

GAO

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FEDERAL TAXES

Information on Payroll
Taxes and Earned Income
Tax Credit Noncompliance

Statement of Michael Brostek
Director, Tax Issues



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Accountability * Integrity * Reliability

Federal Taxes: Information on Payroll Taxes and Earned Income Tax Credit Noncompliance

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I am pleased to join you today as you address a number of tax issues. You asked that I cover two areas of taxation: (1) how payroll taxes fund Social Security and the Medicare Hospital Insurance programs and (2) noncompliance associated with the Earned Income Tax Credit (EITC) and efforts to deal with that noncompliance. My testimony is based primarily on work we have done in the past. I will summarize my main points and then cover the two tax issues in greater detail.

Payroll taxes are so named because they represent taxes imposed on wages. They provide the funding for the Social Security program—including both Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI)—and for the Hospital Insurance (HI) portion of Medicare—referred to as part A. These taxes are paid in equal portions by employees and their employers—and have on occasion been called “contributions” since they are to be used to fund these social insurance programs. Once workers have paid taxes and worked sufficient time in covered employment, they and their families are considered to have earned the right to future benefits. Social Security benefit payments are calculated based on a formula that replaces a larger portion of wages for low wage earners than for higher wage earners. Hospital insurance benefits do not vary on the basis of individuals’ wage histories; any benefits paid depend on the health situation of covered workers. As we have reported in the past, demographic trends indicate that these

programs will impose an increasing burden on the federal budget and the overall economy in the future.

The EITC is a refundable tax credit established by Congress in 1975. The EITC offsets much of the impact of Social Security taxes paid by low-income workers and is intended to encourage low-income persons to seek work rather than welfare. There are significant compliance problems associated with the EITC that have led to our listing the Internal Revenue Service's (IRS) administration of the credit among the high risk areas for the federal government. Congress and IRS have taken various steps to reduce EITC noncompliance, and, as a result, IRS has denied about \$1.5 billion in erroneous EITC claims over the past 2 years. However, information is not yet available with which to determine whether those steps have been effective in reducing the overall rate of noncompliance associated with the credit. IRS has also not reported any data on the extent to which EITC overclaims were due to taxpayer errors, which may flow at least in part from the complex provisions of the credit, or from fraud.

Payroll Tax Financing of Social Security and Medicare Benefits

Payroll taxes are the main source of financing for Social Security—which includes OASI and DI—and for the HI program in Medicare—also referred to as Medicare part A. The payroll taxes for these programs are levied on wages and on the net self-employment

income of workers under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA).¹

Although Social Security is often discussed as a retirement program, Social Security (OASDI) is a social insurance program that provides cash payments to persons or families to replace income lost through retirement, death, or disability. Workers make “contributions” in the form of payroll taxes that are then credited by the Treasury to the Social Security trust funds. Once individuals have worked a sufficient time to qualify, they become eligible for benefits under the program.

Medicare HI is a nationwide health insurance program for the aged and certain disabled persons. It covers inpatient hospital stays, skilled nursing care, hospice, and certain home health services. Most Americans age 65 or older are entitled to Medicare on the basis of paying HI taxes on earnings during their working careers. Medicare also has a part B—Supplementary Medical Insurance—that covers physician and outpatient hospital services, diagnostic tests, and certain other medical services and supplies. Medicare part B is not funded by payroll taxes, but rather by premiums of enrollees (about 25 percent of total annual funding) and appropriations of general funds (about 75 percent of total funding).

¹ Over 95 percent of all jobs were subject to OASDI and HI payroll taxes in 1999. Several categories of workers are not subject to these taxes. For example, certain state and local government workers who participate in alternative retirement systems and federal government workers hired before 1984 may not be subject to OASDI taxes.

While both the Social Security OASDI and Medicare HI are overwhelmingly financed by payroll taxes, those trust funds receive some general revenues in the form of income taxes paid on a portion of the Social Security benefits of upper-income retirees.²

Collection of the payroll taxes that fund OASDI and Medicare HI is administered by IRS. However, because these payroll taxes are earmarked to fund specific retirement, disability, and medical benefits for which workers become eligible through their qualified employment, they are fundamentally different from income taxes, which are imposed on certain segments of the population and which are not earmarked for any specific purpose.

**Who Pays Payroll Taxes
and How?**

Under FICA, employees and their employers each pay one-half of the OASDI and HI tax, which in aggregate represents 15.3 percent of covered wages.³ The employer's portion of the payroll tax is a deductible expense for income tax purposes for employers, but the

² As is discussed later, the trust funds receive interest on their balances. The Medicare HI trust fund also receives some income from other sources, such as premiums of voluntary enrollees.

³ Most economists agree that employees bear most, if not all, of the burden of the employer's share in the form of lower wages or lower fringe benefits.

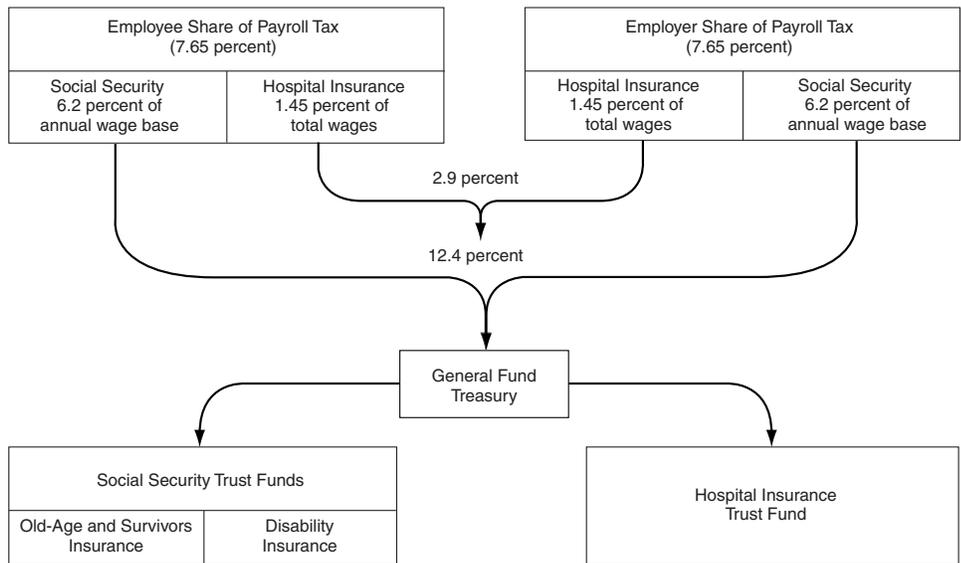
**Statement
Federal Taxes: Information on Payroll Taxes
and Earned Income Tax Credit
Noncompliance**

employee portion is not tax deductible by individuals.⁴ The OASDI tax is imposed on workers' earnings up to a maximum of \$80,400 in 2001. This "taxable wage base" is adjusted annually based on the growth of average wages in the economy. In 2001, the combined OASDI tax (employer and employee, OASI and DI) is 12.4 percent—broken down into 10.6 percent for OASI and 1.8 percent for DI. The HI tax is 2.9 percent, divided evenly between the employee and the employer. Until 1994, the wage base for HI was identical to that for OASDI. Since 1994, however, the HI tax has been imposed on all of a worker's wages and self-employment earnings. Figure 1 illustrates the flow of payroll taxes into the Social Security and Medicare trust funds.

⁴ Under SECA, the same 15.3 percent payroll tax rate is levied on self-employed persons' earnings, with the same split between OASDI and HI as occurs under FICA. For many years, the self-employed paid a lower rate than the combined employee and employer rate under FICA. Since 1990, the SECA tax structure has been designed to achieve parity between employees and the self-employed. The base of the SECA tax is adjusted downward to reflect the fact that employees do not pay the employer's portion of the tax. The adjusted base is equivalent to net self-employment earnings (up to the taxable wage base) less 7.65 percent. In addition, self-employed workers are allowed to deduct half of their SECA tax liability for income tax purposes to reflect the fact that employees do not pay income tax on the employer's portion of the FICA tax.

**Statement
Federal Taxes: Information on Payroll Taxes
and Earned Income Tax Credit
Noncompliance**

Figure 1: Distribution of Payroll Tax Funding for Social Security and Medicare



Source: GAO analysis.

**How Are Benefits
Determined?**

Although a number of specific rules apply in determining eligibility for OASI benefits, in general, workers who have earned a sufficient number of credits for time worked establish eligibility for themselves, their dependents, and their survivors. Reduced retirement benefits are available at age 62, and full benefits have been available at age 65. However, the full retirement benefit age will gradually move to age 67, beginning with persons who reached age 62 in 2000. Numerous rules are based on individuals' work histories and wages earned—but not on FICA taxes actually paid—apply in determining the specific amount of retirement benefits that will be paid to them or their survivors. Overall, while FICA taxes apply at a fixed rate, up to the maximum wage level, OASI provides greater proportional benefits to low wage earners than to higher wage earners. Table 1 illustrates that retirement payments to low

**Statement
Federal Taxes: Information on Payroll Taxes
and Earned Income Tax Credit
Noncompliance**

income wage earners replace a larger portion of their earnings than do the payments to higher wage earners.

Table 1: Social Security Replacement Rates for Entitlement Year 2000

Replacement Rates ^a		
Low earnings ^b	Average earnings ^c	Maximum earnings ^d
52.8	39.2	23.7

^aTotal monthly benefits payable for year of entitlement at full retirement income (at age 65) expressed as a percentage of earnings in the year prior to entitlement for workers with steady career incomes.

^bEarnings equal to 45 percent of the Social Security average-wage index.

^cEarnings equal to the Social Security average-wage index.

^dEarnings equal to the maximum wage taxable for Social Security purposes.

Source: Committee on Ways and Means, U.S. House of Representatives, "2000 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means," Oct. 6, 2000, p. 57.

As with retirement benefits, a number of rules apply in determining who is eligible for disability benefits. Generally, a disability is defined as the inability to engage in "substantial gainful activity" by reason of physical or mental impairment. Workers who have become fully qualified for OASI benefits and who become disabled are also generally qualified for disability benefits. Workers who become disabled before becoming fully qualified for OASI benefits may nevertheless qualify for disability benefits under certain circumstances. Payments to disabled individuals, like those to retirees, take into account personal work histories and wages earned. As with retirement benefits, lower wage earners have a larger portion of their wages replaced than do higher wage earners.

Part A Hospital Insurance (HI) benefits are automatically available to almost all persons age 65 or older through eligibility established by time spent in covered employment during their working careers. Those under 65 who are receiving Social Security disability payments also may be covered after a 24-month waiting period. Most persons needing a kidney transplant or renal dialysis may also be covered, regardless of age. Medicare payments go to those providing the covered medical service rather than to the covered individual. For certain types of medical services, patients may be required to pay deductibles or additional charges.

**How Are Payroll Taxes
Collected, Transmitted to
the Government,
Accounted for, and Used?**

Under current law, employers withhold OASDI and HI payroll taxes from employees' pay along with federal and state income taxes, if any. Both the employees' and the employers' shares of FICA taxes are deposited—along with other federal taxes—to a designated Federal Reserve bank or other authorized depository. All federal taxes are then deposited in the Treasury. Treasury credits the Social Security and HI trust funds for the applicable amounts. Neither eligibility for benefits nor the amount of benefits is based on the amount of taxes paid by an individual, and neither IRS nor the Social Security Administration (SSA) directly credits to the individual the annual and cumulative FICA taxes paid by or on behalf of each individual.

Cumulatively, the OASDI and HI taxes collected represent dedicated receipts. They are accounted for in earmarked funds: the Social

Security OASI trust fund, Social Security DI trust fund, and Medicare HI trust fund. These trust funds hold funds in the form of special nonmarketable U.S. Treasury securities that are backed by the full faith and credit of the U.S. government. They are an asset to the trust fund and a legal claim on—or an obligation of—the general fund of the Treasury. When benefits are to be paid, securities sufficient to fund those benefits are redeemed, and benefits are paid by the Treasury.

Virtually since their creation, Social Security and Medicare HI have been funded on a “pay-as-you-go” basis in the sense that taxes collected from current workers are used to pay benefits to current beneficiaries. Because it is important that the trust funds always have sufficient balances to cover required payments, some reserves are necessary. These reserves—that is, the excess of current receipts over current benefit payments—have been lent to the Treasury. The proceeds to the Treasury are used either to meet other general government expenditures or to pay down debt held by the public. In a time of budget deficits, borrowing from these trust funds serves to reduce the need for the government to borrow from the public. In a time of budget surplus, borrowing from the trust funds can generate cash to pay down debt held by the public. The trust funds earn interest on the funds lent to the Treasury. This interest is paid in the form of additional Treasury securities. Until 1983, program revenues and expenses were closely matched, and the reserves were modest. After the 1983 Social Security Commission recommendations were enacted, balances grew. As a

result, interest credits have become a more important source of revenue for the OASDI trust funds.

Longer Term Outlook

As we have reported,⁵ both Social Security and Medicare face serious financing challenges. Today, taxes paid into the trust funds exceed benefits paid out. However, as more and more of the “baby boom” generation enters retirement, this will change. The combination of a larger elderly population, increased longevity, and rising health care costs will drive significant increases in health and retirement spending when the “baby boom” generation begins to retire.

Over the long term, the trust funds are not solvent. SSA projections show that, absent a change in the structure of the program, the OASDI trust funds will only be able to pay full benefits through 2037.⁶ However, as we have reported,⁷ because a trust fund’s accumulated balance does not necessarily reflect the full future cost of existing government commitments, it is not an adequate measure of the fund’s solvency or the program’s sustainability. The cash

⁵ *Long-Term Budget Issues: Moving From Balancing the Budget to Balancing Fiscal Risk* (GAO-01-385T, Feb. 6, 2001).

⁶ OASI is solvent through 2039, while DI is solvent only until 2023. After cash flows become insufficient to cover expenses, incoming payroll taxes will cover a decreasing portion of expenditures as more and more retirees enter the system.

⁷ *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions* (GAO-01-199SP January 2001).

flows for these programs will create pressure on the federal budget long before these so-called trust fund exhaustion dates.

Beginning in 2015, OASDI funds will begin to experience a negative cash flow that will escalate as time passes. HI cash deficits are projected to begin in 2009. When the cash deficits begin, the funds must redeem their securities. To obtain the cash to redeem those securities and pay benefits, the government would have to raise taxes, cut spending for other programs, increase borrowing from the public, or retire less debt (if there is a surplus)—or some combination of these. As the Comptroller General testified last month, our long-term simulations show that, absent a change in the design of Social Security and Medicare, ultimately the government would do little more than mail checks to the elderly and their healthcare providers.⁸

The EITC and Noncompliance

The EITC is a refundable tax credit established by Congress in 1975. The credit offsets the impact of Social Security taxes paid by low-income workers and encourages low-income persons to seek work rather than welfare. The EITC is available to taxpayers with and without children and depends on the nature and amount of qualifying income and on the number of children who meet age, relationship, and residency tests. The amount of EITC allowed to an individual is first applied as a payment against any income tax

⁸ GAO-01-385T.

liability of that individual. Any remaining amount is refunded to the individual. Workers can receive the credit as a lump sum payment after filing an income tax return or in advance as part of their paycheck.

Table 2 shows, for the past 3 years, the number of EITC recipients, the relatively small number of those who reported receiving an advance EITC, and the total EITC amount.

Table 2: Number and Amount of EITC Claims

EITC	Calendar year 1998	Calendar year 1999	Calendar year 2000
Total number of recipients	19.7 million	19.4 million	19.2 million
Number who reported receiving an advance EITC	216,238	185,027	169,002
EITC amount	\$29.7 billion	\$30.6 billion	\$31.2 billion

Source: IRS.

In December 1998, the Council of Economic Advisers concluded that “the EITC is one of our most successful programs for fighting poverty and encouraging work.”⁹ Among other things, the report said that the EITC had lifted 4.3 million Americans out of poverty in 1997, had reduced the number of children living in poverty that year by 2.2 million, and had increased the labor force participation of single mothers.

⁹ *Good News for Low Income Families: Expansions in the Earned Income Tax Credit and the Minimum Wage*, The Council of Economic Advisers, December 1998.

For many EITC recipients, the credit is more than enough to fully offset Social Security taxes. Most EITC recipients earn credits that exceed their income tax liabilities. The Joint Committee on Taxation has estimated that 87 percent of the credit earned in 2000 will be refunded as direct payments to taxpayers. For many of the recipients these refunds will be more than enough to offset their payroll tax burdens. For example, a head-of-household filer who has two children and earns \$15,000 in wages would have earned an EITC of \$3,396 in 2000. This amount would have exceeded her precredit income tax liability of \$24 plus her \$1,148 portion of payroll tax liability. It would also have been more than enough to offset her employer's \$1,148 share of the payroll tax, which most economists believe to be borne by the employee. However, many low-income individuals and couples, especially those without children, do not earn the EITC. Looking at all low-income taxpayers together, the Congressional Budget Office estimated that in 1999 households with cash incomes between zero and \$10,000, on average, received EITC refunds equal to 4.1 percent of their incomes. This average refunded credit was enough to offset the average payroll tax liability of these households, but it would not have completely offset the burden of the employer's portion of the payroll tax. The average refunded credit for households with cash incomes between \$10,000 and \$20,000 typically would not have been sufficient to offset any of the employer's share of the payroll tax and only a portion of the employee's share for those households.

EITC Noncompliance

Since 1995, we have identified EITC noncompliance as one of the high-risk areas within IRS because such noncompliance exposes the federal government to billions of dollars of risk through overpayments of the EITC.¹⁰ Although IRS has estimated that billions of dollars have been overpaid to EITC recipients, it has not reported on the portions of noncompliance that may be due to unintentional errors, perhaps attributable at least in part to the complexity of the EITC, or to fraudulent efforts to obtain the credit.

In April 1997 and September 2000, respectively, IRS reported on the results of two EITC compliance studies—the first involving tax year 1994 EITC claims accepted by IRS between January 15 and April 21, 1995,¹¹ and the second involving tax year 1997 claims processed by IRS between January 20 and May 29, 1998.¹² Although changes in IRS' study methodology as well as legislative changes between 1994 and 1997 made the results of the two studies noncomparable, both studies documented a significant amount of EITC noncompliance.¹³

¹⁰We had identified IRS tax filing fraud as the high risk area until this year, when we renamed the high-risk area “noncompliance with the EITC” to better reflect the focus of our current concern—billions of dollars for EITC claims that IRS paid but should not have.

¹¹ *Study of EITC Filers for Tax Year 1994*, IRS, April 1997.

¹² *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns*, IRS, September 2000.

¹³ Both studies were designed to estimate the amount of EITC claimed erroneously. Neither study was designed to detect or quantify EITC claims that taxpayers could have made but did not.

- Of \$17.2 billion in EITC claimed during the first study period, IRS estimated that \$4.4 billion (about 26 percent) was overclaimed.
- Of \$30.3 billion in EITC claimed during the second study period, IRS estimated that \$9.3 billion (about 31 percent) was overclaimed.¹⁴

The largest source of taxpayer error identified by IRS in both studies related to EITC requirements that are difficult for IRS to verify—principally those related to eligibility of qualifying children.

Currently, to be a qualifying child, a child must (1) be the taxpayer's son, daughter, adopted child, grandchild, stepchild, or eligible foster child (i.e., meet a relationship test); (2) be under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled (i.e., meet an age test); and (3) have lived with the taxpayer in the United States for more than half the year or for the entire year if an eligible foster child (i.e., meet a residency test). Failure to meet the residency test was the most common qualifying child error identified in both studies.¹⁵

IRS' studies identified the following as other sources of EITC errors.

- Complicated living arrangements—when a child meets the rules to be a qualifying child of more than one person, the person with the higher modified adjusted gross income (AGI) is the only one who can claim the

¹⁴ In both studies, IRS also estimated the amount of overclaims that it would have caught through its enforcement programs. After netting out those estimates, the overclaim rates for 1995 and 1998 were reduced to about 24 percent and 26 percent, respectively.

¹⁵ We reported on the advance payment option in 1992; *Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public* (GAO/GGD-92-26, Feb. 19, 1992). Although information in that report is dated, it did indicate that there were potential compliance problems associated with the advance payment option. Many individuals who received the advance payment did not report that receipt on their tax return, thus setting up the possibility that they could receive the credit again as a lump sum payment.

EITC using that child.¹⁶ The person with the lower modified AGI cannot use that child to claim the EITC even if the other person does not claim the EITC. This rule does not apply if the other person is the taxpayer's spouse and they file a joint return.

- Misreporting of filing status—these errors involved married taxpayers filing as single or head of household when they should have filed as married filing separately. Persons who file as married filing separately are not eligible to claim the EITC.
- Income misreporting—these errors included misreporting of earned income and underreporting of investment income.

EITC “noncompliance” as identified in IRS’ studies and as referred to in this testimony includes errors caused by mistakes—possibly due to the complexity of the EITC—or an intent to defraud. Both of these potential sources of error have been of concern to IRS and others. Some analysts consider the EITC to be a complex tax provision that challenges those applying for it to properly understand and follow the qualifying rules. On the other hand, the credit’s possible susceptibility to fraud has also been a concern to Congress and IRS for many years. Although being able to differentiate between these different causes may be important in identifying appropriate corrective measures, IRS’ primary goal in conducting its compliance studies was to identify the level of overall EITC noncompliance. Determining the causes of overpayments is more challenging and costly, especially determining whether an

¹⁶ To compute their modified AGI, taxpayers have to add certain amounts, such as tax exempt interest and some other gains and losses, to their AGI. According to IRS, for most people the modified AGI is the same as the AGI.

EITC claim is fraudulent, which requires knowing the difficult-to-prove intent behind the taxpayer's actions.

IRS' reports on its two compliance studies did not discuss the extent to which EITC overclaims were due to mistakes versus fraud. However, as we discussed in a July 1998 report on IRS' first study, IRS examiners and case reviewers did make a determination of intent for almost every case involving an overclaim.¹⁷ Based on those determinations, about one-half of the returns with an EITC overclaim and two-thirds of the total amount overclaimed were considered to be the result of intentional errors. Because these assessments were judgmental and made without any specific criteria, they were considered too imprecise to be included in IRS' report. However, as we said in 1998, the results did indicate that IRS' compliance efforts should include activities aimed at taxpayers who intentionally misclaim the EITC.

Efforts to Reduce EITC Noncompliance

Concerned about the level of EITC noncompliance, Congress and IRS have taken various steps to reduce it. After the 1994 compliance study, Congress took the following steps:

- According to law, an EITC is not to be allowed unless the tax return contains the EITC-qualifying-child's Social Security number (SSN) as well as the SSNs of the taxpayer and the taxpayer's spouse, if any. Before 1997, if IRS identified a return with an invalid SSN, it had to resolve that issue

¹⁷ *Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance* (GAO/GGD-98-150, July 28, 1998).

through its normal audit procedures.¹⁸ Because those procedures are resource intensive, IRS was not able to follow up on most of the invalid SSNs identified. In 1995, for example, IRS stopped the refunds on about 3 million returns with invalid SSNs.¹⁹ However, IRS was only able to follow up with taxpayers on about 700,000 of those returns. For the other 2.3 million returns, IRS released the refunds without any follow-up. In 1996, Congress authorized IRS to treat invalid SSNs as “math errors,” similar to the way that IRS had historically handled computational mistakes. With that authority, IRS has been able to (1) automatically disallow any EITC claim associated with an invalid SSN and (2) make appropriate adjustments to any refund that the taxpayer might be claiming.

- Congress passed the Taxpayer Relief Act of 1997, which, among other things, (1) required paid tax return preparers to fulfill certain due diligence requirements when preparing EITC claims for taxpayers;²⁰ (2) provided that taxpayers who were denied the EITC as the result of an IRS audit are ineligible to receive the EITC in subsequent years unless they provide evidence of their eligibility through a recertification process; (3) gave IRS access to the Department of Health and Human Services’ (HHS) Federal Case Registry of Child Support Orders, a federal database containing state information on child support payments that could help IRS identify erroneous EITC claims by noncustodial parents; and (4) required SSA to collect SSNs of birth parents and provide IRS with information linking the parents’ and child’s SSNs.
- Congress began providing IRS with appropriated funds (about \$143 million a year) for a 5-year EITC compliance initiative beginning in fiscal year 1998.

As part of the 5-year compliance initiative and using the tools provided by Congress, IRS implemented a plan that calls for

¹⁸ IRS considers an SSN invalid if it is missing from the return or if the SSN and associated name on the return do not match data in SSA’s records.

¹⁹ These invalid SSNs were for EITC-qualifying children and dependents. How many involved the EITC is unknown.

²⁰ To demonstrate due diligence, preparers, among other things, must complete an EITC worksheet or the equivalent and must have no knowledge that any of the information used to determine the taxpayer’s eligibility for, or the amount of, the EITC is incorrect. The 1997 Act provides for a penalty of \$100 for each failure to comply.

reducing EITC noncompliance through expanded customer service and public outreach, strengthened enforcement, and enhanced research. In implementing its plan, IRS has taken several actions, with some significant results. For example:

- In 1999 and 2000, IRS identified a total of about 3.4 million “math errors” related to the EITC, about 24 percent of which involved invalid SSNs.²¹ According to IRS, it denied about \$675 million in erroneous EITC claims during fiscal years 1999 and 2000 because of EITC-related “math errors.”
- Other types of EITC noncompliance are not as easy to identify as invalid SSNs. These types of noncompliance can be detected only through an in-depth review. For the past few years, IRS has targeted for in-depth review certain types of EITC claims, such as those involving the use of a child’s SSN on multiple returns for the same year, that IRS had identified as important sources of noncompliance. Returns identified by IRS were to be audited to determine if the EITC claims were valid. During fiscal years 1999 and 2000, according to IRS, it completed more than 500,000 of these audits and identified about \$800 million in overclaims.
- In the fall of 1999, IRS began an integrated EITC education and compliance effort directed at tax return preparers. IRS designed this effort because data indicated that 62 percent of returns with EITC claims were prepared by paid preparers. IRS divided preparers into five groups based on a preparer’s filing history, with each group getting a different type of visit. Last year, for example, IRS visited about 1,000 preparers for the purpose of determining if they complied with the due diligence requirements. According to IRS, its examiners proposed penalties totaling about \$435,000 for 143 of those preparers. We do not know how, if at all, IRS’ visits resulted in improved due diligence by preparers. That question may be addressed in IRS’ report on the results of its visits, which, according to IRS, will be issued about May 1.
- IRS implemented a program to enforce the recertification requirements of the Taxpayer Relief Act of 1997. According to IRS data, (1) about 312,000 taxpayers were required to recertify after being denied the EITC for tax

²¹ Other EITC math errors include such things as errors in computing earned income and in figuring the EITC.

year 1997 and (2) about 193,000 of those taxpayer did not claim the EITC on their tax year 1998 returns. IRS sees these results as an indication that recertification has reduced the number of improper claims.²²

- IRS expanded its EITC outreach and educational efforts. For example, it developed partnerships with groups that are advocates for low-income taxpayers and with businesses and large employers who include EITC information in monthly billings or employees' pay statements. IRS also refocused its media campaign and publications toward educating the public about EITC eligibility requirements.
- IRS developed a database that can be used to help verify the accuracy of taxpayers' claimed dependents and EIC-qualifying children. It incorporates data from an assortment of sources including the HHS and SSA information provided for in the 1997 Act. According to IRS, the database is used to screen returns during processing for potential compliance issues and to select for pre-refund audits those with the highest potential. Also, according to IRS, the returns being selected are primarily ones filed by EITC claimants.

Despite these initiatives, it remains to be seen how, if at all, Congress' and IRS' efforts have succeeded in reducing the 31-percent EITC overclaim rate identified by IRS' tax year 1997 EITC compliance study. IRS is doing a study of tax year 1999 returns and plans to study tax year 2001 returns. The results of those studies, when compared to the results of the tax year 1997 study, should provide a basis for assessing the impact on overall EITC noncompliance.

²² It is also possible that some taxpayers did not reapply because they were confused about the recertification requirements. We are reviewing IRS' implementation of that program at the request of the Oversight Subcommittee of the House Committee on Ways and Means.

Although well-designed and effectively-implemented processes should help reduce EITC noncompliance, certain features of the EITC represent a trade-off between compliance and other desired goals. Unlike income transfer programs, such as Temporary Assistance for Needy Families and Food Stamps, the EITC was designed to be administered through the tax system. Accordingly, while other income transfer programs have staff who review documents and other evidence before judging applicants to be qualified to receive assistance, the EITC relies more directly on the self-reported qualifications of individuals. This approach generally should result in lower administrative costs and possibly higher participation rates for the EITC than the other assistance programs. However, EITC noncompliance may also be higher. This is especially true when eligibility depends on information that cannot be readily and rapidly verified by IRS as it processes tax returns. EITC eligibility, particularly related to qualifying children, is difficult for IRS to verify through its traditional enforcement procedures, such as matching return data to third-party information reports. Correctly applying the residency test, for example, often involves understanding complex living arrangements and child custody issues. Thoroughly verifying qualifying child eligibility basically requires IRS to audit individual tax returns, as was done in the tax year 1994 compliance study—a costly, time-consuming, and intrusive proposition.

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**Statement
Federal Taxes: Information on Payroll Taxes
and Earned Income Tax Credit
Noncompliance**

I appreciate this opportunity to appear today to provide a basic description of the payroll taxes funding Social Security and Medicare hospital insurance and to discuss what is known about EITC noncompliance. Mr. Chairman, that concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee might have.

Contact and Acknowledgements

For further information regarding this testimony, please contact Michael Brostek at (202) 512-9110. Individuals making key contributions to this testimony included David Attianese, Kenneth Bombara, Christine Bonham, Barbara Bovbjerg, Carol Henn, Susan Irving, Deborah Junod, and John Lesser.

Related GAO Products

Long-Term Budget Issues: Moving From Balancing the Budget to Balancing Fiscal Risk (GAO-01-385T, Feb. 6, 2001).

Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions (GAO-01-199SP, January 2001).

Medicare Reform: Issues Associated With General Revenue Financing (GAO/T-AIMD-00-126, Mar. 27, 2000).

Medicare Reform: Leading Proposals Lay Groundwork, While Design Decisions Lie Ahead (GAO/T-HEHS/AIMD-00-103, Feb. 24, 2000).

Social Security: Evaluating Reform Proposals (GAO/AIMD/HEHS-00-29, Nov. 4, 1999).

Social Security Reform: Implementation Issues for Individual Accounts (GAO/HEHS-99-122, June 18, 1999).

Social Security: Different Approaches for Addressing Program Solvency (GAO/HEHS-98-33, July 22, 1998).

Earned Income Tax Credit

Tax Administration: Assessment of IRS' 2000 Tax Filing Season (GAO-01-158, Dec. 22, 2000).

Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance (GAO/GGD-98-150, July 28, 1998).

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

**Statement
Federal Taxes: Information on Payroll Taxes
and Earned Income Tax Credit
Noncompliance**

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

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