

IMPROPER PAYMENTS IN THE ADMINISTRATION OF REFUNDABLE TAX CREDITS

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED TWELFTH CONGRESS FIRST SESSION

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HEARING ON TRANSPARENCY AND FUNDING OF STATE AND LOCAL PENSION PLANS

WEDNESDAY, MAY 25, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
WASHINGTON, DC.

The Subcommittee met, pursuant to notice, at 10:35 a.m., in room 1100, Longworth House Office Building, the Honorable Charles W. Boustany, Jr. (Chairman of the Subcommittee) presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

Boustany Announces Hearing on Improper Payments in the administration of Refundable Tax Credits

Thursday, May 26, 2011

Congressman Charles W. Boustany, Jr., MD, (R-LA), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on improper tax payments in the administration of refundable tax credits. The hearing will take place on Wednesday, May 25, 2011, in room 1100 of the Longworth House Office Building, beginning at 10:30 A.M.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

While some tax credits reduce a taxpayer's liability to zero, refundable credits can also result in a taxpayer receiving money from the government even if they have paid no taxes. In recent years, the number and dollar amount of improper payments arising from refundable tax credits has been increasing at an alarming pace. Over the last few years, the rampant abuse and misapplication of these credits has cost taxpayers an estimated \$106 billion.

Despite this alarming abuse of taxpayer dollars, the Treasury Inspector General for Tax Administration has noted that the IRS has made little progress in reducing improper payments since being required to report these figures to Congress and the Office of Management and Budget. In fact, the Government Accountability Office reported that in 2010, the EITC was the fourth largest source for improper payments among all Federal Government programs, with an estimated \$16.9 billion in improper payments.

In announcing the hearing, Chairman Boustany said, "At a time of record level Federal deficits, the last thing the government can afford is to be hemorrhaging tens of billions of dollars in improper payments. The Subcommittee needs to understand the current levels of waste, fraud, and abuse and what can be done to prevent billions of dollars of improper payments each year."

FOCUS OF THE HEARING:

The hearing will focus on the administration of refundable tax credits, with an emphasis on the level of improper payments attributable to refundable credits, and steps the IRS is taking to reduce the level of waste, fraud, and abuse related to these credits.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. Attach your submission as a Word document, in compliance with the formatting requirements listed below, by the close of

business on Wednesday, June 8, 2011. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-5522.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

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

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

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

Note: All Committee advisories and news releases are available on the World Wide Web at <http://www.waysandmeans.house.gov/>.

Chairman BOUSTANY. This Subcommittee hearing will come to order. Good morning to everyone. I would like to welcome everyone to this morning's hearing on improper payments in the administration of refundable tax credits.

In the course of less than a decade, improper payments arising from refundable tax credits have cost taxpayers an estimated \$106 billion, according to government reports. To put this amount of money in perspective, it's more than the fiscal year budgets of the Departments of Homeland Security, Justice, Treasury, and Transportation, combined.

Refundable tax credits not only reduce an individual's tax liability, they can also result in payments from government when credits exceed one's tax liability, meaning that millions of Americans have been able to eliminate any income tax liability, and even get a check back from the government via refundable credits. Not surprisingly, this makes them an attractive target for those willing to claim more than they are legally due, or otherwise to cheat the system.

The problem is so widespread that the inspector general has even found IRS employees abusing refundable tax credits. Some improper payments can also result from honest errors that are an inevitable result of our complex and convoluted Tax Code. But whether caused by innocent mistakes or outright fraud, improper payments cost the taxpayer dearly.

For instance, the earned income tax credit consistently ranks among one of the most vulnerable Federal programs, with improper payments totaling nearly \$17 billion in 2010, according to GAO. This is roughly a quarter of the program's total outlays. And this is not a new problem with this credit, as IRS has issued as much as \$83 billion in improper payments since 2003.

Another example is the additional child tax credit for which improper payments have reportedly risen from under \$100 million in the year 2000 to well over \$4 billion in 2010. And the list goes on.

In the case of the first-time homebuyer credit, over half-a-billion dollars reportedly has gone to individuals who did not qualify for the credit. The inspector general recently found thousands of tax filers who claimed the first-time homebuyer credit by listing a P.O. box as their qualifying home.

Thousands of prisoners successfully claim the first-time home buyer credit, as did hundreds of children. Hundreds more successfully claimed undecided or to-be-determined as their address, and still received the credit.

Despite these numbers and examples, not enough is being done to stem the tide of improper payments. Reports suggest that IRS has failed to develop an effective way to measure progress at reducing these improper payments. The Agency has also failed to implement years of inspector general recommendations that, if accepted, could save the taxpayers billions of dollars.

Given these staggering numbers, this morning's hearing will explore the size and scope of these improper payments, and whether IRS is doing what is necessary to ensure the integrity of refundable tax credit programs. I am hopeful that the testimony provided by today's panel will also help the Committee identify additional actions that might be taken to protect taxpayer dollars.

Before I yield to the Ranking Member, Mr. Lewis, I ask unanimous consent that all Members' written statements be included in the record.

[No response.]

Chairman BOUSTANY. Without objection, so ordered.

I now—I like to recognize the Ranking Member for the purposes of an opening statement.

Mr. LEWIS. Good morning. Good morning, Mr. Chairman. I want to thank you for holding this hearing today. The topic is both timely and important. But I must say that I am troubled. I am concerned by the current path of this Committee.

I continue to ask, "Who is next? What else is on your list?" We started the year with seniors and proposals to end Medicare. The committee then moved to teachers and their pensions, and then to women, health, and uninsured. And today the target is middle-class working families.

In 2009 the tax credit discussed today delivered almost \$160 billion to more than 100 million Americans. They help students pay for college. They help family care for their children. They help families adopt children. They help million buy homes. They help make work pay. They help middle class family do just a little bit better.

Today we are here about a program for working families created over 35 years ago, the earned income tax credit, a program that encourages and rewards work and give dignity to people who work

hard each and every day, a program that lifts families and their children out of poverty and into the middle class—over 70 million families last year alone. A program expanded by both Democrats and Republican, alike, including President Reagan.

The administration of tax benefits for middle-class and working families is no different than from corporations and the wealthy. Tax benefits are complex. We all agree that we must improve the administration of our taxes. However, we should not use flawed estimates based on old data to single out working families, middle-class Americans.

Why are we here today, putting tax benefit for middle class families in a bad light?

Now, I stand for fairness in tax administration, and I stand for million of working American families. These families need our help today. I support these tax credits. And I will fight to improve these program and give these families a fair shake.

I want to thank each and every one of the witnesses for being here today. Thank you, Mr. Chairman, and I yield back.

Chairman BOUSTANY. I thank the Ranking Member for his statement. I now want to welcome our panel of witnesses.

First we have Mr. Steven Miller, who is deputy commissioner for services and enforcement at the IRS. Mr. Miller, welcome.

We have Mr. Russell George, the Treasury inspector general for tax administration. Mr. George, we welcome you. And you are accompanied by Mr. McKenney, Mr. Mike McKenney, assistant inspector general for audit. Mr. McKenney, welcome.

We also have Mr. Michael Brostek. He is the director for tax policy and administration at the government Accountability Office. Welcome, Mr. Brostek.

And, of course, Ms. Nina Olson, who is the national taxpayer advocate at the IRS. Ms. Olson, welcome.

We thank you all for being here today.

You will each have 5 minutes to present your testimony, with your full written statements being submitted for the record.

Mr. Miller, we will now begin with you. You may proceed with your opening statement.

**STATEMENT OF STEVEN MILLER, DEPUTY COMMISSIONER
FOR SERVICES AND ENFORCEMENT, INTERNAL REVENUE
SERVICE, WASHINGTON, D.C.**

Mr. MILLER. Thank you, Mr. Chairman, Ranking Member Lewis, Members of the Subcommittee. My name is Steve Miller, Deputy Commissioner at the Internal Revenue Service. I appreciate the opportunity to testify on refundable tax credits.

The IRS currently administers numerous refundable credits, including the earned income tax credit, first-time home buyer credit, additional child tax credit, adoption credit, making work pay, and the American Opportunity tax credit. As we administer these credits, we must balance two considerations: first, refundable credits are provided to achieve important Congressional purposes, such as relief from poverty or boosting the economy; second, a refundable credit allows the taxpayer to receive cash without regard to tax liability. As a result of these factors, the IRS must deliver the prom-

ised refunds in the intended timeframe, while ensuring that appropriate controls are in place to minimize errors and fraud.

To be more specific, let me outline some of the challenges in this area. The first is complexity. Complexity in the rules governing eligibility, and in the operation of certain refundable credits creates challenges for both taxpayers and the IRS. Mistakes in the application of the law are a significant portion of claims made in error.

Second is the lack of third-party data. In many cases, the IRS lacks real-time third-party data to verify eligibility. For example, under one version of the home buyer credit, an individual must have owned and lived in a house for five consecutive years during an eight-year period prior to the subsequent purchase of a home. There is no third-party data to verify that requirement.

Third, the timing of data. Even if third-party data does exist, the IRS often must decide on the validity of a refund before receiving that data. Now, I want to note that we are continuing to focus on getting more information in earlier than the filing season to do matching. But it is a challenge.

Fourth, hard-to-detect fraud. The IRS confronts on an ongoing basis schemes involving erroneous refund claims, including claims made by prisoners, non-citizens, as well as schemes involving deceased persons. The problem is particularly acute in the case of prisoner refunds, and we have developed systems that provide special scrutiny in this area and, in fact, have doubled the number of refunds being stopped this year.

Finally, tax law changes. The IRS often faces extremely compressed timeframes for implementing a new law. Let me take a moment to outline some of our work on the earned income tax credit. Fraud and error in the EITC is a significant problem, and a top priority for us. Because the eligibility requirements are numerous and complex, our work begins with informing people of these requirements before they file.

Our enforcement tools recover or protect billions annually. These tools include examinations, math error, and document matching. The IRS started more than 500,000 EITC exams in 2010, most of which were pre-refund. Last year, using math error authority, IRS also blocked approximately 350,000 improper refund claims. We do matching of data that is effective, as well, finding 900,000 mismatched returns last year. And we have asked for additional enforcement resources for next year in the 2012 budget.

While traditional compliance efforts are effective, we continue to explore other ways to combat non-compliance. The cornerstone of these efforts is our return preparer approach. More than 60 percent of EITC returns are from preparers. Our work begins with outreach, but includes thousands of contacts, including 10,000 notices and more than 1,000 due diligence visits. Most importantly, we now require registration of return preparers, and will shortly require testing and continuing professional education. More than 700,000 have registered with us.

Finally, in 2011, return preparers who file an EITC return will have to attach the current form 8867, detailing the due diligence they performed in preparing the EITC claim. More changes in the due diligence requirements will be proposed later this summer.

Let me conclude. Refundable tax credits play an important role in fulfilling congressional policies. But, as I have mentioned, they pose challenges. I believe we are improving our administration of these credits. But much work remains. And toward that end, as part of our 2012 budget, in addition to the enforcement resources that we have outlined above, we have also requested funds to create a refundable credits office that will centralize planning and oversight in this area.

Mr. Chairman, this concludes my prepared remarks. I will be glad to answer any questions.

[The statement of Mr. Miller follows:]

**WRITTEN TESTIMONY OF
STEVEN T. MILLER
DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT
INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT
ON REFUNDABLE TAX CREDITS
MAY 25, 2011**

INTRODUCTION AND SUMMARY

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee on Oversight, my name is Steven Miller and I am Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. I appreciate the opportunity to testify on refundable tax credits and the ongoing efforts by the IRS to ensure proper administration of the laws relating to these credits.

The number of refundable tax credits has grown in recent years. A refundable credit, unlike other tax credits, not only has the potential to reduce a taxpayer's tax liability to zero but allows the taxpayer to receive a cash payment of any remaining credit amount. Non-refundable credits simply decrease a taxpayer's liability dollar for dollar. These credits implement important Congressional policies, but because taxpayers do not need to have any tax liability to benefit from refundable credits, these credits increase the scope for unintentional error and abuse.

Although a small number of refundable tax credits have existed in the tax code for many years, the proliferation of refundable credits is a fairly recent phenomenon. The IRS currently administers numerous tax laws related to such credits, including, but not limited to the Earned Income Tax Credit, First Time Homebuyer Credit, Additional Child Tax Credit, Adoption Credit, Making Work Pay Credit and the American Opportunity Tax Credit.

The IRS has a dual mission when it comes to administering refundable tax credits. We must balance the mandate to get refunds to those eligible as quickly as possible with ensuring that the money goes only to individuals who are eligible to receive it.

BACKGROUND

Earned Income Tax Credit

Congress created the Earned Income Tax Credit (EITC) as part of the Tax Reduction Act of 1975, to offset Social Security taxes. The credit has evolved into an important program that now lifts millions of children and families above the poverty line each year. In fact, the EITC has come to be known as one of the most important anti-poverty

programs, specifically because it can be claimed by workers whose incomes are so small that they incur no tax liability.

The EITC experiences a high participation rate (75 percent - 80 percent). In 2009, the EITC was claimed on approximately 26 million returns, and the total amount claimed was more than \$58 billion. The value of this credit can be as high as \$5,751 in 2011 for a taxpayer who has three or more qualifying children. For taxpayers with two qualifying children, the maximum credit that can be claimed is \$5,112. For those with one qualifying child it is \$3,094 and for those with no children, it is \$464.

The credit is taken on "earned income," which includes wages, salaries and other employee compensation, plus earnings from self-employment. To qualify for the credit, individuals must:

- Have earned income;
- Have a valid Social Security number for themselves and for any qualifying child;
- Have investment income of no more than \$3,150 for 2011; and
- Be a U.S. citizen or resident alien for the entire year for which the credit is claimed.

For a child to be considered a qualifying child, the following tests must be met:

- *Age:* The child must be under age 19 at the end of the year (under age 24 in the case of a student) and younger than the taxpayer (or younger than both the taxpayer and the taxpayer's spouse if filing a joint return), or the child must be permanently and totally disabled at any time during the year for which the EITC is claimed;
- *Residency:* The child must have lived with the taxpayer for more than half of the year for which the credit is being claimed, although certain exceptions to this rule apply
- *Relationship:* The child must be the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, such as a grandchild, niece or nephew. Adopted children also qualify, including those lawfully placed with the taxpayer for legal adoption.

In addition, a claimant cannot be the qualifying child of another taxpayer, and cannot use the "married filing separately" filing status. Additional requirements apply for individuals who do not have qualifying children. The credit initially increases as earned income increases, and then is phased out. Taxpayers whose income exceeds certain thresholds are not permitted to claim the EITC.

The American Recovery and Reinvestment Act of 2009 (ARRA) increased the benefit of the EITC for working families with three or more children for 2009 and 2010. Thus in 2009, those families could receive a maximum benefit that was \$629 more than families with two children could receive. In 2010, Congress extended this increase in the EITC through 2012. The additional amount that can be received in 2011 is \$639. Marriage penalty relief and certain other simplification provisions enacted in 2001 are also scheduled to expire after 2012.

First Time Homebuyer Credit

The First Time Homebuyer Credit (FTHBC) was enacted in July 2008 as part of the Housing and Economic Recovery Act of 2008. Under this law, taxpayers who purchased a principal residence after April 8, 2008 and before July 1, 2009, were allowed a credit equal to 10 percent of the purchase price of the home, but not more than \$7,500. In its original form, this refundable credit served as an interest-free loan to taxpayers that must be paid back over a 15-year period beginning two years after the credit was claimed. The FTHBC phases out for taxpayers over certain income levels.

The FTHBC has been amended by three subsequent tax law changes that crossed tax years and also changed the credit type and amount, the eligibility requirements and the effective dates. ARRA extended the tax credit to home purchases through November 30, 2009, increased the credit amount to \$8,000, and extended timeframes for certain military personnel to claim the credit. For homes purchased in 2009, the repayment requirement was eliminated for any taxpayer who kept the home as a primary residence for at least three years. Taxpayers were also allowed to claim a 2009 purchase on a 2008 return.

In November 2009, the Worker, Homeownership, and Business Assistance Act (WHBAA) extended the tax credit to home purchases through April 30, 2010 (but required buyers to close on the home before July 1, 2010). It authorized a credit of up to \$6,500 for long-time residents who buy a new principal residence. It also increased income limits and extended dates for certain members of the military and certain federal employees serving outside of the U.S. Taxpayers were also allowed to claim a 2010 purchase on a 2009 amended return. In this third iteration of the credit, taxpayers were required by Congress to submit documentation with their claims and the IRS was given compliance tools to automatically deny a claim using math error authority under certain circumstances.

In July 2010, the Homebuyer Assistance and Improvement Act (HAIA) allowed those in a binding contract on April 30th to have an additional three months to close on their home purchase, by extending the deadline from June 30th to September 30th.

As of March 2011, more than 4 million returns have been processed claiming more than \$28 billion in the FTHBC.

Child Tax Credit

The Child Tax Credit (CTC) was enacted as part of the Taxpayer Relief Act of 1997. The law allows taxpayers a credit for each qualifying child under the age of 17. In 1998, the first year after enactment, the maximum allowable credit was \$400 per qualifying child, rising to \$500 the next year. In 2001, Congress increased the maximum credit to \$1,000 per qualifying child. The higher amount is scheduled to expire at the end of 2012.

For a child to be considered a qualifying child, the following tests must be met.

- *Age:* The child must be under age 17 at the end of the year and younger than the taxpayer (or younger than both the taxpayer and the taxpayer's spouse if filing a joint return) during the year for which the CTC is claimed;
- *Residency:* The child must have lived with the taxpayer for more than half of the year for which the credit is being claimed, although certain exceptions to this rule apply.
- *Relationship:* The child must be the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, such as a grandchild, niece or nephew. Adopted children also qualify, including those lawfully placed with the taxpayer for legal adoption;
- *Support:* The child must not provide more than half of his or her own support;

The taxpayer must also be able to claim the child as a dependent on his or her tax return. In addition, the child must be a U.S. citizen, U.S. national or U.S. resident alien. In contrast to the treatment of the EITC, the Internal Revenue Code does not require a qualifying child to have a Social Security number for purposes of the child tax credit.

In general, the CTC is a nonrefundable credit and phases out over certain adjusted gross income thresholds. However, the taxpayer may be eligible for a refundable amount (the Additional Child Tax Credit, or ACTC) if the amount of child credit for which the taxpayer was otherwise eligible exceeds the taxpayer's tax liability. Taxpayers may claim an ACTC equal to 15% of earned income in excess of \$3,000 up to the value of any otherwise unclaimed amounts in excess of tax liability. Taxpayers with three or more children may claim an additional child tax credit equal to the amount by which the taxpayer's Social Security taxes exceed the taxpayer's EITC, if that amount is greater than the additional child tax credit based on the taxpayer's earned income. After 2012, the ACTC will largely expire. Thereafter, only families that would receive the ACTC under the alternative, EITC-based formula will be eligible for a refundable child credit.

In 2009, \$26.8 billion in ACTC was claimed on 20 million returns.

Adoption Credit

The Adoption Credit was enacted in 1996 as part of the Small Business Job Protection Act. That law allowed taxpayers to take a nonrefundable credit of up to \$5,000 of qualifying expenses paid to adopt an eligible child (\$6,000 in the case of a child with special needs). Congress raised the limit on adoption expenses to \$10,000 in 2001. The Patient Protection and Affordable Care Act of 2010 increased the maximum again, to \$13,170 per adopted child, and made the credit fully refundable for 2010 and 2011. After 2011 the credit reverts back to a nonrefundable credit.

For purposes of this credit, qualifying expenses include reasonable and necessary adoption fees, court costs, attorney fees, travel expenses and other expenses directly

related to, and for which the principal purpose is, the legal adoption of an eligible child. An eligible child must be under 18 years old, or be physically or mentally incapable of caring for himself or herself. The credit phases out above certain income levels. Effective for 2010, the IRS required taxpayers to attach one or more adoption-related documents with the completed Form 8839, Qualified Adoption Expenses that is filed with the taxpayer's return.

In the current filing season, through April 29, 2011, we have received just under 73,000 returns claiming the adoption credit, for a total of \$880 million.

Other Refundable Tax Credits

The Making Work Pay Credit (MWP), enacted as part of ARRA, is a fully refundable tax credit based on earned income, and can be up to \$400 (\$800 on a joint return) in 2009 and 2010. The credit is reduced and begins to phase out at \$75,000 of modified adjusted gross income for single taxpayers and \$150,000 for couples. To receive this credit, a taxpayer must have earned income such as wages, salaries, tips, net earnings from self-employment, and a valid Social Security number. The credit was advanced to taxpayers throughout the year through withholding and then later claimed on income tax returns. More than 100 million taxpayers claimed more than \$50 billion in the MWP credit in 2009. Beneficiaries of Social Security, Supplemental Security Income, Railroad Retirement and Veterans Disability received a \$250 one-time Economic Recovery Payment that reduced the allowable MWP credit amount. Many taxpayers were not aware of the required reduction and IRS had to take actions to correct these returns.

The American Opportunity Tax Credit (AOTC), also created under ARRA, is essentially a modified version of the HOPE Credit for education and can be taken for tuition and certain related expenses paid during 2009 and 2010. The maximum AOTC is \$2,500 per year, and the credit can be claimed for expenses for the first four years of post-secondary education. The HOPE Credit can be claimed only for the first two years of post-secondary education, and its maximum dollar amount is \$1,800. The AOTC is 40 percent refundable, whereas the HOPE Credit is nonrefundable. The AOTC begins to phase out at \$80,000 of modified adjusted gross income (\$160,000 on joint returns). In addition, the definition of "qualified tuition and related expenses" was expanded to include expenditures for "course materials." For this purpose, the term "course materials" means books, supplies and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance. In 2009, the AOTC was claimed on 9 million returns, for a total of approximately \$7.8 billion.

IRS TREATMENT OF REFUNDABLE TAX CREDITS

In administering refundable tax credits, the IRS must deliver the benefits that the legislation provides in the intended time frame, while ensuring that appropriate and prudent controls and filters are in place to minimize errors and fraud. This is not an either/or proposition. We must do both well.

In this regard, the IRS recognizes that there is the potential for both fraud and unintentional errors whenever a refundable tax credit is enacted into law or is modified in some fashion. Our compliance challenge has been made all the more difficult in recent years when in some cases late or retroactive passage of statutory changes require us to meet razor-thin implementation deadlines. In addition, annual changes such as those that occurred with respect to the FTHBC, make it very difficult for the IRS to adequately plan for processing and compliance.

Taxpayer Outreach and Assistance

The IRS is committed to assisting taxpayers in understanding and fulfilling their tax obligations. We also strive to ensure that taxpayers are aware of any tax relief to which they may be entitled. For refundable tax credits, these efforts have resulted in a variety of strategies tailored to the specific tax relief being provided, as well as the expected impacted taxpayer segment. Following are specific examples of outreach activities.

Earned Income Tax Credit. The IRS has developed a robust, multi-year integrated communication strategy that leverages communication channels and marketing to increase usage of the credit.

Along with public service announcements on TV and radio, the IRS is also utilizing social media, including Facebook and Twitter. Our website, IRS.gov, includes a page devoted to information about the EITC, called EITC Central, at www.eitc.irs.gov. This site contains information for both taxpayers and preparers, including a Paid Preparer Due Diligence Training module in both English and Spanish.

On January 28, 2011, the IRS held its fifth annual EITC Awareness Day, generating more than 600 activities to increase EITC awareness and help individuals find free tax preparation. Events included 180 press conferences and news releases, 63 letters to the editor, 148 electronic media postings, including postings on Facebook and Twitter, and more than 270 other local activities. Many of these events were supported by congressional, state and local government officials. At the national level, the IRS reached 1,266 English and 87 Spanish-language radio affiliates throughout the country. EITC Satellite Media Tours in English and Spanish reached more than 1.9 million people.

First Time Homebuyer Credit. Upon enactment of the FTHBC, the IRS undertook significant efforts to ensure that taxpayers were aware of the benefit, in addition to developing new forms and instructions to allow taxpayers to file the claim, and implementing significant compliance programs to ensure that the claims were valid.

We focused outreach efforts not only on taxpayers, but also the return preparer community and industry partners. This included numerous media interviews, press events, podcasts, public service announcements and a national marketing campaign leading to countless news articles in English and Spanish featuring the FTHBC. The

IRS publicized the program's details through a special section on IRS.gov, created YouTube videos in English, Spanish and American Sign Language, and issued numerous news releases. We also sent notices to taxpayers who claimed the \$7,500 FTHBC but who may have actually been entitled to the expanded \$8,000 credit under the Recovery Act, to encourage them to file an amended return to claim the additional benefit.

The IRS conducted extensive education and outreach activities with return preparers who assisted taxpayers claiming the credit. We sought to ensure that preparers understood the FTHBC eligibility requirements to minimize inaccurate FTHBC claims. We made visits to some preparers to explain the new law. We also distributed written materials through our e-news for Tax Professionals email service, and we covered the FTHBC at seminars attended by more than 6,500 preparers during the IRS Nationwide Tax Forums.

Additionally, the IRS held a phone forum in partnership with the Department of Housing and Urban Development's Department of Single Family Housing Planning and Development to educate their industry partners and advocacy group partners on the FTHBC requirements for their clients. These partners spread the information through their own networks.

Making Work Pay Credit. As with the FTHBC, the IRS developed and distributed a broad range of related communication products for the media, Internet, partners and taxpayers. Beginning in early 2009, we also held thousands of IRS outreach events where we discussed this credit with partner and stakeholder groups, and we highlighted this credit at our own IRS Open Houses for taxpayers.

For the 2010 filing season, the IRS provided taxpayers with the Making Work Pay Withholding Calculator, in both English and Spanish, to help them determine whether they needed to adjust their withholding to avoid having too much or too little Federal income tax withheld from their pay. A total of 4.4 million taxpayers took advantage of this tool.

Processing of Returns with Credits

In administering refundable tax credits, the IRS takes very seriously the need to prevent erroneous and fraudulent refund claims. To the extent possible, it is important to process returns in such a way that identifies problems at an early stage. Tax returns that contain claims for refundable credits first go through standard processing procedures that we have established for all returns, whether they are filed on paper or electronically. Returns with refundable credit claims are also subjected to various filters during return processing to identify potentially erroneous credits.

Our normal processing for all returns involves matching them with certain pieces of information. Returns are "rejected" and not allowed to enter the system for a number of

reasons. For example, we reject over 1.7 million returns because an invalid or duplicate Social Security number was used.

If a return is accepted, it is sent to our Submission Processing Function. We next determine if math error issues exist. Math error authority under the Internal Revenue Code allows IRS to make adjustments to a return without performing an examination. Absent math error authority, adjustments can only be made through an examination. Math error authority is available for errors in computation, use of incorrect Social Security numbers, claims for more than the statutory limit and several other enumerated items. If a math error issue is identified, an adjustment can be made immediately to the taxpayer's return, reducing potentially erroneous refund claims that could result in an improper payment. The IRS has been given specific, legislative math error authority with respect to several refundable credits. In general, math error authority can help the IRS better administer a refundable credit and reduce improper payments when it allows proactive/pre-refund corrections to erroneous or fraudulent claims. Requiring documentation from taxpayers and disallowing claims when such documentation is not provided is also an effective tool in some cases. However, this approach is most effective when the documentation can be verified using third-party data and the number of claimants is relatively small. It is important to note that electronic filing is preferable because of its efficiency and accuracy and requiring taxpayers to submit documentation, as was the case for FTHBC and the adoption credit, has to date forced taxpayers to submit a paper return that must be processed manually. Thus, in requiring taxpayers to submit documentation, the IRS must recognize the additional burden this places on taxpayers and the IRS.

After being checked for math error issues, returns then go through the IRS' electronic fraud detection system (EFDS). This system is designed to identify schemes and patterns. If a return is flagged in EFDS, it is routed to a group of IRS employees to work during which time the full refund is frozen.

Returns are also sent through the IRS' Dependent Database Process (DDB). This process uses business rules and filters to select cases for examination. Third-party information (e.g., the Federal Case Registry) is used in making these selections. If a return is flagged in this process, the portion of the refund attributable to the flagged issue is frozen.

Later in the process, when information returns filed by third parties are available, matching of tax returns to that data is performed.

Challenges Related to Enforcement of Refundable Credits

There are a number of factors that present challenges to our compliance efforts as they relate to refundable tax credits. As the IRS considers this area and how to deal with the administrative challenges outlined below, it must, as previously stated, consider the trade-off of delaying a proper refund versus preventing an erroneous payment. Many of the credits in this category are refundable because of Congressional intent to get help to

those in need as quickly as possible. The EITC is in this category. Other credits are intended to boost the economy, and unnecessary delay in delivering these refunds is arguably equally counter to Congressional intent. A key example in this area is the FTHBC. The IRS must determine what eligibility verification can reasonably be put in place by balancing the need to provide the refundable credit in a timely manner with the administrative challenges outlined below.

In addition, the IRS must determine whether to take action before or after the refund is issued. Enforcement actions can take place pre- or post-refund. Pre-refund enforcement actions include math error adjustments and examinations. Post-refund enforcement actions also include examinations as well as document matching and criminal sanctions. Obviously, it is much more difficult for the IRS to recover erroneous payments after a refund is issued. However, under the Internal Revenue Code, we have a limited period of time (45 days from the due date of the return) in which to issue a refund before interest begins to accrue to the taxpayer.

Challenges that the IRS faces in the administration of the individual income tax, including the administration of refundable credits include the following.

Complexity. Complexity in the rules governing eligibility for and the operation of certain refundable credits creates challenges for both taxpayers and the IRS. Mistakes in the application of the law cause a significant portion of claims that are made in error. Changes in a taxpayer's personal situation and shifting populations also contribute to this challenge. For example, the eligible population for the earned income tax credit shifts by one third each year.

Lack of Third Party Data. In many cases, the IRS lacks real-time third-party data sources that could be used to verify taxpayers' eligibility. A key example in this area is proof that an individual owned and lived in a house as a personal residence for the 5 consecutive years during the 8-year period prior to the new home purchase, part of the eligibility requirements for one version of the FTHBC. Another example is in the Adoption Credit area where the eligibility rules vary depending on the type of adoption. In many of these areas we have had to require documentation of the events claimed, an inefficient process that to date has required taxpayers to file paper returns and requires the IRS to rely more heavily on examinations to detect errors and fraud.

Timing of Data. Even if data may exist, the IRS is often in the position of having to process returns and determine the validity of a refund before it receives the third party data it needs to match against the return. For example, Form 1098-T, which verifies the eligibility for the AOTC, most often arrives after the processing of the refund.

Hard-to-Detect Fraud. The IRS must confront, on an ongoing basis, refund schemes involving erroneous refund claims. This includes claims made by or on behalf of prisoners and individuals who are not U.S. citizens or residents, as well as schemes involving the use of personal data of deceased persons. The IRS has taken a number of steps this year to reduce fraud in these areas. The problem is particularly acute in the

case of prisoner refunds, and the IRS has developed systems that provide special scrutiny to review prisoner refunds. The situation involving prisoners is not a simple process, because some inmates and their families are legally entitled to refunds, and because the prisoner population is constantly changing. Recent efforts to address the prisoner issues include outreach to the states with the highest prisoner fraud, entering into agreements with states and the Federal Bureau of Prisons so that the IRS can disclose information on prisoner fraud, and increasing the number of prisoner returns that will be reviewed. The Administration's 2012 Budget includes a proposal to require state and federal prisons to provide information to IRS.

Tax Law Changes. The IRS often faces extremely compressed timeframes for implementing a new refundable tax credit law. One example is the effective date ARRA imposed for the FTHBC, which was the date of enactment (Feb. 17, 2009). The ARRA modifications to the FTHBC affected the 2008 returns that were being filed and processed at the very time of enactment. Developing new compliance checks and changing IRS' computer processing systems to implement new checks in the middle of a filing season presents unique and difficult challenges. Such compressed timeframes are unforgiving. They do not provide us adequate time to develop, program and implement a robust and effective compliance strategy. Further, unanticipated implementation needs such as IT system changes, testing, form creation, and other requirements can necessitate resource reallocations that affect the performance of core tax administration programs. Early planning to identify potential problems and allocate sufficient resources, including personnel with the appropriate skills and experience is a critical factor in successfully implementing new legislative requirements.

Cash Payments. Refundable credits allow for overpayments beyond income tax liability, and increase the scope for unintentional errors and abuse to filers who do not have any income tax liability.

As stated, refundable credits trigger administrative issues that should be considered as they are designed. Our experience with the EITC and the FTHBC in particular present a number of illustrative compliance challenges to the IRS.

Earned Income Tax Credit

Fraud and error in the Earned Income Tax Credit (EITC) is a significant problem and is a top priority for IRS. Much of the difficulty in administering the EITC derives from its eligibility requirements. EITC eligibility depends on items that the IRS cannot readily observe, including marital status and the relationship and residency of children with the taxpayer. In many cases, the only way in which eligibility claims can be verified is through taxpayer audits. The percentage of payments made in error is estimated to be between 24 percent and 29 percent. Note, however, that this figure is based on a historical sample of tax returns (rather than current filings) analyzed to estimate the rate of mistake and noncompliance. The IRS is taking a number of steps to reduce the amount of payments made in error. One key component of our efforts to reduce the

error rate is the outreach we do to inform people of eligibility requirements in advance of their filing.

In terms of enforcement, the IRS has a multi-faceted approach that uses a variety of traditional and nontraditional tools. Our current enforcement tools recover or protect amounts approaching \$4 billion annually. These include examinations, math error and document matching.

The audit coverage for EITC is higher than for other individual filers (EITC filers are roughly twice as likely to be examined than other individual filers) and EITC examinations constitute more than 30 percent of all individual audits (protecting approximately \$2 billion). For the past several years, the IRS has planned for approximately 500,000 EITC audits to ensure enforcement resources are applied across all parts of the taxpayer spectrum. Sixty percent of examinations are conducted before issuing the EITC.

Under our math error authority, the IRS automatically adjusts items on a return when we identify math or other statistical irregularities related to the EITC. Last year, using math error authority, the IRS blocked approximately 350,000 improper refund claims.

The IRS also modified its traditional underreporter program to specifically include EITC cases. Through this program, the IRS corresponds with taxpayers in regard to approximately 900,000 potentially improper claims each year.

The IRS recognizes that it cannot sufficiently address this issue by traditional enforcement tools alone and continues to explore alternatives to address noncompliance. The IRS' recent Tax Return Preparer Initiative is expected to have a significant impact on reducing EITC fraud and error. Approximately 66 percent of EITC returns are prepared by paid tax return preparers. The IRS is in the first year of this ground-breaking initiative, which includes requiring registration, testing and continuing education for tax return preparers. The new initiative also brings all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools in the case of preparer misconduct. More than 700,000 tax return preparers have registered this year. New education and enforcement requirements will be aimed at improving the accuracy of EITC returns that paid preparers file on behalf of their clients.

In addition to this new registration and testing regime, the IRS has taken steps to affect return preparer behavior through a series of other actions. Components of this strategy include due diligence visits, preparer investigations, notices and injunctions. Additional criminal enforcement efforts, including "knock and talk" visits and undercover shopping are discussed below.

As part of this strategy, for FY2011, the IRS is conducting 1,000 due diligence visits. In these visits, field examiners visit EITC preparers to verify they are meeting the due diligence requirements that Congress imposed. The Administration's FY 2012 Budget includes a proposal to increase the penalty imposed on paid preparers who fail to

comply with the EITC due diligence requirements. The IRS is also exploring the implementation of a new requirement for paid tax return preparers to file a due diligence checklist with the taxpayer's return when the preparer has assisted the individual in claiming the credit. These changes are expected to markedly reduce the number of improper claims on tax returns prepared by paid preparers.

The IRS continues to explore other new ways to address this issue. In connection with OMB's Partnership Fund for Program Integrity Innovation, the IRS recently began a research pilot to determine if state data can be used to reduce errors and improve the integrity of EITC payments. This pilot will explore whether state data can be used as a reliable indicator of relationship and residency of children to taxpayers. Current efforts also include exploring the use of other third-party data, including information from the Federal Case Registry (the national database used to enforce child support laws) to determine if it can be used to decrease improper claims. Additional studies are also in progress, including a test to see if contacting taxpayers by phone will improve our examination process with respect to EITC eligibility issues.

The IRS will continue to take new steps in reducing the amount of erroneous payments in this area while ensuring that those entitled to the credit are able to receive it timely.

First Time Homebuyer Credit

Administering the FTHBC has posed some of the same challenges we face with other refundable credits: There are numerous eligibility requirements, and the Federal government lacks real-time third-party data sources that could be used to verify taxpayers' eligibility. In addition, the FTHBC rules changed at least annually over a span of years with little lead time. The IRS had to develop a compliance strategy within these limitations.

The IRS faced the challenge of designing a compliance program using the tools available. Originally, the IRS had limited statutory authority for math error to prevent mistakes only in certain situations. In the third iteration of the law, IRS was given expanded authority (including the requirement to include certain documentation) to disallow claims up front in other situations as well.

Even with expanded math error authority, the principal tool available for enforcement of the credit is the examination. After the original credit was expanded, the IRS, with no historical data to rely on, developed screening filters that would identify the highest-risk returns and select them for examination, most before the credit was released. As IRS gained additional experience with the credit, we added new filters and improved those already in existence to increase their effectiveness.

With respect to the FTHBC, the IRS has identified more than 370,000 returns with math errors, conserving exam resources and stopping erroneous refunds from being issued. Through more than 450,000 examinations, the IRS has protected revenue of almost \$1.5 billion. The IRS has also identified more than 200 possible criminal schemes.

Efforts to ensure compliance and prevent abuse can sometimes create burden for both the IRS and taxpayers who legitimately claim the credit. When the law changed to require taxpayers to attach documentation to their returns, it enhanced taxpayer compliance, but the IRS was challenged to manually process paper returns, which is less efficient and accurate than electronic return processing. Some eligible taxpayers were challenged when paper returns were required and processing of their refunds was slowed. Those taxpayers selected for examinations also saw delays in their refunds.

In December 2010 and January 2011, before this filing season, the IRS sent notices to millions of FTHBC recipients. The notices reminded taxpayers who had a 15-year repayment obligation to report the first year of repayment. The IRS also provided information about situations that might cause recapture. In addition, taxpayers for whom third party information indicated a situation that causes recapture were notified that they needed to report it. The notices were a proactive effort to have taxpayers accurately self-report this coming year - to reduce taxpayer burden, as well as IRS burden.

Administration of the FTHBC was challenging in light of its ever changing provisions. Due to the complexity, the IRS experienced some programming problems this filing season on the repayment provisions discussed above which unfortunately caused some delays in processing.

Criminal Actions and Investigations

IRS Criminal Investigation (CI) plays a key role in the IRS' efforts on refundable credits. CI does this both by participating in filing season visits to preparers and by identifying and pursuing refund filing schemes.

CI is involved in a specific program that targets return preparers who file large numbers of EITC or FTHBC returns. The Knock and Talk Visit (KTV) program provides outreach to specific return preparers before the beginning of each filing season. CI and other IRS employees visit preparers who have a history of preparing returns where claims are considered suspect. During these visits, preparers are reminded about the rules and requirements surrounding the credits. These preparers are then monitored throughout the filing season to determine whether there is an improvement in the claims being made on returns filed by these preparers. CI also does a significant number of undercover shopping visits to test the integrity of certain return preparers.

With respect to fraudulent refund schemes, CI has eight Scheme Development Centers (SDCs) across the country whose primary mission is detecting refund fraud, and over the past four years these centers have uncovered numerous schemes involving refundable credits. Once these schemes are identified, the SDCs forward the information to our CI field offices for further investigation. These field offices, in turn, recommend prosecution of refund fraud to the appropriate U.S. Attorney's Office when sufficient evidence is uncovered to support such recommendations. So far in 2011,

recommendations have been made for almost 700 schemes, affecting over 400,000 tax returns.

When the IRS uncovers a refund fraud scheme that involves a refundable tax credit, that scheme is usually one of two types:

- A return preparer files tax returns for clients claiming refundable credits that the taxpayers are not qualified to receive, in order to maximize the clients' refunds; or
- Individual identities, some of which are stolen, are used to file false returns claiming refundable credits to obtain tax refunds.

Schemes that utilize refundable credits most often involve the larger refundable credits, like the EITC and the FTHBC.

In FY 2010, we initiated more than 300 investigations of suspected refund fraud schemes involving refundable tax credits, the majority of which utilized the EITC. We recommended prosecution in 140 of those cases, and obtained 89 indictments.

Some of the successes involving refundable credits include the following:

- An Alabama man was sentenced in March 2011 to three years in prison and ordered to pay more than \$600,000 in restitution to the U.S. in conjunction with a scheme involving 158 false tax returns. This individual fraudulently obtained names and Social Security numbers of individuals and forwarded them to a person who filed the returns of these people without their knowledge. The tax returns falsely claimed the FTHBC and fuel tax credits.
- A Memphis woman was sentenced in March 2011 to nine months in prison and ordered to pay more than \$250,000 in restitution to the IRS in connection with a scheme that involved helping a number of other individuals file tax returns that included false claims for the FTHBC.
- A California preparer was sentenced in November 2010 to more than a year in prison and ordered to pay approximately \$19,000 in restitution for false returns on behalf of her clients. The returns included false claims for the EITC and Child Tax Credit.
- A Connecticut tax preparer was sentenced in April 2010 to 14 months in prison after pleading guilty to aiding and assisting in the filing of a false tax return. The preparer and her employees had filed returns for clients that improperly claimed the EITC and various deductions. IRS audits revealed that they prepared approximately 183 false tax returns resulting in improper refunds totaling more than \$500,000.

Beyond investigating fraud, CI also strives to stop fraudulent refunds before they are paid. Investigative analysts in our SDCs often identify schemes related to refundable

credit fraud where refunds appear to be going to the same bank account, to the same client, or to the same return preparer. In these instances, the SDCs advise the IRS processing personnel that they have discovered fraudulent claims, and request the refunds be stopped.

CONCLUSION

Refundable credits play an important role in fulfilling Congressional policies, but are inherently subject to a number of administrative challenges. As with all aspects of tax administration, in the case of each refundable credit, the IRS must determine the proper balance of taxpayer service and enforcement to ensure that benefit is afforded only to those taxpayers who are eligible. In the 2012 Budget, the IRS proposed the creation of a new refundable credits office. This office is intended to provide added flexibility and capacity around the IRS' ability to ensure pre-refund compliance and combat refund fraud. Our experience with provisions like the Earned Income Tax Credit and the First Time Homebuyer Credit is that the IRS must be able to act quickly upon passage of legislation to protect the public from refund fraud. This includes education, creating compliance strategies, the programming of refund filters, and downstream review of returns on a pre-refund basis. The IRS will continue to explore new ways to ensure accuracy in this area.

Mr. Chairman, this concludes my testimony. I appreciate the opportunity to testify about the IRS' efforts to ensure proper administration of the laws relating to refundable tax credits.

Chairman BOUSTANY. Thank you, Mr. Miller.
Mr. George, you may proceed.

**STATEMENT OF J. RUSSELL GEORGE, TREASURY INSPECTOR
GENERAL FOR TAX ADMINISTRATION, U.S. DEPARTMENT OF
THE TREASURY, WASHINGTON, D.C., ACCOMPANIED BY MI-
CHAEL E. MCKENNEY, ASSISTANT INSPECTOR GENERAL
FOR AUDIT**

Mr. GEORGE. Thank you, Mr. Chairman, Chairman Boustany, Ranking Member Lewis, Members of the Subcommittee. Thank you for the opportunity to testify on the Internal Revenue Service's administration of refundable tax credits.

As noted, refundable credits were designed to help low-income individuals reduce their tax burden, or to provide incentives for other activities. The earned income tax credit, created in 1975, is used to offset the impact of Social Security taxes on low-income families, and to encourage them to seek employment rather than public assistance.

More recent refundable credits provide incentives for other activities such as, as you noted Mr. Chairman, buying a home, obtaining a college education—Ranking Member, you pointed that out—and adopting a child. The two largest refundable credits, the EITC and Additional Child Tax Credit, receive a much larger appropriation than the IRS' own budget. The appropriations for these credits in Fiscal Year 2010 were approximately \$55 billion for the EITC, and \$23 billion for the Additional Child Tax Credit. In contrast, the IRS' total Fiscal Year 2012 budget request is just over \$13 billion.

Although each of these refundable credits provides benefits to individuals, the unintended consequence of these credits is that they are often the target of individuals who file erroneous claims for the credits. In a 2010 report to TIGTA, the IRS noted that refundable credits present an additional avenue for individuals to commit filing fraud.

Nonrefundable tax credits are limited to the amount of an individual's income tax liability. As such, the maximum benefit an individual would receive if a nonrefundable credit is claimed inappropriately is to fully offset his or her tax liability resulting in owing nothing. Refundable credits do not have such limitations. In essence, individuals can obtain money they did not earn, and to which they are not entitled, simply by claiming a refundable tax credit. Refundable credits can result in tax refunds, even if no income tax is withheld or paid.

The total amount of improper payments relating to refundable credits far exceeds the amount of fraudulent tax returns the IRS identifies and stops as part of its Taxpayer Assurance Program. The IRS continues to report that 23 to 28 percent of EITC payments are issued improperly each year. In fiscal year—as pointed out earlier, in fiscal year 2009, this equated to \$11 billion to \$13 billion in improper EITC payments. Although the IRS has annually reported billions in EITC improper payments, little improvements have been made in reducing these payments.

TIGTA has conducted a number of audits that have identified opportunities to reduce EITC improper payments. We have provided the IRS with specific actions that could have been taken to reduce

improper payments, and allow the IRS to establish measurable reduction targets. While the IRS has implemented some of our recommendations, it has not taken action to address key recommendations aimed at preventing or reducing improper EITC payments.

The IRS does not require individuals to provide any supporting documentation to verify eligibility for claiming the EITC, although it piloted such a plan a few years ago.

In 2009 we reported a significant increase in the Additional Child Tax Credit claims by filers who were unable to obtain a Social Security Number or were not eligible to receive a Social Security Number. These individuals were not authorized to work in the United States and filed tax returns using an Individual Taxpayer Identification Number, referred to as an ITIN.

The refundable credit claims made by these filers have grown substantially. For Tax Year 2000, a total of 62,000 ITIN filers received \$62 million in Additional Child Tax Credits. This has since grown to 2.3 million ITIN filers, claiming the credit totaling \$4.2 billion in 2010. As part of our Recovery Act oversight, we are in the process of completing a review assessing the effectiveness of the IRS's processes to identify erroneous American Opportunity Tax Credit claims.

The Recovery Act amended the HOPE Scholarship Credit to allow a refundable tax credit. This program allows individuals to receive a credit for higher education expenses up to \$2,500 per year for Tax Years 2009 and 2010, with up to \$1,000 being refundable. The IRS requires no documentation to be provided to verify eligibility, including whether an individual claimed as a student even attends a required accredited educational institution. Our review is identifying significant improper payments being made to taxpayers claiming the credit and using ineligible students.

The Adoption Credit was changed to recognize the amount—to increase the amount, and made the credit refundable. Recognizing that this could increase the risk for erroneous claims, the IRS developed a strategy to attempt to reduce this risk. However, our analysis found that while the IRS requires individuals to provide documentation that verifies their eligibility, the IRS does not have the authority to deny the Adoption Credit if the documentation is not provided. Without this math error authority, the IRS cannot deny the credit during processing of tax returns, but must instead deny the credit post-processing, through the examination process, which is a much more costly, resource-intensive, and burdensome process.

Mr. Chairman, Members of the Committee, we take our mandate seriously at TIGTA, and we want to help you conduct your oversight of this most important responsibility. Thank you.

[The statement of Mr. George follows:]

**HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES**

**"Improper Payments in the Administration of
Refundable Tax Credits"**



**May 25, 2011
Washington, D.C.**

**Testimony of
The Honorable J. Russell George
Treasury Inspector General for Tax Administration**

TESTIMONY OF
THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES

"Improper Payments in the Administration of Refundable Tax Credits"

May 25, 2011

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, I thank you for the opportunity to testify on the Internal Revenue Service's administration of refundable tax credits.

Refundable credits were designed to help low-income individuals reduce their tax burden or to provide incentives for other activities. The Earned Income Tax Credit (EITC), created in 1975, is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare.¹ Prior to the enactment of the *Taxpayer Relief Act of 1997*,² the tax law did not provide tax credits based solely on a taxpayer's number of dependent children. Congress then created the Child Tax Credit and the Additional Child Tax Credit (ACTC) because the individual income tax structure did not reduce tax liability enough to reflect a growing family's reduced ability to pay taxes as family size increased. In addition, the Congress further believed that a tax credit for families with dependent children would reduce their individual income tax burden, better recognize the financial responsibilities of raising dependent children, and promote family values.³

More recent refundable credits provide incentives for other activities, such as buying a home, obtaining a college education, and adopting a child. The First-Time Homebuyer Credit (Homebuyer Credit) was enacted to encourage home purchases to stimulate the weak housing market. The American Opportunity Tax Credit allows

¹ Tax Reduction Act of 1975 § 204, 26 U.S.C § 32.

² Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C.A.).

³ Staff of Joint Committee on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in 1997 (Comm. Print 1997).

individuals to receive a credit for higher education expenses. The Adoption Credit⁴ allows individuals to offset qualified adoption expenses, making adoption possible for some families who could not otherwise afford these expenses.

The two largest refundable credits, the EITC and ACTC, receive a much larger appropriation than the IRS's own budget. For the 2011 Filing Season, the maximum EITC is \$5,666; while the ACTC is generally limited to 15 percent of earned income in excess of \$3,000.⁵ The appropriations for these credits in Fiscal Year 2010 were \$54.7 billion for the EITC and \$22.7 billion for the ACTC. In contrast, the IRS's total Fiscal Year 2012 budget request is \$13.3 billion.

These appropriations continue to grow as a result of recent legislative changes that have increased the number of individuals eligible for the credit and the amount individuals can claim. For example, the *American Recovery and Reinvestment Act of 2009* (Recovery Act)⁶ temporarily increased for Tax Years' 2009 and 2010 the EITC percentage for individuals with three or more children from 40 to 45 percent of the individuals first \$12,570 of earned income. Also, the income limit used for calculating the credit was increased for married individuals filing a joint tax return.

In addition, the Recovery Act temporarily increased the number of individuals eligible for the credit by changing the income threshold for calculating the ACTC for Tax Years 2009 and 2010. Prior to the Congress enacting the Recovery Act, the ACTC would have been limited to 15 percent of earned income over \$12,550. The Recovery Act changed this threshold to 15 percent of earned income over \$3,000. As such, more individuals were eligible to claim the ACTC or a greater amount.

Although each of these refundable credits provides benefits to individuals, the unintended consequence of these credits is that they are often the targets of unscrupulous individuals who file erroneous claims for these credits. In its June 14, 2010, report to TIGTA, the IRS noted that they have found that refundable credits of significant amounts attract fraud.⁸ In particular, refundable tax credits present an additional avenue for individuals to commit filing fraud. Nonrefundable tax credits are

⁴ Small Business Job Protection Act of 1996, Pub.L. No. 104-188 110 Stat. 1755 (codified in scattered sections of 26 U.S.C. 42 U.S.C. and 19 U.S.C.).

⁵ The ACTC is the refundable portion of the Child Tax Credit. This credit phases out for taxpayers depending upon their income level. Taxpayers with earned income of less than \$3,000 may be eligible for a refundable credit if they have three or more qualifying children and have paid Social Security taxes that exceed their EITC.

⁶ Pub. L. No. 111-5, 123 Stat.115.

⁷ The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁸ IRS, Initial Report on Earned Income Tax Credit (EITC) Improper Payments, pursuant to Executive Order 13520: Reducing Improper Payments (June 14, 2010).

limited to the amount of an individual's income tax liability. As such, the maximum benefit an individual will receive if a nonrefundable credit is claimed inappropriately is to fully offset his or her tax liability resulting in owing nothing. Refundable credits do not have such limitations. In essence, individuals can obtain money that they did not earn and to which they are not entitled simply by claiming a refundable tax credit. Refundable credits can result in tax refunds even if no income tax is withheld or paid; that is, the credits can exceed the liability for the tax.

The total amount of improper payments relating to refundable credits far exceeds the amount of fraudulent tax refunds the IRS identifies and stops as part of its Taxpayer Assurance Program. The IRS estimates the improper payments for the earned income tax credit are between \$11 to \$13 billion each year. The IRS's Taxpayer Assurance Program, formerly known as the Questionable Refund Program, was set up to identify and stop fraudulent refunds. As of March 4, 2011, the IRS had identified 335,341 tax returns with \$1.88 billion claimed in fraudulent refunds and prevented the issuance of \$1.82 billion (97 percent) of the fraudulent refunds claimed.

I will now discuss each of these refundable credits, providing improper payment estimates and amounts when available; IRS actions to address these improper payments; and recommendations we have made to reduce these payments.

Earned Income Tax Credit – The IRS continues to report that 23 to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to \$11 to \$13 billion in improper EITC payments. Although the IRS has annually reported billions in EITC improper payments since it began reporting estimates to Congress in 2002, little improvement has been made in reducing these payments. Executive Order 13520, signed by the President on November 20, 2009, further increased agency accountability for reducing improper payments and required the IRS to intensify its efforts and set targets to reduce EITC improper payments. However, in the IRS's June 14, 2010 report to us, the IRS did not include required strategies or quantifiable targets to reduce EITC improper payments. IRS management noted that reduction targets were not set because it has to balance compliance and enforcement resources among all income groups.

We have conducted a number of audits that have identified opportunities to reduce EITC improper payments. We have provided the IRS with specific actions that could be taken to reduce improper payments and allow the IRS to establish measurable reduction targets. While the IRS has implemented some of our recommendations, it has not taken action to address key recommendations aimed at preventing or reducing improper EITC payments. For example, we reported in December 2008 that the IRS

had developed processes to successfully identify billions of dollars in erroneous EITC payments. However, the IRS stated it did not have the resources to implement the processes that would help address many of these cases, resulting in the majority of the improper claims being paid.

We recommended that the IRS develop alternative processes that are less costly than audits to protect revenue associated with erroneous EITC claims at the time a tax return is filed.⁹ The IRS agreed with our recommendation, noting that it was continuing its ongoing efforts to identify new alternatives to address erroneous payments. The IRS acknowledged that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts.¹⁰ However, the IRS has not made any significant progress in developing and implementing these alternatives. This continues to hinder the IRS's ability to reduce the billions of dollars paid in erroneous EITC claims.

Furthermore, the IRS does not require individuals to provide any supporting documentation to verify eligibility for claiming the EITC. In a pilot project the IRS conducted from 2003 to 2006, it required individuals to pre-certify eligibility for claiming the EITC, which included providing specific documentation. This documentation included third-party affidavits, letters on official letterhead from a third party (generally community organizations, churches, etc.), and official records such as school or medical records. At the completion of the pilot, the IRS concluded that requesting this documentation created a burden on the taxpayer,¹¹ even though this is the same documentation that the IRS requests from individuals as part of EITC examinations.

Additional Child Tax Credit – In 2009, we reported a significant increase in ACTC claims by filers who were unable to obtain a Social Security Number or were not eligible to receive a Social Security Number.¹² These individuals were not authorized to work in the United States and filed tax returns using an Individual Taxpayer Identification Number (ITIN).¹³ The refundable credit claims made by these filers have grown substantially.

⁹ *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Reference Number 2009-40-024, dated December 31, 2008).

¹⁰ IRS, Initial Report on Earned Income Tax Credit (EITC) Improper Payments, Executive Order 13520: Reducing Improper Payments (June 14, 2010).

¹¹ IRS, Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests (January 2008).

¹² *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference # 2009-40-057, dated March 31, 2009).

¹³ An ITIN is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain a Social Security Number because they are not authorized to work in the United States.

For Tax Year 2000, a total of 62,000 ITIN filers received \$62 million in ACTCs. This has since grown to 2.3 million ITIN filers claiming ACTCs totaling \$4.2 billion in 2010.¹⁴ This increase is due in part to changes in the law which changed the eligibility criteria and calculation. Another reason for the increase in claims is that a significant number of individuals are filing returns for multiple years to obtain the ACTC for prior year tax returns (*e.g.*, filing for Tax Years 2007, 2008, and 2009). In 2010, approximately 238,000 ITIN filers submitted over 608,000 tax returns for multiple years and claimed just over \$1 billion in ACTC on those tax returns. Moreover, in our analysis of tax returns processed in 2010, we found that some individuals have also submitted duplicate tax returns for multiple years to multiple IRS processing centers and received ACTC refunds.

Along with the increase claims for the ACTC, there has been an increased demand for ITINs in order to file these returns. For Fiscal Year 2011, the IRS estimates they will expend a significant amount of resources to process over 2.2 million ITIN applications.¹⁵

Prior to 1996, filers using an ITIN were entitled to claim the EITC. However, concerns were raised by the Government Accountability Office, the IRS, and the Congress regarding noncompliance with EITC requirements. The law was subsequently changed to deny the EITC to individuals who file a tax return without a Social Security Number that is valid for employment.¹⁶ Specifically, the *Personal Responsibility and Work Opportunity Reconciliation Act of 1996*,¹⁷ prohibits individuals residing without authorization in the United States from receiving most Federal public benefits as that term is defined in the Act. The Act also amended 26 U.S.C. § 32 (c) to require that claims for the credit be filed by taxpayers using SSNs. As such, filers using an ITIN are not eligible for the EITC.

The change in the law prohibiting EITC to filers using an ITIN was made prior to the creation of the ACTC and other refundable credits. However, the law also prohibits individuals residing without authorization in the United States from receiving most

¹⁴ *Budget Hearing with the Treasury Inspector General for Tax Administration, Hearing Before the H. Comm. on Appropriations, Subcomm. on Financial Services and General Government, 112th Cong. (Apr. 15, 2011)* (statement of J. Russell George).

¹⁵ ITIN processing uses the full time equivalent of 463 IRS employees.

¹⁶ The Social Security Administration will issue a Social Security card that notes "NOT VALID FOR EMPLOYMENT" to individuals from other countries who: (1) are lawfully admitted to the United States without work authorization but with a valid non-work reason for needing a Social Security Number or (2) need a number because of a State or Federal law requiring a Social Security Number to obtain benefits to which an individual has already established entitlement.

¹⁷ Pub. L. No. 104-193, 110 Stat. 105 (codified in scattered sections of 42 U.S.C., 21 U.S.C., 8 U.S.C., and 7 U.S.C.).

Federal public benefits, with the exception of certain emergency services and programs, and defines a public benefit as:

Any grant, contract, loan, professional license, or commercial license provided by an agency of the United States or by appropriated funds of the United States; and any retirement, welfare, health, disability, public or assisted housing, postsecondary [sic] education, food assistance, unemployment benefit, or any other similar benefit for which payments or assistance are provided to an individual, household, or family eligibility unit by an agency of the United States or by appropriated funds of the United States.¹⁸

The current situation with the ACTC appears similar to that which preceded the prohibition of the EITC to ITIN filers. Both the EITC and the ACTC are calculated based on a percentage of earned income and both are refundable. Both are paid by an agency of the United States by appropriated funds. Billions of dollars in ACTC are being provided to ITIN filers without verification of eligibility, and IRS employees have raised concerns about the lack of an adequate process for identifying and addressing improper claims.¹⁹

IRS management's view is that the *Personal Responsibility and Work Opportunity Reconciliation Act of 1996* does not provide sufficient legal authority for the IRS to disallow the ACTC to ITIN filers. Currently the Internal Revenue Code Title 26 U.S.C. section 24 does not require taxpayers to use a Social Security Number to claim the credit and does not provide the IRS with math error authority to deny the credit without an examination.²⁰

As such, legislation would be needed to clarify whether a Social Security Number that is valid for employment is needed in order to claim the ACTC, consistent with requirements for the EITC. If the ACTC may not be paid, the IRS should be provided with math error authority to disallow associated claims for the credits. We estimate that allowing the ACTC only to those filers who are eligible to live and work in the United States (*i.e.*, those with a Social Security Number that is valid for employment) would reduce Federal outlays by approximately \$4.2 billion annually.²¹

¹⁸ 8 U.S.C. § 1611(c)(1)(a)(b).

¹⁹ *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference Number 2009-40-057, dated March 31, 2009).

²⁰ Math error authority statutorily allows the IRS to correct tax return errors during processing, including calculation errors and entries that are inconsistent or exceed statutory limits and assess additional tax without using deficiency procedures.

²¹ Changes made to the ACTC in the Recovery Act are effective through Tax Year 2012. If no further changes are made, the eligibility requirements revert to previous levels and would result in fewer individuals qualifying for the ACTC.

American Opportunity Tax Credit – Also as part of our Recovery Act oversight, we are in the process of completing a review assessing the effectiveness of the IRS's processes to identify erroneous American Opportunity Tax Credit (AOTC) claims. The Recovery Act amended the Hope Scholarship Credit²² to allow a refundable tax credit—the AOTC. The AOTC allows individuals to receive a credit for higher education expenses up to \$2,500 per student per year for Tax Years 2009 and 2010, with up to \$1,000 being refundable. The IRS requires no documentation to be provided to verify eligibility, including whether an individual claimed as a student even attends a required accredited educational institution. Our review is identifying significant improper payments being made to taxpayers claiming the credit and using ineligible students.²³

Adoption Credit—The Adoption Credit was changed to increase the amount from \$12,150 to \$13,170 and also made the credit refundable. Recognizing that this could increase the risk for erroneous claims, the IRS developed a strategy to attempt to reduce this risk. As part of this strategy, the IRS requires individuals to verify eligibility by attaching documentation to their tax returns in support of an adoption.

However, our analysis of the IRS's Adoption Credit processing controls identified that, while the IRS requires individuals to provide documentation that verifies their eligibility, the IRS does not have the authority to deny the Adoption Credit if the documentation is not provided. Without this math error authority, the IRS cannot deny the credit during processing of the tax return, but must instead deny the credit post-processing through the examination process, which is a much more costly, resource-intensive, and burdensome process.

On October 29, 2010, we alerted IRS management and recommended that they work with the Department of the Treasury to request from Congress math error authority to deny Adoption Credit claims that lacked documentation. The IRS did not agree with this recommendation because it believed that it had developed and implemented sufficient filters and compliance tools to handle potential Adoption Credit fraud. This has resulted in a significant number of Adoption Credit claims being sent to its post-processing Examination function. As of April 28, 2011, the IRS has received 72,656 individual claims for more than \$897 million in Adoption Credits. Of these, 42,399 (58 percent) either had no required documentation or the documentation was invalid or

²² The Hope Credit was included as part of the Taxpayer Relief Act of 1997, and was established to assist middle-class families with the costs associated with a college degree. The credit is set forth at 26 U.S.C. § 25A (a).

²³ An eligible student must be enrolled in a program that leads to a degree, certificate, or other recognized educational credential, and be enrolled at least half time for at least one academic period during the year. Students are not eligible if they have already completed the first four years of post-secondary education or if they have been convicted of a felony for possessing or distributing a controlled substance.

insufficient. According to IRS procedures, each of these claims will be sent to the Examination function for further review.

Math error authority to deny those claims without required documentation at the time the tax return was processed would have been less burdensome on individuals than post-processing examinations. Individuals would have been immediately notified of the denial of the Adoption Credit. These individuals would have been informed that they can provide the IRS with required documentation in response to the denial to support their eligibility. If the individual provides the IRS with required documentation supporting their eligibility for the Adoption Credit the IRS has a goal to resolve these responses within 30 days of receipt of the documentation.

In comparison, the IRS was unable to provide an average timeframe for resolving Adoption Credit claims sent for post-processing examinations. The IRS will not have this information until the end of this fiscal year because of the limited number of Adoption Credit examinations closed to date. However, the IRS estimates that an individual would receive notification that documentation is needed to support eligibility for claiming the Adoption Credit within three to four weeks after his or her tax return is received in the Examination function. The individual then has 30 days to respond to the IRS's request for required documentation. Once the IRS receives the information, the IRS does not have a specific time goal for closing the case subsequent to receipt of the information.

Homebuyer Credit – As part of our Recovery Act oversight, we addressed the IRS's administration of the Homebuyer Credit. The *Worker, Homeownership, and Business Assistance Act of 2009*²⁴ revised, extended, and expanded the Homebuyer Credit allowed by previous acts to a broader range of home purchases and added new documentation requirements. For example, residents of the same main home for at least five years may claim the Homebuyer Credit if they purchase new principal residences. In Processing Years 2009 and 2010, the IRS reported issuing Homebuyer Credits of more than \$12.3 billion and \$13.7 billion, respectively.

We recommended that the IRS require taxpayers to supply documentation with their tax return to substantiate a home purchase. IRS management initially responded that such a requirement would be burdensome for individuals and the IRS. Nonetheless, the burden of providing documentation to substantiate such a credit is no greater than the burden placed on individuals receiving payments from other Federal Government agencies and on the agencies providing those payments. For example, to receive food stamps, individuals are required to provide identification such as a driver's

²⁴ Pub. L. No. 111-92, 123 Stat. 2984 (2009).

license, State identification, birth certificate, or alien card; proof of income; proof of amounts spent on child care; rent receipts or proof of mortgage payments; records of utility costs; and medical bills for certain household members.

The IRS also stated that it did not have math error authority to disallow the Homebuyer Credit during tax return processing even if it did ask for documentation but none was provided. The IRS initially took no steps to obtain this math error authority. After the issuance of TIGTA's first interim report on that credit,²⁵ Congress passed legislation requiring documentation for the Homebuyer Credit and providing the IRS with math error authority to disallow the credit if the documentation was not provided.²⁶ In response to our report, the IRS required taxpayers claiming the credit after November 6, 2009, to attach a copy of their Form HUD-1, *U.S. Department of Housing and Urban Development Settlement Statement*, to support their claim. The documentation requirements meant that individuals claiming the Homebuyer Credit had to file a paper tax return and could not electronically file their tax return. The IRS indicated that its current electronic filing system was not able to handle the wide variety of required and recommended supporting documents that would have to be scanned and submitted.

A significant number of erroneous claims of the Homebuyer Credits were processed prior to implementation of the documentation requirements. Overall, we estimate that at least \$485 million of the more than \$513 million in potentially erroneous claims we identified were issued with no IRS scrutiny, such as an examination or steps to validate the claim. These erroneous credits might have been denied if documentation requirements were in place.

Based on our review of the various refundable credits, we believe the IRS should require individuals to provide documentation to support eligibility for all refundable tax credits. If such documentation is required, the IRS will also need math error authority to deny refundable credits when supporting documentation is not provided.

As with the Homebuyer Credit, the IRS requires individuals claiming an Adoption Credit to file a paper tax return. However, the IRS's Modernized e-File System is replacing the IRS's existing electronic filing system with a new modernized, Internet-based system that has the capability of allowing individuals to scan and attach documents to their tax returns. The IRS first began receiving a limited number of tax returns through the Modernized e-File System in Processing Year 2010 and expects full migration in Processing Year 2012. The ability to attach supplemental information to an

²⁵ *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).

²⁶ Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984 (2009).

electronic tax return will reduce the need for the IRS to require individuals to file paper tax returns.

We at TIGTA take seriously our mandate to provide independent oversight of the IRS in its administration of the Nation's tax system. I hope my discussion of refundable credits helps the Congress to ensure accountability of the IRS and assists you with your oversight duties.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, thank you for the opportunity to share my views.

Chairman BOUSTANY. Thank you, Mr. George.
Mr. Brostek, you may proceed.

**STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX POLICY
AND ADMINISTRATION, STRATEGIC ISSUES, U.S. GOVERN-
MENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.**

Mr. BROSTEK. Chairman Boustany, Ranking Member Lewis, and Members of the subcommittee, thank you for the opportunity to discuss IRS' pre-refund compliance checks.

To provide an idea of the universe that these checks could affect, in 2010 IRS processed 137,000,000 individual income tax returns and issued about 107,000,000 refunds, totaling over \$312 billion. Its compliance checks thus could affect millions of taxpayers and billions of dollars of refunds by identifying taxpayers who overclaim refunds and taxpayers who underclaim benefits to which they are entitled.

My statement focuses on pre-refund checks and their benefits, how those checks can be enhanced immediately, and how they may be enhanced in the future.

Pre-refund checks take several forms. When tax returns are received, the initial process helps correct taxpayer identification errors, and ensure that taxpayers have filled in all required fields. Then, return information is captured in IRS' systems.

At this point, IRS applies additional computerized filters. Some filters identify errors that can be corrected using IRS' math error authority. Others identify errors that can be addressed through audits. Finally, still others identify possible fraud.

When IRS identifies errors that can be corrected with virtual certainty, they are correctable under IRS' math error authority. Despite the name, math errors encompass much more than simple arithmetic errors. They also include, for instance, identifying incorrect Social Security or other taxpayer identification numbers, problems with taxpayers' filing status or claiming of dependents, and missing schedules and forms. Some of these errors are detected from information included on the tax return, and some are detected by comparing the return to IRS databases or to databases obtained from other parties, such as the Social Security Administration.

IRS staff manually review the math errors and enter codes that automatically generate a notice to the taxpayer explaining the error, identifying the revision in the taxpayer's refund amount, or possibly a new balance due to IRS, and instructing a taxpayer on how to respond if she or he disagrees.

When math error authority cannot be used, the return is placed in queue for possible pre or post-refund audit. Depending on available resources, IRS will audit a portion of these returns, generally through correspondence, before complete refunds are sent to taxpayers. To the extent returns are not handled in pre-refund audits, IRS will include them for possible post-refund audits.

IRS' computer filters also identify some refund claims that may be fraudulent. These are forwarded to IRS' criminal investigation division. In some cases, the investigation may be of a taxpayer, and in others it may focus on paid preparers or others who may be engaging in fraud affecting many returns.

IRS' pre-refund checks can be enhanced if Congress provides greater math authority, math error authority, to IRS. We have suggested that Congress consider extending a broad math error authority to IRS with appropriate protections for taxpayers. Broad authority would be especially valuable for addressing possible non-compliance with newly created refundable tax credits.

In terms of protections, Congress can specify the level of certainty that IRS needs to have that it will be correct in identifying and correcting an error. It might also require IRS to report to Congress or to a committee of Congress before or after they use math error authority. Or, Congress could require consultation with the National Taxpayer Advocate before IRS actually uses a new authority.

Congress could also enact specific new math error authorities that GAO has suggested, such as allowing IRS to use prior-year tax return information to ensure taxpayers do not claim benefits in excess of lifetime limits, and enabling IRS to correct various age-related errors.

Looking forward, IRS has significant opportunities to move more compliance improvement efforts into the pre-refund environment. IRS receives a substantial amount of documentation that is used after the filing season. Over time, this documentation may be usable pre-refund. This would, however, require significant investments in computer systems and likely changes in requirements for those who provide information to IRS. It's a long-term endeavor.

Further, IRS' paid preparer regulatory regime may improve the accuracy of returns prepared by this industry when they are filed, and give IRS the ability to take corrective measures during the filing season as it identifies emerging error trends.

This concludes my oral statement. I would be happy to answer questions.

[The statement of Mr. Brostek follows:]

GAO

United States Government Accountability Office

Testimony

Before the Subcommittee on Oversight,
Committee on Ways and Means, House of
Representatives

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TAX REFUNDS

Enhanced Prerefund Compliance Checks Could Yield Significant Benefits

Statement of Michael Brostek, Director
Strategic Issues



GAO-11-691T



Highlights of GAO-11-691T, a testimony before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

In 2010, the Internal Revenue Service (IRS) processed about 137 million individual income tax returns and issued 107 million refunds totaling over \$312 billion. The compliance checks it performs before refunds are issued thus could affect millions of taxpayers and billions of dollars of refunds by identifying taxpayers who overclaim or underclaim tax benefits to which they are entitled. Math error authority (MEA) is just one example of the prerefund compliance checks that IRS uses. During 2010, IRS sent taxpayers 8.4 million notices for almost 10.6 million math errors identified on their 2009 individual tax returns.

GAO's statement today will focus on three key areas: (1) prerefund checks and their benefits, (2) how those checks can be enhanced immediately, and (3) how they may be enhanced in the future. It is mostly based on GAO's previous work issued from 2008 through 2011, including an interim report on IRS's 2011 tax filing season, and our ongoing analysis of the 2011 filing season.

What GAO Recommends

GAO makes no new recommendations in this testimony but describes prior matters for Congress to consider in granting IRS expanded MEA.

View GAO-11-691T or key components. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

May 25, 2011

TAX REFUNDS

Enhanced Prerefund Compliance Checks Could Yield Significant Benefits

What GAO Found

Prerefund compliance checks enable IRS to help confirm taxpayers' identity, quickly and efficiently correct some errors with virtual certainty, and identify and audit some returns before refunds are issued. Math error checks are among the most beneficial of these checks for both IRS and taxpayers. For example, they have the potential to deter billions of dollars in erroneous refunds, especially for refundable tax credits that have increasingly been enacted and that have resulted in significant overclaimed refunds and fraudulent claims. Taxpayers benefit from prerefund checks in several ways, including that IRS identifies those underclaiming benefits. Last year GAO reported that IRS corrected about 7.7 million errors associated with the Making Work Pay credit, including about 60 percent in the taxpayers' favor, meaning that taxpayers received larger refunds (or had lower taxes due) than they had anticipated.

For almost a century, Congress has been expanding IRS's MEA on a case-by-case basis. In 2010, GAO suggested that authorizing the use of MEA on a broader basis with appropriate controls to protect taxpayer rights could help IRS immediately address compliance problems with newly created tax credits. In the absence of broader MEA, from 2008 through 2011, GAO also suggested that Congress expand MEA for more limited purposes as shown below.

GAO Math Error Authority Matters for Congressional Consideration	
Matter for consideration	Status (May 2011)
Provide IRS with math error authority (MEA) to use prior years' tax return information to ensure that taxpayers do not improperly claim credits or deductions in excess of applicable lifetime limits.	Not yet enacted
Provide IRS with MEA to use prior years' tax return information to automatically verify taxpayers' compliance with the number of years the Hope credit can be claimed.	Not yet enacted
Provide IRS with MEA to (1) use the prior year's tax return information to automatically verify compliance with the 2008 First-Time Homebuyer Credit payback provision and (2) ensure that homebuyers do not improperly claim the credit in multiple years.	Enacted in Public Law 111-92
Provide IRS with MEA to identify and correct returns with ineligible (1) individual retirement account (IRA) "catch-up" contributions and (2) contributions to traditional IRAs from taxpayers over age 70½.	Not yet enacted

Source: GAO.

Longer term, other IRS initiatives, such as matching information returns to tax returns during the filing season and leveraging new paid preparer requirements, could enhance compliance before refunds are issued. One prerequisite would be a major reworking of some fundamental IRS computer systems.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee:

Thank you for the opportunity to be here today to discuss the Internal Revenue Service's (IRS) prerefund compliance checks and the tools used as part of these checks.

To provide an idea of the universe that these checks could affect, in 2010, IRS processed about 137 million individual income tax returns and issued 107 million refunds totaling over \$312 billion. Its compliance checks thus could affect millions of taxpayers and billions of dollars of refunds by identifying taxpayers who overclaim the amount due to them and taxpayers who underclaim tax benefits to which they are entitled.

Before processing refunds, IRS checks returns for clerical and mathematical errors and conducts some additional checks on the information presented in the return. Math error authority (MEA) is just one example of the prerefund compliance checks that IRS uses.¹ In 2010, IRS sent 8.4 million notices to taxpayers for almost 10.6 million math errors identified on their 2009 tax year returns.

We have long highlighted the importance of improving IRS's prerefund compliance checks as a means to improve compliance while minimizing taxpayer burden. In 1998, we found that inadequate controls over refunds was a material weakness that could adversely affect IRS's ability to record, process, summarize, and report financial data.² We continue to believe that enhanced preventive controls are keys to improving IRS's ability to correct taxpayer errors by preventing the disbursement of erroneous refunds, thereby saving the federal government potentially billions of dollars.

My statement today will focus on three key areas: (1) prerefund checks and their benefits, (2) how those checks can be enhanced immediately, and (3) how they may be enhanced in the future. It is based mostly on our previous work issued from 2008 through 2011, including our interim report

¹IRS is granted math error authority in 26 U.S.C. § 6213 (b). It can be used for certain purposes specified by Congress in 26 U.S.C. § 6213 (g)(2) including correcting calculation errors and checking for other obvious noncompliance such as claims above income and credit limits. If it is not specified in statute, IRS cannot pursue assessment and collection activities without issuing a statutory notice of deficiency.

²See GAO, *Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements*, GAO/AIMD-98-77 (Washington, D.C.: Feb. 26, 1998).

on IRS's 2011 tax filing season, and our ongoing analysis of the 2011 filing season.³ Those performance audits were conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Current Prerefund Checks Provide Significant Benefits

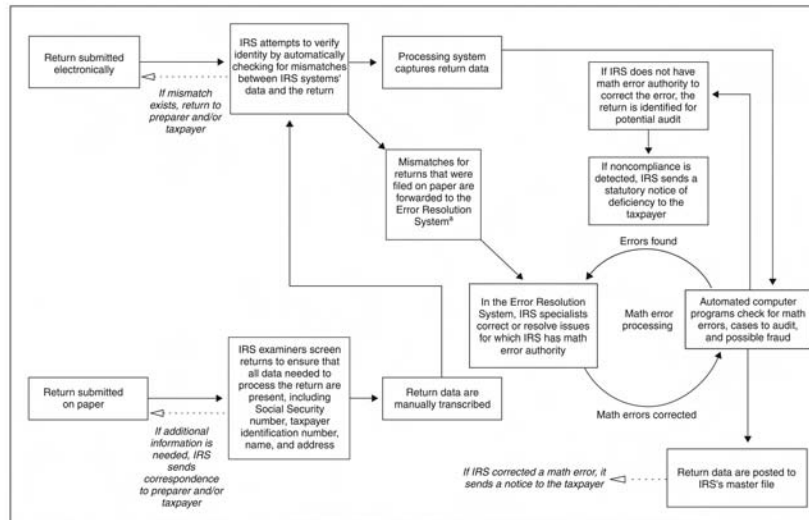
Prerefund compliance checks enable IRS to help confirm taxpayers' identities and ensure that returns have required information, quickly and efficiently correct certain errors with a virtual certainty of being right, identify and audit some returns even before refunds are completed, and help detect possible fraud.⁴ Figure 1 shows IRS's prerefund process.⁵

³GAO, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance*, GAO-11-481 (Washington, D.C.: Mar. 29, 2011).

⁴Tax fraud is defined as the willful attempt to defeat or circumvent the tax law in order to illegally reduce one's tax liability.

⁵Identity theft becomes a problem for taxpayers and IRS through refund fraud. The name and Social Security number used by identity thieves can be stolen from numerous sources outside of IRS's control. See GAO, *Tax Administration: IRS Has Implemented Initiatives to Prevent, Detect, and Resolve Identity Theft-Related Problems, but Needs to Assess Their Effectiveness*, GAO-09-882 (Washington, D.C.: Sept. 8, 2009).

Figure 1: Processing and Correcting Returns with Errors



Source: GAO analysis of IRS information.

*IRS's Error Resolution System is generally used to correct errors on tax returns so that they can be processed or to change the amount of tax owed pursuant to math error authority before a refund is issued.

Steps to Confirm Taxpayers' Identities and Ensure That Required Information Is Provided

When tax returns are first received by IRS, the initial process helps correct taxpayer identification errors and ensure taxpayers have filled in all fields that are required for IRS to process the return. The process differs slightly for electronically and paper filed returns. For electronic returns, IRS checks for possible mismatches among taxpayers' identity information, such as their names, Social Security numbers, and addresses. When mismatches occur, IRS rejects the tax return back to the taxpayer or paid preparer for possible correction. For paper returns, IRS staff review each return to ensure that all forms and data needed to process the return are

	present and may correspond with the taxpayer for missing information. IRS staff then transcribe data from the paper return into IRS computer systems and programming matches taxpayers' identity information if possible. Later on in the process, IRS staff may also correspond with taxpayers or their paid preparers to obtain other missing information, as well as research and correct certain errors that would affect processing the return, such as transposed numbers within Social Security numbers.
Application of Computerized Filters	After initial errors are corrected, the return information is captured in IRS's tax return processing systems. At this point, IRS applies additional computerized filters. Some filters identify errors that can be corrected using IRS's MEA. Other filters identify errors that can be addressed through audits either before a complete refund is sent to the taxpayer or afterwards. Finally, still other filters identify possible cases of tax fraud.
Math Error Authority Checks	When IRS's computer programs identify errors on returns that can be corrected with virtual certainty, those returns are forwarded to IRS's Error Resolution System (ERS). Despite the name, math errors encompass much more than simple arithmetic errors. They also include, for instance, identifying incorrect Social Security or other taxpayer identification numbers, problems with taxpayers' filing status or claiming of dependents, and missing schedules or forms. Some of these errors are detected from information included on the tax return itself, and some are detected by comparing information on the return to other internal IRS databases or databases of information obtained from others, such as the Social Security Administration. In ERS, IRS staff manually review the error and enter codes that then automatically generate a notice to the taxpayer that explains the error, identifies the revision in the taxpayer's refund amount—or possibly a new balance due to IRS, and instructs the taxpayer on how to respond if he or she disagrees with the change IRS has made.
Prerefund and Postrefund Audits	When IRS filters identify an error not correctable with MEA, the return is placed in queue for possible prerefund or postrefund audit. Depending on available resources, IRS will audit a portion of these returns, generally through correspondence audits with taxpayers, before complete refunds are sent to the taxpayers. In some cases, IRS will send the taxpayers the portion of their refunds that was claimed correctly while withholding the portion that IRS considers likely to be in error. To the extent returns are not handled in prerefund audits, IRS will include them for possible postrefund audits.

Fraud Investigations	Based on IRS's computer filters, IRS identifies some refund claims that may be fraudulent. These are forwarded to IRS's Criminal Investigation division. Those investigations may occur simultaneously as math error or audit corrections are being made to the return. In some cases, the investigation may be of a taxpayer and in other cases it may focus on a paid preparer or others who may be engaging in systematic fraud affecting more than one return.
Benefits of Prerefund Checks	Collectively and individually, these prerefund checks have benefits for IRS and taxpayers. The initial checks on taxpayers' identities and completeness of returns help ensure that returns can be accepted and processed quickly for taxpayers. It also allows IRS to detect common errors or noncompliance such as if a taxpayer uses a false Social Security number to claim a dependent. Math error checks are among the most beneficial of the prerefund checks for both taxpayers and IRS. These checks have the potential to protect billions of dollars in federal revenue from being erroneously refunded to taxpayers, especially for refundable tax credits that have been increasingly enacted in recent years, as significant overclaimed refund amounts result, sometimes through fraudulent claims. For example, Congress enacted three different versions of the refundable First-Time Homebuyer Credit (FTHBC) but did not immediately provide IRS with MEA to automatically verify certain information.⁶ In 2009, we proposed that Congress grant MEA to IRS to conduct prerefund compliance checks to ensure that taxpayers do not claim the homebuyer credit in multiple years.⁷ We calculated that IRS prevented about \$95 million in erroneous refunds in fiscal year 2010 using this new authority. In addition, this and various other MEA provisions for the FTHBC granted to IRS after the credit was first enacted allowed IRS to deny approximately 350,000 erroneous claims in 2010,

⁶The Housing and Economic Recovery Act of 2008 established a refundable FTHBC, repayable over 15 years with a \$7,500 limit. Pub. L. No. 110-289, § 3011, 122 Stat. 2654 (July 30, 2008). The American Recovery and Reinvestment Act of 2009 amended the credit to waive the repayment requirement and raised the maximum to \$8,000. Pub. L. No. 111-5, div. B, tit. I, § 1006, 123 Stat. 115 (Feb. 17, 2009). The Worker, Homeownership, and Business Assistance Act of 2009 extended the time frame to claim the credit and allowed claims by certain long-term homeowners purchasing new homes. Pub. L. No. 111-92, § 11, 123 Stat. 2984 (Nov. 6, 2009).

⁷Congress provided IRS authority to check the previous year's tax returns when it extended the credit for the final time in November 2009. Pub. L. No. 111-92, § 12(d).

thereby saving tax revenue and enabling IRS to use scarce enforcement resources elsewhere. If not denied, this large volume of erroneous claims would have roughly translated into a billion dollars or more in improper payments.

IRS can use MEA to correct errors it identifies and send the corrected refund amount to the taxpayer instead of trying to recover overpayments after audit. In postrefund enforcement, IRS may not recover all funds that are owed, which may be especially true for cases of fraud, and may incur additional costs in attempting to collect the delinquent taxes. We have previously reported that prompt compliance checks are important because as unpaid taxes age, the likelihood of collecting all or part of the amounts owed decreases.⁸

For taxpayers, some MEA helps them receive tax benefits for which they are eligible by identifying individuals who underclaimed the benefits. For example, last year we reported that from January 1 through September 30, 2010, IRS corrected about 7.7 million errors associated with the Making Work Pay credit, including about 60 percent in the taxpayers' favor. These corrections meant that taxpayers received larger refunds (or had lower taxes due) than they had anticipated.⁹

If IRS conducts a prerefund audit, it holds disputed refund amounts until the taxpayer's proper tax liability can be determined and the audit is concluded. As with math error checks, prerefund audits are preferable because once a refund has been paid, IRS may be unable to collect all amounts due and can incur significant expenses in the collection of delinquent tax debts. For taxpayers, prerefund audits also minimize the possible interest expenses they would incur if the audits did not occur for months or more after their return was filed. Generally, taxpayers accrue interest on underpaid taxes from the date the tax becomes due.

⁸GAO, *Tax Administration: IRS's 2008 Filing Season Generally Successful Despite Challenges, although IRS Could Expand Enforcement during Returns Processing*, GAO-09-146 (Washington, D.C.: Dec. 12, 2008).

⁹The refundable Making Work Pay tax credit provided up to \$400 for working individuals and up to \$800 for married taxpayers filing joint returns for 2009 and 2010. Pub. L. No. 111-5, div. B., tit. I § 1001, 123 Stat. 115, 309 (2009). See GAO, *2010 Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others*, GAO-11-111 (Washington, D.C.: Dec. 16, 2010).

Finally, beginning fraud investigations as quickly as possible has several advantages for IRS. In general, the more quickly such investigations are begun, the more likely evidence will be available. To the extent that investigations lead to quick action, perpetrators of fraud may be stopped before they can continue their efforts through the filing season. An affirmative IRS investigative presence and successfully resolved cases may also deter some who would otherwise be tempted to engage in fraudulent activities.

Prerefund Checks Can Be Enhanced

For almost a century, Congress has been expanding IRS's MEA on a case-by-case basis. Its most recent expansions were to help determine the eligibility for certain credits such as the FTHBC. The increase over time has resulted in the 13 existing MEA provisions shown in appendix I.

Although Congress sometimes quickly extended MEA to address compliance issues with newly created tax credits, at times a round of initial errors occurred before IRS was able to obtain the new authority. We suggested in 2010 that authorizing the use of MEA on a broader basis rather than on a case-by-case basis, with appropriate controls to protect taxpayer rights, could minimize the danger of that happening in the future.¹⁰ In the past we identified benefits to IRS and taxpayers that could arise from broader MEA. I already mentioned some of these earlier, but, to summarize, broader MEA could

- enable IRS to correct all or nearly all returns where IRS identifies the noncompliance and the needed correction with virtual certainty, not just those it can address through other enforcement means;
- be low cost and less intrusive and burdensome to taxpayers than audits;
- ensure that taxpayers who are noncompliant on a particular issue are similarly treated, that is, that a greater portion of them are brought into compliance, not just those that IRS could otherwise address through other enforcement means;
- enhance equity between compliant and noncompliant taxpayers because a greater portion of the noncompliant taxpayers would be brought into compliance;
- provide a taxpayer service as it would generally allow noncompliant taxpayers to receive their refunds faster than if IRS had to address the error through some other compliance mechanism, have their returns

¹⁰GAO, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed*, GAO-10-349 (Washington, D.C.: Feb. 10, 2010).

corrected without penalty and before interest is accrued, and avoid time-consuming interaction with IRS under its other programs for resolving noncompliance;

- help ensure that taxpayers receive the tax benefits for which they are eligible by identifying taxpayers who underclaim a tax benefit;
- free up IRS resources to pursue other forms of noncompliance; and
- allow IRS to quickly address provisions arising from new and quickly moving initiatives like the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5) without waiting for new MEA to go through the legislative process.

While providing broad MEA is ideal, we have also suggested that Congress expand MEA for more limited purposes. As we recently reported, IRS does not have MEA to review prior year tax returns to ensure that taxpayers do not claim credits or deductions in excess of lifetime limits such as for residential energy credits.¹¹ We have identified four specific cases where IRS could benefit from additional MEA, including for the FTHBC for which Congress granted authority. Expanding MEA should also provide many of the same benefits described above. Table 1 provides a summary of GAO's previous matters for congressional consideration for expanded MEA.

Table 1: GAO Math Error Authority Matters for Congressional Consideration

	Matter for consideration	Date of report	Disposition (as of May 2011)	Source
1	Provide IRS with math error authority to use prior years' tax return information to ensure that taxpayers do not improperly claim credits or deductions in excess of applicable lifetime limits.	March 29, 2011	Not yet enacted	GAO-11-481
2	Provide IRS with math error authority to use prior years' tax return information to automatically verify taxpayers' compliance with the number of years the Hope credit can be claimed.	December 10, 2009	Not yet enacted	GAO-10-225
3	Provide IRS with math error authority to (1) use the prior year's tax return information to automatically verify compliance with the 2008 First-Time Homebuyer Credit payback provision and (2) ensure that homebuyers do not improperly claim the credit in multiple years.	September 23, 2009	Enacted 2009 in Public Law 111-92	GAO-09-1026
4	Provide IRS with authority to use math error checks to identify and correct returns with ineligible (1) individual retirement account (IRA) "catch-up" contributions and (2) contributions to traditional IRAs from taxpayers over age 70½.	December 12, 2008	Not yet enacted	GAO-09-146

Source: GAO.

¹¹GAO-11-481.

MEA allows IRS to correct a tax return and send a notice to the taxpayer regarding the correction without going through the statutory deficiency procedures. Instead, IRS notifies the taxpayer that it has identified the error and has made a change to the return. Taxpayers have 60 days to contest the assessment outlined in those notices. Further, if they do not contest the assessment within that time, they lose their right to file an appeal with IRS or the U.S. Tax Court but have the option of filing an amended tax return to be considered by IRS. The National Taxpayer Advocate and some in Congress are concerned that not following the statutory deficiency procedures might undermine taxpayer rights because IRS might use broad authority in situations where it does not know with a high degree of certainty that the taxpayer made an error. In addition, taxpayers might not ask, within 60 days after being assessed tax by IRS, to have their assessment reversed by IRS and thus might be unable to challenge an IRS notice through normal deficiency procedures or in the Tax Court.

To mitigate these concerns, Congress could extend broader MEA to IRS but could specify criteria governing when IRS could use the authority. Traditionally, math error checks have allowed IRS to detect errors or determine taxpayer eligibility with virtual certainty, thus letting IRS make corrections without first corresponding with the taxpayer. To ensure IRS continues to use MEA only in these limited circumstances if given broader authority, Congress could, for example, require IRS to submit a report to it or an entity it designates on a proposed new use of MEA. The report could include how such use would meet the standards or criteria outlined by Congress. The report could also describe IRS's or the National Taxpayer Advocate's assessment of any potential effect on taxpayer rights. Or, Congress could require a more informal procedure whereby IRS simply notifies a committee, such as the Joint Committee on Taxation, of its proposed use and subsequently submits a report after such use is underway. In any case, Congress could provide IRS broader authority to use MEA than is currently authorized but still provide appropriate safeguards and require IRS to report in order to alleviate concerns of improper use of MEA.

The Future Holds Significant Possibilities for Enhancing Prerefund Checks

The benefits I listed earlier of broadening MEA or using other prerefund compliance checks could also result from other initiatives that IRS has already begun or is contemplating. For example, in April, 2011, the Commissioner of Internal Revenue talked about a long-term vision to increase upfront compliance activities during returns processing. In one example, IRS is exploring requiring that information returns be sent to IRS and taxpayers at the same time as opposed to the current requirement that some returns go to taxpayers before going to IRS. The intent is to move to matching those information returns to tax returns during tax return processing. IRS currently matches data provided on over 2 billion information returns to tax returns only after the normal filing season. Matching during the filing season would allow IRS to detect and correct errors before it sends taxpayers their refunds, thereby avoiding the costs of trying to recover funds from taxpayers later.¹² This approach could also allow IRS to use its enforcement resources on other significant compliance problems. However, the Commissioner made clear that his vision for more prerefund compliance checks will take considerable time to implement. One prerequisite would be a major reworking of some fundamental IRS computer systems.

Other IRS initiatives should also enhance compliance before refunds are issued. For instance, IRS could leverage new paid tax return preparer requirements to improve taxpayer compliance before tax returns are filed. Our work has shown that paid tax preparers play a vital role in administering our country's tax system and ensuring compliance with tax laws. Paid preparers prepare about 60 percent of the federal tax returns filed annually. However, we and others have found that some paid preparers make significant errors. We also found that emulating Oregon's paid preparer regulatory regime had the potential to lead to more accurate federal returns.¹³ In response, IRS is currently implementing new regulatory requirements in order to oversee the conduct and competency of paid preparers.

These new requirements may improve the accuracy of tax returns initially prepared by paid preparers. The new requirements may also help IRS

¹²GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, GAO-11-168 (Washington, D.C.: Mar. 24, 2011).

¹³GAO, *Tax Preparers: Oregon's Regulatory Regime May Lead to Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, GAO-08-781 (Washington, D.C.: Aug. 15, 2008).

address compliance problems that arise during filing seasons. For instance, IRS may be able to identify specific paid preparers that are making errors and send them information on their errors, thus reducing errors on additional returns they may prepare during the filing season. To achieve the full benefits of the paid preparer regulatory regime, IRS must continue to make progress with its plans to develop a comprehensive database containing information on the preparers and tax returns they prepare. IRS must use information from this database to test which strategies are most effective for improving the quality of tax returns prepared by different types of paid preparers. To help with this effort, we recently recommended that IRS provide a documented framework for using the paid preparer requirements to improve taxpayer compliance.¹⁴ IRS agreed with this recommendation.

Concluding Remarks

In closing, IRS has a massive challenge in ensuring compliance with the tax laws. Looking forward, with budget constraints a reality and burden on taxpayers a concern, doing more compliance checks before refunds are issued has great appeal for both taxpayers and IRS. Through oversight efforts like today's hearing, Congress can encourage and authorize the use of appropriately designed prerefund compliance checks that are critical to stopping erroneous refunds and ensuring that federal dollars are protected.

Chairman Boustany, Ranking Member Lewis, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Michael Brostek, Director, Strategic Issues, on (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Joanna Stamatiades, Assistant Director; Steven J. Berke; Amy R. Bowser; David Fox; Tom Gilbert; Lawrence M. Korb; Inna Livits; and Sabrina Streagle.

¹⁴GAO, *Tax Preparer Regulation: IRS Needs a Documented Framework to Achieve Goal of Improving Taxpayer Compliance*, GAO-11-336 (Washington, D.C.: Mar. 31, 2011).

Appendix I: IRS Math Error Authorities

Table 2 summarizes the Internal Revenue Service's (IRS) 13 areas of existing math error authority (MEA). As early as the first codification of the Internal Revenue law in 1926, Congress granted IRS MEA so that IRS does not have to provide taxpayers with a statutory notice of deficiency for math errors. A 1976 statutory revision defined the authority to include not only mathematical errors, but other obvious errors, such as omissions of data needed to substantiate an item on a return, and provided a statutory right to file a request for abatement of the assessment within 60 days after the notice is sent. In the 1990s, Congress extended the authority multiple times, and more recently it has added other provisions to help determine eligibility for certain tax exemptions and credits, such as the First-Time Homebuyer Credit.

Table 2: IRS's 13 Existing Math Error Authorities

No.	Description
1	An error in addition, subtraction, multiplication, or division shown on any return.
2	An incorrect use of any table provided by IRS with respect to any return if other information in the return makes the incorrect use apparent.
3	An entry on a return of an item that is inconsistent with another entry of the same or different item on that return.
4	An omission of information that is required to be supplied on the return to substantiate an entry on that return.
5	An entry on a return of a deduction or credit in an amount that exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on the return.
6	A correct taxpayer identification number (TIN) not provided on the return as required for the following provisions: • Earned Income Tax Credit (EITC); • child and dependent care credit; • personal or dependent exemption; • child tax credit; or • Hope and Lifetime Learning credits.
7	A return claiming an EITC for net earnings from self-employment, where the self employment tax imposed by I.R.C. § 1401 on those net earnings has not been paid.
8	An omission of information required for recertification of eligibility for the EITC.
9	An entry on the return of a TIN required for the EITC, the child credit, and the child and dependent care credit, when information associated with that TIN indicates that the child does not meet the age eligibility requirements for those credits.

Appendix I: IRS Math Error Authorities

No.	Description
10	An entry on the return of a claim for the EITC where the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of that child.
11	A failure to reduce Electronic Stimulus Payment credit on a return related to the Economic Stimulus Act of 2008 by amounts previously advanced.
12	A failure to reduce the Making Work Pay credit by the amount of any payment received as a result of tax abatement resulting from the combat-related deaths of members of the Armed Forces, deaths of astronauts, and deaths of victims of certain terrorist attacks, or by the amount of any credit allowed under the American Recovery and Reinvestment Act of 2009, or a failure to submit a proper Social Security number with the claim.
13	A claim for the First-Time Homebuyer Credit where the taxpayer has not included the required settlement statement; or where other information indicates that the taxpayer is under 18 years of age, or where information from the past 2 years of returns indicates ineligibility for the credit. Additionally, IRS may correct the return where the taxpayer has failed to include the increased tax required under the recapture provision for the credit, when applicable.

Source: GAO analysis.

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Chairman BOUSTANY. Thank you, Mr. Brostek.
Ms. Olson, you may proceed.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER
ADVOCATE, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.**

Ms. OLSON. Chairman Boustany, Ranking Member Lewis, and distinguished Members of the Subcommittee, thank you for inviting me to testify today about improper payments of Federal funds.

The Tax Code authorizes numerous refundable credits that may give rise to improper payments. These include the earned income tax credit, additional child tax credit, first-time home buyer tax credit, adoption credit, American Opportunity tax credit, and the fuel tax credit for businesses.

It goes without saying that the job of the IRS in administering these provisions is to ensure that payments are made to eligible persons and only to eligible persons. But for context, it is important to keep in mind that the IRS has a lot on its plate.

For tax year 2001, the tax gap was estimated at 345 billion a year. By comparison, improper payments related to the EITC constitute less than five percent of that amount.

As money is fungible, overstatement of a refundable credit is economically equivalent to underpayment of tax for any other reason. They both have the same impact on the public treasury. The IRS must address both problems. And with limited resources, every additional EITC audit the IRS conducts cuts into the resources it has available to audit other areas of the tax gap. At present, the audit rate for returns with EITC claims is more than twice that for individual returns in general. Moreover, EITC audits constitute about a third of all individual audits, yet they yield, on average, only about a third as much tax per exam.

For tax year 1999, an IRS study estimated that 27 to almost 32 percent of EITC claims should not have been paid. For fiscal year 2009 the IRS estimate of EITC improper payments was 23 to 28 percent. Assuming that these IRS estimates are comparable, the compliance rate would have appeared to have improved by 4 percentage points. Taking a 27 percent non-compliance rate down by 4 points to 23 percent would have reduced the gap by almost 15 percent. And this is huge for any tax administration program. It suggests that over the last 10 years both the IRS and interested stakeholders may be making progress in addressing EITC non-compliance.

That said, I believe all of these estimates substantially over-estimate the percentage of ineligible taxpayers claiming the benefit. Among other things, the EITC requires taxpayers to prove that they have a qualifying relationship with a claimed child, and that they lived with the claimed child for more than half the year. In many cases, these requirements are notoriously difficult to prove, and an IRS denial of claim in these cases proves simply that the taxpayer could not prove these elements, not that he or she didn't actually meet them.

Two taxpayer advocate service studies have found this to be the case. In one study, taxpayers had been confused by IRS audit procedures, notices, and documentation requirements. When TAS staff explained the requirements, reported eligibility increased. Notably,

the percentage of taxpayers who received EITC increased in direct proportion to the number of telephone contacts that TAS had initiated.

In other studies, taxpayers who were represented fared substantially better than taxpayers who were not. TAS has made numerous regulatory and legislative recommendations to improve the administration of refundable credits, particularly the EITC, and to reduce improper payments without unduly burdening taxpayer rights. Regulation of return preparers, including testing and continuing education on EITC and ethics, curtailment of refund anticipation loans, which has been statistically linked with non-compliance, enhanced preparer penalties, and strengthened due diligence requirements should all have a positive impact.

If the IRS could receive and process third-party information returns before it issues refunds, and if Congress separated the worker portion of the EITC from the portion of EITC attributable to family size, and consolidated all family-related benefits into one provision, we could further reduce improper payments, incentives for fraud, and taxpayers' compliance burden all in one stroke.

Additional legislative action could also reduce improper payments, notably limiting public access to the database of decedents' Social Security numbers and other personal information, and authorizing the use of math error authority for revisions that cap either the lifetime amount of a credit or the number of years for which a credit may be claimed.

I appreciate the opportunity to share my thoughts with you, and would be happy to answer your questions.

[The statement of Ms. Olson follows:]

WRITTEN STATEMENT OF

NINA E. OLSON

NATIONAL TAXPAYER ADVOCATE

HEARING ON

**IMPROPER PAYMENTS IN THE ADMINISTRATION
OF REFUNDABLE TAX CREDITS**

BEFORE THE

**SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

MAY 25, 2011

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Chairman Boustany, Ranking Member Lewis, and distinguished Members of this Subcommittee:

Thank you for inviting me to testify today about improper payments in the administration of refundable tax credits.¹ In my testimony today, I will make the following points:

1. Federal tax law allows individuals, as well as businesses, refundable credits that are not necessarily associated with improper payments.
2. The earned income tax credit (EITC) is a refundable credit, enacted as a work incentive in the Tax Reduction Act of 1975 signed by President Ford, that has become the government's largest means-tested anti-poverty program.²
3. The optimal design of a social benefit program maximizes both participation and compliance levels.³
4. There is a complex overstatement problem in the EITC that cannot be characterized simply as fraud or ineligibility.
5. Estimates of improper EITC payments contain uncertainties as to the amount and rate of overstatement.
6. EITC overstatement statistics should be evaluated in light of Taxpayer Advocate Service (TAS) research findings.
7. TAS has made numerous recommendations to improve the administration of the EITC and reduce improper payments, and I will describe our most significant recommendations below.
8. Additional legislative action could help reduce improper payments – notably, limiting public access to the database of decedents' Social Security numbers (SSNs) and other personal information and authorizing the use of math error authority for provisions that cap either the lifetime amount of a credit or the number of years for which a credit may be claimed.

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget (OMB) for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² See Pub. L. No. 94-12, 89 Stat. 26 (1975).

³ National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 103 (Research Study: *Running Social Programs Through the Tax System*).

9. Although there are additional steps the IRS can take to improve its administration of the EITC, some proposals that have been advanced could undermine effective tax administration.

At the outset, I should note that my perspective on refundable credits, particularly the EITC, is based not only on my experience as the National Taxpayer Advocate but also on my prior experience of almost three decades preparing taxes for individuals and small businesses and representing them before the IRS; founding and serving as Executive Director of The Community Tax Law Project, the first independent low income taxpayer clinic in the country; and successfully representing hundreds of low income taxpayers on EITC issues in audits before the IRS and in litigation before the United States Tax Court.

I. Federal Tax Law Allows Individuals, as Well as Businesses, Refundable Credits That Are Not Necessarily Associated with Improper Payments.

Most tax credits merely reduce the amount of tax a taxpayer owes, but in the case of *refundable* tax credits, the IRS may end up paying a taxpayer more than the taxpayer paid in tax, resulting in a "negative" tax. Refundable credits may have become familiar as a benefit to low income taxpayers and therefore may be viewed as a form of "welfare." Nevertheless, these credits are no longer limited to this population. To the contrary, refundable credits are now available to middle-income taxpayers as well as businesses.

In addition, economic incentives may be designed as non-refundable credits for large and small businesses. Recently, the Hiring Incentives to Restore Employment (HIRE) Act provided an incentive for employers to hire previously unemployed workers via a 6.2-percent payroll tax incentive, effectively exempting them from the employer's share of Social Security tax on wages paid.⁴ The incentive also allowed an employer an income tax credit up to \$1,000 for retaining a worker under certain circumstances.⁵ Under the Patient Protection and Affordable Care Act of 2010, a small business may receive a credit of up to 50 percent of premiums for health insurance on low and moderate-income employees.⁶

To provide context for our discussion of improper payments, significant examples of refundable credits are briefly described below.

⁴ See IRC § 3111(d).

⁵ See Pub. L. No. 111-147, § 102, 124 Stat. 71, 75 (2010).

⁶ See Pub. L. No. 111-148 § 10105(e)(1), 124 Stat. 119, 906 (2010), adding IRC § 45R. The credit for small tax-exempt employers is limited to 35 percent.

- The earned income tax credit (EITC) may be described as a wage supplement, with a \$5,666 maximum, administered by the IRS to low income workers.⁷
- The additional child tax credit (ACTC) refers to the portion, dependent on earnings, of the \$1,000 per child tax credit for low and moderate-income taxpayers that the IRS may refund even in excess of tax owed.⁸
- The First-Time Homebuyer tax credit (FTHBC), enacted in 2008 and subsequently modified, provides the lesser of \$8,000 or ten percent of the purchase price to certain low and moderate-income first-time or long-time homeowners.⁹
- The adoption credit allows low and moderate-income parents to claim a credit of up to \$13,170 for the expenses of adopting a child.¹⁰
- The American Opportunity Tax Credit is a partially refundable credit to low and moderate-income taxpayers of up to \$2,500 for college tuition, fees, and course materials.¹¹
- The fuel tax credit to purchasers of gasoline used on farms or local buses or of fuels for certain other purposes generally is 18.3 cents per gallon.¹²

All of these credits are refundable and may give rise to improper payments, yet data do not necessarily connect refundable credits with more noncompliance than any other tax provision. On the contrary, certain understatements of business income may create more of a tax gap than do overstatements of tax credits.¹³

Generally, the tax gap is a measure of noncompliance that refers to the difference between what taxpayers owe and what they pay voluntarily and timely – an estimated

⁷ See IRC § 32(f); IRS Pub. 596, *Earned Income Credit* 45 (2010).

⁸ See IRC § 24.

⁹ See IRC § 36; see also National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 100-103 (discussing administrability problems specific to the First-Time Homebuyer Credit).

¹⁰ See IRC § 36C.

¹¹ See IRC § 25A(i).

¹² See IRC §§ 34, 4081(a)(2)(A)(i), 6420, 6421, 6427.

¹³ See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 82 ("National Research Program (NRP) data for tax year 2001 suggest that approximately 55 percent (\$109 billion) of the individual underreporting gap (totaling approximately \$197 billion) came from understated net business income, such as unreported receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent (\$17 billion) came from overstated tax credits. *** Based on these data, the National Taxpayer Advocate believes that noncompliance is not necessarily more prevalent in refundable credits than any other type of tax incentive.").

\$345 billion.¹⁴ This gross tax gap consists of three types of noncompliance, namely failure to report all income (\$285 billion), file a tax return (\$27 billion), and pay all tax due (\$33 billion).¹⁵ Of the \$285 billion gross underreporting gap, the largest single segment is business income underreported by individuals (\$109 billion or 38 percent).¹⁶ These individuals include those who should report business income as sole proprietors on Schedule C (Profit or Loss from Business) or as farmers on Schedule F (Profit or Loss from Farming).

In context, EITC noncompliance may be a relatively small portion of the tax gap.¹⁷ Nonetheless, the discussion below focuses primarily on the EITC because it is the refundable credit identified under applicable law as an "improper payment."¹⁸

II. The EITC Is a Refundable Credit, Enacted as a Work Incentive in the Tax Reduction Act of 1975 Signed by President Ford, That Has Become the Government's Largest Means-Tested Anti-Poverty Program.

A. Legislative Background

Generally, the amount of the EITC increases with earned income, creating an incentive to work.¹⁹ The EITC amount also increases if a worker has one, two, or three qualifying children, but is disallowed if the worker has more than \$3,100 of investment income.²⁰ The EITC phases out at an income ceiling of \$48,362 (for a married couple filing jointly

¹⁴ See IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007), Fig. 1 at 10 (containing an IRS estimate for TY 2001).

¹⁵ See *id.*

¹⁶ See National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 11 (Research Study: A Comprehensive Strategy For Addressing The Cash Economy).

¹⁷ See IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007), Fig. 4 at 13 (reflecting \$17 billion in credits out of \$197 billion in individual income tax underreporting for TY 2001); GAO, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges* (Apr. 15, 2011) (reporting \$16.9 billion in improper EITC payments in FY 2010).

¹⁸ See GAO, *Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments*, No. GAO-09-628T (Apr. 22, 2009) App. I, at 20 (identifying EITC as the Treasury improper payment).

¹⁹ See Stacy Dickert, Scott Houser & John Karl Scholz, *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation*, Tax Policy and the Economy, vol. 9, ed. James M. Poterba (MIT Press, 1995); Janet Holtzblatt, *Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits* (Dept. of the Treasury, 2004) 13 (citing Dickert, Houser & Scholz among academic economists who "estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work").

²⁰ See IRC § 32(b) (increasing EITC amount based on number of children), (i) (denying EITC to workers who have excessive income-producing investment assets).

with three or more qualifying children), while detailed requirements govern eligibility and computation.²¹

The Tax Reform Act of 1986, signed by President Reagan, significantly expanded the EITC, raising the maximum credit from \$550 to \$800 and the phase-out ceiling from \$11,000 to \$13,500, while indexing the EITC for inflation.²² The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, signed by President Clinton, substantially reformed traditional welfare programs. As a central component of welfare reform, the EITC was expanded with respect to the amount of work incentive and modified with respect to immigration and work status in the U.S.²³ The Taxpayer Relief Act of 1997, also signed by President Clinton, denied the EITC for two or ten years to a taxpayer who had made a claim that was reckless (*i.e.* due to intentional disregard of rules and regulations) or fraudulent, respectively.²⁴ The Education, Jobs, and Medicaid Assistance Act of 2010, signed by President Obama, eliminated the advance EITC, which had allowed periodic payments through reduced payroll withholding but had been associated with noncompliance as well as low participation.²⁵

²¹ A 2009 House committee report provided the following description:

Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2009). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

H.R. Rept. No. 111-16, at 519 (2009).

²² See Pub. L. No. 99-514, § 111, 100 Stat. 2085 (1986).

²³ See Pub. L. No. 104-193, § 451, 110 Stat. 2105, 2276 (1996).

²⁴ See IRC § 32(k).

²⁵ See Pub. L. No. 111-226, § 219, 124 Stat. 2389, 2403 (2010), repealing IRC § 3507.

B. Compliance History

For tax year (TY) 1999, an IRS study estimated that 27.0 to 31.7 percent of EITC claims should not have been paid.²⁶ For fiscal year (FY) 2009, the IRS estimate of EITC improper payments was 23 to 28 percent.²⁷ Assuming *arguendo* that these IRS estimates are comparable, *the compliance rate would appear to have increased by four percentage points.*²⁸ *Taking a 27 percent noncompliance rate down by four points to 23 percent would have reduced the gap by almost 15 percent.* A comparable compliance rate increase in many other tax gap areas would be overwhelming. As discussed below, however, significant statistical questions about the IRS estimates remain.

Over the past decade, the IRS has pursued EITC compliance through a strategy comprising a disproportionately high audit rate of EITC returns, enforcement of rules for paid tax return preparers, and outreach and education directed toward low income taxpayers.

The audit rate for returns with EITC claims is approximately twice the rate at which the IRS audits individual taxpayers in general.²⁹ This doubled audit rate is counterintuitive when the additional tax recommended after audits averages significantly less for the EITC than for individual returns in general.³⁰ The following chart shows that EITC audits constitute about a third of all audits, yet they yield on average only about a third as much tax per exam and an even smaller proportion of tax from individual audits overall.³¹

²⁶ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002) 3 ("Of the estimated \$31.3 billion in Earned Income Tax Credit (EITC) claims made by taxpayers who filed returns in 2000 for tax year 1999, it is estimated that between \$8.5 and \$9.9 billion (27.0 percent to 31.7 percent) should not have been paid.").

²⁷ See Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* (Feb. 7, 2011) (hereinafter *Reduction Targets*), at 1 ("The FY 2009 EITC improper payment rate is estimated to be between 23 percent to 28 percent or \$11 billion to \$13 billion in EITC improper payments each year.").

²⁸ A FY 2010 Improper Payment study shows the EITC noncompliance rate at 23.9 percent to 28.7 percent based on tax year 2006 IRS National Research Program (NRP) data. This noncompliance rate is slightly higher than in the FY 2009 study; however, since the FY 2010 study used methodology not directly comparable to the 1999 EITC study, we have used the 2009 study, which permits a better comparison.

²⁹ See IRS Pub. 55-B, *Data Book* (2010), Table 9a at 22.

³⁰ See *id.* at 23.

³¹ IRS Data Book, 2006 - 2010, Table 9a; EITC Program Office response to TAS information request (May 18, 2011).

FY	All Individual Returns			Returns with EITC			EITC Compared to All Individual Returns		
	Exams	Rec'md add'l tax (\$) (in billions)	\$ per Exam	Exams	Rec'md add'l tax (\$) (in billions)	\$ per Exam	Percent of Exams	Percent of Rec'md add'l tax (\$)	Percent of \$ per Exam
2006	1,283,950	13.05	10,160	517,617	1.49	2,872	40.3%	11.4%	28.3%
2007	1,384,563	15.71	11,343	503,267	1.49	2,969	36.3%	9.5%	26.2%
2008	1,391,581	12.46	8,956	503,755	1.99	3,958	36.2%	16.0%	44.2%
2009	1,425,888	14.94	10,478	508,180	2.15	4,232	35.6%	14.4%	40.4%
2010	1,581,394	15.07	9,527	473,999	1.97	4,162	30.0%	13.1%	43.7%
Average	1,413,475	14.24	10,077	501,364	1.82	3,639	35.5%	12.8%	36.1%

As this chart indicates, the IRS takes its mandate to reduce EITC overclaims seriously. Given the IRS's limited resources, however, the large amount of effort the IRS devotes to relatively low-yield EITC audits means that the agency is probably collecting less overall revenue than a strategy of pursuing higher-yield audits would produce.

A specific EITC compliance mechanism is the recertification requirement imposed after a two- or ten-year denial due to a reckless or fraudulent claim.³² To claim an EITC again, the taxpayer must file Form 8862 (Information to Claim Earned Income Credit After Disallowance) to enable the IRS to better verify eligibility. Another compliance mechanism is so-called math error authority, or summary assessment, in which the IRS first assesses additional tax, and in order to gain access to the United States Tax Court, the taxpayer must timely challenge the assessment administratively.³³ As the term "math error" suggests, the IRS may use this streamlined authority to correct arithmetic or clerical errors. In addition, the tax law extends this authority in the case of the EITC to such errors as omission of a Social Security number.³⁴

With respect to tax return preparers, the IRS has used due diligence audits, visits by revenue and Criminal Investigation agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to improve the accuracy of the EITC returns they file.³⁵

At the same time, the IRS has conducted campaigns to educate low income workers about the availability and requirements of the EITC. For example, the IRS sends notices to taxpayers who appear to qualify based on previously filed tax returns to

³² See Treas. Reg. § 1.32-3.

³³ See generally IRC §§ 6213(b) and 6213(g). In general, the United States Tax Court is the only judicial forum in which taxpayers may challenge their tax liabilities before paying the liability in full.

³⁴ See IRC § 6213(b); IRM 21.6.3.4.2.7.13.2 (May 4, 2007).

³⁵ See Dept. of the Treasury, *Performance and Accountability Rept. FY 2010*, at 280 (Nov. 15, 2010).

encourage them to claim the EITC if eligible.³⁶ Moreover, IRS staff working at Taxpayer Assistance Centers prepared approximately 53,000 EITC returns in TY 2009.³⁷

Beyond its own staff, the IRS partners with organizations that serve the low income community to educate taxpayers about the EITC. In particular, the IRS trains volunteers and supports Volunteer Income Tax Assistance (VITA) programs, which offer free return preparation to low income taxpayers and taxpayers who are elderly, disabled, or have limited English proficiency. For TY 2009, VITA prepared approximately three million EITC returns.³⁸ Another exemplary partnership is led by the National Disability Institute (NDI), which conducts an annual campaign known as the Real Economic Impact Tour to assist disabled workers in preparing their EITC claims. Through this effort, the NDI, other organizations, TAS, and the Stakeholder Partnerships, Education and Communication (SPEC) function of the IRS Wage and Investment division have worked together in 100 cities to provide free return preparation to low income taxpayers with disabilities.³⁹

Annually, the IRS has sponsored an EITC Awareness Day. This year on January 28, the IRS held news conferences and produced news releases, e-mail blasts, newsletters, and letters to editors; provided key messages to supplement partners' outreach efforts through their use of Facebook, blogs, Twitter, and other social media; supported events involving mayors of major cities; hosted IRS and other officials along with Members of Congress at events around the country; and provided assistance in local IRS offices to over 15,000 taxpayers on two Saturdays following EITC Awareness Day.⁴⁰ TAS assists the IRS with EITC Awareness Day, attending 96 events this year and reaching an estimated 6,000 taxpayers, including veterans, low income taxpayers, immigrants, and those speaking English as a second language. In January 2011, TAS also issued tweets and Facebook status updates focusing on EITC Awareness Day.

In short, the IRS has invested considerable resources in administering the EITC as Congress directed. The EITC has lifted millions of people out of poverty while requiring them to work, yet its design almost certainly yields higher rates of improper payments than traditional benefits programs.

³⁶ See, e.g., IRS, *Earned Income Tax Credit Program Effectiveness and Program Management FY 2002-FY 2003* (Aug. 8, 2003).

³⁷ TAS Research on IRS data (May 19, 2011).

³⁸ TAS Research on IRS data (May 19, 2011). In 2008, VITA prepared 0.9 percent of all federal income tax returns and 1.9 percent of returns claiming the EITC. See Steve Holt, *Ten Years of the EITC Movement: Making Work Pay Then and Now* 9 (Brookings Institution, Apr. 2011).

³⁹ See <http://www.realeconomicimpact.org/REI-TOUR.aspx>.

⁴⁰ See <http://www.eitc.irs.gov/central/main>.

III. The Optimal Design of a Social Benefit Program Maximizes Participation and Compliance Levels.

Given the social policy of support for low income workers that the EITC brings into the tax law, the question arises whether there is a way to achieve better results than the IRS has achieved in implementing such a policy. Traditionally, social benefit programs such as food stamps or the Section 8 Housing Choice Voucher Program have screened out ineligible claimants on the front end at a high administrative cost with relatively low participation rates.⁴¹ Of course, screening processes are not infallible, resulting in some improper payments.

On the other hand, refundable tax credits have low administrative cost and relatively high participation rates but a higher risk of payments to ineligible claimants.⁴² Generally, the IRS relies on voluntary assessment through the filing of tax returns. Using tax returns as the "application" for EITC benefits rather than a traditional screening process results in low cost with high participation as well as the risk of improper payment. The IRS has pointed out that for the EITC:

Current administration costs are less than 1% of benefits delivered. This is quite different from other non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures.⁴³

For TY 2009, the IRS reports that it paid \$55 billion in EITC claims.⁴⁴ If this amount had been paid by another agency that spent 20 percent of program expenditures verifying eligibility, the administration costs to the government would have been \$11 billion – nearly 100 percent of the amount of improper payments that the IRS estimates were made.

As part of its ongoing efforts to reduce improper payments, the IRS several years ago piloted a pre-certification program that required EITC claimants either to pre-certify their eligibility or to submit documentation of eligibility with their tax returns. However, the

⁴¹ See Housing Act of 1937 § 8, 42 U.S.C. § 1437f; 24 C.F.R. pt. 982; David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 Yale L.J. 955, 1001 (2004) (observing that integration of provisions such as Food Stamps and the EITC into the tax system can enhance "administrative efficiency by reducing bureaucratic costs").

⁴² See Weisbach & Nussim, 113 Yale L.J. at 1010 ("The EITC has a high participation rate but also a high overpayment rate. These facts are likely due to the lack of a precertification process."); Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 560, 564-65, 589 (1995) (observing that "the EITC and other tax-based transfers can enhance administrative efficiency by reducing bureaucratic cost" and identifying "the potential for noncompliance inherent in a tax-based program").

⁴³ *Reduction Targets* 23 (IRS response).

⁴⁴ See *Reduction Targets* 1. Overall EITC claims for TY 2009 exceeded \$60 billion, which consisted of about \$55 billion in refundable benefits and \$5 billion in offsets to other taxes. IRS Pub. 55-B, *Data Book* (2010), Table 1.

IRS ultimately concluded that pre-certification should not be pursued because the "results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers."⁴⁵

While tax administration generally carries a risk of payment to ineligible claimants, a significant criterion for determining EITC eligibility is income, and the IRS has unique expertise in examining income. Thus, it is unclear whether another mechanism for providing a work incentive and paying a wage supplement to low income workers would cost the government less.

IV. The EITC Presents a Complex Overstatement Problem that Cannot Be Characterized Simply as Fraud or Ineligibility.

Improper payments of EITC generally result from overstatement of claims by low income taxpayers. While the IRS has expertise in examining claimed income amounts, examining claims to determine whether a child meets other requirements has presented challenges. In 2004, acting on National Taxpayer Advocate and Treasury proposals, Congress simplified the definition of a qualifying child, generally eliminating the need to prove the cost of supporting a child, as long as he or she is of a prescribed age, relationship, and residence.⁴⁶ The IRS can systematically verify age with federal databases (such as the Social Security Numident database). However, relationship and residence are factual circumstances that often require intrusive inquiries into taxpayers' personal circumstances and are hence more difficult to establish. As a result, the most frequent reason for the IRS's rejecting EITC claims is the taxpayer's failure to establish relationship or residency to the IRS's satisfaction.⁴⁷

Over the years, based on experience administering the EITC, the IRS has developed a fairly sophisticated set of business rules to identify EITC returns that have a relatively high risk of overstatement. For example, the IRS can use databases derived from Social Security and other federal data to help identify cases in which the relationship and residence requirements may not be met. While external data may be a helpful indicator, they also may be misleading in some cases. As discussed below, a child's relationship and residence with respect to a low income taxpayer are highly circumstantial facts to be validated on a case-by-case basis.

Under the relationship requirement, the taxpayer generally may claim the EITC with respect to a child who is his or her son, daughter, stepchild, foster child, or a descendant of any of them (e.g., a grandchild), or a child who is a sibling, stepsibling, or

⁴⁵ IRS, *Earned Income Tax Credit Initiative: Final Report to Congress* (Oct. 2005).

⁴⁶ See National Taxpayer Advocate 2001 Annual Report to Congress 76 (Legislative Recommendation: *Family Status Issues*); Dept. of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004).

⁴⁷ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns*, at 13 (Feb. 28, 2002).

half-sibling of the taxpayer, or a descendant of any of them (e.g., a nephew or grandnephew).⁴⁸

Under the residence requirement, a taxpayer generally may claim the EITC only with respect to a child who lives with the taxpayer for more than half the calendar year (*i.e.*, six months plus one day).⁴⁹

As a practical matter, low income taxpayers have considerable difficulty documenting relationship and residence.⁵⁰ They have difficulty because of lack of clarity from the IRS as well as their own personal circumstances. In the past, TAS has reported that the "two main problems are inconsistency as to which documents the IRS will accept (a document is accepted in one office, but not in another) and inflexibility in accepting proof (failure to accept other types of documents where the taxpayer cannot provide the standard documentation)."⁵¹ On the low income taxpayers' part, one of the biggest issues is "their tendency to be transient or even temporarily homeless" coupled with literacy challenges.⁵² This combination of byzantine requirements with lack of a home

⁴⁸ See IRC § 152(c)(2).

⁴⁹ See IRC § 152(c)(1)(B).

⁵⁰ See Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, Tax Notes (June 23, 2003) 1821; Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), at http://works.bepress.com/leslie_book/8; National Taxpayer Advocate 2002 Annual Report to Congress 50 (Most Serious Problem: *EITC Eligibility Determinations Can Be Made Less Burdensome*).

⁵¹ National Taxpayer Advocate 2005 Annual Report to Congress 106-07 (Most Serious Problem: *Earned Income Tax Credit Exam Issues*).

⁵² Leslie Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net*, 81 Ore. L. Rev. 351, 393 (2002).

in which to store documents, not to mention skills with which to read them, frequently results in a lack of documentation.⁵³

In the context of low income taxpayers, the question of noncompliance takes on a complexity of its own. Generally, noncompliance is best described as a continuum of behavior from inadvertent error to negligence to recklessness (in disregard of the law) to fraud at civil or criminal levels.⁵⁴ Similarly, social scientists have classified noncompliance of different types, such as procedural, lazy, unknowing, asocial, brokered, symbolic, social, or habitual.⁵⁵ Compliance may be influenced by factors such as demographic affiliations, personal morals, social norms, deterrence probabilities, trust in government, complexity and convenience, as well as preparers and other third parties.⁵⁶

Reports of improper EITC payments may create concern about fraud. As noted earlier, a refundable feature *per se* does not account for improper payments. Nor is there any

⁵³ As previously presented to this Subcommittee, another description of the circumstances of low income taxpayers is excerpted below:

Whether English speaking or not, taxpayers working near or at minimum wage levels tend to have limited education and literacy skills, and minimal understanding of financial matters. Often these taxpayers work unusual hours (such as less desirable shift work) and many work two or more jobs, which they get to by public transportation. Housing and food expense are often a reach, and these taxpayers commonly qualify for some form of public assistance. Many of our clients share living space in apartments or houses among several generations and/or collateral relatives and friends, and they often take in boarders to help defray their expensive rent, especially in major cities. Having a phone is often a luxury, and their phones are often disconnected for lack of payment. Job tenure is often short, and many float from job to job. These taxpayers do not own their own homes and do not have retirement plans, brokerage accounts, or other accumulated assets. Most live paycheck to paycheck. * * * *

Adding to the difficulty of the statutory complexity is the fact that a large number of EITC audits are conducted long distance, through EITC centers. Long distance audits are, by their very nature, difficult for the low income taxpayer community to handle. In the case of a long distance EITC audit, for example, taxpayers seeking our services often bring in IRS form requests for documents they have received, such as for birth certificates, school records, and medical records of their children. In many of these cases, the taxpayer has carefully collected the information and sent off a timely response to the IRS to the best of his or her ability. But it is often the case that 'substantiation' of the existence of the child and/or his or her residence is only one of the issues in the audit that the IRS is concerned about, which may also include double claiming of the credit, or the application of the tiebreaker rule.

Statement of Janet Spragens (Prof. & Dir., Fed. Tax Clinic, Washington College of Law, Amer. Univ.), *Hearing on the Taxpayer Advocate Report and Low-Income Taxpayer Clinic Program*, Hearing Before the Subcomm. on Oversight, Comm. on Ways & Means, 107th Cong. 55-56 (Jul. 12, 2001).

⁵⁴ National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 81 (Research Study: *Running Social Programs Through the Tax System*).

⁵⁵ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 *Taxpayer Compliance* 57, 56-62 (1989).

⁵⁶ See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 87 (Research Study: *Running Social Programs Through the Tax System*).

reason to believe that low income workers are particularly fraudulent.⁵⁷ Instead, it is frequently the case that the IRS denies proper claims because of lack of documentation.⁵⁸ Consider the following examples.

Relationship Example

Assume Granduncle claims the EITC with respect to Grandnephew. Assume further that the IRS questions the claim based on the relationship requirement. To document his relationship to the qualifying child, Granduncle may be required to produce his own birth certificate, a birth certificate for his sibling showing common parents, a birth certificate for his niece showing that Granduncle's sibling was the niece's parent, and a birth certificate for Grandnephew showing that the niece was Grandnephew's mother. That is four birth certificates in all. Depending on the states in which these four individuals were born and the restrictions those states impose on who may obtain birth certificates, it may be extremely time-consuming or even impossible for Granduncle to obtain the requisite substantiation. As a result, the IRS may deny the claim even though it was legitimate.⁵⁹

Residence Example

Assume Child lived with Taxpayer for more than half of calendar year 2010, and Taxpayer files a proper EITC claim. Assume further that the IRS questions the claim based on the residence requirement. To prove residence, Taxpayer may request a transcript from Child's school showing that Child lived at Taxpayer's address for the 2009-2010 school year. However, the IRS may not accept the transcript as sufficient because a September through mid-June school year transcript shows residence for four months of 2009 and five-and-a-half months of 2010. The transcript does not prove that Child lived with Taxpayer for more than six months in 2010. Alternatively, Taxpayer may obtain transcripts for both 2009 and 2010 but then discover that the school does not include Child's address on those transcripts. Particularly if Taxpayer has trouble understanding the IRS's EITC notice or lacks the time, knowledge, or diligence to obtain documentation

⁵⁷ See John Karl Scholz, *The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness*, Inst. for Research on Poverty Discussion Paper No. 1020-93, Univ. of Wisc.—Madison, published in 47 Nat'l Tax J. 63 (1994) (suggesting that taxpayers who claim the EITC but are not eligible for it tend to live in low income households).

⁵⁸ See National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at 20 (*EITC Audit Reconsideration Study*) ("Documentation difficulties or deficiencies within the original audit acted as the audit reconsideration trigger in 45% of the cases").

⁵⁹ In a case where a low income worker and child are asylees or refugees legally admitted to the U.S. from a country that is war-torn or experiencing civil unrest, they may not be able to produce a birth certificate. Cf. IRM 3.21.263.5.3.4.2, 3.21.263.6.1.5 (Jan 1, 2011) (in the case of an application for an Individual Taxpayer Identification Number, which does not require legal admission to the U.S., excepting applicants from countries experiencing civil unrest from a birth certificate requirement).

that the IRS will accept, Taxpayer may just give up. As a result, the IRS would deny the claim even though it was legitimate.

These examples are not merely theoretical. These circumstances take place every day. Two Taxpayer Advocate Service studies have demonstrated that the denial of an EITC claim proves merely that the IRS did not accept it, not necessarily that the taxpayer was not eligible for the EITC.⁶⁰ As with all taxpayers who claim deductions and credits under the Internal Revenue Code, EITC taxpayers must substantiate their claims for the credit. In many cases, however, the IRS's narrow and rigid internal rules and training about what documentation its auditors will accept as proof of residency and relationship lead to improperly denied claims. In fact, in recognition of this problem, the IRS is currently working with TAS on a research initiative to expand the scope of documentation it will accept from EITC taxpayers, as discussed below.⁶¹ (A list of alternate sources of documentation, used for training employees as part of this research project, is provided in the Appendix.)

V. Estimates of Improper EITC Payments Raise Uncertainties as to the Amount and Rate of Overstatement.

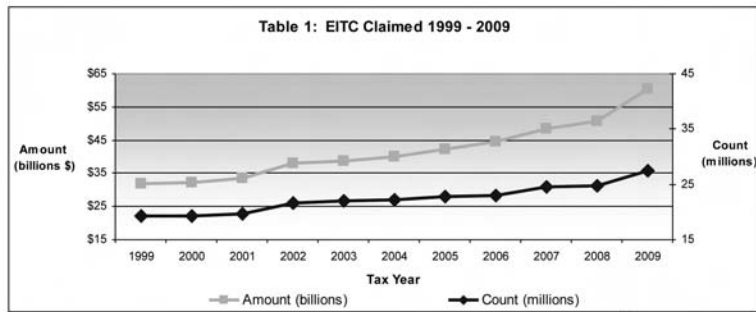
In addition to the complexity of documenting compliance with the tax law, legislative, economic, and statistical factors contribute to the reported EITC improper payment rate. Last month, the Government Accountability Office (GAO) reported that improper EITC payments had jumped to \$16.9 billion in 2010 from approximately \$12 billion in 2009, without reporting a corresponding increase in the noncompliance rate.⁶² However, as Tables 1 and 2 demonstrate, the number and amount of EITC claims have steadily increased each year, for reasons unrelated to noncompliance. Two factors may contribute to the recent reported increase in the dollar amount of EITC noncompliance. The American Recovery and Reinvestment Act of 2009 expanded the EITC to remedy a marriage penalty and allow a higher rate for taxpayers with three children.⁶³ At the same time, the economic recession may have increased the population of low income workers eligible for the EITC. Over a decade, inflation was also a factor.

⁶⁰ See National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at i (*EITC Audit Reconsideration Study*) ("The study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration"); National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 95 (*The IRS EITC Audit Process – A Challenge for Taxpayers*) ("More than half of EITC audited taxpayers reported difficulties obtaining the documents requested by the IRS, and almost half of the taxpayers did not understand why the documents were requested by the IRS").

⁶¹ Even if we assume that a taxpayer does not meet the statutory criteria if he or she cannot substantiate eligibility, both Congress and the IRS would want to know that there is a significant pool of taxpayers who meet requirements but cannot document them, as that would indicate that the design of the program is preventing benefits from reaching the intended beneficiaries.

⁶² See GAO, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges* (Apr. 15, 2011), Table 1 at 4.

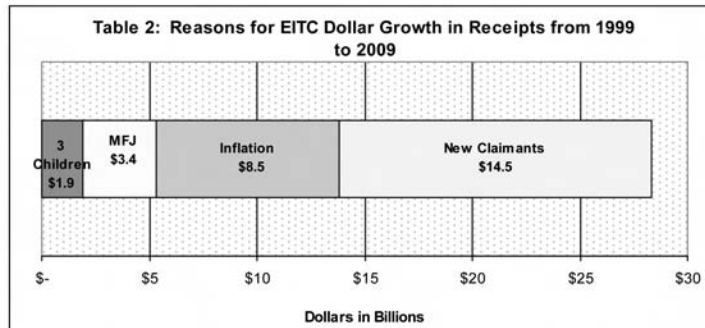
⁶³ See Pub. L. No. 111-5, Div. B, § 1002, 123 Stat. 115, 312 (2009).



Source: IRS, Statistics of Income Division, <http://www.irs.gov/pub/irs-sol/histab1.xls>.⁶⁴

⁶⁴ The following chart shows the growth in the EITC program, with claim amounts nearly doubling since FY 1999:

Tax Year	Count (millions)	Amount (billions)
1999	19.3	\$31.9
2000	19.3	\$32.3
2001	19.6	\$33.4
2002	21.7	\$38.2
2003	22.0	\$38.7
2004	22.3	\$40.0
2005	22.8	\$42.4
2006	23.0	\$44.4
2007	24.6	\$48.5
2008	24.8	\$50.7
2009	27.4	\$60.4



Sources: Compliance Data Warehouse, Individual Returns Transaction File, TY 2009; New Receipts are based on the amount of new receipts actually awarded, computed as new recipients times the average 2009 EITC claim with provisions relating to MFJ and three children factored in. Inflation is based on the Bureau of Labor Statistics calculator, http://www.bls.gov/data/inflation_calculator.htm.

Moreover, estimates of improper EITC payments, including the recent \$16.9 billion estimate, have an uncertain statistical basis to the extent that they are based on previous IRS studies. The IRS study that generated the 31.7 percent estimate of improper EITC payment for TY 1999 had assumed that all taxpayers who failed to document their claims were not eligible, but since then, TAS research has demonstrated that this assumption is not valid.⁶⁵ Similarly, the TY 1999 study does "not reflect the fact that some eligible taxpayers may not have claimed the credit to which they were entitled."⁶⁶ As previously reported to Congress:

[T]he National Taxpayer Advocate believes that the study overstates the overclaim rate because it relied exclusively on the outcome of EITC audits. TAS

⁶⁵ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002) 3 ("assuming that taxpayers who do not appear for audits are not eligible for any credit"). A 2004 Taxpayer Advocate Service study of a representative sample of the EITC Audit Reconsideration population found that 43 percent of taxpayers who in the original audit did not respond to IRS contacts or whose response was received after the IRS deadline and thus was not considered in the audit had favorable outcomes from the audit reconsideration process (meaning that they received more EITC from the audit reconsideration process than from the initial audit itself). This percentage is about the same as the favorable outcome rate for all taxpayers in the audit reconsideration sample. Moreover, the non- and late-responders received about 96 percent of the total EITC claimed on the original return. "This suggests that taxpayers who fail to respond to the audit, or who have a late response, may in fact be eligible for the EITC." (Emphasis in original.) See National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at 29 (Earned Income Tax Credit (EITC) Audit Reconsideration Study).

⁶⁶ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3 (Feb. 28, 2002).

data suggests that audit outcomes are frequently incorrect and that a significant number of entitled taxpayers are being denied the credit in error.⁶⁷

After the TY 1999 estimate, an IRS National Research Program (NRP) has studied audit results from 2001 and later years to estimate taxpayer compliance. The IRS estimates of improper EITC payment based on the NRP may not be comparable to the TY 1999 estimate due to methodological differences. In particular, a 2001 IRS estimate of improper EITC payment has not been released for review by TAS or outside statisticians, apparently because it is not comparable to the TY 1999 study. Likewise, the IRS has not released studies for subsequent years to TAS or the public.

At the same time, it is unclear whether the NRP estimate of compliance based on determinations by IRS auditors accounts not only for overstatements but also for understatements due, for example, to lack of knowledge or documents on the part of low income taxpayers, as discussed above. If not, this estimate may exaggerate the amount of improper payments. Although this \$16.9 billion amount is public, the underlying data and assumptions are not. I would be very concerned about basing policy decisions on limited studies that have not been released for rigorous professional or peer review in an area as complex as EITC overclaims.

Furthermore, focusing on "improper payments" may be disproportionate when other provisions generate significant concern. As money is fungible, overstatement of a refundable credit is economically equivalent to underpayment of tax for any other reason.⁶⁸ Either way, the IRS ends up asserting a deficiency in tax. For instance, a court case in the public record reveals that the IRS has asserted a multi-million dollar deficiency against a single large-business taxpayer for overstatement of the research credit (designed as an incentive for increasing expenditures for research and experimentation).⁶⁹ As a practical matter, IRS resources allocated to EITC are resources not allocated to potentially more productive cases, possibly leading to reduced revenue levels and customer service, as the IRS is stretched thin.

VI. EITC Overstatement Statistics Should Be Evaluated in Light of Important TAS Research Findings.

A. Previous Research

As mentioned above, TAS reported in 2004 on a study of taxpayers who had their audit results reconsidered by the IRS, concluding that

⁶⁷ National Taxpayer Advocate FY 2004 Objectives Report to Congress 21.

⁶⁸ See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. Rev. 1867 (2005).

⁶⁹ See *Union Carbide v. Comm'r*, T.C. Memo. 2009-50.

the manner in which the IRS conducts its audits of low income taxpayers impacts the audit outcomes. One can infer from the study that in many cases – 43 percent of 67,000 FY 2002 audit reconsiderations, or over 28,000 cases – taxpayers were entitled to virtually all of the EITC they claimed. That is, their original audit results did not accurately reflect their eligibility for the EITC. Rather, the audits merely show that the taxpayer flunked the IRS audit process.⁷⁰

The IRS had assumed erroneously that certain taxpayers were not eligible for the EITC. Instead, those low income taxpayers had been confused by IRS audit procedures, notices, and documentation requirements. When TAS staff explained the requirements, reported eligibility increased. Notably, the percentage of taxpayers who received EITC increased in direct proportion to the number of telephone contacts that TAS initiated.⁷¹

In almost all EITC cases, the IRS conducts audits by long distance through so-called automated correspondence exams (ACE), which the IRS describes as a

multifunctional software application that fully automates the initiation, Aging and Closing of certain Earned Income Tax Credit (EITC) and non-EITC cases. Using the ACE, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice and closing, tax examiner involvement is eliminated entirely on no-reply cases.⁷²

In other words, the IRS offers no human contact with a taxpayer unless the taxpayer initiates it by calling the IRS. This approach is particularly inapt for low income workers who face literacy challenges and are often transient.⁷³ Moreover, correspondence is not a reliable means of communication when, for example, a recent TIGTA audit estimated that during FY 2009, approximately 19.3 million pieces of mail, or almost ten percent of all correspondence for the year, were returned to the IRS.⁷⁴

In 2007, TAS reported on another study confirming the discrepancy between actual ineligibility and flunking an IRS audit. The study concluded:

⁷⁰ National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, i & 9 (based on study reviewing a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003).

⁷¹ *Id.* at 10.

⁷² IRM 4.19.20.1 (01-01-2011).

⁷³ See National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low income Taxpayers Are Not Being Adequately Met*).

⁷⁴ See National Taxpayer Advocate 2010 Annual Report to Congress 221 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*), citing TIGTA, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail*, No. 2010-40-055, at 2 (May 14, 2010).

Overall, more than one-quarter of taxpayers receiving an [EITC] audit notice did not understand that the IRS was auditing their return. An even larger percentage, almost 40 percent, of the respondents did not understand what the IRS was questioning about their [EITC] claim. Similarly, only about half of the respondents felt that they knew what they needed to do in response to the audit letter.⁷⁵

The inscrutability of the IRS audit process places low income workers at a serious disadvantage, unless they are represented by an attorney, certified public accountant, enrolled agent, or other tax professional. When TAS reviewed the *entire* EITC audit population for TY 2004, it found that taxpayers who used representatives were nearly twice as likely to be found eligible for the EITC, compared with taxpayers who were not represented during the audit process. Over 40 percent of all taxpayers with representatives emerged from their audit with their full EITC intact, whereas less than one in four taxpayers without a representative kept their full EITC.⁷⁶

B. Pilot Programs

In light of these studies, TAS and the IRS currently are conducting a pilot program to increase EITC compliance by improving communication and certain other protocols during audits. Even as the IRS generally conducts certain examinations by correspondence, the pilot program includes outbound telephone calls from IRS auditors to explain the process to taxpayers.

The pilot program involves a representative sample of taxpayers in EITC correspondence audits conducted by IRS examiners who have undergone training by, among others, the National Taxpayer Advocate and Low Income Taxpayer Clinic directors, who shared their experiences working with low income taxpayers. In a first phase, these IRS correspondence examiners are initiating telephone calls to taxpayers in the test group at two points during the examination process – about ten days after sending the initial contact letter and, for taxpayers who have not responded, just prior to issuing a statutory notice of deficiency (assessing tax due to an insufficient EITC claim).⁷⁷ During the calls, the IRS examiners explain the examination process to the taxpayers, answering their questions. To answer questions about documentary evidence, TAS has developed a list of 50 ways to prove eligibility, ranging from divorce decrees, to Section 8 Housing applications, to baptismal certificates and eviction notices.⁷⁸ TAS researchers will collect data on audit outcomes to determine whether this revision to IRS examination procedures has helped taxpayers overcome communication barriers they may be experiencing during the examination process.

⁷⁵ National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 100, 103-104 (relating to a survey sample designed to achieve an overall accuracy of plus or minus five percent at the 95 percent confidence level).

⁷⁶ *Id.* at 96.

⁷⁷ See IRC § 6212.

⁷⁸ See Appendix.

During a second phase, taxpayers who did not retain all of their EITC and who did not agree to their audit outcomes will be referred to TAS. Case advocates will then attempt to contact these taxpayers to help them through the process of proving eligibility for EITC. TAS researchers will analyze the final audit outcomes after this phase to determine whether TAS assistance impacted the audit results.

Another pilot program tests the use of affidavits to establish qualifying child status. Currently, IRS audit procedures allow either official records or letters on official letterhead to document the residence requirement.⁷⁹ A proposal would allow a third-party affidavit as a documentary option. That is, third parties with knowledge of the child's residence during specific time intervals could fill out a standardized affidavit rather than write a letter.

This proposal originated in a TY 2003 IRS initiative to use affidavits to document residency of qualifying children of low income taxpayers who participated in a test of a proposed EITC pre-certification process. At that time, the IRS concluded that affidavits would be acceptable as well as convenient documentation:

Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. *The results show that affidavits had a higher acceptance rate than the other two types of documents. In each of the tests, about one-half of the records and statements or letters were accepted compared to approximately three-quarters of the affidavits.*⁸⁰ (Emphasis added.)

The current pilot program, involving a large sample population, is designed to show the extent to which the use of affidavits reduces understatement or increases overstatement; the percentage of taxpayers who opt for affidavits to document residence; and the effect of affidavits on the efficiency of the audit process.

VII. TAS Has Proposed Improvements to the EITC and Refundable Credits.

TAS has made numerous regulatory and legislative recommendations to improve the administration of refundable credits, particularly the EITC, and to reduce improper payments without unduly burdening taxpayer rights. Of the following TAS proposals,

⁷⁹ Form 886-H-EIC-2010 (Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child or Children) requires "photocopies of school (no report cards), medical, childcare provider (provider can't be a relative) or social service records" or "a letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of your child's parent or guardian, your child's address and the dates that they lived with you."

⁸⁰ See IRS, *Earned Income Tax Credit Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests*, at 14 (2008).

the first two are being addressed through ongoing regulatory action and the remaining ones merit further consideration.

A. Regulate Paid Tax Return Preparers.

Paid tax return preparers wield significant influence over EITC returns. In the past, TAS has proposed regulation of preparers through registration, competence testing, continuing education, due diligence, and enhanced enforcement.⁸¹ In 2010, the Commissioner of Internal Revenue announced a return preparer initiative.⁸² This initiative should have substantial impact on EITC compliance with preparer-prepared returns, since about two-thirds of tax returns claiming EITC benefits are completed by preparers rather than by the taxpayers themselves.⁸³ Moreover, the IRS has indicated that the new testing and continuing education regime would include a focus on the EITC as well as ethics in tax preparation.

B. Regulate Refund Anticipation Loans (RALs).

A refund anticipation loan (RALs) is a financial product that has developed largely in the EITC preparation market and effectively enables low income taxpayers to accelerate receipt of their tax refund at what frequently turn out to be usurious charges taken off the top by the lender when the refund arrives.⁸⁴ In the past, TAS has proposed regulation of RALs,⁸⁵ which have been statistically associated with noncompliance.⁸⁶ In 2010, the Commissioner announced curtailment of RALs by terminating dissemination of an IRS "debt indicator" that shows whether a claimed tax refund will be offset due to a debt of the taxpayer.⁸⁷

⁸¹ See National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*).

⁸² See IRS Pub. 4832, *Return Preparer Review* (Dec. 2009).

⁸³ EITC Preparer Office, *EITC Summary of Vital Statistics* (May 2011).

⁸⁴ A RAL is money borrowed by a taxpayer from a financial institution based on the taxpayer's anticipated federal income tax refund. The loan is made pursuant to a written agreement between the taxpayer and the financial institution. To apply for a RAL, the taxpayer must sign an application acknowledging that a RAL is a loan and that the loan must be repaid even if the anticipated refund is not received from the IRS. If the taxpayer's application is approved, a temporary bank account is opened in the taxpayer's name by the financial institution, and the IRS is directed to remit the taxpayer's tax refund directly to the taxpayer's account. The financial institution transfers the loan proceeds to the taxpayer. When the IRS subsequently processes the taxpayer's refund, the IRS deposits the taxpayer's refund into the temporary bank account at the financial institution. The taxpayer authorizes the financial institution to withdraw sufficient funds from the temporary bank account to pay off the outstanding RAL and any tax return preparation fees. The taxpayer grants the financial institution a security interest in his or her refund and agrees to be liable for any amounts remaining unpaid.

⁸⁵ See National Taxpayer Advocate 2005 Annual Report to Congress 468 (Legislative Recommendation: *Debt Collection Techniques on EITC Benefits by Refund Anticipation Loan Industry*).

⁸⁶ See Karen Masken, Mark Mazur, Joanne Meikle & Roy Nord, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?* (IRS Office of Research, Analysis and Statistics, 2009).

⁸⁷ IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010).

C. Revise EITC Penalties.

In conjunction with enhanced oversight of preparers, we have recommended that penalties for facilitating EITC overclaims be increased.⁸⁸ In particular, a preparer would have to sign under penalty of perjury Form 8867 (Paid Preparer's Earned Income Credit Checklist), attaching it to the taxpayer's return to confirm compliance with certain due diligence requirements designed to ascertain eligibility. The due diligence requirements set forth in regulations are minimal and do not address the largest areas of EITC noncompliance. We have recommended that these regulations be updated to require preparers to certify, under penalties of perjury, that they have specifically inquired of the taxpayer about certain designated EITC eligibility requirements and, in some circumstances, asked to see specific documentation. We understand that the IRS is considering requiring preparers to file the existing Form 8867 with taxpayers' income tax returns and has committed to reviewing the existing due diligence requirements. We commend the IRS for these actions and look forward to working with it on the revisions.

In addition, we have recommended that Congress replace the \$100 penalty for failure to comply with EITC due diligence requirements with a tiered penalty structure that increases over time with accumulated failures.

Finally, we have recommended that Congress authorize the IRS to assess a penalty on a preparer for joint and several liability (with the taxpayer) in the amount of EITC overclaim that is attributable to the preparer's intentional misstatement, misrepresentation, fraud, or deceit or any unlawful act that causes a taxpayer to incur a tax liability attributable to the EITC.

Because about two-thirds of EITC claims are prepared by tax preparers, I believe that requiring preparers to comply with enhanced due diligence requirements and imposing increased penalties on those who do not live up to their responsibilities is an efficient and effective way to reduce improper claims.

D. Accelerate the Use of Third-Party Information Reports.

Third-party information reports, such as Form W-2 (Wage and Tax Statement), are a principal tool for IRS verification of claimed income amounts. The IRS has identified "income reporting errors" as the type of error resulting in the third largest amount of EITC overstatements (after relationship and residence errors).⁸⁹ To reduce improper EITC payments, we have recommended that steps be taken to enable the IRS to

⁸⁸ See National Taxpayer Advocate 2003 Annual Report to Congress 272-73 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*).

⁸⁹ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3 (Feb. 28, 2002).

receive and process information returns before it issues refunds.⁹⁰ I am very pleased that Commissioner Shulman recently embraced this vision in his annual speech at the National Press Club, and I look forward to working with the IRS to move it ahead.

E. Revise the IRS Mission Statement to Encompass Social Benefits.

We have recommended that the IRS revise its mission statement to explicitly acknowledge that its traditional role as the tax collector has expanded in recent years so that it is now both (i) collecting taxes and (ii) administering social and economic benefit programs.⁹¹ To be clear, the IRS's role in administering benefits programs extends far beyond the EITC. Today's hearing addresses a wide range of refundable credits, and there are other benefits programs as well, including stimulus payments the IRS was directed to make in 2008⁹² and the Hiring Incentives to Restore Employment (HIRE) Act, enacted in 2010, which provides incentives for small businesses to hire additional workers.⁹³

There are significant differences between benefits agencies and enforcement agencies like the IRS in terms of culture, mindset, and the skill sets and training of their employees, and if the IRS is to perform both roles effectively, it must have the right mix of staffing. A dual mission statement would serve as an organizing principle toward that end, and would also make clear that the IRS will require sufficient funding to do both jobs well. Absent adequate funding, the IRS will be forced simultaneously to rob Peter to pay Paul and to rob Paul to pay Peter, and little good will come of that situation.

F. Separate Work and Family Credits.

We have recommended separating the worker portion of the EITC from the portion of the EITC attributable to family size, and then consolidating all family-related benefits. If implemented properly, this simplification initiative should reduce the incentives for fraud and simplify the substantiation process for taxpayers claiming the worker credit. As discussed above, the IRS is the best examiner of income to the extent that the EITC is based on wages, but the IRS is challenged by verification of qualifying children, who also figure in a complex web of family provisions comprising filing status, dependency exemptions, the child tax credit, and the child care credit. Under our proposal, a simplified and consolidated family credit would be separated from a work credit, reducing the high stakes currently generated by the EITC.

⁹⁰ See National Taxpayer Advocate 2009 Annual Report to Congress 338 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reserve the "Pay Refund First, Verify Eligibility Later" Approach to Tax Return Processing*).

⁹¹ See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

⁹² Economic Stimulus Act, Pub. L. No. 110-185, 122 Stat. 613 (2008).

⁹³ Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

The earnings component of a credit can be easily verified through income reporting, leaving the more difficult family status eligibility verification to an isolated family credit.⁹⁴ This refundable family credit would be available to all taxpayers, not just low income ones, thereby eliminating the relatively discriminatory audit focus on low income taxpayers that exists today. Additional legislative action could help reduce improper payments, including limiting public access to the database of decedents' Social Security numbers and other personal information and authorizing use of math error authority for provisions that cap either the lifetime amount of a credit or the number of years for which a credit may be claimed.

VIII. Additional Steps Can Be Taken to Reduce Improper Payments.

A. Public Release of the Social Security Administration's Death Master File Provides Significant Opportunities for Identity Thieves to Commit to Tax Fraud and Must Be Limited.

As a form of identity theft, the IRS has identified schemes to misuse deceased taxpayers' SSNs to obtain fraudulent refunds, including the EITC. Approximately 2.4 million people die every year.⁹⁵ Thus far in 2011, the IRS has received more than 660,000 decedent returns.⁹⁶ Effective April 17, 2011, the IRS instituted business rules to filter out some of these "decedent scheme" returns. Within one month, it stopped 42,441 decedent-related returns claiming questionable refunds estimated at \$194 million.⁹⁷ The IRS estimates that an additional 221,000 returns claiming \$700 million in refunds would have been stopped had the business rules been in place at the beginning of the filing season.⁹⁸

In 1980, the Social Security Administration (SSA) created a Death Master File (DMF) as a result of a consent judgment reached in a Freedom of Information Act lawsuit brought by a private citizen. In essence, the individual had argued that SSN files are government records and that a deceased individual does not retain a privacy interest in his SSN and related information.

The SSA now makes public significant personal information upon a person's death, including the decedent's full name; SSN; date of birth; date of death; and the county, state, and zip code of the last address on record. This information is now regularly

⁹⁴ National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 90 (Research Study: *Running Social Programs Through the Tax System*).

⁹⁵ U.S. Census Bureau, *The 2011 Statistical Abstract*, Table 78, Live Births, Deaths, Marriages and Divorces 1960 to 2007.

⁹⁶ TAS notes from IRS conference call on decedent schemes (Apr. 25, 2011).

⁹⁷ TAS notes from IRS conference call on decedent schemes (May 12, 2011).

⁹⁸ *Id.*

obtained and used by government agencies, credit reporting agencies, financial firms, and genealogists. Unfortunately, it is also used by identity thieves to commit tax fraud.

For tax filing purposes, the SSN of an individual may be used even after his or her death. For example, the surviving spouse of an individual who died in January of 2011 generally may file a joint return for 2011, which would require the decedent's SSN. The due date for the 2011 return, with extension, would be October 15, 2012 – 20 months after the death occurred. For that reason, the IRS cannot immediately block the use of the decedent's SSN. In the interim, however, identity thieves may troll the DMF for recent deaths and file fraudulent returns claiming refunds.

A similar type of tax fraud arises with respect to dependency claims for minor children. In one recent TAS case that the taxpayers authorized me to discuss publicly, a couple had a child who died of sudden infant death syndrome (SIDS) in 2009.⁹⁹ By law, the couple was entitled to claim the child as a dependent on their 2009 tax return. But by the time they filed their 2009 tax return in 2010, an identity thief had already filed a return claiming their child, so their claim was initially denied.

While I understand the competing policy concerns, the government's provision of all of this information in unredacted form aids and abets identity theft and tax fraud, and it is frankly appalling. It provides identity thieves with the opportunity to steal potentially billions of dollars of federal funds through fraud. It also has the effect of imposing untold burden on the innocent victims of identity theft, who often must spend hundreds of hours to prove who they are and straighten out their finances. Not insignificantly, there is also a compelling personal and emotional consequence to all this. One can only imagine how a taxpayer must feel first to lose a spouse or a child and then find out that his sense of privacy was violated by routine government release of information that allowed someone else to profit from the death and requires him to prove to an initially skeptical government agency that his spouse or child was indeed his relative and not the identity thief's.

I urge Congress and the SSA to address this problem immediately. The most comprehensive solution would be for Congress to pass legislation for the SSA similar to IRC § 6103, which prohibits the IRS from releasing taxpayer return information (including SSNs and addresses), absent explicit statutory exceptions or taxpayer consent. (If Congress proceeds along these lines, I recommend that it create a statutory exception for sharing the DMF with the IRS, so the IRS may screen for and ultimately "retire" SSNs of deceased taxpayers from its own databases.) A less comprehensive but quicker solution is for the SSA simply to truncate SSNs in the DMF and make public only the last four digits of the number. If that requires the SSA to ask the court to modify its 1980 consent judgment, it should do so.

⁹⁹ Consent to Disclosure of Tax Return Information (signed May 20, 2011).

B. Limited Additional Use of Math Error Authority Could Reduce Both Inadvertent and Fraudulent Claims.

As noted earlier, IRC §§ 6213(b) and (g) authorize the IRS, in specific instances, to use its math error authority to summarily assess tax without first providing the taxpayer with access to the pre-payment forum of the U.S. Tax Court.

The legislative history to the early authorizations of summary assessments for mathematical or clerical errors makes very clear that this deviation from the protections of deficiency procedures was intended to be limited in scope. Math error authority was to be used only in those instances where errors were apparent on the face of the return or from information that was provided on the return.¹⁰⁰

Over the years, Congress has expanded math error authority to apply where comparison of tax return entries to information contained in non-IRS governmental databases makes apparent an error on the return. One example of this expanded authority is the use of the SSA's Numident database, described above.

Use of external data, a traditional audit indicator, is not justified for summary denial when an inherently qualitative judgment is required.¹⁰¹ For this reason, TAS previously recommended repealing the use of the Federal Case Registry of Child Support Orders (FCR) under math error authority for summary assessment because this database does not accurately verify a child's residence. This reasoning would apply equally to proposals to use certain state databases to determine eligibility, especially with respect to a qualifying child.¹⁰² Applying data collected for other purposes to an EITC claim is akin to verifying addresses with a telephone directory to deny a home mortgage interest deduction. Even if virtually all of the entries in a directory were accurate, they were compiled for a different purpose, do not disprove eligibility under the tax law, were compiled at a prior date and may not be current, and should not deprive a taxpayer of a due process right to present his or her own facts.

However, there are instances where additional math error authority would help reduce both inadvertent and fraudulent claims. For example, the American Opportunity Tax Credit provides for a maximum annual credit of \$2,500 for qualified post-secondary education expenditures.¹⁰³ Up to 40 percent of the credit is refundable. Because the

¹⁰⁰ See National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*).

¹⁰¹ See *id.* at 185.

¹⁰² See TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 13-14 (Dec. 31, 2008) (recommending that the IRS consider "Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return"), referenced in *Reduction Targets 9*; see also Dept. of the Treasury, *Performance and Accountability Rept. FY 2010*, at 280 (Nov. 15, 2010).

¹⁰³ See IRC § 25A(i).

credit is available only for the first four years of a student's post-secondary education and because the number of years claimed for each student is information that is readily available from the face of the return, additional math error authority would enable the IRS to stop the improper payment of capped claims with minimal resources. We believe that a close review of recently enacted refundable and nonrefundable tax expenditures might identify additional candidates for math error authority that would protect both the taxpayer and the public fisc from improper payments without eroding vital taxpayer rights.

IX. Although There Are Additional Steps the IRS Can Take To Improve its Administration of the EITC, Some Proposals That Have Been Advanced Would Undermine Effective Tax Administration.

The EITC and other tax expenditures with refundable components tend to have complex eligibility requirements that present administrative challenges to both taxpayers and the IRS. While TAS has advanced past and pending proposals as described above, certain other recommendations for refundable credit compliance could undermine the IRS's effective administration of the tax laws.

- Removal of tolerance levels, which reflect the IRS's determination of how it can most efficiently utilize its limited enforcement resources, would likely impair the IRS's ability to maximize the collection of taxes. Because lowering or eliminating tolerances would generate a significant number of new cases for which the IRS is unlikely to receive additional funding, the IRS would have to reassign personnel from much more productive programs and leave whole areas of the tax gap unaddressed, thereby increasing the tax gap and reducing overall compliance.
- Freezing questionable refunds has been a practice predicated on the assumption that the IRS can accurately determine fraud unilaterally, but that assumption has proved to be inaccurate.¹⁰⁴ Based on data from 2005, the IRS Criminal Investigation division had frozen hundreds of thousands of refund claims on a suspicion of taxpayer fraud, without notifying the taxpayers involved of its suspicion of criminality or giving the taxpayers an opportunity to provide documentation to support their refund claims.¹⁰⁵ In FY 2005 alone, TAS received more than 28,000 such cases. The TAS Research function analyzed a statistically representative sample of those cases and found that

¹⁰⁴ See TIGTA, Ref. No. 2010-40-062, *Better Use of Available Third-Party Data Could Identify and Prevent More Than One Billion Dollars in Potentially Erroneous Refunds* 2 (Jul. 13, 2010) (recommending that the IRS "freeze refunds while contacting those taxpayers with potentially invalid EITC claims or questionable information on their tax returns"), referenced in *Reduction Targets* 9.

¹⁰⁵ National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*).

TAS ultimately persuaded the IRS that the taxpayer was entitled to all or a portion of the claimed refund 80 percent of the time.

In an EITC case, the complex requirements discussed above could generate circumstances in which a legitimate claim appears to be questionable. With respect to reported fraud by prisoners, who may claim the EITC or other tax refunds, TAS' prior review raises questions about what the IRS may assume is fraudulent. For example, a prisoner may undergo partial-year incarceration, maintaining a marriage or earning wages for months subject to required tax return reporting. These circumstances require a specific factual judgment of fraud, but the IRS relies in large part on computer programs.¹⁰⁶

Moreover, fraud may be an instance of "brokered" non-compliance in which an unscrupulous preparer, perhaps spurred by expectation of RAL charges, coaches a low income taxpayer to overstate an EITC claim.¹⁰⁷ As Treasury economists have observed, the IRS EITC compliance study (relating to the published TY 1999 study) "does not distinguish taxpayer confusion from intentional misreporting."¹⁰⁸

- Requiring a Social Security number for the ACTC would be contrary to current law, and therefore a suggestion that the IRS paid billions of dollars in refundable credits on ACTC claims that were noncompliant is inaccurate.¹⁰⁹ Under a 1996 amendment designed to ensure proper immigration status of EITC claimants, the tax law specifically requires reporting of SSNs for both an EITC claimant and his or her qualifying child.¹¹⁰ By contrast, the child tax credit statute requires a Taxpayer Identification Number (TIN),¹¹¹ which may be an SSN or an Individual TIN or Adoption TIN assigned by the IRS.¹¹² Substantive amendments of the child tax credit statute enacted as recently as the American Recovery and Reinvestment Act of 2009 have left the TIN requirement intact, effectively reaffirming this requirement.¹¹³ Congress may

¹⁰⁶ See TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist with Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (Dec. 29, 2010) 6 ("Tax returns with a prisoner indicator are then evaluated for fraud based on predefined criteria specific to prisoner fraud").

¹⁰⁷ See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 *Kans. L. Rev.* 1145 (2003), at http://works.bepress.com/leslie_book/8.

¹⁰⁸ Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, *The Crisis in Tax Administration*, ed. Henry Aaron & Joel Slemrod (Brookings Inst. Press, 2002) 169.

¹⁰⁹ See TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* 14 (Mar. 31, 2009) ("Billions of dollars in tax credits are provided to ITIN filers without verification of eligibility").

¹¹⁰ See IRC § 32(m).

¹¹¹ See IRC § 24(e); see also IRC § 151(e) (requiring a TIN for the dependency exemption).

¹¹² See Treas. Reg. § 301.6109-1(a)(1)(i).

¹¹³ See Pub. L. No. 111-5, Div. B, § 1003, 123 Stat. 115, 313 (2009).

have had a rational basis for reaffirmation. As then-Commissioner of Internal Revenue Mark Everson (who previously had served as Deputy Commissioner of the Immigration and Naturalization Service) testified to the Committee on Ways and Means in 2006: "ITINs are issued regardless of immigration status because non-citizens may have U.S. tax return and payment responsibilities under the Internal Revenue Code."¹¹⁴

X. Conclusion

Refundable credits are unlike traditional benefits programs. The administrative costs of refundable credits are substantially lower and the percentage of the eligible population receiving benefits is substantially higher than in traditional benefits programs, yet refundable credits carry a heightened risk of improper payments. As the administrator of refundable credits, the IRS has taken and continues to take steps to minimize improper payments. I believe there are additional steps the IRS and others can take, and I have described our most significant proposals in this testimony. However, I also believe that the challenge of improper payments must be viewed in context. The estimated amount of EITC improper payments, while significant, is relatively low as compared with other components of the tax gap that the IRS is also responsible for addressing. Thus, with limited resources, the IRS must make prudent resource-allocation decisions. Lastly, based on TAS research studies, I am concerned that the EITC claims of many taxpayers are denied simply because they cannot substantiate the residence and relationship requirements of the EITC, even where those taxpayers meet the requirements. For that reason, I believe a significant portion of the improper payment estimate is attributable to taxpayers who are the intended beneficiaries of the program. That suggests the requirements should be simplified and that the IRS should be more flexible in working with taxpayers to ensure that the correct result is reached.

¹¹⁴ See Hon. Mark W. Everson, *Testimony Before the House Committee on Ways and Means* (Jul. 26, 2006).

APPENDIX

Earned Income Tax Credit Alternative Documentation

1. Birth certificate (relationship)
2. Marriage certificate (relationship)
3. Divorce decree, separation agreement, or decree of separate maintenance (relationship)
4. Letter from an authorized adoption agency (relationship)
5. Letter from the authorized placement agency or applicable court document (relationship)
6. Custody order (relationship)
7. School records (may require 2 years since school years overlap tax years) (relationship, residency)
8. Medical records (relationship)
9. Social service records (relationship)
10. Section 8 housing applications (residency)
11. Immigration paperwork (relationship, citizenship)
12. Green card (citizenship)
13. Citizenship papers (relationship, citizenship)
14. Child care provider records (relationship, support)
15. Baptismal certificate (relationship)
16. Court document (relationship)
17. Letter on official letterhead from a school, medical provider, social service agency, placement agency official, Indian tribal official, landlord or property manager, or place of worship that shows names, common address and dates (relationship, residency)
18. Statement from any government agency verifying the amount and type of benefits you and/or your dependent received for the year (relationship)
19. Rental agreement or statement showing the fair rental value of your residence (residency, support)
20. Property tax bills (residency)
21. Mortgage receipts (residency)
22. Official mail (residency)
23. Earnings statement (residency)
24. Social Security card (citizenship)
25. Library card (residency, citizenship)
26. Utility and repair bills (proof of household expenses) with canceled checks or receipts (residency, support)
27. Clothing bills (proof of child's support) with canceled checks or receipts (residency, support)
28. Driver's license (residency, citizenship)
29. Automobile registration (residency)
30. Automobile insurance bill (residency)
31. Club memberships (residency)
32. Copies of cancelled checks for mortgage payments, rent, utilities insurance (residency)
33. Credit card statements (residency)

34. Bank statements (residency)
35. Military records (relationship)
36. Statement or records from homeless shelter (residency)
37. Eviction notices (residency)
38. Paperwork to obtain a Post Office box
39. Parole Office files (residency, relationship, citizenship)
40. Accurant (residency, relationship)
41. Magazine subscriptions (residency)
42. DDBKD (relationship, citizenship)
43. Obituary (relationship)
44. Census records (relationship)
45. Voter registration card (residency)
46. Homeowners/Renters Insurance Policy (residency)
47. Passport (relationship, citizenship)
48. Ancestry.com (relationship)
49. DNA test (relationship)
50. Alumni yearbooks (relationship)

Chairman BOUSTANY. Thank you, Ms. Olson. Now we will proceed with questions.

Mr. Miller, we are trying to get a handle on the magnitude of the problem. And in your testimony you sort of glossed over the magnitude. But I think there is broad recognition across the board that there is a problem with overpayments. The Subcommittee welcomes the move to register the tax preparers. This, I think, is good. And we also recognize the difficulties you have had with some of the newer tax credits, the compressed timeframe from implementation and administration, coupled with the complexity.

But could you talk to us a little bit about efforts being made after the fact, after the fact that there have been overpayments? Recognizing that preventing overpayments is easier to do than after the fact, what efforts are being made at IRS to collect on overpayments?

Mr. MILLER. If you are talking about post-refund, after the money has gone out?

Chairman BOUSTANY. Post-refund.

Mr. MILLER. Obviously, it is much more difficult for us to chase down that money once it's outside, out the door. But we maintain a pretty robust system. So, since the mid-2000s we have increased our work in the under-reporter area to the point where, we do something in the realm of 900,000 matches and mismatches, and assess, with respect to those cases, about \$1.4 billion, collecting about 90 percent of that. This is relatively new and enhanced.

We also have quite a bit of post-refund examination. We do hundreds of thousands of exams post-refund, as well. Both of those are

specific to the earned income tax credit. For example, in the child credit, we don't do specific exams in that area. But within the EITC exams, 65 percent of those exams impact the child tax credit. So we look at that there, as well. The same is true for the American Opportunities tax credit, where some 300,000 exams involve that credit as a secondary issue. So we have major coverage in the area.

But again, as has been made clear by this panel, it is much easier for us to stop the refund at the door, instead of trying to chase after it afterwards.

Chairman BOUSTANY. There have been recommendations made by TIGTA, some of which you have followed, others which have not been implemented. Would you comment on the reasons behind not implementing some of the things that have been recommended?

Mr. MILLER. So let me start, Mr. Chairman, by saying we have a very good relationship with the Inspector General and his office. And let me sort of put a baseline down, which is, by our count, something like 13 closed TIGTA reports, something just in excess of 40 recommendations. By our count, four of those we have disagreed on. So I don't want to give you the sense that we disagree very often, because we don't.

Some of the ones that we have not completed yet include one where I think that TIGTA has requested or suggested that we require documentation on all EITC credits. And we are looking at that. But, quite frankly, that would require something in the realm of 26 million paper filings. This is going to cause a substantial delay, in terms of our compliance efforts, and it's going to cause a substantial delay in refunds in that area. So we have to go very carefully in terms of what sort of documentation we require.

The other part of this is the suggestion that we look at alternative means of enforcement here, and that we have done. The return preparer is a harbinger for our efforts in that area. TIGTA has also suggested math error authority. That is statutory, and I will rely on the good wisdom of those on the other side there to speak to whether we should have math error authority. But it's certainly something we look forward to working with you on.

Chairman BOUSTANY. We recognize that on the math error authority.

Mr. George, your agency found instances where numerous IRS employees were themselves engaging in tax fraud through the refundable tax credits. In this case it was the First-Time Homebuyer Credit. Can you tell the Subcommittee a little bit about this investigation?

Mr. GEORGE. Mr. Chairman, those are active criminal investigations, and so I have been advised by counsel not to address it in a public forum, but would be happy to do so in private with you and your staff.

Chairman BOUSTANY. We appreciate that. And, Mr. Miller, can you describe any steps you or IRS has taken to safeguard against this type of activity in the future —

Mr. MILLER. So, Mr. Chairman, it is not a positive, by any means, to have IRS employees engaged in this sort of conduct. It is not welcomed by us. And, in fact, we fire a great number of people for this.

That said, I will say that the Internal Revenue Service, with 100,000 people, is the size of a small city. And we, unfortunately, have people across the spectrum. The IRS's tax compliance work for their employees is considerable. We are the most compliant Federal agency in government, and far outstrip, obviously, the public. But we take these things very seriously. There are going to be instances, unfortunately, where our folks do the wrong thing. We do follow up, we do take quick action. There is statutory authority for us to take aggressive action in those cases and dismiss those people.

Chairman BOUSTANY. I appreciate that. Thank you, Mr. Miller.

And now, the chair now recognizes the Ranking Member for questions.

Mr. LEWIS. Thank you. Thank you very much, Mr. Chairman. I want to thank each of you for being here today. For each panelist, please answer yes or no.

Are all EITC overpayment due to fraud or abuse?

Mr. GEORGE. I am happy to start. While I cannot give you a definitive answer—

Mr. LEWIS. I just want yes or no. I have a limited amount of time.

Mr. GEORGE. Yes and no, sir. Yes and no. I hate—I am not being coy here.

Mr. LEWIS. That is okay. Mr. Miller?

Mr. MILLER. I mean they are subject, yes.

Mr. MCKENNEY. Yes, some of them.

Mr. BROSTEK. I think your question was are all claims due to fraud.

Mr. LEWIS. Or abuse.

Mr. BROSTEK. All due to fraud. And no, they are not all due to fraud.

Mr. MILLER. Then my answer is no, because I misheard. I apologize.

Mr. GEORGE. Yes. Same here, sir. Not all.

Mr. MILLER. Certainly not all.

Mr. LEWIS. Ms. Olson?

Ms. OLSON. No.

Mr. LEWIS. Mr. Miller, I understand that in 2009 over 100,000,000 tax return claim refundable credits for tax benefits of more than 150 billion. Is this correct? Yes or no.

Mr. MILLER. That is correct.

Mr. LEWIS. Nine million claim education tax credit. Is that yes or no?

Mr. MILLER. In 2009, that is our number, yes.

Mr. LEWIS. Twenty million claimed child's tax credit. Yes or no?

Mr. MILLER. Again, our numbers would say yes.

Mr. LEWIS. And 101 million claimed a making work pay credit.

Mr. MILLER. Yes.

Mr. LEWIS. Mr. Miller, further, the EITC overpayment estimate are based on tax return from 5 to 10 years ago. Please answer yes or no. Has the IRS made improvement in its computer systems in the way it processes return over the last 5 to 10 years?

Mr. MILLER. We would say yes.

Mr. LEWIS. Ms. Olson?

Ms. OLSON. Yes, sir.

Mr. LEWIS. It is good to see you again.

Ms. OLSON. Thank you, sir.

Mr. LEWIS. Does a refundable nature of a credit increase non-compliance more than any other tax benefit?

Ms. OLSON. I am sorry. Ask that question again.

Mr. LEWIS. Does the refundable nature of a credit increase non-compliance more than any other tax benefit?

Ms. OLSON. In my opinion, refundability does not increase non-compliance, per se.

Mr. LEWIS. Okay, Ms. Olson. Why refundable tax credit important for working American?

Ms. OLSON. Well, first, it lifts—the earned income tax credit lifts millions of taxpayers out of poverty. It ensures that a taxpayer who is working at minimum wage full-time is not below poverty level, and also does not pay income taxes on poverty-level wages. It serves as an incentive for taxpayers to work, rather than not work. It reduces pressure on increasing the minimum wage. And it basically helps families, working families, be able to enter the work force. It has a very high impact in that threshold of people who are not working to entering the work force.

Mr. LEWIS. Ms. Olson, the other witnesses have stated that the EITC overpayment rate is estimated to be 23 to 28 percent. Do you have concern with how this estimate was reached? If so, please describe.

Ms. OLSON. Well, the estimate has a low and a high bound. And the high bound assumed that every taxpayer who did not respond to an IRS audit letter was non-compliant with the earned income credit, was not compliant. And the low bound assumed that the non-responders had the same compliance rate as the rest of the EITC population.

We then did—my office of research did—significant studies in which we discovered, through representative samples of EITC taxpayers under audit, and in audit reconsideration, that, in fact, the lower bound estimate, where the non-responders had the same non-compliance rate as the responders, was, in fact, the accurate rate.

And one study that we found, which was very telling, was that about 25 percent of the taxpayers who were under audit over a given period did not know that they were under audit when they received the IRS letter. They couldn't understand that the IRS letter was telling them that they were under audit, which has an impact on whether you are going to respond or not.

Mr. LEWIS. For each panelist, could you please answer yes or no? In any year is the EITC estimate or improper payment based on that year's current tax return?

Mr. GEORGE. The answer is no, right?

Mr. McKENNEY. No.

Mr. MILLER. The answer is no.

Mr. GEORGE. No.

Mr. BROSTEK. No.

Ms. OLSON. No.

Mr. LEWIS. Thank you very much. Thank you, Mr. Chairman. And I yield back.

Chairman BOUSTANY. I thank the gentleman. The chair now recognizes Ms. Black for 5 minutes.

Ms. BLACK. Thank you, Mr. Chairman, and thank you, panelists, for being here today.

I want to go to the issue of requiring documentation. It seems to me that this is a huge issue in being able to get to just how much fraud is there or is not there. Because, obviously, if you don't have the information to make that determination, you can't really adequately make that determination.

So, I know that, Mr. George, you did testify about the documentation and the lack thereof in so many of these cases. And some would say, well, this is more burdensome for the individual, and it is too burdensome. I would like for you, first, to speak to that. And then, I would also like any of the other panelists that would like to come behind.

Mr. GEORGE. Thank you, Ms. Black. That is a very important issue. Suffice it to say—and again, I am going to give you the abridged answer—as the IRS increases its efforts and has the systems in place which will allow for taxpayers to file, to scan in documents, to submit other paper material, it will make it a lot easier for the taxpayer to comply with his or her tax obligation.

There is no question that if the IRS received more information—I believe that was acknowledged a moment ago by Mr. Miller—third-party information, that they would have an easier time in assessing whether or not someone is actually eligible for the credit that they seek.

There is no question now that, if taxpayers are given a chance to submit paperwork or not submit paperwork, they are going to do what is easier for them.

And I would just lastly like to point out that there are many other government programs, such as the ones for people seeking food stamps, which require other forms of documentation which are readily provided by the taxpayer.

Ms. OLSON. I think that documentation is possible in certain circumstances. But let me tell you the experience with the first-time home buyer credit which seemed fairly simple for the IRS to say, "In order to claim it you have to attach a HUD closing statement."

After the IRS pronounced that and said, "If you don't, we will reject returns," we found that 22 states do not require the use of the HUD closing statement. Therefore, we have to come up with 22 variations of the acceptable documentation, or we will be discriminating against taxpayers who just happen to live in those states that don't use the HUD closing statement.

You can imagine what that would be like as you try to say, "How are you going to prove that a child lived with you for more than half the year," or that this child has a proper relationship. We give an example in our testimony of trying to prove a grand-uncle who claimed a grand-neice, and he has to get four birth certificates.

So, I think in some instances requiring documentation works. In others, it will really harm taxpayers getting the benefit to which they are entitled.

And if I may make one more point, last year we identified a website called falsereceipts.com, where taxpayers could go to gen-

erate a HUD closing statement that looked pretty good, and would go—so even though taxpayers were attaching that, we would not necessarily catch that that was a false piece of documentation.

Ms. BLACK. Ms. Olson, I appreciate your testimony, and I appreciate your comments there. But I happen to really believe that if someone is going to get a benefit, that they do have a responsibility of—with documentation, to show that that benefit—and there are—there is paperwork that can be done in those situations where a child lives with you more than half of the year by court order of the—who the primary care giver is.

I want to just go to another thing very quickly, and my time is very limited. But I wanted to deal with the issue of when someone is fraudulently found to have committed fraud. How vigorous is the penalties, applying those penalties to those individuals, so that we are showing by not only receiving the money back, but also holding them accountable with a penalty, that—are they put into the system that they have fraudulently filed a document, so we know that in the future, and we don't have repeats?

I don't know whether Mr. George or Mr. McKenney can help out with that one.

Mr. MCKENNEY. They—the IRS does have a recertification program, and there is different levels, depending on the level of non-compliance. It can—it means they have to recertify before they come back into the program. It can also bar them for two years from claiming the EITC, and then have to recertify it when they come to the program, or it can bar them for 10 years, depending on the level of negligence or intent.

And what we found, in many cases, when the taxpayer does come in and try to recertify, in about 80 percent of those cases they are still not eligible.

So, yes, they do have a mechanism for that.

Ms. BLACK. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the lady. The chair now recognizes Mr. Becerra for questioning.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you all for your testimony today, and for helping illuminate some of the issues that we all must confront as we try to make the Tax Code a document filled with laws that most people will voluntarily agree to comply with. And that is obviously what we are trying to get, is voluntary compliance. We don't have police roaming the streets, forcing you to show how much you earned. And we are hoping that people will do the right thing and pay their taxes.

You all pointed out some very important areas that we can explore. But my sense is that we are exploring more than other areas this issue of refundability and credits. I think, Ms. Olson, you mentioned that we do—what was it—a third more audits, but we get a third—why don't you restate what you said?

Ms. OLSON. EITC's taxpayers are audited twice as much as all individual taxpayers.

Mr. BECERRA. And how much—do we reap—do we yield the benefit of having that many audits on those middle class—

Ms. OLSON. No. The dollars of the EITC exams are, on average, over the last few years, about a third of what comes from other examination issues in an individual area.

Mr. BECERRA. And I think one of the things that was pointed out by, I believe, most of you was that one of the issues with regards to the earned income tax credit compliance is that, often times, we find that many of the errors or mistakes that are made, or fraudulently claimed EITC reimbursements, are the result of paid preparers who have prepared these returns for, often times, middle and modest income families.

Is it the case that, with these new changes that the IRS has made to require more integrity in the process for these paid preparers, could help us reduce the error rate, or the wrongly submitted EITC claims?

Mr. MILLER. So that is certainly our hope, in rolling out the return preparer initiative. And we hope, in fact, that, as we require the form 8867, which right now, a preparer is supposed to fill out as they question the individual on their eligibility, they are supposed to put that in their drawer. We are now going to require that to be filed with the return. And we hope that has a salutatory effect, as well.

Mr. BECERRA. I hope you move aggressively on the issue of getting people who get paid a good chunk of money to help file returns for folks who are getting a very modest return—because, in my city of Los Angeles, and in particular, my congressional district, I have the vast majority of constituents who are working class, make a modest income, who don't own their homes, and who constantly tell me the stories of how they got ripped off by their preparer, and now they are being audited by the IRS because of some erroneous entry into the form. And ultimately, they correct it, but meanwhile they have got IRS breathing down their necks, and it is costing them probably more money than they paid these preparers, just to correct their tax filings. So, I think it's a big problem.

Mr. Brostek?

Mr. BROSTEK. If I could contribute on this, I definitely agree that the paid preparer regime has promise for addressing issues like this.

About six years ago we did some undercover visits to major paid preparer organizations, and had tax returns prepared for us. In 5 of 10 cases, the paid preparers claimed a child for EITC when the child was not eligible. We were honest taxpayers, we made sure they understood that the information we were providing indicated the child wasn't eligible. Sometimes they ignored our responses, sometimes they changed the answer from what our responses were.

So, I don't want to impugn that the whole industry has a problem here, but I do think that addressing the industry and improving its understanding and addressing some bad actors is a very important thing.

Mr. BECERRA. Thank you for that point. Because I think what we are looking at here are some extremely important programs. Some of these programs have helped lift families out of poverty, working families. Because now they get to keep a little bit more money that they would have otherwise paid in taxes.

And so, I think it's important that we not try to undermine programs that have helped a middle class family afford college for their child, working families who are better off working than going

on welfare. And so it's very important that we try to get them right, no doubt.

Now, Ms. Olson, you pointed out something else that I think is important. I think you said that the earned income tax credit overpayments constitute about 5 percent of the tax gap from all sources of individuals and corporations that either don't pay their taxes, or pay them incorrectly. It sounds to me like we need to do a lot more research into the 95 percent of other areas where folks aren't paying their taxes properly or making mistakes before we go after middle class families and target them. So thank you very much for your testimony.

Chairman BOUSTANY. I thank the gentleman. I think you raise some important points, especially about after-the-fact and audits. And as we, in Congress, design these programs, we ought to be cognizant on how we design them with regard to the simplicity in administration. But we will eagerly await the results from the regulation of the tax preparers. I think this is an important step. But at the same time, we all have to ensure that the integrity of these programs is what it should be. So I thank the gentleman for raising those important points.

The chair now recognizes Mr. Buchanan for questioning.

Mr. BUCHANAN. Thank you, Mr. Chairman, for holding the important hearing today. I also like to thank all our panelists, witnesses, for being here today.

Mr. BROSTEK, let me ask you. The GAO has long viewed the EITC as the largest single type of improper refund payment. And I guess it amounts to about \$16 billion in 2010. How does that stack up about other programs where you've got challenges? Is that the largest area of abuse, or potential abuse? Your number, I think, is—or GAO's number is \$16 billion in 2010 of improper payments.

Mr. BROSTEK. Unfortunately, I can get back to you for the record on that. I don't know for sure if that is the largest improper payment.

Mr. BUCHANAN. But what's your thought? I mean why is it such a huge amount? How did you come up with \$16 billion? That is a huge amount of taxpayer money that is—

Mr. BROSTEK. Right.

Mr. BUCHANAN.—that is flowing out—

Mr. BROSTEK. That \$16 billion amount is our averaging of the upper and lower bound estimate that Ms. Olson referred to from estimates made by the Treasury Department, by IRS itself.

In terms of what are the causes, there are many causes that are in play here, including the complexity of the credit, where people sometimes don't understand. There are certainly, as we have heard, cases of fraud that occur. And there are certainly cases where the documentation that is required in order to prove eligibility is difficult for taxpayers to round up.

So, there are lots of different causes. And I think, as is common across the tax gap in general, it is going to take multiple solutions in order to try to address the level of non-compliance.

Mr. BUCHANAN. And is—what is your sense of how many people are, you know, deliberating trying to take advantage of a situation, in terms of fraud? How much of it is just mistakes, in general? I know this would be a guess, but I was just curious—

Mr. BROSTEK. I would like to be able to answer that, but there is no solid evidence, one way or the other, on what those proportions might be, that I am aware of.

Mr. GEORGE. Mr. Buchanan, if I may, though—

Mr. BUCHANAN. Yes.

Mr. GEORGE.—this is Russell George. If I may, I have an answer to your question—

Mr. BUCHANAN. Yes, go ahead. I appreciate it.

Mr. GEORGE. GAO has estimated that earned income tax credit is the fourth largest, in terms of improper payments, that medical fee—service is \$34.3 billion each year, Medicaid \$22.5 billion each year, unemployment insurance \$17.5 billion, Earned Income Tax Credit, again, around \$16 billion to \$17 billion, and the Medicare Advantage program \$13.6 billion per year in improper payments.

Mr. BROSTEK. Thank you for the assistance.

Mr. BUCHANAN. And let me ask you, while you brought that up. What are we doing to try to minimize that effort? I know the IRS has, you know, a lot of things it is involved in every day. Someone said 73,000 pages, in terms of the Code. But what are we doing to try to move in that direction to minimize some of the abuse?

Mr. GEORGE. Well, first of all, I think it is extraordinarily important, what the IRS is doing as it relates to preparers, paid preparers. They are at the frontline of the effort for the IRS to ensure that people can—are able to voluntarily comply with their tax obligations.

There is a statistic, sir, that I point out at every opportunity that I can about third-party information reporting. And by the IRS' own information, the IRS estimates that individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes, that self-employed individuals who operate non-farm businesses are estimated to report only 68 percent of their income for tax purposes. But the striking number is that self-employed individuals operating on a cash basis report just 19 percent of their income.

So, there is no question that the more third-party reporting of information, the more likely people are to comply with their tax obligation, and help address both the tax gap issue, let alone this issue of improper payment, seeking credits that they are—and the refunds they are not entitled to.

Mr. BUCHANAN. Thank you. Mr. Miller, just quickly, you stated that you are doing all you can to try to reduce or minimize improper payments. But it's not clear in my mind—you get a bunch of recommendations, I guess, that were brought up. Are you really implementing a lot of these recommendations, as it relates to protect the \$8.2 billion of taxpayer's money?

Mr. MILLER. Well, we believe we are. We believe a hunk of that—if you are referring to Mr. George's reports talking about \$8 billion on the table—

Mr. BUCHANAN. Yes.

Mr. MILLER.—We have agreed to some of those, some of those are in process. A large hunk of that is math error authority, which is up to you all, and not us. And also, looking at alternatives to tra-

ditional enforcement, which we have talked about here. Obviously, the stalking horse for that is the return preparer initiative.

Mr. BUCHANAN. Thank you. I yield back, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman. The chair now recognizes Mr. Kind for questioning.

*Mr. Kind. Thank you, Mr. Chairman. I want to thank the witnesses for your testimony here today. And let me start—maybe Mr. George, Mr. Brostek, you guys might be the ones to have the answer to this. We have been focusing on the amount of improper payments, the amount of money, the number of people applying. But do we have good data on people who are eligible to claim these credits who are not seeking them, not filing and receiving it?

Mr. GEORGE. I am not aware of that information.

Mr. KIND. Mr. Brostek?

Mr. BROSTEK. We have a number of estimates, including estimates that GAO did a little over a decade ago, that the take-up rate, the number—percentage of people who are eligible, is very high for EITC. I believe it was around 90 percent for people with children, and maybe 85 percent or so overall who are eligible.

And that does contrast some with more traditional discretionary spending programs, where take-up rates tend to be lower, and administrative costs much higher.

Mr. KIND. And of that who are eligible, how many of them are actually applying? Do you have any percentage bases?

Mr. BROSTEK. Well, those were the figures I meant to convey, about—

Mr. KIND. Oh, that was—

Mr. BROSTEK. About 90 percent of those eligible with children apply, and about 85 percent overall of those eligible apply.

Mr. KIND. Okay.

Mr. BROSTEK. That is my recollection of those figures.

Mr. KIND. And, Ms. Olson, in your opinion, is there a greater need or effort, as far as education or outreach for the families that are eligible who, for whatever reason, aren't applying right now?

Ms. OLSON. Well, I think that there is—that outreach and education always help, and that that is a very important component of getting people to file appropriate claims.

A really important fact of the earned income tax credit is that about a third of the population each year becomes ineligible, and a new third is eligible, because people's family circumstances change. Another child is born, another—you know, somebody loses a job and has lower income, or gets a raise. And so that causes confusion with the earned income credit, and leads to some of the claims, too. You were eligible last year, not eligible this year. Why is that?

Mr. KIND. And I think in your written testimony you indicated that a lot of the improper payments going out isn't necessarily a result of out and out fraud or ineligibility, but also some other factors that are at play here.

Ms. OLSON. Right. I think it's very confusing for people. The dollar amount also of the increase in overclaims is attributable to changes in the law that Congress has made, you know, extending it to three children, as opposed to two, extending the phase-out rate, giving some married filing joint, married relief. And just the

effect of inflation over the 10 years, as you look at the dollar and how it's increased over the last 10 years.

Mr. KIND. Right. Mr. George, you had indicated in your testimony that IG has made some specific recommendations to IRS to implement in order to deal with improper payments. I sense a source of frustration in your voice that they haven't been able to make greater progress on all of the recommendations. How many of the recommendations have they, however, moved forward on? Do you know?

Mr. GEORGE. I believe I have that information for you, sir, if you will bear with me for one moment.

In terms of an actual number, I can't give that to you. But in terms of just broad categories, seeking additional documentation, as we indicated before, making sure that information that is provided—that there is more sharing of information between various governmental agencies, such as Health and Human Services and the Department of Agriculture——

Mr. KIND. I think it is safe to say, according to your testimony, the IRS has made some progress in some of their recommendations. They haven't just completed everything that——

Mr. GEORGE. That is correct.

Mr. KIND.—IG's office is recommending.

Mr. GEORGE. That is correct.

Mr. KIND. And have you gotten feedback from them why, or what is holding them up, as far as implementing the——

Mr. GEORGE. They have cited a lack of resources as a major hindrance to addressing many of our concerns. But I would actually defer to the IRS to respond to that in detail, sir.

Mr. KIND. Mr. Miller?

Mr. MILLER. So, with respect to requiring documentation for all claims, resources is an obvious issue for us, and whether the cost benefit analysis—makes sense to do that or not. With respect to——

Mr. KIND. Well, Mr. Miller, I think that is helpful, and helpful to the committee, because some of us were also raising concerns about the budget proposal that was before us earlier in the year. It was talking about another \$600 million in cuts to the IRS, about a billion dollars in additional cuts in the next fiscal year.

So, almost 8 percent of the IRS budget that was being proposed for cut-backs under the budget proposal that was voted on by the other side. And now we are having a hearing, in some part criticizing the IRS for not doing a better job of enforcement or compliance issues. I just don't think they can have it both ways, you know, demanding greater compliance and better enforcement, while at the same time drastically cutting your budget, which you need in order to accomplish what you are being asked to do.

Now, I am not going to ask you to respond, because it is an opinion that I am expressing here. But it just seems logical, hearing the testimony that we had today, that we have to be a little bit more sensitive to the needs of the IRS resources as we move forward on these issues, Mr. Chairman. Thank you.

Chairman BOUSTANY. I thank the gentleman. The chair now recognizes Mr. McDermott for questioning.

Mr. McDERMOTT. Thank you, Mr. Chairman. I have taken the liberty of passing out the tax gap map of the year 2001, so everybody could look here. I always think that Willie Sutton kind of had it right, that the reason you rob banks was because that is where the money was. So, when I see us spending a hearing on these folks on EITC, I have to—I figure, well, are they the only ones in the process that aren't paying their taxes? And, lo and behold, we have got \$290 billion worth of taxes not collected, and we are talking about \$17 billion.

Now, it isn't as though we want people to file fraudulently. There is nobody up here wants that. But I don't understand why we are focusing on \$17 billion of earned income tax credits and child tax credits. Because I was sitting here, thinking about the fact that, as a Member of Congress, I live in two different places. I live here some and I live in Washington State some. And, on tax bases, I have to figure out every year how many days did I live in Washington, D.C. and how many days did I live in the State of Washington. I say to my secretary, "Will you take my schedule and count the days?"

Now, I have a secretary to do that. So I am thinking about these people who cannot prove how long their kids lived with them, and I, being a child psychiatrist, I also know that when there is a divorce, sometimes the children live with the mother and sometimes they live with the father. And if the father is getting the tax credit because he is working, and he is taking care of the kid, that is one thing.

But if the kid is living with the mother and he has to pay child support payments, does—Ms. Olson, how is that figured out? Does he get credit for when the child is living with the mother, but he is paying tax?

Ms. OLSON. No, but this is—no, he doesn't. And this is some of the complexity of the Code. The mother can release the dependency exemption, and the child tax credit will follow the dependency exemption. So the mother, the custodial parent, can release it to the non-custodial parent who is making the money.

However, the earned income tax credit stays with the custodial parent, the person who has the child for more than half the year. And so, some of these errors are from confusion, because it makes—why would one provision go to the non-custodial, but the other doesn't?

I have seen court orders where family court judges are ordering the custodial parent, against the law, to give up the earned income credit to the non-custodial parent. And, you know, the Federal law says that the non-custodial parent can't get it. And yet the family court judge is confused about it. That is just one layer of complexity with the earned income credit, and goes to how difficult it is for people to provide documents in these circumstances.

Mr. McDERMOTT. Well, as I look at this tax gap map here, I see that individual income tax under-reporting is \$197 billion. Now, why are we doing twice as much scanning of these earned income tax credit folks than we are on others, where they are making almost 10 times—where we have got 10 times as much in play? Why would we be doing that? What is the purpose of that?

Ms. OLSON. If you are asking me, I see no reason to do that. Earned income credit audits bring in less dollars than a audit on unreported business income or unreported individual income. That is what our numbers show.

I think that it is just this sense that refundable credits are somehow worse to the public treasury than not—you know, overclaiming charitable contributions, or under-reporting your business income, or overstating your cost of goods sold. They all—the last few that I have just stated have a much greater impact on the public treasury in non-compliance than the earned income credit claims do.

Mr. McDERMOTT. Mr. Miller?

Mr. MILLER. No—

Mr. McDERMOTT. Help me out here. Why do you spend twice as much money looking at these poor folks? They are all making less than a median income in the United States, less than \$43,000. Why are you going after them, when you are not going after—you are going after them twice as often, as opposed to the business people.

Mr. MILLER. So let me re-straighten the baseline here.

Mr. McDERMOTT. Okay.

Mr. MILLER. About 30 percent of our audits are EITC audits.

Mr. McDERMOTT. Thirty percent of your audits.

Mr. MILLER. Correct.

Mr. McDERMOTT. Are on EITC?

Mr. MILLER. That is correct.

Mr. McDERMOTT. For 17 billion? Okay.

Mr. MILLER. Correct. They are—the vast majority of them are campus examinations, which are a very efficient way to do an examination. We have purposely said, let's maintain a balanced program, so that we have resources—and I believe we have resources within our constraints—to reach other areas. And so, we maintain coverage across all sorts of taxpayers.

The two-percent rate versus the 1 percent rate—

Chairman BOUSTANY. Mr. Miller, if you would wrap up, the gentleman's time has expired.

Mr. MILLER. Absolutely. The coverage rates we are talking about are all individuals versus EITC individuals. There are different coverage rates for different categories within the individual category.

Chairman BOUSTANY. The gentleman's time has expired.

I want to make the statement that, yes, we have a tax gap. And we—and this Committee has the obligation to examine all of the causes of the tax gap.

I also want to make the point that we are talking about an estimated \$106 billion over several years, based on GAO and TIGTA estimates. And this Committee has an obligation to investigate all of these problems with all these tax credits. And I think everybody has admitted that the refundable tax credits are problematic, from the standpoint of complexity.

And so, yes, we are investigating this. We will investigate other areas of importance, as we look at the tax gap. But I think that point needs to be made. And this hearing is focused on not just the earned income tax credit, a very valuable program, but all of these

refundable tax credits, and the problems that are inherent in the administration thereof.

And, with that, the chair now recognizes Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman, and thank you for holding this hearing. Thank you all for your participation and being here today.

Mr. George, last week TIGTA released a report showing that the IRS cannot determine whether taxpayers claiming residential energy credits were entitled to receive them. TIGTA was unable to verify homeownership for 30 percent of the sample returns. Home ownership, of course, being required to claim the credit.

More troubling, TIGTA identified 362 ineligible recipients of the tax credit, totaling more than \$400,000, including 262 prisoners because, according to the report, the IRS did not have a process in place to identify prisoners or individuals too young to buy a home, despite the IRS having data that could be used to identify the erroneous credits.

In the report I believe you stated that, "I am troubled by the IRS' continued failure to develop appropriate verification methods for distributing Recovery Act credits."

Can you just reiterate for the Committee what actions the IRS can take to prevent this sort of fraud in the future?

Mr. GEORGE. Yes, Ms. Jenkins. It is a question of seeking information, getting third-party information, as it relates to who is eligible and who is ineligible for this. As a preface to this report, you rightfully pointed out—and I think the chairman did, also—the First-Time Homebuyer's Credit, which was a complete example of where the IRS, if they had followed recommendations that we had identified early in the process, while they were first implementing that program, and that is requiring some sort of proof, whether it is the HUD-1 form, which ultimately Congress did require, or some other way of documenting that a person was eligible for the credit, that he or she would be able to receive it.

And so, there seems to be a pattern here where the IRS—again, I give them credit in terms of the inability to have resources to address every single one of these on an expedited basis—but again, with this modernized eFile system that should be up and running within the next 2 years, and they should no longer be able to rely on that as an excuse for not ensuring that people who are not eligible for these credits do not receive them.

But there is—and again, to Mr. Miller's credit and to the IRS' credit, they do require math error authority. They need legislation from Congress which will allow them to prevent mistakes before they go out. Because the bottom line is if—once it goes out the door, it is almost next to impossible—with a few exceptions, like prisoners, because that is such a defined population, and in some instances, children—to identify those people and eventually attempt to recover the money.

And again, I would have to defer to Mr. Miller, in terms of actually how much money they are able to recover, once it goes out the door.

Ms. JENKINS. Okay. Thank you.

Ms. OLSON. May I make a comment? I think your question really goes to a major issue about these credits, which is the design of

them, that some of the programs, the IRS could get documentation. But we would still, even with math error, we would still have to have the staff to look at them. And then they start turning into a traditional welfare program, which has very high costs, because everybody is looking at every single application that comes in.

So, some of these programs really shouldn't be run through the Internal Revenue Code at all, because we can't do a good job of them, if we do it efficiently. And if we do it with great scrutiny, such as the inspector general is suggesting, then we start running up our costs of personnel, and things like that.

So, I just wanted to make that point about maybe some of these programs shouldn't come in.

Ms. JENKINS. Okay. I appreciate that. Thank you. In addition, a 2009 Treasury Inspector General for Tax Administration report found \$39 million in Federal tax refunds were issued to prison inmates. That was nearly tripling the \$13.4 million found in 2004. At the time, the IRS said it could not immediately determine how much, if any, of the fraudulent returns in 2009 has been recovered, because the recapture process can take several years.

Following that report, Mr. George, you stated that if the IRS does not take action, the problem will only worsen, and more taxpayer dollars will be lost. So, Mr. George, since 2009, just please remind us what substantial action has the IRS taken to address this epidemic of inmates defrauding taxpayers? What further action might be required? And I think you have already hit on it, but what does the IRS need, in additional authority, from Congress?

Mr. GEORGE. The interesting part, Ms. Jenkins, is that in this very hearing room almost 7 years ago I testified on this very issue, of the fact that prisoners and a propensity—an actual number of them were coming from Florida. And Congress did give the IRS a limited Federal authority to execute agreements with State prison officials in order to help educate both the IRS, as well as State prison authorities, about this growing problem.

And our most recent report unveiled that the IRS has failed to complete many of these agreements. I think they now changed their attitude toward this, given—in the wake of the Homebuyer Credit and a few of the other credits that you have cited. But the IRS failed once again in that instance to comply with the recommendation that we believe, had they done so, that problem may not have been eliminated, but it would have been stemmed greatly.

Mr. MILLER. So, Mr. Chairman—

Ms. JENKINS. Thanks.

Mr. MILLER. I apologize for breaking in—and I will be glad to do this in a response for the record—but we have taken substantial steps, with respect to prisoners, substantial steps in the last 6 months, coming to agreements with seven States, with the Federal Bureau of Prisons, doubling the number of returns that we are stopping in our pre-refund. And I would be glad to—

Chairman BOUSTANY. If you would, Mr. Miller, provide a more detailed reporting.

Mr. MILLER. I will do that, sir.

Chairman BOUSTANY. Of the steps taken, we would appreciate it. Thank you.

The chair now recognizes Mr. Rangel for questioning.

Mr. RANGEL. Thank you, Mr. Chairman. I am happy that this hearing—this is a very sensitive program, and we think when it is effective it really has pulled so many people out of poverty and given them the incentive to continue to work, rather than go on welfare.

Mr. George, did you say that soon, and very soon, you expect that the new computer system is going to correct most of these errors?

Mr. GEORGE. Not correct, but will enable the IRS to more efficiently process forms that would help provide documentation as to whether or not someone is eligible for a tax credit, or whatever they may be seeking.

Mr. RANGEL. Is there any difference in the penalty if the taxes are made by a paid preparer, rather than the—the penalties are different?

Mr. GEORGE. No, I am just saying that that is an issue because, ultimately, it is the taxpayer's responsibility to ensure that the tax forms submitted are accurate.

Now, some companies have a program which they would say they will seek—they will represent you before the IRS if they prepare your tax return and there happens to be a mistake, or the IRS questions something. But ultimately, it is the taxpayer who is obligated—

Ms. OLSON. Actually, if I may clarify that, there is—the taxpayer, if they are negligent in preparing their own return, or providing information to the IRS, has a negligence penalty. But that penalty can be waived if the taxpayer has reasonably relied on the return preparer.

Mr. RANGEL. But the standard is higher with a professional preparer?

Ms. OLSON. Actually, the taxpayer is—if the taxpayer goes to a preparer and it is a good preparer, then the IRS is very—is actually lenient to the taxpayer. What we have pointed out—

Mr. RANGEL. I don't mean to the taxpayer. Is there a penalty for the professional preparer—

Ms. OLSON. Well, that is the question—

Mr. RANGEL [continuing]. when you see fraud?

Ms. OLSON. The—I think that we really need enhancement on the preparer side for some of the penalties—

Mr. RANGEL. So all of you believe this Committee should look into the sanctions as relates to deliberate fraud by paid preparers?

Mr. MILLER. We certainly would support that. And, in fact, in the 2012 budget proposal that has been set forth, there is a due diligence penalty. If a paid preparer does not exercise due diligence, a level of due diligence in the EITC area, there is a specific penalty.

Mr. RANGEL. Okay.

Mr. MILLER. We have actually asked for that to be multiplied—

Mr. RANGEL. Okay, we will look into that.

Mr. MILLER [continuing]. by five.

Mr. RANGEL. As it relates to the policy decision as to where you have the audits, I think Mr. Crowley and others were asking if you get less money for investing more time, why would you have that policy?

[No response.]

Mr. RANGEL. I think, Ms. Olson, didn't you indicate that you thought that it was more attention being paid to these lower-income people than the corporate structure?

Well, who would make a policy decision like that? I mean is that your—everybody's understanding, is that you do spend more time auditing in these type of things than you would where there are larger amounts of moneys that could be collected?

Mr. MILLER. So if I could—and I am sure the Taxpayer Advocate can chip in, but if I could—again, the 2 percent coverage rate for the EITC versus the 1 percent for all individuals is—

Mr. RANGEL. Why is that?

Mr. MILLER [continuing]. very high-level. For those who are over \$200,000, that individual rate goes up to something like 6 percent. For those who are over a million, it goes up to 8 percent. So we try to maintain a balance. For very large corporations, it is in excess of 25 percent.

Mr. RANGEL. I know Ms. Olson said—and no one challenged it, unless you are doing that now—that, based on the amount of money that is collected, and the amount of time that is being put in for the audit, that, by far, there is less money to be collected from this group.

First, I want to make it abundantly clear. This program is so good that I would just want it to be as pure as the driven snow. And so, I do want everything done possibly so that people who are against the program for policy reasons won't have an excuse that there is fraud, deliberate fraud that is going on. And the government should assist people not to make mistakes by educational programs.

Did someone say that there is 75 or 80 percent participation with eligible people for this?

Mr. MILLER. Yes, I did say that.

Mr. RANGEL. Wow. I don't know whether other people on the committee find that high percentage, but we do a lot of educating on this subject.

But you know what I am trying to say, Mr. Miller. Is this targeted for political reasons, this group of people?

Mr. MILLER. No, sir, it is not.

Mr. RANGEL. And you think this is the most efficient way to use the auditors' time, to concentrate on this group more than you concentrate on others?

Mr. MILLER. So you ask how is this set up. Frankly, it is set up in discussions with my boss, Mr. Shulman. But it is also our top-level group, including especially me, quite frankly, that sets an annual work plan and determines where, generally, we are going to be spending our time.

Mr. RANGEL. Well—

Mr. MILLER. I believe that this is a balanced approach.

Mr. RANGEL. Send something to me.

Mr. MILLER. Surely.

Mr. RANGEL. Because there has been other questions asked similar to the ones that I have asked. And, for whatever reason—I am not saying that they might not be a good reason to send a message out that if you find that there is more fraud in this par-

ticular tax benefit, that you may want to increase the penalty or increase the audits. But you are not saying that.

And so, if you could send to me, like—the Google question is, “Are there more—is there more oversight for EITC recipients than other taxpayers?”

Mr. MILLER. Surely.

Mr. RANGEL. And if I was to ask you that, what would you say right now?

Mr. MILLER. It is really going to depend. I can’t answer that, based at 10,000 feet. Is there more on the EITC than there are on wealthy Americans? No, I can say that. Than there are on large corporations? No. Small corporations? No.

Mr. RANGEL. Anybody else.

Chairman BOUSTANY. Mr. Miller—

Mr. RANGEL. This—

Chairman BOUSTANY. Yes, thank you.

Mr. RANGEL. Okay.

Chairman BOUSTANY. The gentleman’s time has expired, but I appreciate the line of questioning. And I think Mr. Miller will respond to you—

Mr. RANGEL. Please, Mr. Miller, just—

Mr. MILLER. I will do that. Absolutely.

Mr. RANGEL. Because I want to defend what you are doing. And the answers don’t just fit into a category that you can easily respond.

Mr. MILLER. Right.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman from New York. The other gentleman from New York now is allowed to ask questions.

Mr. CROWLEY. Thank you, Mr. Chairman. Thank you, Doctor. I appreciate you for that.

And first I will say, Mr. Chairman and Mr. Lewis, I have some great concerns about the subject of the hearing today. The U.S. has a \$14 trillion deficit, \$14 trillion deficit. And I would argue that more than half of that was run up by the borrowing and spend policies of the previous Administration, from 2001 to 2009. And yet, we are starting today, this hearing, at the bottom, the very bottom of the scale.

An Administration that oversaw the enactment of tax cuts for the wealthiest in this country, the start of two wars—some would argue three, now that we’re entered into what started with the first two—and the biggest bail-out in the history of the United States, TARP, for the wealthiest in this country. Yet we are still starting at the bottom today.

But has my—but have my Republican colleagues in the Congress taken responsibility for the part that was started? Have they put forward a plan to remedy the situation to scale back spending? Well, kind of. They are not willing to admit that the policies of their party got us to this point in the first place, but they are willing to try to pay down the bills. Good news, right?

Well, maybe not exactly. First, their budget proposal to eliminate Medicare as we know it, and in turn, drastically increasing seniors’ cost for their health care, I think I was home sick during my high

school days when we were taught about how seniors have been fleecing America. I could have sworn they were the ones who actually paid their dues and living out their retirement years now.

Now, my colleagues on the other side are making tweaks in the Tax Code to find savings. That is good news, isn't it?

Well, maybe not so much. Are Republicans returning tax rates on millionaires to what they were during the economically prosperous years of the nineties? No. Are they eliminating tax subsidies provided to the oil industry, an industry profiting from \$4 a gas cost at the pumps, and the industry's record profits? No.

Here is a list of what tax benefits they are cutting—proposing to cut back on: the child tax credit, the adoption tax credit, the housing benefits for middle class credit. Republicans appear to believe the rich pay too much in taxes, and the middle class not enough. And that is the subject of this hearing today.

That brings me to my first question. Mr. Miller, you are from the IRS. From preliminary returns from the 2010 tax year, 41,000 tax returns claimed the refundable adoption tax credit. Is that correct?

Mr. MILLER. I think our numbers are maybe updated to 70,000 or so.

Mr. CROWLEY. Seventy thousand? Who is eligible to claim this? Is it not for families who are adopting children? Or am I confused on what the adoption tax credit is for?

Mr. MILLER. It is for adopting families.

Mr. CROWLEY. Thank you. Mr. Miller, 7.9 million Americans claimed—have claims—claimed the refundable higher education tax credit. Is that correct, or has that number changed?

Mr. MILLER. I think that number is correct, although I would have to check it again.

Mr. CROWLEY. Isn't that for families, again, who are sending their children to—or child to college, to make it more affordable, and to give them an opportunity, a better way of life, and to help our country expand and to grow? Well, at least isn't it—don't answer that. The end of the—I have the end part. But isn't it to help make affordable more—college more affordable?

Mr. MILLER. I believe it is.

Mr. CROWLEY. These are tax benefits that my colleagues on this side want to repeal in the name of budgetary soundness. But, like the Republican Medicare voucher plan, the Republican plan to eliminate tax benefits, may save the government money, but it bankrupts these families, families like those that want to take such activities as adopting a child, sending a child to college, or trying to purchase a home.

But what is even more ironic is, while the Republicans are ripping Medicare away from seniors and stealing tax benefits from the middle class, they uniformly oppose tax measures pushed by the Democrats to punish the wealthy Americans who hide their money in Swiss bank accounts.

Yes. Hundreds of billions of dollars of money are hidden overseas. And my colleagues on the other side, including every member of this Committee but one—I believe Ms. Black—opposed—she wasn't here—opposed legislation to track down and reclaim those hidden funds. They are protecting people who have money in Swiss bank accounts. How many of us have constituents with money in

Swiss bank accounts? Anyone here? How many of us have constituents who use the child tax credit? Anyone here use that?

They also oppose efforts to crack down on Federal contractors who owe back taxes.

And in a press release from the Republican Committee majority, they have lambasted this administration for raising taxes on people in prisons. And I appreciate Ms. Jenkins bringing up the point—

Chairman BOUSTANY. The gentleman's time has expired.

Mr. CROWLEY. Thank you, Mr. Chairman.

Chairman BOUSTANY. I appreciate the gentleman's statements of a broad political nature, but I want to point out that the purpose of this hearing was focused on the integrity of these programs. We all recognize the value of the programs. But we also have a responsibility to provide oversight as to the integrity of these programs. And we are—

Mr. CROWLEY. Will the gentleman yield? One question, one—

Chairman BOUSTANY. We are going to look at tax reform, as the gentleman well knows, and it is going to be a fundamental look at the entirety of the Tax Code. And this is but a small part of the oversight of these specific refundable tax credits, which all the witnesses have proposed that there are endemic problems with the administration of those programs.

And so, that is the purpose of this hearing. I want to get us back on track—

Mr. CROWLEY. Mr. Chairman, can I—for the purpose of a question?

Chairman BOUSTANY. Yes.

Mr. CROWLEY. Will this Committee consider a Committee hearing on the concept of a shared sacrifice in this country? Is that something that we could look forward to?

Chairman BOUSTANY. This Committee is going to fulfill the functions that are outlined in the rules of the Committee, which is to look at the jurisdiction of the Full Committee, in concurrence with the other subcommittees. And since tax reform is a big part of what we are going to be doing over the course of this year, that will be the focus of the oversight function in this—

Mr. CROWLEY. I will take it as a yes. Thank you, Mr. Chairman.

Chairman BOUSTANY. It is basically what the rules of the subcommittee and the Committee are. And I will leave it at that.

And now the chair will recognize Mr. Marchant, who has waited patiently.

Mr. MARCHANT. Thank you, Mr. Chairman, and thank you to the panelists.

Every time I stand before a group of taxpayers in my district, my constituents, the question comes up, "Congressman, what are you doing, and what is Congress doing, and what is the Federal Government doing, to cut waste, fraud, and abuse?" I don't think there is a single congressman that does not get that question when they go home.

So, I deeply appreciate the fact that you are at the hearing today, that the hearing has been called for this purpose, and I appreciate your comments, because I think this is the purpose of this—of Congress. This is oversight. And I have learned a great deal today. And

to our constituents this Congress is going to do something with your help on this fraud and abuse, because I don't think anybody here would deny that there is fraud and abuse going on.

For Mr. Miller, when a person accepts a refundable tax payment, and they receive the cash, and they have done so fraudulently, have they committed a crime?

Mr. MILLER. I suppose some have. There is civil fraud, as well as criminal fraud. So not necessarily in all cases, depending on various things that I am less familiar with than I should be.

Mr. MARCHANT. But it is undoubtable that when they do receive that refundable tax credit, if they don't deserve to receive it and they are audited, they have, in fact, created for themselves a tax liability, because they owe the money back.

Mr. MILLER. Correct.

Mr. MARCHANT. When the tax liability is created, does that tax liability take any kind of precedence over any other tax liability that the person—that any other taxpayer owes? Is the collection activity different from a collection activity from someone who owes \$2,700 on last year's taxes and have not paid?

Mr. MILLER. So if I could rephrase the question, if—I think I understand it—in our collection operations, is \$2,700 \$2,700, regardless of whether it is—

Mr. MARCHANT. Yes. Is this a priority—

Mr. MILLER. It is not a priority. Whether it actually ends up being—moved up in line will depend on what else is there, and what our determination of the collectability of that amount is.

Mr. MARCHANT. So, the collection activity will fall under the same criteria as all collection activity, and you are going to look at each individual taxpayer and say, "Is this a"—you know, "How likely are we going to be able to collect this money back?"

Mr. MILLER. Correct.

Mr. MARCHANT. And do you take the next step and say, this person, or this taxpayer, whether it be corporate, energy, earned income credit, any of the tax refundable programs we have talked about today, does that person then earn a—the same kind of treatment that any taxpayer would have if they owed a tax liability?

Mr. MILLER. Yes. I will note the EITC, as was mentioned earlier, there is a re-certification rule that can occur. We have the ability to ban a person from EITC under—all these things are statutory—for either 2 or 10 years. There are things that we can do that are different, with respect to this tax liability, than others.

Mr. MARCHANT. Well, to the taxpayers in my district that consider it a duty to pay their taxes and to pay what they owe, it is demoralizing to them to pick up the newspaper or see a report that is given that reports these kinds of obvious fraud. It is demoralizing for them to pick up the Wall Street Journal or any newspaper and read that people—that prisoners, or people from—that don't deserve the home buyer credit are getting it. I don't give any more weight to the earned income credit as I do the energy credits or the homebuyer credit. Fraud is fraud.

I agree that the preparer—we should begin to look more closely at the preparer. Because in my area most—I believe most of the fraud is aided and abetted by the preparer. In fact, I pick up the newspaper and you can see in the classified ads or on late night

cable—I am a night owl, so I—you can see the preparers are enticing people into the scheme, and showing them how to get the money, and they are charging them exorbitant amounts of money, and the benefit to the taxpayer ends up that they actually are accruing the tax liability that probably will brand them for years.

So, thank you for what you are doing. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman. I want to thank all the witnesses for being here today, and providing testimony. This has been very helpful to us. Please be advised that Members may have written questions that they will submit to each of you, and those questions and answers will be made part of the record, the official hearing record.

So, thank you again. I thank the Members for their participation. This hearing is now adjourned.

[Whereupon, at 12:06 p.m., the Subcommittee was adjourned.]

[Questions for the Record follow:]

Ways and Means Oversight Subcommittee
Hearing on Improper Payments in the Administration of Refundable Tax
Credits
May 25, 2011

Questions for the Record from Rep. Kind

Question: Mr. Miller, each year the Internal Revenue Service undertakes an extensive education and outreach program to inform taxpayers about the Earned Income Tax Credit, including holding an annual EITC Awareness Day. What is the IRS' estimate of the percentage of EITC-eligible taxpayers who fail to claim the credit? In each of the three most recent tax years, how many eligible taxpayers may have failed to claim the credit?

Response: The most recent study, conducted in collaboration with the Census Bureau, shows an upward trend in the estimated percentage of eligible taxpayers claiming the credit. The participation rate for tax year (TY) 2008, the most recent year available, is estimated to be 79% with a margin of error of +/- 1 percent. This translates into about 4.5 million taxpayers, or about 21 percent of eligible taxpayers, who did not claim the credit.

The estimates of participation from the latest study, as shown in the table below, range from 76% for TY 2005 to 79% for TY 2008. The margin of error for each estimate is +/- 1 percent. Thus, an estimated 21% to 24% of eligible taxpayers failed to claim the credit. The table below reflects the upward trend in participation.

Tax Year	Estimated Participation Rates
TY 2008	79%
TY 2007	79%
TY 2006	77%
TY 2005	76%

Note:

The 2005 -2008 estimates are based on the project study - Earned Income Tax Credit Participation Rate for TY2005 – TY2008, conducted by Wage and Investment Research in collaboration with the Data Integration Division, U.S. Census Bureau.