up to two children in a household.

However, since the current dependency exemption is a deduction rather than a credit, the result is regressive (that is, the higher the tax bracket, the greater the tax benefit) at the income levels that the EITC can be claimed. Therefore, if the dependency exemption is to take part of the place of the EITC, one point Congress might consider would be replacing the dependency exemption with a refundable credit, not a deduction. The credit could be refundable and set at a fixed dollar amount per dependent child. This credit could be available in advance from the taxpayer's employer, as is the advance EITC. The per child credit amount could be a round number that is easy to multiply.

The proposed child credit could be phased-out above some threshold AGI that is simple and consistent with other phase-out rules. We suggest that the phase-outs for itemized deductions, personal exemptions, and this proposed child credit all start at the same threshold and that threshold should be a number that is easy to apply—e.g., $100,000 of AGI. The phase-out mechanism for all tax provisions in the Code should be the same.

4. Combine and expand the denial provisions.

IRS and GAO have stated that many people receiving the credit are not considered "low-income" individuals. As these individuals are identified, greater restrictions are placed on eligibility for the credit, and the computation is made more complex for all EITC recipients. As mentioned earlier, Congress recently agreed to deny the credit to individuals with interest and dividends, tax-exempt interest, and net rental and royalty income in excess of $2,350. Additionally, the credit currently is not available if the taxpayer: excludes from gross income any income earned in foreign countries, or claims a tax benefit for foreign housing amounts. An individual who owes alternative minimum tax (Form 1040, line 48) is allowed a credit, but the EITC is reduced by any alternative minimum tax. The taxpayer's AGI is used as a limitation for the credit and greatly complicates the computation for most taxpayers.

RECOMMENDATION:

We support Congress limiting the credit to those taxpayers originally intended to benefit from the EITC. However, we suggest that this limitation only occur through the denial rules, not the computation rules. We recommend that all the denial provisions be included in one place. The eligibility/denial rules should include the current denial for taxpayers with foreign earned income. We suggest adding to the denial rule all taxpayers subject to AMT. This would delete the computational exception for AMT taxpayers.

Congress also should include in the denial provision taxpayers with AGI that exceeds earned income by $2,350 or more. H.R. 831's denial for taxpayers with $2,350 of interest or dividends should be replaced (and essentially combined) with this denial for taxpayers with AGI that exceeds earned income by $2,350 or more. This exclusion based on AGI would deny the credit to taxpayers with all forms of unearned income (i.e., capital gains, income from partnerships and'S corporations, etc.), not just taxpayers with interest and dividends of $2,350 or more. As the H.R. 831 proposed EITC restriction stands now, these "wealthy" individuals affected by the legislation (i.e., with this type and amount of non-earned income) could change their investments to earn partnership investment income, capital gains, or pay off their home mortgage and still claim an EITC. If H.R. 831 is enacted as currently drafted, when additional abuses occur, Congress will have to add more restrictions to the EITC statute. However, if our proposed broader AGI denial is used, fewer, or no, additional limitations will be needed. This denial of credit for individuals with higher incomes seems to be the intent of the unearned income restrictions.

An important result of moving the AGI calculation restriction to the eligibility rules is that the calculation would be much simpler. The calculation would no longer require a worksheet.

Specifically, in order to implement this change, we suggest that section 32(h), which currently requires a reduction of the EITC for taxpayers subject to the alternative minimum tax, be modified. On the basis of simplicity, this provision should be combined with section 32(c)(1)(D), denying the EITC to anyone claiming a foreign

earned income exclusion. Section 32(c)(1)(D) should also include taxpayers with AGI that exceeds earned income by $2,350. Section 32(a)(2) should also be modified to remove AGI from the computation. All the restrictions based on income should be contained in one paragraph or subsection, rather than throughout this Code provision.

5. Modify the EIC Table or provide a percentage rate instead of the table.

Although the IRS EIC Table takes into account all the phaseouts, the table can still be a mystery to many taxpayers. Many taxpayers are confused between the EIC Table and the Tax Table.

RECOMMENDATION:

Section 32(f) currently requires that the EIC Table have income brackets not greater than $50 each. Form 1040 instructions currently include two pages of the EIC Table with $50 brackets, resulting in earned income credit intervals of $3–$8. Congress should amend section 32(f) to allow wider brackets which result in greater than $3 earned income credit intervals. This will reduce the EIC Table to half a page and will minimize the overwhelming nature of the table, and, hopefully, facilitate ease of use.

RECOMMENDATION:

We suggest an even bolder alternative—eliminate the EIC Table completely, and instead provide a credit equal to a certain percent (i.e., 10 percent) of earned income. This option could be modified to provide for a few percentage levels (i.e., 30% if earning less than $8,000, 25% if earning between $8,000 and $16,000, and 20% if earning between $16,000 and $24,000). This would approximate the average credit currently allowed—$900 if earning $3,000 (with 2 qualifying children), $2,500 if earning $10,000 (with 2 qualifying children), and $2,000 if earning $20,000 (with 2 qualifying children), and would be much easier to calculate. This would be much simpler and would save space in the instruction booklets and ease much of the confusion. The rates could be written directly onto the EITC line of the Form 1040. This, combined with a changes in the "earned income" definition and AGI limitation should make the worksheets, checklists, and tables a thing of the past.

OTHER REFORMS TO THE SYSTEM

Lastly, in reviewing comprehensive reform of benefits and tax reform, in general, Congress should consider the problems and complexities for low-earning Americans illustrated above. Some of the reforms listed below have been suggested as a potential solution to the EITC problems.

- Use the EITC to eliminate the regressivity of the social security tax, by setting the refundable credit at the current social security tax rate (7.65 percent). The FICA tax regressivity results because the first dollar earned is taxed for FICA purposes, while income (for 1994) generally up to: $11,250—married filing jointly, $8,050—head of household, $6,250—single, and $2,450—married filing separately is exempt from the progressive income tax. This option would permit all taxpayers with "earned income" to claim this credit regardless of their age, filing status or dependency status.
- Limit the EITC benefit to no more than 15.3 percent (the current self-employment rate) of any self employment income reported. This would address the fraud and overreporting problems involved with self-employment income.
- Exempt the first $X of taxable earned income from the employee's share of social security tax and from ° of the self-employment tax. (This tax could be administered by adjusting social security withholding and by amending Schedule SE). Exempting low-income individuals from FICA (social security and Medicare) taxes would directly address (with no paperwork) what the EITC was intended to do—mitigate the regressivity of the FICA taxes.

CONCLUSION

In conclusion, we have identified quite a few areas that need simplification and proposed various means to achieve it. We support measures to eliminate the current EITC problems so that those who legally qualify for the EITC receive it and can claim the benefits in a simplified and easy process.

APPENDIX—SUGGESTED ADMINISTRATIVE (IRS) CHANGES TO THE EITC CLAIMING PROCESS

1. EITC Line of Form 1040 Should be in the Credits Section of the Form.

Even if the taxpayer is not allowed to claim the credit, the taxpayer must go through many procedures to find out if he/she is ineligible, and then write "NO" on line 56. Line 56 is not even in the section of the Form 1040 dealing with credits; it is in the section of the Form 1040 dealing with payments. The current placement of the EITC line on the tax return could be confusing to taxpayers (although it is in bold). Therefore, we suggest the EITC line be moved to the credit section of the Form 1040.

2. The IRS Calculation Option Should be Presented at the Beginning of the Checklist and Instructions.

IRS currently offers to calculate the EITC for taxpayers, but it mentions the option rather late in the process and requires the taxpayer to supply additional information on a separate schedule. The IRS calculation option is mentioned on the last line of the checklist, which reads "If you want the IRS to figure it for you, enter 'EIC'" on the appropriate line on the appropriate type of Form 1040. IRS should encourage more taxpayers to use this option and should consider mentioning this option at the top of the checklist and instructions.

3. All Information Required for the Credit Should be on the Form 1040—Schedule EIC and the Dependency Exemption Information Should be Combined on the Form 1040.

The Form 1040 should provide sufficient information for the IRS to determine if a taxpayer legitimately qualifies for the EITC. The IRS should inform legitimate eligible taxpayers of the correct credit amount. The taxpayer should not have to take the currently required additional steps of reading the instructions and completing the checklist, worksheet, and Schedule EIC.

We agree with GAO's Sept. 1993 report, Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved, that stated,"most of the necessary information could be included on the tax return itself. With minor modifications to the dependency and filing status sections of the Form 1040 or 1040A, all the requisite information (the already required child's name, social security number, relationship to taxpayer, and number of months lived with taxpayer, as well as the age and student/disability status of the child) would be available to determine whether a child qualified * * *. We believe taxpayer simplification can be better achieved by the elimination of the separate EIC Schedule; the separate two-page schedule is an additional obstacle for very low-income tax filers." We, therefore, support elimination of the current separate Schedule EIC that merely covers repetitive information, and suggest the necessary information be combined into the existing Form 1040 exemption section, as shown on page 64 of the GAO report. This issue would disappear if a legislative change is made (as we proposed) so that the distinction in number of children is pursued through the dependency exemption.

We also suggest an even easier modification to the Form 1040. The only additional pieces of information (not currently required on the Form 1040) that are requested on the Schedule EIC are: (1) if the child was older than 18—whether the child was a student under age 24 or permanently/totally disabled, and (2) the child's year of birth. The year of birth could easily take the place of column 2 on line 6c, where the IRS currently asks the taxpayer to check if under age 1. The information in (1) could also be included and coded on line 6c (i.e., next to the age, put an'S if a student and/or D if disabled). If the legislative change we proposed concerning the definition of "eligible child" and dependent is not made, the taxpayer also could put an "E" on line 6c to indicate that the child is an "eligible child" for the EITC. The Form 1040 would then include all the information currently requested on the Schedule EIC.

4. All Responses on the Checklist Should Consistently Direct the Taxpayer.

The current locations and responses are confusing to taxpayers and should be switched. Checklist question number 5 should be worded in such a way that a YES response is positive and a NO response results in the taxpayer not qualifying for the credit (similar to all the other seven questions on the checklist). Accordingly, the YES and NO box locations to question number 5 should be switched too.

5. The Worksheet Should be Incorporated in the Schedule EIC.

If the credit remains as complex as it is right now, instead of a worksheet calculation, the EITC should be calculated on an IRS designed schedule which is attached

to the tax return. The Schedule EIC could be modified for this purpose to include the actual computations rather than mere taxpayer identification information. The IRS also could better monitor the credit amounts and if fraud or abuse is involved. It does not make sense for the taxpayer to first complete a checklist, then be directed to the worksheet, then complete the informational Schedule EIC, and then enter the credit from the worksheet onto the tax return. The IRS never sees the worksheet and, therefore, cannot see where the taxpayer made a mistake in the calculation and if it was intentional or not.

6. The Description of Items Subtracted from "Earned Income" Should be Stated Similarly in All IRS Publications.

All IRS publications should clearly state the same definition and explanation of earned income. Specifically, IRS Publication 596 currently includes a detailed list of items to subtract from earned income, while the worksheet and instructions do not contain this list. The worksheet and instructions should include this list. Taxpayers may inadvertently include these items as "earned income." Specifically, according to Publication 596, the various forms of income that are not included in the earned income calculation (and are not subtracted on the worksheet) are not included in line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). Our legislative recommendation to define "earned income" as taxable wages (line 7 of the Form 1040) and self-employment income (line 12 of Form 1040) would greatly simplify this problem.

7. The Taxpayer Should be Directed to the EIC Table Only Once.

Rather than sending the taxpayer to the EIC Table twice (once for earned income and another time for AGI), the worksheet should direct the taxpayer to enter the smaller of the net earned income or the taxpayer's AGI, and then look up that smaller number in the table. The repetitive reference procedure is not necessary if the AGI is less than the beginning of the phase-out threshold. However, if that is the case, the taxpayer should be told to stop once the first credit amount is found in the table, before entering AGI and completing the rest of the worksheet meaninglessly.

Mr. SHAW. The hearing is now adjourned.

[Whereupon, at 1:04 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

CENTER FOR LAW AND
HUMAN SERVICES
May 23, 1997

A.L. Singleton
Chief of Staff
Ways and Means Committee
U.S. House of Representatives
1102 Longworth H.O.B.
Washington, D.C. 20515–6348

Re: 5/8/97 Hearing on IRS Study of Earned Income Tax Credit Noncompliance

Dear A.L. Singleton:

I am writing on behalf of the Center for Law and Human Services, Inc. (CLHS) to offer comments and recommendations on the IRS Study of Earned Income Tax Credit Noncompliance and the Treasury Department legislative initiative.

CLHS is a non-profit organization devoted to improving effectiveness of human service programs through legal research, training, technical assistance and advocacy. CLHS has a long history of involvement in tax issues affecting the working poor. In 1991 CLHS developed the Nation's only training package on tax benefits for foster and adoptive parents; since 1995 the organization has sponsored the Tax Counseling Project (TCP), one of the country's largest VITA projects. During the '97 filing season, TCP fielded 220 volunteers at ten sites across Illinois, and assisted more than 4,400 low income taxpayers.

The Earned Income Tax Credit is a critical source of financial support for low income workers, and its importance is growing during implementation of welfare reform. The IRS study on noncompliance is an obvious source of concern for all taxpayers. Maintaining the continued integrity of EITC requires effective remedies that will reduce noncompliance to more reasonable levels while assuring eligible persons are able to claim the credit. Unfortunately, certain legislative remedies offered by the Department of Treasury will not achieve this result. The following are comments on Treasury Department proposals:

Civil Sanctions. The recommendation that anyone fraudulently claiming EITC be ineligible for 10 years is a classic case of overkill. This sanction represents a civil penalty that could exceed $36,000 (A taxpayer who fraudulently claimed the maximum EITC benefit in the '97 tax year, $3,648, would be subject to potential loss exceeding $36,000 over 10 years, if the taxpayer qualified for maximum benefits in those years). While no one can argue that a fraudulent EITC claim should go unpunished, no documentation has been offered that the current civil and criminal sanctions are inadequate. Current law authorizes a civil penalty for fraud of 75% of the amount received. Therefore an individual who fraudulently claimed the maximum EITC benefit for the '97 tax year, $3,648, would be subject to an penalty of $2,736.

The proposed sanction, two years ineligibility, for "negligently" claiming EITC represents a potential civil penalty of more than $7,200. Comparison to current civil penalties also raises troubling concerns about fairness. A taxpayer who "negligently" claimed an EITC refund of $3,648 for '97 tax year would be subject to a civil penalty of 20%, or $730. The proposed sanction potentially increases by penalty by a factor of 10. Moreover, to be effective, these penalties would have to be widely publicized. The resulting chilling effect will reduce the participation rate for taxpayers who are eligible for EITC.

Verification. The most effective strategy involves prevention of EITCpayments to ineligible persons. The Treasury Department proposal regarding prior verification of claims is a step in the right direction, but it does not go far enough. This measure should not be limited to persons who have erroneously received EITC payments in a prior year. The IRS should utilize compliance data and verification of SSN's to flag categories of taxpayers with high risk of ineligibility, and require documentation for qualifying children and filing status prior to releasing refunds to these individuals. Careful attention needs to be given to assuring adequate procedural safeguards for taxpayers. The emphasis on "mathematical errors" as a basis for limiting safeguards is a cause for alarm if in fact the IRS makes a substantive decision on whether a taxpayer has adequately documented residence for a qualifying child.

VITA. Expansion of Volunteer Income Tax Assistance programs is indeed part of the solution to the EITC noncompliance problem. However, the Treasury recommendations fail to address three major weaknesses in the current VITA structure. First, there is a complete absence of funding at the federal level to support VITA programs. Staff time is essential to recruit and screen volunteers; to establish, market and manage sites; and to supervise work of volunteers.

A second limitation of the VITA programs is the narrow range of tax issues that they typically address. Almost all VITA programs decline to prepare prior year returns. Because the Tax Counseling Project in Illinois recruits accounting and tax professionals, that project has emphasized prior year returns, and about 15% of all federal returns we have completed are for prior years. Generally, VITA programs also decline to handle moderately complex returns, such as those involving self employment income. According to a SOI report for the '94 tax year, 15% of EIC claimants had self employment income. Many cannot afford the $150 or more that a competent, professional preparer would charge for such a return.

A third limitation of VITA programs is their seasonal nature. Virtually all operate only during the regular tax season. Given the likelihood of increasing correspondence between the IRS and EITC claimants, there is an additional need for year round VITA projects. The Tax Counseling Project, with support from area foundations, corporations, and the Illinois Department of Public Aid, maintains extended hours at four sites through June 30th, and we have two staff, an accountant and an attorney, available to assist taxpayers in responding to IRS correspondence throughout the year.

A small (about $3 million) appropriation currently exists to support Tax Counseling for the Elderly, with most of that funding allocated to the American Association of Retired Persons. A similar appropriation should be made to support grass roots efforts directed at creating and expanding VITA programs. These funds could be tied to a condition that matching grants be obtained by local sponsors. It is worth noting that IRS officials have not welcomed this suggestion in prior years, on the ground that the Service is not a grant making institution, and no administrative

funds were expected to be available. The IRS is not necessarily the only federal agency that could administer this funding stream. HHS could manage the funds, or a set aside in Community Development Block Grant might be an option.

Levy on Welfare Benefits. The proposal to collect EITC over-payments from welfare benefits is not a productive solution. In Illinois a mother with two children receives $377 per month in cash assistance and $315 in food stamp benefits. The total monthly income of $692 represents 62% of the federal poverty level. Reducing that family to 50% or less of the federal poverty level increases risk of harm to the children in the family, as well as risk of greater costs for child welfare and other services for the family.

Foster Children. The proposed changes in the definition of foster children have not been directly tied to any compliance data. Currently a foster child is anyone that the taxpayer care for as if he/she were the taxpayer's own child and the child lives in the taxpayer's home for the entire year. The proposal to create a new relationship test is a substantial change that raises some concerns. It appears that many caretakers of extended family arrangements that are common in low income communities could lose EITC eligibility. For example, great grandchildren, great nieces and great nephews and cousins appear to lose qualifying child status. Also, the description is unclear about implications for disabled adults who are presently qualifying children.

Finally, I want to make an urgent plea for more detailed information regarding the Noncompliance findings. I was pleased to read that Chairman Archer has requested that the Joint Committee on Taxation obtain underlying data and findings. I would urge that the Committee share with the public as much of this as is consistent with confidentiality protections.

Thank you for the opportunity to make these comments and recommendations known to the members and staff of the Ways and Means Committee. I am looking forward to reviewing and commenting on any specific legislative language that may be introduced.

Sincerely,

MICHAEL A. O'CONNOR
Executive Director

Enc.

P.S. For your general information, and not necessarily for inclusion in the record of this hearing, I am forwarding copies of the most recent annual report for the Tax Counseling Project, as well as copies of a handbook on tax benefits for foster and adoptive parents produced by CLHS.

[Attachments are being held in the Committee's files.]

Statement of Community Tax Aid, Inc.

These comments were prepared by Jeffrey S. Gold, JD, CPA, based on 28 years of volunteer work with low-income taxpayers. He is the founder and past chairman of Community Tax Aid, Inc. in New York City, the oldest public service group in accounting, which began in 1969, and co-founder and chairman of Community Tax Aid, Inc. in Washington, DC, which began in 1987. Both groups are all-volunteer and have never had paid staff. Mr. Gold served two years on IRS Commissioner Donald C. Alexander's advisory group and has testified before several Congressional committees on matters affecting low-income taxpayers.

We are concerned that, while the Earned Income Credit (EIC) is being abused to the substantial tune of billions of dollars, several of the proposed remedies are overdone to the point of being draconian. With the 1993 expansion of the maximum credit the current abuses were all but predictable—it's almost as though the credit would be killed by kindness.

From its start, the intent of the EIC was to provide relief to families with children. Yet, some of the proposals, if enacted, would harm these same children. The following discussion addresses each proposal separately.

1. DENYING EIC ELIGIBILITY.

In describing intentional abuses—as distinguished from errors (a 50–50 split according to Assistant Commissioner Ted Brown at the hearing)—nothing was said about the percentage attributed to tax-return preparers.

The majority of low-income taxpayers—those eligible for the credit—have little education and below-average literacy skills. According to the United States Department of Education, in studies spanning almost 20 years, nearly half of the adults over age 17 in our country are either illiterate or functionally illiterate. This, say the studies, means that, for example, people have difficulty reading bus schedules or following recipes.

Do we really expect them to understand tax-form instructions despite the best efforts of the very able people at the IRS forms and publications department to translate the tax laws passed by Congress into readable, usable forms and instructions? Even one half of the 300 IRS employees interviewed, noted a Ways and Means Committee member at the hearing, say that the EIC is a complex area.

Most low-income individuals rely on help to have their tax returns prepared. They simply cannot stand or understand our system and when they err, no matter how innocently, they certainly cannot withstand IRS enforcement. When a preparer gives them a completed form, they sign it. They want a refund, often as a way to pay off Christmas bills or other consumer debt. Preparers know this and many take advantage.

The commercial preparer system also works against the taxpayer much as the initial drop of a taxi meter. The hourly rate for getting in the paid preparer system, like the taxicab, is far higher than the rate for additional work beyond the basic form. Turnover is the key. Even well-intentioned preparers may not take all the time needed to get all the details needed to cope with the complex rules.

When proposing a denial of the credit, whether for two years or ten, the Office of Tax Analysis (OTA) options of April 21, do not indicate whether preparer error or fraud will be attributed to the taxpayer who signs the tax return. After all, the taxpayer ultimately is responsible for everything on it. The proposals also do not indicate who will determine what is "reckless or intentional disregard of rules or regulations" and what standards will apply. This could well vary from IRS district to IRS district as well as from agent to agent.

When due to fraud, denial of the credit for ten years would affect the child for about half of the time he or she would be a qualifying child. It would deny the substantial benefits to a family likely already at or below the poverty line. Sub-sistence would have to come from another pocket, whether government or charitable, and would likely harm the child.

If draconian measures must be invoked, let the burden fall on those who take advantage of both the taxpayer and the tax system. To suggest, as do the OTA proposals, that the severe taxpayer penalties would be "subject to review by the courts," ignores the reality that "most of them [the American poor] have been poor so long and have such a feeling of hopelessness about the enterprise of life that it is not in character for them to be aggressive, to assert claims, or to find ways to solve their problems within the framework of society's laws."—Monrad G. Paulsen in The Expanding Horizons of Legal Services.

The proposed severe penalties also ignore the prohibitive cost—in dollars and in time— of seeking relief through the courts. This "remedy" would not be a remedy at all.

2. Recertification Required for Taxpayers Ineligible for the EIC.

This proposal seems reasonable. But it does transfer a substantial part of the cost of not being able to understand the complex system from the government that enacted it, and the agency that administers it, to the low-income people affected by it—those least able to afford it. Nowhere in the proposal is the estimated cost to the IRS of recertification.

As costly as the deficiency procedures are to the IRS, allowing taxpayers only 60 days to respond is demanding. As noted earlier, the vast majority of the people affected have low literacy skills. Too often they are coping with day-to-day existence and even a letter from the IRS, as feared as the agency might be viewed, might not be opened when a more pressing matter exists.

Compare this with taxpayers who have access to, and can afford, lawyers, accountants and lobbyists to argue their case. From the May 14, 1997 Wall Street Journal Tax Column:

"Pressure grows on the IRS to waive penalties for some businesses [about the new law requiring electronic deposits of federal payroll taxes as of July 1] * * *. Lobbyists fear the electronic federal-tax payment system won't be running smoothly enough by then—and that unsuspecting companies may get hit with stiff IRS penalties."

Compare this also with the user fees—in addition to interest and penalties—imposed on taxpayers applying for installment agreements. This fee was imposed two

years ago to make up a budget shortfall first imposed on the IRS by Congress although it was rather clear to the IRS that the amounts owed by about 95 percent of the delinquents applied to unsuspecting individuals—people improperly treated as independent contractors, recipients of unemployment compensation [a withholding option has been in place since 1/1/97], and working couples who did not understand withholding and both parents claimed their children.

Only three people testified at the IRS hearings against this penalty and a few IRS employees were brave enough to go on the record against it. The $43 fee, wrote one, may be the cost of lunch in Washington but to us it's real money. To someone earning $6 an hour—more than 25 percent higher than the current $4.75 minimum hourly wage—the $43 is about a full day's net income after social security taxes. For future action, the IRS needs to be funded so it can end this fee.

3. Improve Debt Collection and Extend IRS Continuous Levy.

This is another proposal that seems draconian. The resources that would be levied typically are those of families already on the edge, or below the edge, of poverty. The penalty ultimately would be paid by the children.

4. Due Diligence Requirements for Paid Preparers.

This proposal is sound. The statement that about half of EIC claimants use a paid preparer to complete their income tax returns apparently includes only those who sign the returns. Consider also that many preparers do not sign returns and that many returns are prepared by unpaid relatives or friends who cannot cope with the complexities of the law. The proposals do not affect these unpaid preparers, apparently preferring instead to "motivate" the taxpayer by seeking out a paid preparer—regardless of the reality that a preparation fee is not in the taxpayer's budget.

5. Simplification of Foster Child Definition.

This may be simplification for the IRS but the severe restriction in the definition denies the reality of caring, extended families. We have seen enough great nieces, great nephews and cousins fit within the "qualifying child" definition after their parents or grandparents were unable to care for them. In passing, it is worth noting that in the early 1980s grandchildren were not deemed eligible for the EIC by the IRS until CTA pointed out that the statute and the committee reports both supported this construction. Needless to say, what low-income taxpayer could have afforded the services of a tax professional to challenge the original IRS interpretation?

6. Advance Payment Demonstration Projects.

As noted in item (1), many EIC recipients use the sizable credit to help pay their debts, which is one likely reason why the advance payment system has not succeeded after several years of trying. Another is fear and mistrust of the IRS and "the system" in general.

Despite the billions of dollars of fraud in claiming the EIC, the vast majority of recipients are honest and need this financial boost. Consider that if the taxpayer were later found ineligible for a credit already received—and spent—where would the money come from to repay the amount, plus interest, plus penalties to the IRS?

We agree that it would be more prudent to manage a large amount of money by receiving it throughout the year. But nearly all EIC recipients do not have even rudimentary money management skills and do not agree. For a Congress that has made much of letting the market decide, why are we continuing to spend more money on this? It would seem better to allocate the money to other projects.

7. Continue Aggressive Action to Prevent EIC Errors.

In pursuing EIC errors it is regrettable that as many as 550 full-time equivalent positions are needed. The proposal, however, does not indicate how many of these are additional resources. Nor does it account for needless pursuit of taxpayers who have proved eligibility for themselves or their qualifying child(ren) in the past.

For example, one CTA client, a single parent, had two qualifying children for 1994. One had a social security number (SSN) but the other did not and it was taking their lawyer longer than expected to secure it. This was before SSNs were required for the EIC. Not only did the Philadelphia Service Center hold the portion of the credit that applied to the child without the SSN, it held the entire credit and the amount of over withheld income tax and issued a deficiency notice.

We mailed the information the Service Center asked for, including copies of school records with the child's address so it was clearly the same as the parent's. Only a

few days before the 90-day letter expired and as we were about to file a protective claim with the Tax Court, the refund arrived.

For 1995, it was surprising to have the IRS tackle the same issue the same way. The refund did not arrive and our volunteer attorney did file a claim with the Tax Court. After a meeting with District Counsel, the matter was stipulated in the client's favor. But it took many months for the more-than-$2,000 refund check to be issued— truly a hardship for a three-person family with an income of less than $14,000.

8. IMPROVE ACCESS TO TAXPAYER ASSISTANCE.

CTA began in the same year as VITA and maintains contact with VITA although we are not a VITA program since our CPA and attorney volunteers represent clients at audits and, in a few cases, at Tax Court. As long as a client's income is within our limits—$18,000 for individuals and $25,000 for families for 1996—we also handle such situations as prior-year returns, Schedule C (self-employed) and non-resident aliens, including those that require reference to tax treaties.

VITA—and taxpayer service—does need to be encouraged with more resources, particularly within the IRS budget. But, VITA is, at best, a band-aid solution to an increasingly complex problem.

The most important suggestion to improve compliance is to slow down the frequency of tax law changes. Give people a chance to become familiar with the forms, the instruc-tions and the law. With twelve changes in the EIC alone since it was enacted in 1975, the burden on those it is intended to benefit is too great.

[Attachments are being held in the Committee's files.]

Statement of Nina E. Olson, Executive Director, Community Tax Law Project

Thank you, Mr. Chairman and members of the Committee, for providing the opportunity for comment upon the matter of Earned Income Tax Credit compliance. I am writing as the Executive Director of The Community Tax Law Project (CTLP), a 501(c)(3) organization providing pro bono legal representation to low income Virginia residents in tax disputes. CTLP provides this representation through a panel of volunteer attorneys (and accountants) and an in-house staff attorney.

The Community Tax Law Project receives referrals form local social service agencies, legal aid societies, homeless shelters, churches, agencies on aging and other community service organizations throughout Virginia. In January, 1996, CTLP entered into an agreement with the United States Tax Court whereby letters advising pro se petitioners about our services are included in trial notices for the Richmond and Roanoke Tax Court calendars.

As CTLP's executive director and staff attorney, I have gained some insight into the difficulties experienced by taxpayers claiming the Earned Income Tax Credit (EITC), head-of-household status and dependency exemptions. While I do not deny that there is an element of fraud among EITC claims, based on my professional experience, I believe that the majority of EITC errors are not attributable to fraud or neglect but simply to a reasonable misunderstanding of a very complex statute as well as to that statute's counter-intuitive interaction with other provisions such as the dependency exemption rules.

In this statement today, I will limit my remarks to the procedural and administrative implications of the IRS 1994 EITC Compliance Study. At the outset, it is interesting to note that the study itself does not identify what percentage of overclaims are attributable to fraud (as opposed to error) nor does it identify what category of household is responsible for the most overclaims. We are not told of the reasons for the errors. For example, did many people claim children in multi-generational households, where the person with the highest income is the only taxpayer entitled to claim the credit? This rule is an obscure, complicated requirement and conducive to honest mistakes. With over 50% of EITC returns prepared by tax return preparers, shouldn't we know how many of the errors occurred on such returns? Without this information, the Administration's proposals for 10-year and 2-year EITC restrictions appear heavy-handed. The Internal Revenue Code contains ample provisions for prosecuting taxpayer fraud; any "automatic" fraud penalties will lead to greater taxpayer alienation and noncompliance. Further inquiry may confirm that compliance efforts should focus on preparers rather than on the taxpayers themselves.

During the last two weeks of this year's tax filing system, my organization received five calls from taxpayers who were denied electronic refunds because someone else claimed their children as dependents and as qualifying children for EITC purposes. Based on these interviews, CTLP determined that these callers were in fact entitled to the EITC, but that the noncustodial parent of the children managed to file electronically and claim the children first. The taxpayers were advised to send their return to the Service by mail with supporting documentation and a cover letter explaining the circumstances. We all know this issue will take months to resolve during which the eligible household will not receive the intended benefit of the EITC. Further, it highly likely that the government will never recover the EITC erroneously paid to first filer.

Of the last year's United States Tax Court dockets in Richmond and Roanoke, Virginia, I personally entered an appearance in or otherwise directly counselled five cases in which the EITC was at issue. Each of these cases were resolved in favor of the taxpayer. Somehow they made it through all IRS administrative review levels without an accurate ruling on their eligibility. On the collection side I see numerous pre-1994 cases of people who are denied the EITC. Some are eligible, some are ineligible. All of the ineligible cases are the result of inadvertent error or reasonable mistake. As the Treasury report shows, approximately 88% of 1994 EITC recipients had adjusted gross income of under $20,000. The ineligible taxpayers will most likely be placed in "currently not collectible" collection status; their credit will be permanently damaged as a result of the filing of a federal tax lien. Surely this is not the intended result of this benefit program.

There are many sources of taxpayer confusion, but one stands out above the rest. With increased child support enforcement measures, many non-custodial parents in this income category are now paying support for their children. Because of the confusion between the dependency exemption "support" requirement and the EITC "residence/maintaining household" requirements, it is understandable (and predictable) that errors occur. A major source of the problem rests with return preparers who fail to adequately question their clients as to the circumstances surrounding the dependent/EITC claims. Many preparers receive referrals from taxpayers who receive large refunds and thus have an incentive to not question clients too closely. A few preparers are downright unscrupulous and criminal; we should remember that while the government is injured by these people, it is the taxpayer/client who is the true victim here.

Imagine a preparer dialogue with a client who is a noncustodial parent paying child support.

Preparer: Do you have children?

Taxpayer: Yes.

Preparer: Do you support your children?

Taxpayer: Yes.

Neither of these answers are false statements. If the preparer fills out a tax return claiming dependency exemptions and the EITC, where is the taxpayer fraud in this return? The taxpayer is relying on a paid professional to correctly prepare his return. And yet, the taxpayer is the one who will have the full weight of the IRS collections efforts thrown upon him.

Last week, I received a phone call from an attorney on the Eastern Shore of Virginia. This attorney's client is a legal resident alien who supports his children living in Mexico. He is entitled to a dependency exemption for these children. The client had his return prepared by someone who set up shop in the community of migrant workers. The client told the preparer about his children and also told the preparer that he had heard from fellow workers that he could not claim the EITC because his children lived in Mexico. The preparer told him "not to worry, it was all right" to claim the EITC and prepared the return accordingly. The client filed the return as prepared but became worried and contacted the attorney. The preparer had not signed the return as required.

The manner in which the Service attempts to determine the legitimacy of dependent and EITC claims is also fraught with problems. Although the notices requesting additional information list a few examples of documentation which can support the deduction, there is no clear, easy-to-read explanation of the support requirement for dependents or the "maintaining a household" requirement for qualifying child included in the notice. Since so many returns are professionally prepared, the IRS letter may be the first occasion the taxpayer has actually learned the legal requirements for the dependency exemption or the EITC. It is unreasonable to expect a surprised, upset, and intimidated taxpayer to adequately represent him-or herself before overworked and hurried Service employees, especially where the taxpayer has no idea of what he or she needs to prove.

Today I received a call from a woman who claimed her deceased sister's children as dependents and qualifying children. They were living with her during the tax years under audit. The children each received social security as minor dependent children. During the office audit, the agent never explained to the taxpayer that she had to prove that she contributed more than the social security received by the children. When the taxpayer offered evidence of her purchase of a car for her 16-year old nephew, the agent called her a "liar" and told the taxpayer that with her income no bank would ever loan her money. (This despite the loan documents and payment book offered as proof.) This same agent asked the taxpayer how much her niece spent on sanitary napkins. The taxpayer told me that she never imagined she would have to justify to her government the cost of feminine hygiene. Such taxpayer contacts are not conducive to taxpayer compliance. Nor do they help discover the truth about the entitlement to deductions and credits. They only make the taxpayer defensive. Needless to say, we are appealing the revenue agent's report.

It is highly likely that EITC and dependency exemption errors occur most frequently in divided households. We must remember that among the lower middle class and the working poor, many do not have the benefit of counsel at the time of separation or divorce. Divided families in the middle and upper classes often work out such issues as dependency and custody during a separation or property settlement agreement and are instructed by counsel as to the rules for claiming the dependent care credit, head of household status and the like. Because the dependency exemption is a bargaining chip in many divorce/separation proceedings, people are more aware of the rules and the parties reach an informed agreement. These taxpayers are not relying on IRS brochures for their tax information—they rely on their counsel or their tax advisors. In effect, the Treasury's proposed EITC compliance measures would punish people because they cannot afford counsel or other professional advice.

As stated earlier, I believe that the Code today contains sufficient penalties to punish fraud. My concern is that with the compliance measures suggested by Treasury we will rope in people who have not committed fraud or negligence but who simply cannot represent themselves adequately before the Internal Revenue Service. We will lose people to the underground cash economy and further alienate people from their government. These measures will undermine the increased compliance efforts that my organization and others like it are trying so hard to accomplish.

How can we solve these problems? How can we get at the cause of error in EITC reporting and the related problems with multiple claiming of dependents and household status? Certainly the Administration's proposals to make the dependent and qualifying child tests more congruent will reduce inadvertent mistakes. Better publicity and readable explanations of current law will also help. (CTLP targets all of its materials to a second grade and fifth grade reading level.) The following suggestions will also have a positive impact on the error rate as well as targeting unscrupulous preparers.

- When the Service sends a taxpayer a request for additional information about his/her entitlement to the dependency exemption or EITC, it should include a graphically attractive, easy-to-read, simple brochure describing the dependent/EITC requirements and listing examples of documentation that might prove these requirements. A computer-generated letter just doesn't cut it. The information form should be designed with input from nonprofit tax groups who actually serve the target taxpayer population, including groups working with newcomers to the United States.
- Even the most honest and careful return preparer will forget on occasion to ask if a taxpayer has custody of his children or provides the majority support for the child. Certain unscrupulous preparers enhance their business by purposely failing to ask these questions. A professionally prepared return should include a certification by the preparer and the taxpayer, under penalties of perjury, that the preparer has asked a series of questions, listed on the form, designed to avoid the most common errors. Failure to include this certification in the return will result in a penalty against the preparer (unless the preparer can show that he gave the form to the taxpayer and the taxpayer did not include it with the return).

This form will not only deter certain "preparers" from committing fraud but it will also help honest taxpayers accurately prepare returns. The minor inconvenience of handling another form is outweighed by the increased accuracy of returns and decrease in erroneous refund payments.

- As a matter of course, the Service should delay sending EITC refunds to taxpayers until June 1 of each year. Prior to June 1, the Service can match all social security numbers for dependent/EITC duplicates. If any matches arise, the Service should send a notice to both taxpayers listing the social security number. This notice will request information and include the graphic brochure outlining the law and

providing examples of documentation. Proof should be required from any taxpayer claiming a duplicate SSN/qualifying child, regardless of who files first.

While this delay may have a negative impact on the electronic filing rate, it is my perception that electronic filing enables much of the EITC compliance problem (i.e., first come, first served, even if fraudulent). After the first year's shock at the delay, there will be no economic disadvantage to taxpayers—they will receive their EITC refund the same time each subsequent year.

• Where the "delayed refund" procedure flags returns and taxpayers do not respond, the Service can deny the EITC and flag the taxpayer's account. A legible notice should be sent to the taxpayer explaining the refund procedures for claiming the denied EITC. (Again, this notice should be designed with advice from taxpayer service groups.) If the taxpayer claims the EITC in a subsequent year, the claim can be checked by the customary questionnaire; if it is determined that the taxpayer has acted negligently or in reckless disregard of the tax laws in the subsequent year, the civil fraud penalty (where applicable) or a new fine could be levied, designed to cover the administrative cost of compliance checking.

• The Service should "promote" qualified nonprofit taxpayer assistance groups which provide taxpayers with pro bono representation. Taxpayers represented by trained professionals always fare better than pro se taxpayers. These organizations have greater credibility with taxpayers than does the Service and they can often place the taxpayer on the road to continued compliance. Inserts like those utilized in Tax Court trial notices and posters at IRS walk-in offices are simple promotional devices that do not require IRS personnel to unnecessarily inquire into a taxpayer's financial circumstances.

Although all of these methods put some burden on the Service to accomplish some fact-finding, it is the least we can offer our lower income taxpayers. Our first goal should be continued compliance. Punishment is necessary only in the egregious cases.

Ultimately, the manner in which Congress and the Service addresses EITC fraud is a taxpayer fairness and access to justice issue. If we decide to deal harshly and automatically with underrepresented taxpayers, let no one be surprised at the lack of compliance in other tax responsibilities or of respect for government's functions. Low income taxpayers, i.e., the EITC population, must be granted respect and due process within the tax system. The EITC program can be altered to provide law-abiding low income taxpayers with information and assistance, under the assumption that they intend to comply with the law. Until Congress and the Service do a better job at simplifying these complex provisions of law, taxpayers should not be faulted or unduly punished for being confused.

The Earned Income Tax Credit is a valuable work incentive that is directly delivered to taxpayers without government intervention. Given the complexity of its requirements, additional error checking devices should be established. These measures must be designed with the characteristics of the EITC population in mind—they should not be unduly harsh but instead distinguish between reasonable error on the one hand and fraud and negligence on the other.

Thank you for your interest and attention to these matters impacting low income taxpayers. I would be happy to answer questions you might have about EITC compliance and proposed reforms.

Statement of Judy VandeZandschulp, EA, President, Iowa Society of Enrolled Agents on behalf of the National Association of Enrolled Agents

Mr. Chairman and members of the Ways & Means Committee, my name is Judy VandeZandschulp, EA. I am an Enrolled Agent in private practice in Sioux City, Iowa. I am submitting these written comment on behalf of the more than 9,500 members of the National Association of Enrolled Agents.

As you know, Enrolled Agents are licensed by the Treasury to represent taxpayers before the Internal Revenue Service. Enrolled Agents were created by legislation signed into law by President Chester Arthur in 1884 to remedy problems arising from claims brought to the Treasury after the Civil War. We represent taxpayers at all administrative levels of the IRS. Since we collectively work with millions of taxpayers and small businesses each year, Enrolled Agents are truly at the front lines of tax administration.

PROBLEMS WITH THE EARNED INCOME TAX CREDIT

I would like to make three points with respect to the Earned Income Tax Credit.

First and foremost, the concept and theory behind the EITC is essentially sound. The idea, that we as a nation wish to help low-income individuals who have children living with them and who are working, is definitely worthwhile and deserving of our support. By providing the Earned Income Tax Credit, which offsets part of the cost of Social Security taxes, we are aiding those families by supplementing their income. Often it makes the difference in whether those families need welfare assistance.

Second, the Earned Income Tax Credit, as it is written and administered today, is unfair in how it is calculated. Let me provide you with some very typical examples: Take two single women, each with one child. Both women earn $12,000 in wages from their jobs. One woman receives $1,000 a month in tax-free child support, and the other woman receives none, yet they both receive the same amount of earned income credit. A similar situation takes place with respect to Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) payments which are also not considered when computing the Earned Income Tax Credit. All untaxed income, including child support, AFDC, or SSI payments, should be considered in arriving at the Earned Income Tax Credit. Another problem occurs when couples live together or any other adult earning incomes lives with the candidate for the EITC. Consider the situation where parents allow their unmarried daughter with children to live with them and then claim they charge her rent in an effort to make their daughter eligible for head of household status and the EITC.

Third, we are undermining marriage and family formation with our tax policy. If I may provide you with another very typical example: A single woman with one child makes $15,000 per year and lives with her boyfriend who also makes $15,000 per year. Together, their income exceeds the threshold for the EITC. However, as long as the woman can claim that she is paying the costs of the household, she is eligible for the EITC (based on her income alone). If she and her boyfriend marry, their dual income exceeds the threshold for the EITC. She will lose her head of household status and the EITC, and they will pay substantially more in income taxes. I have attached a spreadsheet to demonstrate precisely this situation. My colleagues and I see many taxpayers coming in with this sort of living arrangement. Many couples do not marry rather than lose their tax benefits. Our system actually encourages them to live together rather than marry.

RECOMMENDATIONS

We would like to offer several suggestions for ways in which the Earned Income Tax Credit can be reworked and improved. We would note that there is always tension between simplicity and fairness. Often, to achieve fairness, some amount of complexity must be accepted. In this instance, we believe a little more complexity is needed so that fairness may be achieved.

1. The Earned Income Tax Credit should not be received with the income tax refund. It should be calculated and handled much like the way Minnesota used to do its property tax credit. An additional form, much like the 1040X (amended tax return), needs to be created. The form needs to be totally separate from the tax return and needs to be signed by the taxpayer. On the original tax return, taxpayers would only be able to receive their overwithholding of federal income taxes as a tax refund.

2. The EITC form should be filed at the same time as the tax return, but the credit should not be paid out until after the filing season has passed. Congress could select a date—perhaps August 31—at which time all EITC refunds would be mailed out.

3. The EITC form should be revised to include a thorough determination of the taxpayer's eligibility. The definition of head of household should be clarified, or eliminated, to equalize the single and married statuses. Two single people in the same household should equal a married household status, a dependency exemption could only be used on one return, just as it is now.

The EITC form should contain a series of questions to determine eligibility for the credit. The form could ask questions such as:

(A) How long have you resided at your current address?

(B) Do your children reside with you all year, part of the year?

(C) If your children did not reside with you all year, please provide names, addresses and social security numbers of any other parties they lived with.

(D) Do you receive child support, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI)? How much do you receive from each?

(E) Are you responsible for all the costs of the household in which you and your children live?

(F) Do any other adults reside at your address at any part of the year? If so, please provide their names, social security numbers, and any other addresses they may have had this year. Also, please provide income information on the other adults who have resided with you for any part of the year.

The list of questions should be long enough and detailed enough to address the real issues surrounding EITC eligibility. If done correctly, the individual who is answering these questions will come to understand the basis for this eligibility and will be less likely to enter a false claim for the EITC.

4. Slow down the refund and do not make it part of electronic filing. The abuse is so significant in part because of how fast and easy it is to receive the money and in part because of how simple the current EITC form is to add to the tax return.

5. Mailing the refunds after tax season would allow the IRS the opportunity to verify the information.

6. Finally, IRS would need to educate the public on the changes and why they are necessary.

PENALTIES FOR TAX PREPARERS

The U.S. Department of the Treasury has recently proposed initiatives to curb abuses of the EITC. One proposal would levy stiff penalties on preparers who do not use "due diligence." We would comment that policing the Earned Income Tax Credit should not be solely the responsibility of the practitioners. Most practitioners strive to provide accurate tax returns. If we see the same clients each year, we know their circumstances with a fair degree of certainty. However, in the case of new clients, we often must take their word for their situation. We would therefore suggest that IRS provide some definition of "due diligence" with perhaps a checklist or guidelines and that taxpayers be held accountable for the information they provide to the preparer, perhaps through the revised EITC form as suggested above, which the taxpayer would sign. These steps would go a long way toward helping both taxpayers and practitioners in understanding and achieving accuracy in determination of EITC eligibility.

CONCLUSION

As Enrolled Agents who are actively participating in administering our nation's tax laws, we are very pleased to have this opportunity to share our views with the Committee. We hope that our recommendations will be seriously studied in order to assure the continuation of the Earned Income Tax Credit and the confidence of the American taxpayer in the fairness of our tax system.

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