EITC fraud

TESTIMONY OF
U.S. SENATOR DON NICKLES
SENATE COMMITTEE ON GOVERNMENT AFFAIRS

The Earned Income Tax Credit
April 5, 1995

MR. CHAIRMAN, I want to thank you and the ranking member for inviting me to address the Committee on Government Affairs about an out-of-control federal spending program whose faults have been too long overlooked.

Mr. Chairman, the earned income tax credit, or EITC, was enacted in 1975 to offset payroll taxes for low-income families with children and provide an incentive for work. The credit was first expanded in 1990, and it was again expanded dramatically in 1993 as part of President Clinton's tax bill. Unfortunately, what began as small work "bonus" has ballooned into a massive wealth redistribution program.

During his state of the union address in January, President Clinton called the 1993 EITC expansion a "working family tax cut".

> "We took the first step in 1993 with a working family tax cut for 15 million families with incomes under $27,000, a tax cut that this year will average about $1,000 a family." (Bill Clinton, State of the Union, January 24, 1995)

In fact, Mr. Chairman, the EITC is not a tax cut. It is the federal government's fastest growing and most fraud-prone welfare program.

As the chart I have brought with me illustrates, the EITC will cost $17 billion this year, more than twice as much as it cost in 1992. EITC growth rates for the last four years are 55%, 18%, 22%, and 55% respectively, and the program's cost continues to grow out of control into the near future, reaching $26 billion in fiscal year 2000. Amazingly enough, the EITC will in fiscal year 1996 eclipse the federal cost of Aid to Families with Dependent Children.

With regard to the EITC's original purpose of reducing the tax burden on working families, consider the following facts. Ninety-percent of the cost of the EITC is direct handout, or federal outlays paid directly to individuals who have zero income tax liability. Only ten percent of the cost of the EITC is a tax refund. Consider further that, although the EITC is supposed to encourage work, the Government Accounting Office found that the average EITC recipient worked only 1,300 hours a year, compared with a normal work year of 2,000 hours. The maximum EITC is equally available to both a fry-cook who works 2,000 hours per year at $5.00 per hour and a part-time lawyer who works 100 hours per year at $100 per hour. Finally, the President's expansion of the EITC opened the program up to taxpayers without children, a dramatic departure from the program's original purpose.

The most unsettling part of the EITC story, Mr. Chairman, brings us to the purpose of your hearings yesterday and today. Numerous studies of the EITC by the IRS, GAO, and others have revealed massive program losses due to fraud and error. It is my understanding that you, Mr. Chairman, have estimated that between 30 percent and 40 percent of all EITC benefits are lost to fraud and error, which is an amazing statistic.

The primary sources of EITC fraud are people who falsely claim they have children or understate the age of their children, people who fabricate jobs, and married couples who claim to be divorced. Studies and hearings have also revealed growing tax return preparation fraud, whereby tax preparers recruit low-income people, set-up fictitious companies to pay the recruits, and then file electronic returns claiming refunds which are split with the recruits.

Why does the EITC attract such abuse? Because the EITC offers big checks. The maximum credit for a multiple-child family is $3,114 in 1995, and although recipients can elect to collect the credit in equal paycheck installments rather than in lump sum, less than one-half of one percent choose to do so according to the GAO.

Mr. Chairman, the IRS has come under fire this year for their initiative to reduce fraud by cross-checking Social Security numbers on all returns and by running returns seeking refundable credits through computerized screening systems and holding refundable credits until the return is verified. While the delays these activities may cause law-abiding taxpayers are regrettable, I applaud the IRS for this initiative.

However in order to curb this program's massive growth, we must do more than reduce fraud and error. We must overhaul the entire program and reduce its cost.

As a member of the Senate leadership's working group on entitlements, I was asked to examine options for reducing the cost of the EITC. What I discovered was that the massive expansion of the program in 1993 must be reversed. Congress took the first step with the recent passage of the self-employed health deduction bill, which included a provision to deny EITC benefits to taxpayers with significant sources of passive income. I think we could have done even more with that provision, Mr. Chairman, to ensure that taxpayers with substantial assets do not qualify for the EITC.

I believe the EITC credit levels which Congress doubled in 1993 must be scaled back, and the top income eligibility levels of $24,394 to $26,691 must be reduced to more closely reflect need. Further, the expansion of the EITC to taxpayers without children should be repealed. Finally, we should examine other options, including proposals to fold this program into a welfare block grant to the states.

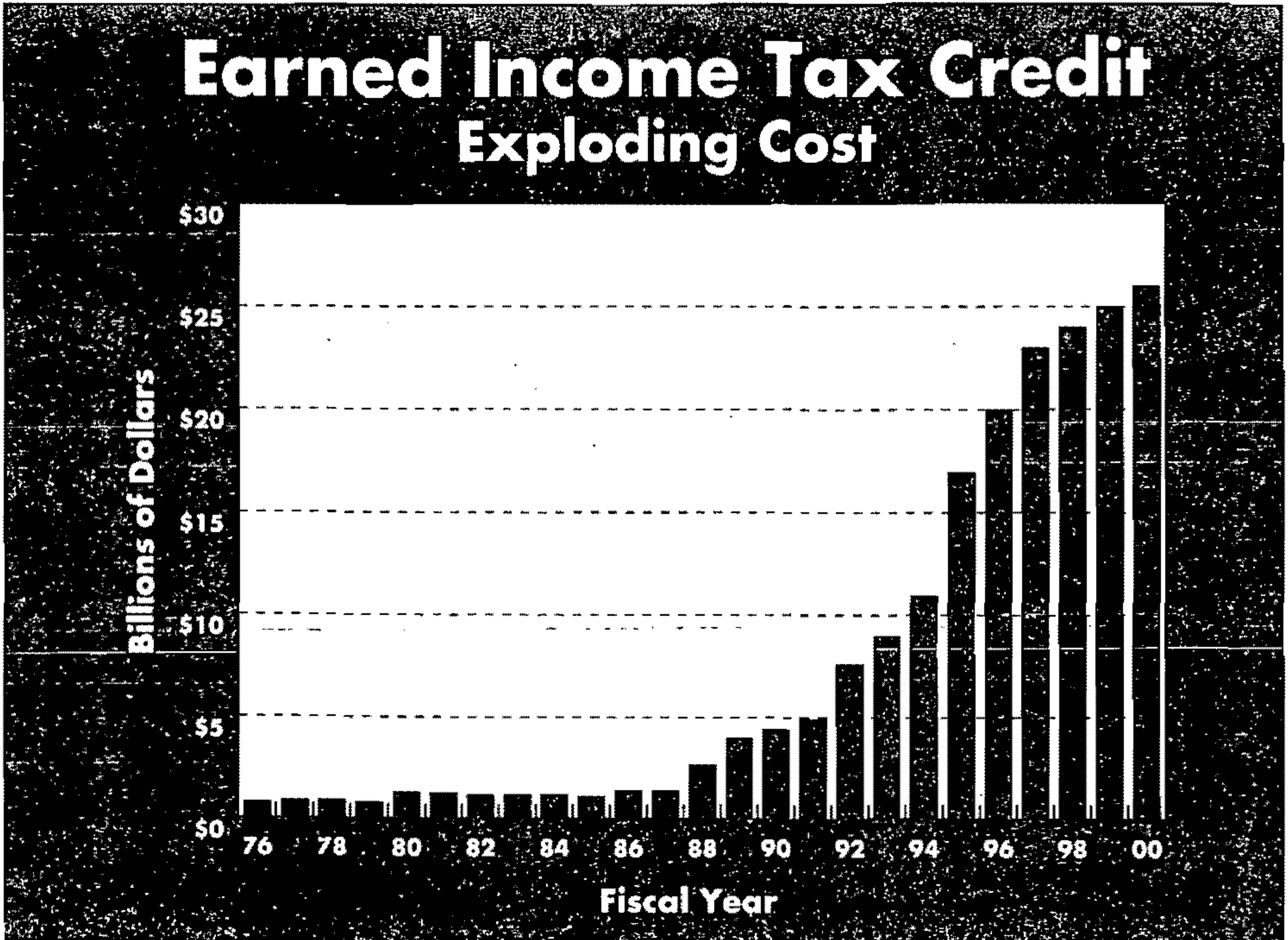
Mr. Chairman, I commend you for holding these hearings and I look forward to working with you as these issues are addressed by both the Government Affairs and Finance Committees.

EARNED INCOME TAX CREDIT

YEAR	Credit Percent	Maximum Credit	Min Income for Max Credit	Phaseout Income	Federal Cost (in billions)	% Growth
1976	10.0%	$400	$4,000	$8,000	$0.8	
1977	10.0%	$400	$4,000	$8,000	$0.9	12%
1978	10.0%	$400	$4,000	$8,000	$0.9	0%
1979	10.0%	$500	$5,000	$10,000	$0.8	-11%
1980	10.0%	$500	$5,000	$10,000	$1.3	63%
1981	10.0%	$500	$5,000	$10,000	$1.3	0%
1982	10.0%	$500	$5,000	$10,000	$1.2	-8%
1983	10.0%	$500	$5,000	$10,000	$1.2	0%
1984	10.0%	$500	$5,000	$10,000	$1.2	0%
1985	11.0%	$550	$5,000	$11,000	$1.1	-8%
1986	11.0%	$550	$5,000	$11,000	$1.4	27%
1987	14.0%	$851	$6,080	$15,432	$1.4	0%
1988	14.0%	$874	$6,240	$18,576	$2.7	93%
1989	14.0%	$910	$6,500	$19,340	$4.0	48%
1990	14.0%	$953	$6,810	$20,264	$4.4	10%
1991	17.3%	$1,235	$7,140	$21,250	$4.9	11%
1992	18.4%	$1,384	$7,520	$22,370	$7.6	55%
1993	19.5%	$1,434	$7,750	$23,050	$9.0	18%
1994	30.0%	$2,528	$8,425	$25,299	$11.0	22%
1995	36.0%	$3,114	$8,650	$26,691	$17.0	55%
1996	40.0%	$3,560	$8,900	$28,524	$20.0	18%
1997	40.0%	$3,668	$9,170	$29,387	$23.0	15%
1998	40.0%	$3,780	$9,450	$30,289	$24.0	4%
1999	40.0%	$3,900	$9,750	$31,249	$25.0	4%

Data for FY91 through FY99 for multiple-child beneficiaries.

Provided by the Office of Senator Don Nickles, 04/04/95


Earned Income Tax Credit
Exploding Cost
Billions of Dollars
$30
$25
$20
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$5
$0
76
78
80
82
84
86
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94
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98
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Fiscal Year

EITC fraud

America's Secret Welfare Scam, by Lisa Schiffren

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Lisa Schiffren

America's Best-Kept Welfare Secret

What are Republicans doing supporting the Earned Income Tax Credit, a 20-year-old, fraud-riddled giveaway that makes AFDC seem positively civilized?

In July 1993, Health and Human Services secretary Donna Shalala announced a major expansion of the Earned Income Tax Credit (EITC) program, which gives cash supplements to people who make too much money to qualify for Aid to Families with Dependent Children—or AFDC, the nation's primary welfare program. Shalala billed it as the keystone of the Clinton administration's plan to reform welfare. Her announcement came despite admissions by the Internal Revenue Service, which administers EITC, that the fraud and error rate in the program was at least 30 percent, and perhaps as high as 45 percent, adding up to $6 billion yearly.

When that ridiculous number became the subject of hearings last year in front of the House Ways and Means [IRS] Oversight Subcommittee, former secretary of the treasury Lloyd Bentsen admitted there had been little or no accountability or monitoring in the program. Clinton administration officials themselves—including Bentsen and IRS commissioner Margaret Richardson—admitted that the fraud rate might be as high as 45 percent. The GAO (General Accounting Office, Congress's main oversight arm) issued a report this past October, citing the astonishing fraud rate. In response, the administration, perhaps fearful of scandal on the eve of the election, dispatched top officials to smooth over and de-emphasize the report, even as they were making it public.

Even while a hotly contested election was underway, with government spending a key issue, the mainstream media devoted almost zero coverage to these public revelations. The only aspect of this scandal that attracted attention—and not much at that—was the revelation that illegal immigrants were eligible for EITC benefits, and hundreds of thousands of them were receiving these cash grants as a gift from American taxpayers. The media failed even to report that prisoners were eligible for it.

One can only guess that this extraordinary example of government malfeasance and lack of accountability with

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taxpayer money got no attention because the EITC is so perfectly camouflaged. The name itself is so eye-glazingly technical that when it appears in print readers pass over it without noticing, assuming that it is tax arcana and not a welfare program. That's why, after almost twenty years, only dedicated policy wonks know the program exists.

Although the EITC will surpass AFDC in cost by 1997, the low-profile program has the kind of bipartisan support that should always make taxpayers wary. It is regarded by both liberals and conservatives with the same uncritical reverence as Head Start—and, like Head Start, its great selling point seems to be that while no one can prove EITC does any long-term good, it doesn't seem to do great harm either. Democrats see it as a way to offer "income assistance" to what used to be called "the deserving poor"—those earning just enough not to qualify for welfare—without having to expand AFDC itself. Republicans like it because giving out cash in the form of exaggerated tax "refunds" to people who are already working, if only part-time, seems so much neater and less liberal than doing it through the standard welfare system.

The great claim for EITC is that the program is a way of helping the poor without undermining their work ethic; the money is a "bonus" for working, unlike AFDC, for which people only qualify by not working. Despite the fact that it has been in existence, in one form or another, for nineteen years, there have been few studies of EITC's actual effects. The most rigorous study, conducted last year at the Institute for Research on Poverty at the University of Wisconsin, indicates that EITC creates as much disincentive to work as incentive. Indeed, recipients who are already working work less when they receive this additional cash supplement.

There is no asset test for EITC. You could have a house, car, and boat and still qualify.

Even without its staggering fraud rate, the plain fact, as we shall see, is that EITC is not a refund of taxes paid, but merely a transfer program for people who are too successful to qualify for welfare. Legitimate recipients are often genuinely poor—of that there is no question. And many do work hard for not much money. But when did the American taxpaying public agree to institute a second tier of welfare? When did our leaders conduct a national debate over whether we wished to permanently subsidize all workers at the low end of the pay scale to make sure their incomes reach a guaranteed minimum level?

When we did have such a debate—during the Nixon administration—over what was then called the "guaranteed annual income," or a similar plan, the "negative income tax," these radical redistribution programs were rejected. Studies at the time showed that such programs invariably diminish the amount of work people are willing to do to support themselves.

Perhaps we wish to subsidize the working poor all the same. Perhaps the nation enthusiastically agrees with Robert Shapiro, the "new Democrat" economic guru at the Progressive Policy Institute, who says, "No American family with a full-time worker should have to live in poverty." But at a time when the nation seems to be concluding that Great Society transfer programs have created as many problems as they've solved, at tremendous and unsustainable cost, it's important that our leaders put the dozens of means-tested redistribution programs on the table for re-evaluation. When advocates argue that welfare only costs $24 billion a year, they are merely referring to AFDC. Food stamps cost another $40 billion annually. If you include all of the other programs—including EITC, Volunteer Grandparents, daycare, etc.—the stunning cost of welfare reaches the neighborhood of $350 billion a year. And we're back to the question of priorities.

Where EITC Came From

The Earned Income Tax Credit began, innocently enough, in 1976. After a particularly large jump in the Social Security payroll tax, officials worried that people with incomes near the poverty line would be driven into poverty by federal taxes. The EITC was intended to refund the Social Security (FICA) tax, and to make sure that recipients got credit as if they had paid into Social Security. In its original form, the program prevented a fairly small number of workers and their children from falling into poverty as a result of government tax policy. What could be more laudable?

That's why the program is administered by the IRS, and why EITC payments take the form of a "refundable tax credit," even though, as with so many income redistribution programs, the rationale and goals for the EITC—and, more importantly, its size—have expanded several times since the program's inception. In a paper published last November, John Karl Scholz, an economist at Wisconsin's Institute for Research on Poverty, called EITC "the cornerstone of the Clinton Administration's welfare reform agenda." By 1998, the paper pointed out, EITC is expected to cost the federal government $24.5 billion per annum; AFDC, in contrast, will cost $16 billion yearly.

EITC is not like any other tax credit you've ever heard of. Most of them reduce taxes dollar for dollar, like a grocery-store coupon. If your normal tax bill is ten dollars, and you're eligible for a two-dollar child-care credit, you simply pay eight dollars in taxes rather than ten. The catch is that you actually have to pay taxes for such a credit to do you any good.

Unlike any other tax credit—with the arcane exception of the "off-road motor fuel tax credit" (which also has an enormous fraud rate)—the EITC is a "refundable credit." If you qualify for the EITC, and you owe $5 in taxes, you might, for instance, get a $10 "refundable tax credit." With a normal credit you would simply not pay the $5 you owe.

But with a refundable credit, you pay no taxes at all, and then Uncle Sam sends you five bucks in the mail.

Since people with incomes under the poverty line do not pay federal income taxes, you can qualify for EITC without having much, or any, tax liability to begin with (besides, of course, the payroll tax). According to studies by Marvin Kosters of the American Enterprise Institute, an expert on EITC, almost 90 percent of those who receive EITC cash payments pay no federal taxes to begin with. For them, the program simply amounts to a cash bonus.

What does it take to qualify for this extra spending money? In 1994, a worker with one or more qualifying (dependent minor) children and an income up to $25,296 was eligible for some credit. The maximum credit, for a worker with two children and a salary of $11,000, was more than $2,500.

Under the generous Clinton expansion announced by Shalala, the rates of the credit will be increased by one-third by 1996. That means that, at the maximum level, EITC will give recipients roughly 40 cents for each dollar they earn. So, in 1996, a worker who earns $11,000 will get a bonus of $3,370. Workers who earn more get a smaller payment, up to an income of $27,000, at which the credit is phased out. In addition, most of these workers are also eligible for food stamps and, in many places, subsidized housing. As should be obvious, the value of benefits far exceeds restitution of the 7.5 percent tax on wages that workers contribute to Social Security.

EITC creates a disincentive to work, Scholz maintains. "People's preferences are such that as they have more income, they buy more of the things that they like, and they like leisure."

Who Gets It? Who Should?

The EITC is widely understood to be for the benefit of full-time, year-round, low-wage workers supporting families; the payments are supposed to make up the difference between their yearly income and the national poverty level. Jeff Hammond, an economist at the Progressive Policy Institute, the think tank of the Democratic Leadership Council, articulates this wishful understanding with evident sincerity. "The EITC is designed to insure that families who work year round will at least reach the poverty line," says Hammond. "It is designed to be the amount of credit equivalent that will pull your income up to the poverty level, depending on the structure of your family."

Hammond describes the target recipient as "a person who works very hard, makes the minimum wage—which doesn't get you to the poverty level if you have kids. But he's doing the right thing. He's setting a good example, even though he could go on welfare. There is a tremendous social benefit to supporting workers, and, thereby, the work ethic."

It's difficult to argue with the sentiment that says that people who work very hard to support their kids but don't make a lot of money ought to do better than people who take welfare. Surely our wealthy nation ought to make things easier for such people. (Of course, one reason work appears not to pay is that welfare is so generous.)

But while some working families fit this picture, they aren't the majority of EITC recipients. For most of them, economic hardship is traceable to predictable reasons, not random bad luck in the face of tenacity. Contrary to the claims of EITC's political advocates, for instance, workers do not have to work full-time or year-round to qualify. They don't even have to earn low wages. You can work part time. You can work seasonally. You can work part of the year, receive AFDC part of the year, and qualify. Now that the Clinton administration has allowed single, able-bodied workers with no dependents to claim the credit for the first time, many students who work part-time qualify for some level of cash grant. Furthermore, unlike AFDC, there is no asset test for EITC. You could have a house, car, and boat, and still qualify.

A second fact that erodes the compelling picture of mom and dad battling inexorable economic forces is that roughly half of the families that receive EITC payments are headed by single mothers. This is worth noting because, in the relentless drive never to offend women, it is forbidden to mention that single mothers—especially those never-wed mothers and even those not on welfare—have a very hard time supporting children adequately. In reality, that cost is imposed on their fellow citizens. Only 20 percent of married, two-parent families with children earn less than $25,000 per year, whereas 75 percent of all families headed by single mothers live on $25,000 or less.

Without blaming women who find themselves in such circumstances, most of whom are doing the best they can, it is important to keep track of the economic costs of social problems such as divorce and illegitimacy. Both of those conditions arise from decisions made by individual men and women; they are not the result of forces of nature. While such families may require assistance, it is unclear why society should be perpetually required to compensate for people's lack of comfort.

The third divergence between the EITC proponent's claims and the truth, as astute readers have already noticed, is that the program is not limited to workers whose incomes fall under the poverty line. Again, according to John Karl Scholz, who has written extensively on EITC, half of the recipients have incomes above the poverty line. In most of the country, for instance, $25,000 is understood to be a solid lower-middle-class family income.

(As a small political footnote, "New Democrat" support for EITC originated as a "progressive" alternative to raising the minimum wage, which, Robert Shapiro has argued, is an inflationary action that hurts more poor families than it helps. In a 1989 report, Shapiro noted that only one-fifth of minimum-wage workers are poor; the rest are the second or third wage earners in their families. Former DLC leader Bill

Clinton expanded EITC in 1993, but has since proposed a $1.15 raise in the minimum wage, which seems to indicate that he only takes sophisticated "centrist" arguments seriously if they advocate redistribution.)

It's important to note that there is a serious problem among men with high-school (or less) education, whose incomes have remained stagnant for two decades. It is harder and harder for them to support families decently, even with working wives. Clinton administration economic policy, including current tax-cut proposals, is focused around this issue. Yet it remains questionable whether a problem of the re-organization of the nation's economy will be solved with personal subsidies. As Donna Shalala maintained in congressional testimony in 1994, "The EITC is essentially a pay raise for the working poor." She failed to add that it was a pay raise taken out of the pockets of other working Americans whose real incomes also have not seen major increases.

For Once, the Experts Agree

Remember: the reason politicians love this program is that it encourages people to work, not loaf. But does it really?

The University of Wisconsin's Scholz, who is an enthusiastic supporter of EITC, says the program offers "an unambiguous incentive for the non-working to start working, because the EITC increases their after-tax wages substantially." But for those already working, EITC creates a disincentive to work, Scholz maintains. "Because the EITC makes their incomes higher, they are likely to buy more leisure. People's preferences are such that as they have more income, they buy more of the things that they like, and they like leisure." Economists call this universal trade-off among people getting free money the "income effect."

"Many families not in the labor force are not on the margin of working," Scholz notes in a recent study. That means that incentives don't overcome everyone's decision not to work. The implication—at least as I see it, though I doubt he would agree—is that for some people sticks such as a welfare cut-off may work better than carrots. "Ninety-nine point five percent of EITC recipients," the study continues, "receive the credit in a lump sum after filing a tax return, so the links between earnings and benefits . . . are likely to be less clear to recipients."

It is another one of the unique aspects of EITC that experts on both sides of the ideological divide report precisely the same findings. Marvin Kosters, who for a decade has been the only expert on the EITC to testify against it, agrees that the disincentives are as strong as the incentives. He explains that "any level of income can be attained by working less than would be required in the absence of an EITC payment."

Furthermore, Kosters asks the one question never heard in Washington: "Suppose it's a good idea. Does that mean the bigger the better? Does it mean that any structure is just as good? I think not. The income cutoff is very high relative to average wages. It goes well into the middle class." He recommends simply excluding low-wage workers from all federal taxes or restoring EITC's original plan to simply refund payroll taxes.

But Kosters's objections to the program are not limited to its efficacy as policy. He also believes that the EITC's stratospheric fraud rate is due to inherent vulnerabilities in the program's current size and form. "The system lends itself to abuse when it gets larger," he says. "The possibility of complicated fraud emerging is greatly encouraged by the generosity and size of the thing. If it were small there would be much less fiddling around."

The term "fiddling around" is quaint and delicate when it comes to a discussion of the huge rate of chicanery in the EITC. In a political culture where the cynical expectation is that all programs are permeated by some degree of waste, fraud and abuse, the EITC, with its current 30-45 percent ($5-6 billion) fraud rate, is in a league by itself.

Helping the Inner City Help Itself

Jim Bruton, a Washington attorney with Williams and Connolly, served during the Bush administration as deputy assistant attorney general in the tax division of the Justice Department—i.e., the office that oversees the prosecution of all federal tax-fraud cases. Bruton thus became one of the nation's leading experts on the types and extent of EITC fraud. He suggests that the program invites fraud in a way the normal tax-return process does not, because the program gives out money directly to filers, instead of the more usual arrangement in which a refund is disbursed after taxes are paid. The EITC, he says, has "created a new type of tax criminal. Usually tax criminals are white-collar, or simply people who underreport, or don't pay their taxes. [EITC cheaters] are often street criminals who can file fraudulently and take money from the system."

According to Bruton—and to other senior Bush administration officials at Justice and the IRS—the problem began to escalate in 1990. Bruton and his boss, Shirley Peterson, then–assistant attorney general for tax, noticed an increase in fraud reports coming in from around the country, resulting, he speculates, from an expansion of EITC that took effect that tax year.

Peterson, say colleagues, was particularly interested in dealing with the problem. As cases came in from IRS field offices, she made sure that the local U.S. attorneys were apprised of them. But, as one official said, "the maximum fraud in most of these cases was about $2,000. U.S. attorneys have long dockets. These cases got pushed to the back." Bruton adds, "It costs roughly $3,000 for the IRS to send a criminal investigator to check up on a filer."

Over the years, small-time EITC fraud has involved obvious schemes such as a husband and wife, each with a qualifying income, filing as if they were divorced, and both receiving the credit; people with illegal income filing tax returns and getting the credit; two single mothers who don't work (and may receive AFDC) pretending that they are each paid to look after the other's children; people filing with wholly fictitious children; people under-reporting income to maximize the amount of the credit they get.

Slightly more creative chicanery involved people filing requests for employer ID numbers (which are utterly routine and never checked), making up a company, filing phony W-2 forms, and collecting the cash refunds. Some hustlers used phony addresses, stolen or phony Social Security numbers (the IRS sent the refunds even when they noted that the number was incorrect). One common trick was to steal Social Security numbers from the files of schoolchildren at public schools. (The subcommittee's records are full of such colorful anecdotes, by tax-preparers currently residing in federal prisons.)

Far more innovative fraud was encouraged by the IRS's new electronic filing procedures. Regular taxpayers are generally reluctant to file by computer, because there are no safeguards to ensure that the information you file doesn't get changed once it reaches IRS headquarters, and in all criminal tax prosecutions the burden of proof is on the taxpayer. But the IRS, eager to shift to electronic filing, created a special inducement to use the new system—the Direct Deposit Indicator (DDI). Within mere hours of filing a return electronically, the filer would be notified of the amount of his refund with DDI. (Under normal conditions it takes a couple of weeks.)

Street entrepreneurs and members of the criminal underclass must have felt like prospectors stumbling on gold nuggets glittering in a riverbed. DDI allowed banks and some tax preparers to offer loans, using the DDI as collateral. These "refund anticipation loans" fueled major economic activity in the inner cities. Bruton tells of refund anticipation loan centers springing up in used-car lots—so that people could file their EITC claim and drive away in a Chevy.

There were other fabulous schemes. In one Midwestern city, when business got slow for a network of illegal drug dealers, the dealers helped clients file for the EITC. Your tax dollars flooded back into the ghetto within hours, sending drug sales booming.

Word of the scheme spread quickly. Soon street gangs in Los Angeles were preparing neighborhood tax returns—for a cut of the EITC refund loan. A group of immigrant cabdrivers in Texas was caught doing the same thing. Across the country, people whom liberals believe cannot hold a job were impersonating tax preparers and helping the Clinton administration achieve its goal of helping the working poor.

Not just criminals but even legitimate banks and tax preparers, such as H&R Block, were doing a land-office business with the refund-anticipation loans. They even lobbied to maintain the DDI well after the fraud had surfaced. The IRS was entirely aware that this fraud was going on. In 1991, when Shirley Peterson moved from the Justice Department to head the IRS, she brought along a sophisticated understanding of the problem. According to one former IRS official, she was extremely frustrated to discover that the IRS's antiquated computer system made it impossible to trace the eligibility of EITC applicants efficiently. In early 1992 she ordered DDIs to be stopped, because they were the direct catalyst for much of the program's fraud.

Among the first moves made by the incoming Clinton administration—and new IRS Commissioner Margaret Richardson—was to reverse that decision and restore the DDI. This ensured that the massive fraud would continue, just as President Clinton was expanding the program. In response to congressional pressure, Richardson suspended the DDI last December 28, creating havoc in the current filing season. (See sidebar at left.) And provisions in the GATT treaty passed last December will stop EITC benefits from going to non-resident aliens as well as prisoners.

While the magnitude of the fraud was well known enough that Richardson should have been aware of it, much of the blame must go to the permanent bureaucracy at the IRS, which has been criticized for intransigence, internal bureaucratic feuding, and an institutional culture that does not allow for the admission of problems. The "systems people" at the IRS, who were gung-ho about electronic filing and whatever it would take to expand it, were engaged in destructive internal squabbling with the Criminal Investigative Division (CID), which naturally felt that fraud should be prosecuted.

THE LATEST EITC MESS

Four days before the January 1 start of tax-filing season, in a last-minute attempt to avoid a repeat of the past year's 45-percent EITC fraud-and-error rate, the IRS, under pressure from congressional investigators, announced that it would crack down on electronic refunds by halting use of the Direct Deposit Indicator (DDI), and instituting new verification procedures, including cross-checking returns against social security numbers. The verification could delay EITC "refunds" by up to two months.

The new policy has created havoc and anger among recipients. Those outraged include many of the poor who have come to depend on the quick turnaround. So far, more than 1 million people have called Beneficial National Bank, a major "refund anticipation loan" (RAL) processor. It is just such loans that are the target of the reform: last year, the IRS concluded that 92 percent of fraudulent electronic returns involved RALs.

An H&R Block hotline has received more than 5 million calls about RALs. Said H&R Block president Harry Buckley, "You just can't have this many poor people depending on this money and have it not be there—it's like saying we're not going to pay welfare this month." (This is not pure altruism: last year Block and a handful of banks processed roughly 9.5 million RALs, of roughly $1,500 each, for an average fee of $31, grossing $300 million.)

Is cancellation of the DDI justified? Truly needy people would not face harm from delayed returns if the money were paid out in monthly increments instead of lump sums. The IRS offers the monthly check option, through employers, yet fully 99 percent of recipients prefer the lump-sum payments. EITC recipients would obviously benefit from the weekly approach, which would also more clearly "make work pay."

—*L.S.*

Writing in *Tax Notes Today* in October 1994, reporter George Guttman—who broke the scandal in the tax community—revealed that, according to Joe Santavicca, a recently retired employee of the Criminal Investigation Division, "The onus was on CID employees to do nothing that slowed the electronic filing process. Suspicion of fraud, in many instances was not enough. The message from many senior managers at the service centers was that questionable claims should not be held back unless the reviewers were absolutely sure that the claims were fraudulent."

The IRS has traditionally been reluctant to discuss tax fraud since it has a large stake in conveying a sense of omniscience, considering that we still have a largely voluntary compliance system. The IRS generally only discusses fraud that it has discovered in conjunction with punishment it has meted out. For obvious reasons, the IRS cannot and does not discuss fraud that is successful. The internal political culture of the IRS is not conducive to admissions of massive failure by one or another competing department.

For all these reasons, when the House Ways and Means Committee wished to investigate the fraud, they bypassed top IRS officials and went straight to then-Treasury Secretary Bentsen.

Some hustlers used phony addresses, stolen or phony Social Security numbers. One common trick was to steal Social Security numbers from the files of school children at public schools.

The Threat to Liberty

In his opening statement in February 1994 hearings on refund fraud, former oversight committee chairman J.J. Pickle of Texas said, "In my judgment, the IRS has almost perfected the art of using its computers to give out tax refunds quickly, without making a corresponding effort in the area of fraud control."

Toward the end of a long interview, Jim Bruton, a man whose conversation reveals a passion for liberty and an ingrained distrust of state power rare in a political official, said, "When we take people's money under threat of punishment, aren't we obligated to be careful about where it goes?"

Not everyone involved with the EITC shared Bruton's concerns. Asked whether the EITC's fraud rate makes a difference in the utility of the program, Jeff Hammond, the economist at the Progressive Policy Institute, answered, "If 90 percent of eligible workers are receiving it, that's a great success rate. If there's some fraud, we can't help that." When questioned about the vulnerability to fraud inherent in the program's structure, Hammond replied testily, "We just design the ideas and the policy. It's not our fault if the IRS can't administer it effectively. Look, the problem is that the IRS doesn't have enough auditors."

The IRS is staffed so that only one percent of all tax returns are audited in any given year. Other than conducting a complete audit, there is no way to determine whether someone who claims the EITC is, in fact, eligible for it. Even if the IRS had the resources to check more returns, it generally chooses to audit taxpayers suspected of hiding significant amounts of income. It would cost the government more than the amount of the credit to investigate whether or not the recipient was eligible. As Bruton put it, "As soon as a program distinguishes between people who get and people who don't, you have to have a policing mechanism." That is why, for example, state departments of health and human services have armies of caseworkers assigned to monitor each AFDC recipient.

Just as a great many people in Washington think that it makes sense to use the military to deliver humanitarian aid, because it is more efficient than the average relief organization, so politicians are enamored of using the IRS to deliver social services. In recent years the IRS has been given the task of collecting student loans and child support payments, garnishing wages, and the like. IRS may well be more efficient than the Health and Human Services Department (who would doubt it?), but in a society based on a high degree of liberty and privacy, there are very troubling implications to broadening the scope and power of the institution most hostile to privacy, one that already has the coercive power of the state behind it.

Do we want the already overly powerful tax collection agency to have additional enforcement powers? Isn't this ultimately the most pernicious cost of the welfare state? Corruption increases because the government is giving away money. So the government increases its size, power, and ability to intrude into citizens' private financial affairs in order to fight the corruption. As former deputy assistant attorney general Bruton put it, "Every time we establish a new crime, we're creating a new mechanism for the government to check up on you." Adding more auditors imposes a non-monetary cost that citizens interested in liberty should find unacceptable.

The Earned Income Tax Credit makes an apt case study precisely because the program is not extremely big, overreaching in its goals, or fraught with the emotional baggage of AFDC. It is a cautionary example of a great truism of the welfare state: any program that starts out transferring money from those who earn more to those who earn less, even for the best of reasons, will ultimately be co-opted and turned into a general welfare program. It demonstrates, too, just how many obstacles even minor social engineering runs up against, even when the goal is the simple distribution of cash. These are not new truths, but they don't seem to have been learned yet, either.

Finally, the fact that IRS administers a cash giveaway program with a 30-45 percent fraud rate—and the shocking fact that President Clinton would expand such a program—gives a fair indication of just how much contempt the powers that be have for those who continue to pay their taxes, either voluntarily or because of the coercive power of the state to send those who don't cooperate to jail. ❑

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
Washington, D.C. 20503-0001

LRM NO: 891

FILE NO: 705

3/31/95

LEGISLATIVE REFERRAL MEMORANDUM

Total Page(s): 19

TO: Legislative Liaison Officer - See Distribution below:

FROM: Janet FORSGREN (for) Janet L. Forsgren
Assistant Director for Legislative Reference

File - EITC Fraud

OMB CONTACT: Chris MUSTAIN 395-3923
Legislative Assistant's line (for simple responses): 395-7362

SUBJECT: TREASURY Proposed Testimony on Refund Fraud Prevention, focus on the Earned Income Tax Credit

OK w/me

DEADLINE: 2:00 pm Monday, April 03, 1995

In accordance with OMB Circular A-19, OMB requests the views of your agency on the above subject before advising on its relationship to the program of the President.

Please advise us if this item will affect direct spending or receipts for purposes of the "Pay-As-You-Go" provisions of Title XIII of the Omnibus Budget Reconciliation Act of 1990.

COMMENTS: Margaret Milner Richardson will give the attached testimony before the Senate Government Affairs Committee on Tuesday, April 4th.

AGENCIES:
328-HEALTH AND HUMAN SERVICES - Frances White - (202) 690-7760
217-JUSTICE - Kent Markus - (202) 514-2141
429-National Economic Council - Sonyia Matthews - (202) 456-2174
315-Small Business Administration - Kris Swedin - (202) 205-6702
-Social Security Administration - Jack Camilleri - (202) 482-7148

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Wendy Taylor
Joe Minarik
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Bob Damus
Chuck Konigsberg
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Bruce Reed
Jeremy Ben-Ami
Tim Keating
Clarissa Cerda
Jim Murr
Janet Forsgren
Jim Jukes
Ron Jones

RESPONSE TO
LEGISLATIVE REFERRAL MEMORANDUM

LRM NO: 891
FILE NO: 705

If your response to this request for views is simple (e.g., concur/no comment), we prefer that you respond by e-mail or by faxing us this response sheet.

If the response is simple and you prefer to call, please call the branch-wide line shown below (NOT the analyst's line) to leave a message with a legislative assistant.

You may also respond by:

(1) calling the analyst/attorney's direct line (you will be connected to voice mail if the analyst does not answer); or
(2) sending us a memo or letter.

Please include the LRM number shown above, and the subject shown below.

TO: Chris MUSTAIN 395-3923
Office of Management and Budget
Fax Number: 395-6148
Branch-Wide Line (to reach legislative assistant): 395-7362

FROM: ______________________ (Date)

______________________ (Name)

______________________ (Agency)

______________________ (Telephone)

SUBJECT: TREASURY Proposed Testimony on Refund Fraud Prevention, focus on the Earned Income Tax Credit

The following is the response of our agency to your request for views on the above-captioned subject:

_____ Concur

_____ No Objection

_____ No Comment

_____ See proposed edits on pages _____

_____ Other: ______________________

_____ FAX RETURN of _____ pages, attached to this response sheet

STATEMENT OF MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

BEFORE THE

SENATE COMMITTEE ON
GOVERNMENTAL AFFAIRS

APRIL 4, 1995

Mr. Chairman and Members of the Committee:

With me today are Mike Dolan, Deputy Commissioner and Ted Brown, Refund Fraud Executive.

We appreciate the opportunity to be here today to discuss the IRS's efforts to stop refund fraud in general and Earned Income Tax Credit (EITC) fraud in particular. The IRS has addressed tax refund fraud through its Questionable Refund Program since 1977. Teams of trained personnel in each of the ten Service Centers have used both manual techniques and computer criteria to select suspicious returns for further review. However, technology has significantly improved the capabilities of both government agencies and financial institutions to deliver money faster. Because the risk of fraud is greater with shorter payment cycles, both public and private institutions must be more vigilant than ever in guarding against fraud.

Shortly after becoming Commissioner a little less than two years ago, I recognized the need to step up fraud detection efforts, and the IRS has taken many steps since then to ensure that fraud detection receives the highest priority. The IRS is and will remain committed to detecting and preventing attempts to undermine our tax system by those who are unwilling to comply with the tax laws. Our fraud prevention efforts are and will continue to be balanced with the need to safeguard taxpayers' rights and privacy.

Fraud is a dynamic, constantly changing and adapting phenomenon that is not unique to the government. The IRS, like other financial businesses such as credit card and insurance companies, is challenged on a daily basis by individuals who attempt to fraudulently circumvent the system for financial gain. The IRS has a significant additional challenge, however, because the IRS cannot screen its customers based on credit history or other information -- we must take all comers.

Mr Chairman, and distinguished Members of the Committee, Assistant Secretary Samuels will discuss with you tomorrow the effectiveness of the EITC in achieving its policy goals. This morning, I would like to share with you what the IRS has learned about refund fraud, describe for you the IRS's actions during the current filing season to stop this fraud, and discuss with you our future fraud prevention plans.

FILING FRAUD STUDIES

Understanding the fraud schemes confronting the IRS is essential to planning the most effective methods to detect and prevent its reoccurrence. This is a difficult task, especially when fraud perpetrators think creatively, relish devising complex schemes, and adapt continuously to new fraud controls.

Before this Committee last July, I reported on three filing fraud studies that the IRS planned to provide a more comprehensive analysis of the characteristics and extent of refund fraud. The first study involved a small statistically valid sample of

1000 returns filed electronically during January 1994 which claimed the EITC. The EITC claimed on these returns was verified by personal contact with taxpayers, return preparers, and employers. The preliminary results of this study, as reported to this Committee last July, showed that roughly 35% to 45% of the 1.3 million returns with EITC filed electronically through January 28, 1994, contained errors that required adjustments, both up and down, in the amount of EITC claimed. Approximately 50% of the EITC claims with errors were believed to result from unintentional errors; the errors in the remaining 50% of the returns appeared to be the result of intentional misrepresentations to qualify for EITC. Taxpayer characteristics gleaned from this study aided in the development of additional fraud controls for the 1995 filing season. The final analysis of this study should be available in the next month, and we will share the results with this Committee.

The second study, which was conducted in February 1994, involved 2,200 taxpayers whose returns had been filed electronically by Electronic Return Originators (EROs). The purpose of this study was to determine whether refunds from the electronic filing system (ELF) were being received by taxpayers as issued. This study has also been completed and in only a handful of the cases did there appear to be evidence that EROs were keeping a part of a taxpayer's refund.

The third study is currently underway. It involves a statistically valid, random sample of approximately 2,000 refund returns filed electronically and on paper claiming EITC filed throughout the 1995 filing season. Results from the third study will be used to expand our understanding of issues identified during the first study. The field work and analysis of results will be completed in the fall.

Maintaining effective fraud prevention demands continuous assessment of emerging trends and constant revision of prevention mechanisms. Strategies which are perfectly satisfactory today, may be of no use tomorrow. Thus, the study of refund returns filed during this filing season that is currently underway will provide valuable information that will be used to better plan our strategy for next year's filing season and beyond.

FISCAL YEAR 1995 INITIATIVES AND RESULTS

As part of its continuing efforts to prevent and detect fraud, the IRS has developed and implemented numerous systemic verifications and enhancements for the 1995 filing season. Additionally, significant resources are being directed to preventing and detecting questionable and fraudulent refund claims before the refunds are paid. These initiatives include increased verification of taxpayers' social security numbers, additional checks of returns claiming certain credits, ERO suitability checks and increased ERO monitoring, and additional compliance resources devoted to fraud detection and prevention. In addition, a significant part of our strategy includes delaying all refunds that, as a result of computer analysis and fraud identification profiles, appear erroneous or fraudulent. This additional time, in most cases up to eight weeks, helps us detect fraud schemes, including duplicate uses of Social Security Numbers.

Verification of Social Security Numbers

Through internal studies and the report of an outside expert, the IRS learned that fraud was being perpetrated through the use of incorrect and invalid social security numbers. As a result of this knowledge, during this filing season, the IRS is devoting substantial resources to ensuring that taxpayers claiming refunds use the proper taxpayer identification number -- generally a taxpayer's Social Security Number (SSN). If electronically filed returns have no SSN, have an invalid SSN, or more than one taxpayer uses the same SSN (duplicate SSNs), the returns are not accepted into the system. A correct, valid SSN must be provided for the taxpayer, spouse, and dependents before an electronically filed return will be accepted. So far this filing season, over 3.7 million occurrences of missing, invalid, or duplicate SSNs have been identified on electronically filed returns resulting in the affected returns being rejected.

The additional checks of SSNs are not limited to ELF returns, however. The IRS is also checking paper returns for missing, invalid, or duplicate SSNs. Failure to provide such a valid SSN results in a delay of the refund until the matter is resolved.

In one service center, we have identified over 400 uses of the same SSN for dependents -- this SSN, however, is not a valid number. A single preparer prepared returns using this "false" SSN over 400 times -- 64 times as the SSN for the primary taxpayer; 113 times as the SSN for children being claimed for EITC; and 261 times as the SSN for children being claimed as dependents. In this case alone, through the use of our duplicate SSN report, we have delayed over $380,000 in refunds pending further review.

We have spent a lot of time both before and during this filing season urging taxpayers to use correct social security numbers (SSNs) on tax returns for themselves and their dependent. We emphasized the importance of accurate SSNs this filing season by including a message to that effect on the cover of all tax packages and through many public service announcements. In December 1994, over 150,000 taxpayers who filed in 1994 with incorrect or invalid SSNs received letters from the IRS alerting them to be more careful on their 1995 tax returns. If the taxpayers did not have a SSN for themselves or their dependents, the letter advised them to contact the Social Security Administration before filing their tax return. While the increased scrutiny of SSNs may cause delays for legitimate taxpayers, once the SSN problems are corrected, these taxpayers will not experience delays in future years.

Additional Scrutiny of Returns Claiming Certain Credits

Our studies of fraud also revealed, as detailed above, that a large amount of fraud is related to refundable credits, such as the EITC. As a result of these findings, during this filing season, we are performing additional checks on returns that claim refundable credits -- including EITC -- to ensure that only those taxpayers who are entitled to such credits receive them. Refunds are being delayed on some returns to allow us additional time to verify claims prior to issuing the refunds. Because of the additional time needed to complete this review, in some cases taxpayers who claim refundable credits may initially receive their refunds of withheld income taxes followed by a separate refund check for refundable credits. If a taxpayer's refund is delayed, a notice will be sent explaining the reason for the delay. Generally, the refund will be sent within eight weeks from the date of the notice.

While our fraud screens are designed to detect only suspicious returns, some taxpayers who have filed complete and accurate returns will have their refunds delayed. We regret any inconvenience this may cause and taxpayers who are in a hardship situation as a result of the refund delay can apply to the Problem Resolution Program for assistance.

At the beginning of this filing season, the IRS estimated that 82 million individual refund returns would be filed in 1995 and up to eight percent of these refunds could be delayed with the new screens and filters put into place. Through March 17, 1995, 35.1 million refunds have been issued -- 32.6 million were issued for the full amount of the refund; 2.5 million were partial refunds. Only 2.2 million refunds have been delayed in their entirety. These numbers are consistent with our estimates, and we continue to project that approximately eight percent of total refunds claimed this filing season will be delayed.

Some examples of potentially fraudulent refund schemes we have detected this filing season are:

a) About 73 paper returns prepared by a preparer in Virginia were being filed at our Philadelphia and Austin Service Centers. These returns all involved large Schedule A deductions. By querying one of our new automated detection systems (AUTO-WIF), an additional 200 ELF returns were identified as being filed by the same preparer, again with large Schedule A deductions.

b) Numerous returns with Schedule C (self-employed) net income in the $8,000 to $10,000 range claiming head of household filing status were identified by one service center. These returns also claimed the full EITC. Most of the taxpayers have similar or identical surnames and live at or around the same address. To date, 112 returns have been identified with over $200,000 in refunds claimed.

c) Another service center identified 23 suspicious returns that were prepared by the same preparer. These returns claimed EITC and all listed a child under the age of one; thus no SSN was required for the child. Total refunds claimed were in excess of $48,000.

Working with the Department of Justice and U.S. Attorneys, the IRS continues to actively pursue prosecution of criminal violations where appropriate. For example, in FY 94, 51 return preparers, convicted of fraudulent refund schemes, were sentenced to an average prison term of 20 months.

The IRS has received many positive responses to our fraud prevention efforts this filing season. I believe that most taxpayers understand that the IRS needs the additional time to verify the accuracy of refunds claimed to maintain the integrity of the tax system.

Screening and Monitoring of Electronic Return Originators (EROs)

We have also learned that some EROs have been responsible for initiating or aiding a large amount of refund fraud. Thus, as part of our fraud prevention efforts this filing season, new policies and procedures were implemented for screening EROs before permitting them to access the IRS electronic filing system (ELF). Fingerprint and credit checks were conducted on new ERO applicants to better ensure that only appropriate and responsible individuals participate in electronic filing. The IRS received approximately 38,000 applications for admission to ELF in 1995. Of the 33,000 applications that had to undergo suitability checks, 1,500 applicants were rejected because of failure to meet our enhanced admission requirements.

Another effort we have undertaken throughout this filing season in our district offices is enhanced monitoring of EROs. So far, these monitoring visits have been extremely successful. For example, while on a monitoring visit to an ERO believed to be in non-compliance with program requirements, the ERO told us: "If you think I am bad, you should look into what another ERO is doing". That contact led to another ERO who was not complying with the program requirements and identification of a potentially abusive scheme involving discounting of refunds. Through March 4, 1995, we have conducted over 3,600 monitoring visits, resulting in the suspension of 103 EROs from the program and the issuance of warnings to an additional 303 EROs.

Another fraud prevention step taken this filing season was the elimination of the Direct Deposit Indicator (DDI). In the past, this indicator signaled an ERO that a taxpayer's refund would not be reduced to satisfy another government debt. Although the DDI has been used by lenders to determine whether to issue refund anticipation loans, the IRS has no involvement in these loans. Our experience over the last few years with electronic filing and the DDI showed that refund fraud schemes were assisted by the availability of refund anticipation loans. Thus, the IRS is no longer providing the indicator. Lenders are still free to make refund anticipation loans based on their usual lending criteria.

For the 1995 filing season, 232 IRS offices and 1,000 volunteer sites around the country are offering free electronic filing. As of March 17, 1995, over 117,000 individual tax returns were electronically filed from these sites. These taxpayers will have the advantages of free electronic filing, including its accuracy (almost 99.5%), the acknowledgement of receipt of the return, faster notification to taxpayers in the event IRS questions arise.

We continue to build on our partnership with practitioners and EROs. The vast majority of practitioners and EROs are interested in maintaining the integrity of our tax system; they recognize their responsibility to prepare, file, or transmit correct information to the IRS. However, when we identify those few who abuse the authority of their position by committing fraud or who fail to adhere to our program guidelines, we will take action to either remove them from the program or pursue criminal enforcement to the full extent. Stopping fraud requires the combined efforts of all our partners in tax administration -- tax return preparers, EROs, tax practitioners, and Congress.

Enforcement Activities

As I stated earlier, this filing season, the IRS has in place new systemic screens to detect questionable and fraudulent refund claims. In addition to this effort, our Criminal Investigation Division (CI) through its Questionable Refund Detection Teams (QRDT) is using new technology to aid in the detection of refund fraud schemes. For example, the Electronic Fraud Detection System (EFDS), an automated fraud detection system, was installed in all five electronic filing centers this filing season, after a successful pilot of the program last filing season in Cincinnati. Before EFDS, the results of fraud screening were printed on paper forms to be reviewed. EFDS converts this paper system so that it is an on-line research tool which can be used to validate claims and identify multi-return fraud schemes.

While EFDS is used in the electronic filing centers, another automated detection system, called AUTO-WIF has been installed in all 10 service centers. Its primary purpose is to provide IRS Service Centers processing paper returns with some of the same capability of EFDS for scheme identification and quicker access to electronically filed data.

The most sophisticated fraud schemes are devised by those skilled in computer programs and techniques. They assume the existence of systemic filters and design their fraud schemes to circumvent these filters and pass through the system unchallenged. The sophisticated fraudsters test the system from time to time to make sure they roughly understand the parameters being used. With this information, they increasingly generate multiple transactions and attempt to incorporate sufficient randomness or variation to minimize the risk of detection.

To identify these sophisticated fraud schemes, we are using the Los Alamos National Laboratory to design software to detect anomalies and match patterns in large data sets. Five new anomaly detection/pattern recognition tools were developed are being tested at the Cincinnati Service Center this filing season. Returns with these patterns can be identified and removed from normal processing for further scrutiny. As we continue to identify the items on returns that are predictive of fraud, we will add them to our systemic filters.

In addition to enhancing our systemic filters to detect more questionable refund claims this filing season, we have substantially increased the enforcement resources dedicated to identifying fraudulent schemes, as well as examining questionable claims. Criminal Investigation resources in our Questionable Refund Detection Teams were increased by 11 percent and Examination resources were increased by 277 percent -- over 1,700 enforcement staffyears are being devoted to curbing the abuses and fraud. As of March 10, 1995, we have identified 504 ELF schemes -- 8,938 returns were detected; 5,906 returns (66%) were held for further action. The schemes claimed refunds of $18.4 million of which $12.5 million (68%) was denied. We have also identified 468 paper return schemes involving 2,598 returns of which 2,573 (99%) were held for further action. These paper returns claimed refunds of $5.0 million of which $4.9 million (99%) was denied.

In past filing seasons, refunds were not delayed until after a potentially fraudulent scheme had been identified. As a result, the refunds on many returns involved in a scheme would be issued before the scheme was detected. The delay of questionable refunds this filing season has provided additional time to identify fraudulent claims and to select questionable claims for examination.

Several returns must be filed before our Service Center Criminal Investigation operations can identify a pattern of a potentially fraudulent scheme. Because we delayed refunds this year while returns are being reviewed, on the schemes identified this filing season so far, over $0.5 million that previously would have been refunded is still in the Treasury.

EARNED INCOME TAX CREDIT

Refundable tax credits, such as EITC, present unique opportunities for those who want to commit fraud for financial gain. Although detection and prosecution of refund fraud are important, it is costly and inefficient to prosecute every instance of fraud. Recognizing this, the IRS must continue to build barriers to fraud. The IRS's goal is to prevent fraudulent returns from entering the system, and one of the biggest challenges in meeting this goal is to install the "up-front" fraud controls that will effectively detect and prevent fraudulent refund claims from entering the system.

A number of the initiatives and systemic enhancements installed in the 1994 filing season and the current filing season were designed to stop fraud involving the EITC. This filing season, we estimated that about 20 million taxpayers would claim their EITC, an increase of about 5 million over 1993. This increase results from expanding the EITC to single taxpayers. We have just received our first report of EITC claimed for this filing season. As of February 1995, 4,892,000 returns have been filed claiming the EITC. This is down from 5,845,000 returns filed claiming EITC at the same time last year -- a decease of 16.3 percent, or 953,000 returns. The total EITC claimed so far is $6.8 billion which is a 4.2 percent increase over the $6.5 billion claimed at this time last year.

These results may be an early indication that the fraud control initiatives put in place this filing season are reducing the number of fraudulent claims involving EITC, thus making the EITC unattractive to the fraudsters and preserving the credit for those who have earned it. However, when we complete the filing season study that I mentioned earlier, we will be able to measure EITC compliance more precisely.

Through these same systemic filters and detection efforts that are addressing EITC fraud, the IRS is making strides in stopping fraud in other areas, such as motor fuel excise tax credits. For example, on one return filed this season, a self-employed beautician claimed the tax-free use of over 42,000 gallons of gasoline, generating a refund of $6,000. We caught this return and many like it, and the refunds were delayed before being paid out.

It has been estimated that between 75% and 86% of all eligible families actually claimed the EITC in 1990. Through our education and publicity efforts, the IRS is making a concerted effort to reach an even larger percentage of eligible families. For example, last year we sent 14.7 million EITC recipients information about the advanced earned income tax credit (AEITC). The Treasury Department contacted corporate CEOs to gain their support and solicit other CEOs and national organizations to provide information about AEITC. In addition, we are using our taxpayer education programs to promote the EITC to those who are eligible by encouraging employers and community or social service organizations to conduct seminars for employees and clients. The IRS and the Small Business Administration are also co-sponsoring employer seminars in strategic locations throughout the filing season to train employers how to compute the AEITC for their employees.

Workers who qualify for the AEITC can get up to $105 per month in their paychecks -- whether they get paid weekly or bi-weekly -- by filling out a very simple Form W-5, Earned Income Tax Credit Advance Payment Certificate and providing it to their employers. By claiming the earned income credit on an advanced basis, taxpayers who are eligible for EITC can avoid potential refund delays and use these funds during the year to pay for expenses. They don't have to wait until they file their return to get the credit. So far this filing season, preliminary results show that more taxpayers opted for AEITC than in all of 1993.

FUTURE FRAUD PREVENTION PLANS

Mr Chairman, I assure you that the IRS is committed to stopping all fraud, including EITC fraud, and that we will continue our efforts to ensure that only those hard working Americans who are eligible for the EITC receive it. Although we are still in the midst of our current filing season, at the direction of Mr. Brown, the Filing Fraud

Executive, we have already begun planning the fraud prevention strategy for next filing season.

We are gaining valuable information this filing season through studies, ERO monitoring, and enforcement activities, on which to base the modification and refinement of our current strategies. Over the next few months, we will be reviewing this information. Based on the results of our review, we will revise the standards used to screen EROs, and adapt the systemic screens used to detect fraud during this filing season, and, if necessary, put in place new filters.

While we will continue to enhance our detection and prevention efforts, the key to improving our ability to detect fraudulent refundable credit schemes is our Tax Systems Modernization program. Without modern equipment and software, applying expert systems analysis to large data bases is virtually impossible. Tax Systems Modernization will not only provide the computing power and capacity needed to apply sophisticated fraud detection systems, but it will also provide us with more timely access to information.

Mr. Chairman, now more than ever, I feel strongly about the need for a steady funding vehicle for Tax Systems Modernization. Fiscal Year 1996 is a pivotal year for the IRS as we continue our plans to acquire and implement major new systems. What happens to our FY 1996 budget will impact the tax administration system of the future, shaping our ability to effectively administer the tax law and collect all the revenue that is due.

CONCLUSION

As I stated earlier, fraud is a dynamic, constantly changing phenomenon. Prevention and deterrence are clearly the keys to controlling it. We will continue our programs to detect, investigate, and prosecute <u>all</u> types of refund fraud. Mr. Chairman, even if the IRS is successful in our current efforts to eliminate all EITC fraud, our job will not be done. In our experience, when one avenue of fraud is shut down, fraudsters merely migrate to other more accessible avenues. As I have stated before, in some instances it may be necessary to delay questionable claims for refunds while they are carefully scrutinized and pay interest, rather than risk allowing fraudulent claims. The IRS will remain vigilant in its fight against fraud to ensure that those who choose not to comply with the law are caught.

Mr. Chairman, this concludes my prepared remarks. My colleagues and I would be happy to answer any question you or other Committee members may have.

FILE: EITC FRAUD

Check w/ Hal/Jeremy

November 14, 1994

MEMORANDUM FOR THE CHIEF OF STAFF
THE SECRETARY OF THE TREASURY
THE SECRETARY OF HEALTH AND HUMAN SERVICES
THE ATTORNEY GENERAL
THE DIRECTOR OF OFFICE OF MANAGEMENT AND BUDGET
THE CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

FROM: CAROL RASCO
BOB RUBIN

SUBJECT: Working Group on the Earned Income Tax Credit (EITC)

Over the past year, the Treasury Department has taken several important steps to preserve the integrity of the Earned Income Tax Credit (EITC). These measures have been taken in response to studies by the Treasury Department, the Internal Revenue Service, and the General Accounting Office that have found continuing evidence of overpayments and fraudulent claims.

Because the EITC is such a crucial element of the Administration's domestic and economic policy, we would like to convene a series of meetings to review its long-term integrity. The meetings will give the Treasury Department an opportunity to outline its ongoing efforts to strengthen the EITC program, and prompt a discussion of what other long-term measures might be necessary.

Please designate one or more high-level members of your department to take part in this effort. We will contact you with a time for the first meeting.

A brief summary of the Treasury Department's efforts is attached.

E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

04-Nov-1994 12:12pm

TO: Bruce N. Reed

FROM: Carol H. Rasco
Economic and Domestic Policy

CC: Jeremy D. Benami

SUBJECT: EITC

Please draft a memo from Bob and me to the Cabinet folks necessary (any reason to throw CEA into this?) and when it is here I will talk to him...I assume Gene is A-OK on this?

Thanks!

EITC

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR IMMEDIATE RELEASE
October 26, 1994

STATEMENT OF TREASURY SECRETARY LLOYD BENTSEN EITC PRESS CONFERENCE

I have a few points to make about the Earned Income Tax Credit program today, and some announcements. I have another meeting I have to go to in a couple of minutes, but this is important to me so I wanted to stop in and say something. I've asked Peggy Richardson, the IRS Commissioner, and our Under Secretary for Enforcement, Ron Noble, to stay and go over the fine points with you.

The Earned Income Tax Credit is an extraordinary program that helps American families stay out of poverty and encourages them to work.. It's been around since 1975, and we improved it last year because helping American families is a priority for this administration. It has the potential to help 20 million low income working Americans and their families have a better life -- by rewarding work. The EITC has a refundable tax credit which can be taken as a lump sum at the end of the year, or a partial credit that comes in the form of lower withholding during the year, with a smaller refund at tax time.

Over the years there have been difficulties, and now there are problems in particular with fraud and electronic filing. We have an on-going effort to attack this problem. I named a task force earlier this year to examine the issue, and it made an interim report to Congress earlier this month. We've also worked with the GAO.

Let me quickly go over some numbers for you. In the good news department, the error rates for the EITC program appear to be more than a third lower now than they were in the 1980s. But they're still too high.

The data the IRS put together tell us that for the last two weeks in January, there were 1.3 million electronic returns that claimed the EITC. The work the IRS has done tells us that if we went through those returns line by line we'd find that 29 percent of them, accounting for 24 percent of the total tax credit claimed, or about $358 million, overclaimed what was due. That doesn't necessarily mean the taxpayer wasn't entitled to some tax credit, but that they claimed too much.

The figures also tell us that 13 percent of the filers, accounting for about 12 percent of the refund total claimed, may have intentionally overclaimed what was due. The good side of that is that 87 percent of the filers are getting it right. Now as to that 13 percent, I'd like to use some strong language about lying and fraud, but the lawyers tell me I have to bite my tongue because of the issue of intent.

We haven't been sitting on our hands. For nearly two years now we've been going after problems and cracking down, and we're going to be doing more.

First, it may not sound like the place for an EITC provision, but we have a number of proposals in the GATT legislation, such as requiring taxpayer identification numbers for all children, regardless of age. It also has an item to have the Defense Department report some of the non-taxable earned income both to military personnel and to the IRS -- such as housing and subsistence allowances. And, the legislation would deny the EITC to prisoners and to non-resident aliens.

Our welfare reform proposal also has a program to look at other administrative ways to improve EITC compliance.

So far we've taken more than a dozen separate actions in our comprehensive program to improve the EITC, such as deciding to add staff to help detect fraud, and making forms more understandable.

Today we're announcing a number of additional steps to make as certain as we can that only those people who are truly entitled to the Earned Income Tax credit receive it. Some of what we're doing can be done administratively, and some of it will take legislation.

By the time we release the 1996 budget -- early next year -- we will develop measures to deny the Earned Income Tax Credit to illegal aliens. The IRS estimates that over 150,000 illegal aliens claimed the EITC this year for last year's taxes. We looked into this one. There was nothing on the books that made it possible to verify the existence of children claimed by an illegal alien, which leaves an opportunity for fraud that we're closing off.

Second, starting in the next tax season, we will no longer provide preparers who file electronic returns what we call a direct deposit indicator. That indicator means that we don't see anything that would require us to hold the tax credit to pay some other tax bill. It's often used as a signal to lenders who work with preparers that a refund will be on the way shortly.

We've found that a very very high number of EITC fraud schemes involve refund anticipation loans, and those loans are based on the direct deposit indicator we send out. The crooks take the money and run, and the taxpayers and banks get burned. So we're no longer going to tell the electronic filing operations whether a refund is likely to be coming. The taxpayer will still get any refund they're due, but we won't be sending out that notification.

The Earned Income Tax Credit is for those who deserve it, who need that extra encouragement to work full time, to lift their families out of poverty, to join the mainstream in American life. It is not for cheats and frauds and slick operators, and we're going to do our best to weed them out, and prosecute them when we find them.

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DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

FOR IMMEDIATE RELEASE
October 26, 1994

STATEMENT OF TREASURY UNDER SECRETARY FOR ENFORCEMENT
RONALD K. NOBLE
EITC PRESS CONFERENCE

Since I arrived here at Treasury, Secretary Bentsen has been committed to addressing the problem of tax refund fraud. Tax refund fraud undermines the integrity of our voluntary tax system, and is a direct assault on the federal Treasury. Those who commit fraud using the Earned Income Tax Credit are preying on a valuable program designed to assist low-income working Americans.

We all are determined not to allow ineligible people and fraud perpetrators to take advantage of the EITC program. We are equally committed to making sure that people who are entitled to EITC get it. As Secretary Bentsen told you, the Treasury Department has been taking continuing steps to combat refund fraud in general, and EITC fraud in particular.

I would like to review some of these steps. Almost as soon as she arrived at the IRS, Commissioner Richardson recognized that refund fraud and EITC fraud were serious problems that had not been properly addressed in the past. She commissioned an outside expert to assess the IRS's vulnerability to fraud. She appointed a Refund Fraud Executive to focus on this problem and to report directly to her. She also directed the IRS to conduct a study of EITC compliance during the 1994 filing season. That study is the basis for the statistics that Secretary Bentsen quoted.

In March of this year, Secretary Bentsen appointed me to chair a Task Force that would make an independent, comprehensive review of the problem. The Task Force hired experienced, impartial experts to manage and direct its efforts. The IRS fully supported the Task Force. The Task Force consulted with representatives of the IRS, OMB, Department of Justice, other components of the Treasury Department, GAO, private industry, and outside experts. Some of the new procedures that the IRS is putting in place for the next filing season are the result of coordination between the IRS and the Task Force.

On October 6, I testified before Rep. Pickle's Oversight Subcommittee, and presented an interim report from the Task Force. There was bipartisan support for the Task Force's work. We plan to provide a final report to Secretary Bentsen and Congress by the end of December.

One area that the Task Force examined closely was the problem of EITC non-compliance. An obvious question is, "How large is the EITC fraud problem?" The IRS's 1994 study provides the best available data on EITC compliance. The encouraging news from the study is that almost 90% of the people who claim the EITC are well-intentioned and trying to comply with the law. As I explained more fully in my testimony on October 6, the EITC forms can be complicated. Complicated forms can lead to mistaken claims for too much EITC. In addition, taxpayers may have legitimate disagreements that lead to erroneous claims. For example, two parents living and filing separately may both believe they can claim their child on the EITC form because they both provide financial support for the child. The child can be claimed only on the EITC form of the parent with whom the child lived for more than half the year. If the child frequently spent nights at both parents houses, the parents may legitimately dispute who qualifies to claim the child for EITC purposes.

The IRS has been working for several years to simplify the EITC form, and to provide greater assistance to taxpayers in understanding how properly to file for the EITC. The IRS is also taking more aggressive enforcement actions, including making expanded fraud checks before refunds are paid. During the 1994 filing season, the IRS instituted improved fraud control systems, which resulted in the rejection of over 600,000 electronically filed EITC claims. As a result of these efforts, we expect to see the number of erroneous EITC claims drop in the upcoming years.

Additional studies are necessary before we can quantify the amount of EITC fraud, but it would be misleading to presume that 29% of the $14-15 billion paid every year in EITC involves fraud. Let me explain the best information that we have.

The Task Force publicly disclosed at the October 6 hearing that between one and five billion dollars in problematic refunds are paid every year. Only a portion of the problematic refund claims involve fraud, and only a portion of those involve the EITC.

In closing, let me say that it is critical for there to be continued cooperation between Main Treasury and the IRS, and that the IRS's Tax System Modernization program be fully and expeditiously funded. Enhanced computer capability will allow the IRS to more vigorously guard against EITC fraud, and other forms of refund fraud.

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

COMMISSIONER

For immediate release
October 26, 1994

STATEMENT OF MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

Since becoming Commissioner over a year and a half ago, I have made the elimination of filing fraud a top priority at the IRS.

We appreciate the support of Secretary Bentsen and in particular his establishment of the Treasury Refund Fraud Task Force. In addition, we appreciate the fine work that Undersecretary Noble and the task force have done and the assistance they have given us in our efforts to eliminate filing fraud from our tax system.

We at the IRS have taken a number of steps to protect the integrity of our tax system and, as Secretary Bentsen stated, we plan to take more during the upcoming filing season.

While these steps are important and, I believe, will be effective, the solution to protecting our system from fraud is the immediate full funding and implementation of our Tax System Modernization efforts. Only with the enhanced computer capabilities that TSM will provide us will we be able to respond to both sophisticated fraud attempts and the various problematic refund returns that we receive each year.

Let me take a moment and list just some of the steps we have taken so far:

- During the last filing season, we began pre-refund examinations of questionable refund claims, including some returns claiming the Earned Income Credit. During the upcoming filing season we will significantly increase the number of these pre-refund examinations.

- Also during the next filing season, we are increasing the staff we have in place in our service centers who work to detect fraudulent returns.

- Earlier this month, we issued new rules for electronic return originators or EROs. These new rules require some new EROs to submit to credit checks and fingerprinting. We feel these new rules will ensure that only appropriate and responsible people are allowed to participate in our electronic filing system.

We also plan to monitor EROs more closely during the filing season. This will ensure that EROs who fail to comply with our requirements are denied access to the electronic filing program.

- The 1994 Earned Income Credit form was simplified to make it easier for low income workers to apply for the credit.

During the 1995 filing season, in addition to the elimination of the DDI, we plan to take other steps to protect our filing system from those intent on filing fraudulent returns.

While we remain committed to issue refund checks timely on returns filed with complete and accurate information, refunds on returns with incorrect or missing social security number will be delayed until we can verify that the taxpayer is due the refund.

I cannot emphasize enough that during the next filing season, it will be essential that all taxpayers file their returns with complete and accurate information. Any taxpayers unsure about the accuracy of their social security numbers should contact the Social Security Administration as soon as possible to verify their numbers.

As Secretary Bentsen stated, the IRS and Treasury are committed to insuring that the Earned Income Credit is there for the 20 million low income American workers who deserve it and need it.

TREASURY DEPARTMENT ACTIONS TO REDUCE EARNED INCOME TAX CREDIT OVERPAYMENTS AND FRAUDULENT CLAIMS

The Earned Income Tax Credit (EITC) provides appropriate incentives for people to choose work over welfare and rewards these working families by helping to lift them out of poverty. The Administration already is in the process of implementing and developing proposals to stem erroneous and fraudulent claims for EITC refunds.

I. ADMINISTRATIVE ACTIONS

The following actions are being implemented:

- The 1994 EITC Schedule was simplified to make it easier for low-income taxpayers to understand if they are eligible for the credit.
- The supplemental credits for health insurance and for infants under the age of one have been repealed. This has helped reduce the complexity of the EITC and improve compliance and administration. It also ensures that the most needy families get the credit amounts to which they are entitled.
- The IRS is conducting studies of refund fraud and EITC compliance to better understand the magnitude and source of erroneous payments.
- Working with the Justice Department, the IRS is prosecuting preparers and electronic return originators (EROs) who take advantage of the EITC provisions to defraud the Federal government.
- The IRS will continue a major overhaul of its information systems to help keep pace with the demands of a growing number of taxpayers.

The following actions will take effect in tax year 1995:

- The IRS will delay refunds on any questionable return with an invalid or missing taxpayer identification number. This will give greater time to verify the refund being claimed.
- The IRS will increase the number of staff devoted to detecting refund fraud by one-third.
- IRS field resources will be shifted to check compliance by electronic return originators (EROs) to ensure they are meeting requirements for participation in the program.

October 26, 1994

II. LEGISLATIVE PROPOSALS

During the past year, the Treasury Department has also made a number of legislative proposals to improve oversight of the EITC. The following proposals are contained in the GATT legislation which will be considered by the Congress in the November/December session:

- The EITC would be denied to prisoners and non-resident aliens.
- Taxpayers would be required to provide taxpayer identification numbers (generally, social security numbers) for all children claimed for EITC purposes. With this information, the IRS will be better able to verify a taxpayer's eligibility for the credit.
- The Department of Defense would be required to report certain types of non-taxable earned income, such as housing and subsistence allowances, to both military personnel and the IRS. Under current law, taxpayers are required to include non-taxable forms of income for the EITC, but many may be unaware how much they have received from their employers.

The Administration's welfare reform proposal also contains a provision related to administration of the EITC:

- The Treasury Department would create a demonstration project, under which eligible claimants could receive advance EITC payments through a state agency if the states verify the eligibility of the EITC claimants. These demonstration projects will allow the Treasury Department to test whether EITC compliance would improve if eligibility were verified up-front before advance payments were made.

III. ADDITIONAL ACTIONS

The Treasury Department is announcing two additional measures today to ensure that EITC refunds are paid <u>only</u> to eligible individuals:

- The Department will develop measures to deny the EITC to undocumented workers. Currently, the undocumented workers are entitled to receive the credit. This proposal will change that. IRS estimates that over 150,000 undocumented workers claimed the EITC for tax year 1993. Generally, they cannot obtain social security numbers for themselves or their children. As a result, it is difficult to verify the existence of a child without the social security number.
- Beginning in the 1995 filing season, the IRS will no longer provide direct deposit indicators (DDIs) to electronic return originators. The IRS currently provides EROs with such information to determine if the taxpayer's refund will be offset by another liability before payment. DDIs are often used by EROs to determine the riskiness of making a refund anticipation loan to a taxpayer. Refund anticipation loans are a source of fraud. Eliminating the DDI will reduce this fraud.

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MICHAEL A. ZUFERATA, MINORITY OVERSIGHT COUNSEL

October 11, 1994

The Honorable Ronald K. Noble
Under Secretary for Enforcement
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Under Secretary Noble:

I want to take this opportunity to personally thank you for leading the effort to combat tax refund fraud. Your recognition of the scope and magnitude of the refund fraud problem, coupled with your candid testimony before the Subcommittee on Oversight on October 6th, has helped generate the momentum necessary to assure that this problem is effectively dealt with at the highest levels of Government. I appreciate your contribution and respect the manner in which you are conducting this important review and presenting the facts.

The Tax Refund Fraud Task Force (TRF Task Force), under your stewardship, should also be commended for its thorough and independent investigation, solid findings, and recommendations for meaningful short-term reform. The TRF Task Force is performing a valuable public service and I'm hopeful its efforts will bring about an end to wide-scale fraud abuses.

The progress made by the TRF Task Force is a good start and your interim report offers some encouraging news. But clearly, more must be done to address the long-term concerns, such as implementation of strong fraud controls as part of IRS's Tax Systems Modernization program. It is my hope that you will help ensure that Treasury and IRS stay committed to addressing the tax refund fraud problem and preserving our voluntary tax system. You are doing an excellent job, Ron; keep up the good work.

With warm personal regards, I am

Sincerely,

Jake Pickle

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/ph
cc: The Honorable Lloyd Bentsen, Secretary
U.S. Department of the Treasury
Mr. Stephen A. Saltzburg, Director, TRF Task Force
Ms. Joyce J. Walker, Manager, TRF Task Force

GAO – this wk

1100 EITC returns IRS   Jan '94 study
- all electronic filers
- 29% overpayment $20 B
- 24% of total payments $5 Bi
were overpaid

Fraud – 13% potential fraud

160,000 illegal aliens claimed it
- Roth's big focus

Steps we've already taken

What are rates for normal?

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① Improve SSA [illegible] – ask for parent's Soc. Sec # when kid applies   Soc Sec database

② a) Only parent or legal guardian can claim EITC
- if you don't, it's acknowm of paternity
- down the road – must have paternity estab. – report to CSE

b) Nat. database will track AFDC – if you collect EITC more parents can't collect it w/another

③ W-4 reporting – link to EITC to get at unreported income
④ Require people to get certified to get EITC

LEGISLATIVE AND ADMINISTRATIVE OPTIONS TO MAKE EITC WORK BETTER

Legislative and Administrative Proposals Taken in 1993 and 1994

Simplicity and verification prior to payment of the EITC are key to the successful operation of the program. The most cost-effective way of lowering the EITC error rates is to ensure that the refund checks are not paid to the wrong people. The IRS can not expend thousands of dollars to recapture overpayments of $2,000 or $3,000 from low-income persons.

Simplicity

Simplicity for EITC Eligible Individuals -- Preventing costly taxpayer mistakes is a first step toward ensuring that EITC refunds are paid to the right taxpayers. This year, the Schedule EIC was redesigned to be easier to read. The repeal of the two supplemental credits for health insurance and young children in OBRA '93 will also reduce the Schedule EIC by a half-page and eliminate complicated provisions which were difficult for taxpayers to understand for the IRS to administer.

- Hispanic politics
- Calif politics

1) Slow down process ~~to~~ on questionable returns
2) SSNs for all kids at birth
3) Crackdown on return preparers
4) stiffer penalties for scams
5) deny EITC to illegal aliens
6) non-resident aliens

Verification

Delay Payment of EITC Until Verification Is Complete --

(1) Allow state agencies the option of providing the advanced EITC -- At the time that advance payments are made to workers under the current system, neither the IRS nor employers have reliable information about workers' eligibility for the EITC. Workers may receive the EITC in advance, only to learn at the end of the year that they must repay the IRS some or all of the advance payments because they erroneously claimed advance payments. Other workers may make fraudulent advance payment claims. If the advance payments were based on more complete information about the worker's eligibility, such erroneous and fraudulent claims could be reduced.

Under the Administration's welfare reform bill, States could have the option to propose to the Secretary of the Treasury a demonstration project pursuant to which advance payments of the EITC would be made to eligible residents through a State agency. Approval by the Secretary of the Treasury of a State's proposal would be required in all cases.

Allowing States the option to provide advance payments of the EITC may resolve many of the problems with the current system. Individuals could receive assistance in determining the appropriate amount of the EITC to claim in advance. States would also have the resources to verify eligibility for the credit better than employers, reducing the risk of erroneous payments being made to ineligible persons. A penalty could be imposed on States for lax verification.

(2) Delay EITC refunds on questionable returns -- During the 1993 filing season, the IRS began to delay payment of refunds on suspicious returns by one week, to allow for verification

of the return information. During the 1995 filing season, the IRS will slow the process further on returns with missing, invalid, and duplicate social security numbers for EITC claimants.

One Child, One Credit -- EITC claimants are required to provide taxpayer identification numbers (TINs) for each EITC qualifying child over the age of one. Generally, social security numbers (SSNs) are used as TINs.

Beginning with 1993 tax returns, the IRS is validating the social security number and the age of each qualifying child reported on a return filed electronically. (About 40 percent of tax returns claiming the EITC are filed electronically.) The returns are matched to a master tape containing SSNs and birth dates from the Social Security Administration (SSA). The IRS rejects returns with invalid SSNs and requires the taxpayer to correct and resubmit the return electronically or to submit the return on paper. The IRS also rejects electronically filed returns with "applied for" entered in lieu of an SSN for children over the age of one. The IRS also has begin to look for duplicate usage of the same SSN for qualifying children on electronically filed returns.

(1) Transcribe the SSN of EITC qualifying children on paper returns -- While all items on electronically filed returns are immediately available to the IRS for automatic testing, information on paper returns must first be transcribed to electronic tape. Because of transcription costs, some information from paper returns, including the SSNs of EITC qualifying children, is not transcribed (or is transcribed from only a sample of returns). Beginning with the 1995 filing season, IRS will transcribe the SSNs of all qualifying children from paper returns. This will allow the IRS to verify each child's SSN and date of birth and to check for duplicate uses of SSNs across all returns filed.

(2) Require SSNs for all qualifying children -- As part of the GATT financing provisions, the Administration has proposed that taxpayers provide the social security numbers of all children, regardless of age, claimed as dependents or for EITC purposes.

Non-taxable earned income -- Under current law, taxpayers are required to report non-taxable forms of earned income for the EITC. Examples of non-taxable earned income include military allowances, 401(k) contributions, and meals provided by employers. As part of GATT financing, we have recommended a proposal to be included in the welfare reform plan to require the Defense Department to report housing and subsistence allowances on Forms W-2.

Increase Knowledge Base

The IRS is conducting three small studies of EITC compliance during the 1994 filing season. The first study examines returns filed electronically during the first two weeks of the filing season (January 14 to 28). The second examines the behavior of electronic returns originators. The third examines paper and electronic returns filed throughout the filing season.
The IRS has used the information obtained in these studies to design a larger study of both electronic and paper returns filed throughout the 1995 filing season.

DEPARTMENT OF THE TREASURY
WASHINGTON

October 25, 1994

ACTION

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

FROM: **ERIC TODER** Eric Toder
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

SUBJECT: **GAO's Study of EITC Compliance**

Within the next week, Senator Roth is expected to announce the results of an interim GAO study of EITC compliance. GAO based its study on data collected by the IRS earlier this year. In February, 1994, IRS Criminal Investigations agents interviewed nearly 1,100 electronic filers who claimed the EITC during a two-week period in January. The study also describes IRS's efforts to prevent erroneous payments of the EITC during the 1994 filing season. GAO expects to release a final report in February; they are releasing the interim report in October at the urging of Senator Roth.

The report contains both good news and bad news for the Administration. On the one hand, the error rates, contained in the report, will be lower than the 40 percent rates found in studies of EITC compliance during the eighties. Nonetheless, the error rates, contained in the report, are still unacceptably high. The report will state that:

- 29 percent of the 1.3 million returns filed electronically during the last two weeks of January claimed too much EITC.[1]

- Of the $1.5 billion claimed in EITC during the first two weeks of the filing season, $358 million, or 24 percent of total EITC claimed, would have been overclaimed.

- About 13 percent of the EITC filers may have intentionally overclaimed the EITC. About $183 million, or 12 percent of the EITC refunds claimed, would have been the result of intentional errors by taxpayers.

---

[1] Earlier this year, the IRS briefed you on the principal findings of the report. At that time, they indicated about 40 percent of the returns had an adjustment to the refund. This estimate is higher than the error rates reported in the GAO study for two reasons. First, the IRS estimate includes returns with adjustments to the total refund, including those filers who correctly claimed the EITC but made errors elsewhere on their tax return. Second, the 40 percent estimate also includes returns with adjustments which were in the taxpayer's favor.

The GAO report indicates that the IRS is continuing to study EITC compliance. As more information becomes available, the IRS will be revising the estimates of non-compliance by the taxpayers included in the January study. For example, information reports (such as W-2's) are now being matched to the tax returns of the EITC claimants in the January study. GAO will state that IRS investigators believe that the error rates will increase as a consequence of further study. (Because the error rates may increase when the study is completed, it may be premature to state that non-compliance has declined since the eighties.)

The report also discusses IRS's processing of EITC returns, and the number of refunds which were delayed or rejected during 1994. According to the report, the IRS delayed $500 million in potentially erroneous EITC refunds claimed by 400 thousand taxpayers who filed paper returns but who did not include a social security number for the qualifying child. (Roughly 8 million taxpayers filed for the EITC on paper returns.) IRS rejected 610 thousand electronic returns, out of 6.3 million electronically filed EITC returns, because the qualifying child's social security number did not match social security records. The interim report does not criticize IRS's processing techniques.

At the request of Senator Roth, the report also contains a short discussion regarding illegal aliens and their eligibility for the EITC. Under current IRS procedures, undocumented workers may obtain the EITC even though they cannot obtain a social security number for their qualifying child from the Social Security Administration. Although taxpayers must report a taxpayer identification number for each child claimed for EITC purposes, there is some ambiguity in the law regarding whether the Social Security Administration is required to provide undocumented workers, with children, with social security numbers. According to the GAO, at least 160,000 EITC claimants were undocumented workers.

Press inquiries about the report are likely. Talking points, which can be used in response to press inquiries, are attached.

RECOMMENDATION -- The Administration could respond to the GAO report in several different ways. The Treasury Department could publicize the results of the IRS study before Senator Roth has an opportunity to release the GAO study. However, this approach may result in bigger headlines than Senator Roth's study. Instead, I would recommend a more low-key approach. Under this approach, press inquiries, following the release of the study, would be directed either to Assistant Secretary Samuels or Commissioner Richardson. In response to inquiries, they would stress the Administration's commitment to the EITC and its efforts to improve compliance.

______ Agree. ______ Disagree. ______ Let's Discuss.

Talking Points on GAO Study of EITC Compliance

- The Administration has made the expansion of the EITC one of its highest priorities. The EITC makes work pay and serves as a incentive to low-income families to reduce their dependency on welfare.

- From past experience, we know that there have been problems with taxpayers claiming the EITC when they were not eligible for the credit. To reduce EITC errors, OBRA '90 contained a number of compliance and simplification provisions. However, until this year, we did not have any information regarding the effectiveness of the OBRA '90 measures.

- In OBRA '93, the Administration proposed a phase-in of the expansion of the EITC in order to use the time to develop better systems to administer the credit.

- As part of that effort, the IRS has been conducting a study of EITC compliance during tax year 1993. The recent GAO report is based on the data collected by the IRS.

- The study confirms that taxpayers are still having difficulty complying with EITC requirements. But the study's findings are only applicable to taxpayers who filed electronic returns during the last two weeks of January.

  -- Early filers may not be typical of EITC recipients in general. For example, many early filers may not have received all of their Form W-2's at the time that they claimed the EITC. As a result, early filers may have a tendency to underreport wage earnings, resulting in erroneous EITC claims.

- In many cases, taxpayers' errors are the result of unintentional errors. Taxpayers may not understand the EITC eligibility criteria and thus can easily make mistakes when completing their tax returns.

- Even though the study of early filers may not be applicable to all EITC claimants, we take the results of this study very seriously. During the past year, we have made several legislative proposals to improve EITC compliance as part of GATT financing provisions.

  -- We have proposed that taxpayers be required to include the social security number of all children, regardless of age, who are claimed as dependents or EITC qualifying children. With this information, the IRS will be better able to verify a taxpayer's eligibility for the EITC.

  -- We have also proposed that the Department of Defense would be required to report to taxpayers and the IRS its payments of housing and subsistence allowances. Nontaxable earned income, such as military allowances, are includable in income for EITC purposes.

- As part of the Administration's welfare reform initiative, we have proposed a demonstration project which will test whether compliance will improve if the EITC is paid out through state offices.

- In OBRA '93, the Administration proposed the elimination of the supplemental credits for health insurance and for infants under the age of one. These supplemental credits have been source of non-compliance.

- During the past year, the IRS has also reexamined its processing of EITC claims. During the next filing season, the IRS will delay EITC refunds if the taxpayers' social security number, or the number of the taxpayer's child, appears questionable.

DEPARTMENT OF HEALTH AND HUMAN SERVICES
ASSISTANT SECRETARY FOR PLANNING AND EVALUATION

DEPARTMENT OF HEALTH & HUMAN SERVICES • USA •

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Date: 10-25-94

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To: Bruce Reed

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Number of Pages + cover 6

REMARKS:

DRAFT

EITC/WELFARE REFORM PROPOSALS TO COORDINATE BETTER TAX AND TRANSFER POLICY

THE NEW INFORMATION SYSTEM

To achieve our vision under welfare reform, we are proposing on the one hand, enhanced State and local information processing systems to improve management and delivery of services and for other purposes and, on the other, a national data "clearinghouse" to coordinate data exchange. With these systems in place, it will also be possible to make significant improvements in preventing and detecting fraud and abuse. These changes are described below.

Enhanced State Systems. At the State and local level, the new systems infrastructure would include automated subsystems for:

- Intake, eligibility determination, assessment, and referral;
- Case management and service delivery; and
- Benefit, payment, and reporting.

The infrastructure would consist of new systems components integrated with existing or modified State and county-level systems. The wide variations in existing automated systems make it unreasonable to try to standardize these systems. Instead, we need linkages that allow for the accurate exchange of data between systems.

By linking the various programs and systems, States could provide integrated services and/or benefits to families and individuals "at-risk" of needing financial assistance, those receiving assistance, and those transitioning from public assistance to self-sufficiency. As part of this automation effort, enhanced funding will be offered as an incentive for States to develop and carry out statewide, automated systems for JOBS/WORK management and monitoring, and to enable seamless services for child care.

Such an automated system infrastructure would enable States to provide greater support to families who might otherwise dissolve and to parents who may, because of unmet needs, be forced to terminate employment or training opportunities. In other words, this structure will allow the integration and interfacing of multiple systems, for example, AFDC, food stamps, work programs, child care, Child Support Enforcement (CSE), and others.

In addition, as Electronic Benefit Transfer (EBT) and Electronic Funds Transfer (EFT) become more widespread, they would be used for other programs, such as reporting of JOBS participation and child care reporting and payments. As an example, a JOBS participant could be required to self-report either with a touch-tone phone that connects to a Voice Recognition Unit (VRU) or with plastic card technology.

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To facilitate development of these systems, the Federal Government, in partnership with the States, or groups of States in partnership with the Federal Government, will develop model systems that perform these functions or subsets of these functions.

National Clearinghouse. The National Clearinghouse will be a collection of abbreviated case and other data that provides the minimum information for carrying out key program features under welfare reform. In addition, it will "point" to where detailed data resides. The Clearinghouse will not be a Federal data system that does individual case activities. Instead, States will retain general processing responsibility, but information will go to and from the Clearinghouse.

The Clearinghouse will maintain at least the following data registries:

- The National New Hire Registry will maintain employment data on all new employees in the U.S. as they are hired. Information in the database will be matched regularly against the National Child Support Registry.
- The National Locate Registry will enhance and subsume the current Federal Parent Locator Service (FPLS) functions and allow States to locate persons who owe child support or who are owed child support.
- The National Child Support Registry will contain data on all noncustodial parents who have support orders and can match these cases against other databases for enforcement purposes.
- The National Welfare Receipt Registry will contain data to operate a time-limited assistance program, such as Social Security numbers, beginning and ending dates of welfare receipt, participation in various work programs, and the name of the State providing benefits.

National Welfare Receipt Registry

In general, the Registries will operate similarly. For example, the National Welfare Receipt Registry will be maintained by obtaining electronically from each AFDC agency information on individuals receiving benefits. Upon request, the Clearinghouse will send electronically information to the State agency.

The information to be exchanged is as follows:

- Information to be sent to the Clearinghouse includes identification information, such as the names and Social Security Numbers of members of the family; the dates an individual went on and off assistance; participation information for AFDC, JOBS and WORK programs; information on extensions of time-limits and sanctions for noncompliance for these and other programs; and other information as specified by the Secretary.
- Information to be received from the Clearinghouse includes whether the applicant has been reported to have received assistance and, if so, when and in which State(s); whether the Social Security Numbers supplied are valid; whether the applicant is contained in the New Hire Registry as recently employed; and other information as specified by the Secretary.

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Information Discrepancies. If an information discrepancy exits between the information the client presents to the State agency and the information in the Clearinghouse, the Secretary will assist in the resolution by verifying that the data contained in the Registry reflects the information contained in the State agency records where the individual had previous assistance, correcting the Clearinghouse information if necessary, and reporting the updated information to the requesting State.

The States involved must take appropriate actions to resolve the discrepancy according to normal due process requirements and must submit corrected information to the Clearinghouse when the discrepancy is resolved.

ENHANCED STATE SYSTEMS

As indicated above, state systems will be enhanced to provide additional capabilities and to exchange data with the National Clearinghouse. The three main enhancements to State welfare information systems are described below.

Transitional Assistance Support Information System

The State agency, to assist in the administration of time-limited welfare, will establish and operate a statewide, automated, Transitional Assistance Support Information System. This system will serve to significantly improve the effectiveness and efficiency of State systems information infrastructures for the management, monitoring, and reporting on clients as they work toward independence and self sufficiency. The State may receive enhanced funding for these changes under specific approaches approved by DHHS and described below.

Minimum System. The minimum capabilities of the State system include:

- Exchanging information as described above in a standard, electronic format with the National Clearinghouse;
- Querying electronically the National Welfare Receipt Registry in the National Clearinghouse before granting assistance;
- Using the information received from the Clearinghouse in the determination of eligibility and period for which assistance may be granted;
- Reporting corrected or updated information to the Registry; and
- Meeting current statutory requirements for security and privacy.

Augmented System. In a collaborative effort with other States in which an augmented system is developed, a State may adopt the augmented system and receive enhanced match for development costs. Under this augmented system, clients will receive considerably enhanced service responsiveness through prescreening to match available services to individuals and determine the required qualifying and verification information needed for each service. The additional automated functions must include at least: determining eligibility; improving government assistance standards;

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performing case maintenance and management functions; calculating, managing, and reconciling payments to eligible recipients; providing for processes and procedures to detect and prevent fraud and abuse; and producing reports.

Child Care Case Management Information System

Again in collaborative efforts, States will be given enhanced match to develop a comprehensive Child Care Case Management Information System. This system will provide statewide, automated, procedures and processes to achieve seamless child care delivery, including all child care programs of the State.

JOBS/WORK Case Management Information System

Finally, States will be given enhanced match to develop a JOBS/WORK Case Management Information System, again if the development is done as a collaborative effort. This system will provide statewide, automated, procedures and processes to control, account for, and monitor all factors of the JOBS and WORK programs and support both management and administrative activities of the programs.

ENHANCED DETECTION OF FRAUD AND ABUSE

The proposed welfare system will lead to substantial improvements in detecting and controlling fraud and abuse compared to the current system. In many States, existing systems cannot handle the growing number of applications for aid and the transient nature of these clients. Compared to existing information systems, new local, State, and Federal systems will dramatically increase the ability to detect fraud and abuse. As knowledge of these efforts grows, prevention and deterrence of fraud and abuse will increase as well.

The following examples illustrate what States could do with the newly-available information. First, the National Clearinghouse will provide States with information on employment so they can detect unreported income of noncustodial parents, leading to increased child support payments. It will also allow States to detect unreported income of welfare clients, leading to lower caseloads.

Improved parent locator capabilities will mean States can find absent parents more quickly and easily. Coupled with improved information on employment, this means increased child support collections and reduced welfare spending.

States can use the location and receipt of AFDC and the names and Social Security Numbers of members of AFDC families to detect and prevent other forms of fraud and abuse. Such information, either alone or by matching it with other data sources, will allow States to prevent, for example, clients from receiving benefits in multiple locations, from claiming non-existent children, and from claiming children by more than one family.

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Partly because of increasing the detection of fraud and abuse and partly because of changing the culture of the welfare system, much fraud and abuse will be prevented or deterred before it occurs. For instance, people who currently have unreported jobs, but are fraudulently getting cash assistance, will be "smoked-out" because the JOBS plus WORK requirements will prevent them from working at their unreported employment. In the face of increased likelihood of detection of fraud and abuse, others may decide not to come onto the rolls at all or, once on, to actively pursue self-sufficiency.

PROPOSALS TO COORDINATE BETTER TAX AND TRANSFER POLICY

The following proposals for improving the coordination of tax and transfer policy could make use of the new data systems proposed under welfare reform. They are meant to be illustrative of what could be done with the new information that will be available when the new systems are in place.

1. *For a male head of household to claim the EITC, paternity, adoption, legal guardianship, or foster care as determined by legal proceeding must be established.*

For checking paternity claims, the National Clearinghouse could verify those claims entered in the National Child Support Registry against IRS records. Checking foster care relationships would depend on how automated the particular State system was.

2. *For a joint or head of household return, all child support must be paid before processing the EITC. The EITC would be reduced (or eliminated completely) by the amount of the unpaid child support and the amount owed would be sent to the custodial parent.*

Since the State child support records keep track of how much is owed for each child, they could supply the amount of unpaid child support by SSN. This data would be provided to IRS.

3. *An adult claiming a child for EITC and other tax purposes, must be the same adult claiming the child for AFDC and food stamp purposes.*

The National Clearinghouse will contain all the SSNs for AFDC cases. This data would be matched annually with the tax data.

4. *Each child claimed for EITC must have a valid Social Security Number. Under this proposal, the IRS must cross-check EITC claims with SSA records.*

The Social Security Administration has validated SSNs for many years.

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5. *The IRS must check that the child is not claimed more than once.*

This check can be done internally at IRS, however, it would be more effective if done in conjunction with validating the SSNs as proposed in 4.

6. *The IRS and HHS must ensure that reporting of wages is similar between tax and transfer systems..*

Currently, the IRS does some checking of the reporting of wages by employees with the records provided by employers to SSA. The checking could be extended to comparing the amount of wages for tax and transfer purposes. Specifically, States could produce annual reported wage totals by SSN to be matched with tax records.

7: *Ensure that welfare overpayments and child support payments can be subtracted from EITC payments.*

Currently, welfare overpayments are collected from on-going benefits, but if the client is no longer receiving welfare the collection is harder. Collecting the overpayment by reducing the EITC would be a single collection rather than a lengthy incremental process as is the case with AFDC currently. State data systems would contain the required data for processing these actions, but the ease with which this can be done depends on the degree of automation of the State systems.