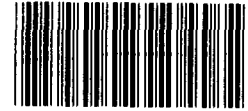


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The New Earned Income Credit Form is
Complex and May Not Be Needed

Statement of
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Before the
Subcommittee on Government Information and
Regulation
Committee on Governmental Affairs
United States Senate



THE NEW EARNED INCOME CREDIT FORM
IS COMPLEX AND MAY NOT BE NEEDED

SUMMARY OF STATEMENT BY
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Last year, about 12 million low income households with children received over \$6 billion in earned income tax credit payments. Until this tax year, taxpayers who qualified could get one refundable credit based on their earned income regardless of the number of children they had. The Omnibus Budget Reconciliation Act of 1990 simplified the credit by eliminating some of the complicated eligibility requirements. The Act also increased the credit for households with more than one child and added two supplemental credits for households (1) with children under one year old, and (2) that purchase health insurance for a qualifying child. In addition, the act required that, to claim the credit, taxpayers include the name and age of each qualifying child, along with the social security number of any child older than one. The Conference Report specified that taxpayers would file a separate schedule with this information in order to get the credit.

IRS went beyond its normal processes in developing the new form. It set up a special taskforce to develop the form, solicited comment from outside the usual channels, and used focus groups to test the clarity and simplicity of the form and instructions. IRS made a number of changes to the initial version of the form based on the comments it received from the public and focus groups. The focus groups, however, were composed entirely of people who filled out their own tax returns and, generally, had experience with the credit.

IRS also developed new processing procedures to handle the new form and expanded its outreach efforts to inform people about the credit. IRS returns processing procedures are likely to limit the number of taxpayers who will receive the credit and result in taxpayers who qualify for the basic credit either not receiving it or receiving it late.

GAO believes that, even with the extra efforts IRS put into developing the form, it is still too complex and will confuse some taxpayers. The complexity could dissuade some eligible taxpayers from completing the form and getting the credit. Under prior rules, IRS could have calculated the credit for these taxpayers using information reported on the tax return. GAO believes that, for most eligible taxpayers, the information currently on the tax return is sufficient for IRS to determine a taxpayer's eligibility for the basic credit. As a result, GAO believes that a separate form is not really necessary.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss the Internal Revenue Service's (IRS) efforts to develop a new form for taxpayers to use in applying for the earned income tax credit. We are examining this and other issues concerning the credit as part of ongoing work for Senator Bill Bradley.

The form has implications for the way IRS will process tax returns for taxpayers who may qualify for the credit, as well as IRS' outreach efforts. While IRS has done much to try to simplify the form, the fundamental question is whether a form is necessary given last year's changes in the law.

BACKGROUND

The earned income tax credit was enacted in 1975 to target tax relief to low-income workers with children, provide an offset to the payroll tax, and improve incentives to work. This year, the credit could amount to as much as \$1,235 for a taxpayer with income between \$7,140 and \$11,250. The credit provided over \$6 billion to about 12 million households last year.

In the past, IRS found more errors with the credit than with any other line item on the individual income tax return. For example, IRS' 1985 Taxpayer Compliance Measurement Program indicated that about 39 percent of claimants in that year were

not eligible for the credit, primarily because they misunderstood the requirements for being a head of household.

The Omnibus Budget Reconciliation Act of 1990 substantially changed the earned income tax credit. The Act simplified the credit by eliminating complicated eligibility requirements for maintaining a household and supporting a child and establishing, instead, a straightforward, three part test for relationship, residence, and age. The new law also required the IRS to develop special procedures to notify taxpayers who have not claimed the credit of their potential eligibility for it.

But, the Act complicated the credit by increasing the credit for households with more than one child and establishing two new supplemental credits for (1) households with children under one year old, and (2) households that purchase health insurance for a qualifying child. It also introduced complicated rules to ensure taxpayers do not make use of more than one tax credit or deduction for the same expense or purpose. The interactions work this way. If the supplemental young child credit is claimed, the dependent care credit for that child may not be claimed. If the taxpayer received employer-provided dependent care expense and claimed the supplemental young child credit, the exclusion for employer provided dependent care may not be claimed. If the health insurance credit is claimed and the taxpayer itemizes, medical expenses must be reduced by the amount of the health

insurance credit. And, if the taxpayer is self-employed and is claiming the health insurance deduction, the amount of the premium eligible for that deduction must be reduced by the amount of the health insurance credit.

The Act also required that, in order to claim the credit, the taxpayer must include the name and age of each qualifying child, along with the Social Security Number of any child older than one year. According to the Conference Committee Report, to implement this provision, a separate schedule containing this information was required to be filed along with the tax return.

IRS EFFORTS TO DEVELOP A SIMPLE FORM

Due to the complexity of the new law, the large number of low income earners who would be using the form, as well as the history of high error rates for the credit, IRS went beyond its normal processes for developing the new form. This included setting up a special taskforce to develop the form, soliciting comments on the form from outside the usual channels, and using focus groups to test the clarity and simplicity of the forms and instructions.

In January 1991, IRS established a taskforce from its various functions, such as taxpayer services and returns processing, to coordinate changes and oversee development of the new form. Over

a period of several months, IRS developed two versions of the form, Schedule EIC for those filing a 1040 and Schedule EIC-A for those filing a 1040A. IRS circulated drafts of the forms for internal comment at the national office and to its service center returns processing staff. On the basis of comments on these preliminary versions, IRS released a form and accompanying instructions for public comment on June 19, 1991.

The form that IRS issued was very complex. It consisted of four parts. The first part, entitled General Information, listed the qualifications for applying for the credit and defined a qualifying child. Part two asked for information on the two youngest qualifying children. This information included name, year of birth, Social Security Number, relationship of the child, and the number of months the child lived with the taxpayer. Part three was for those taxpayers who wanted IRS to figure their credits for them. It asked for information on non-taxable earned income, the name of the health insurance company, and the amount of health insurance premiums paid. Part four was for those taxpayers who wanted to calculate the credits for themselves. This part consisted of calculations for all three credits. The calculations included determining earned income, adjusted gross income, and the credit amounts from tables.

Not only were there four parts to the form but there were a number of cautionary notes and statements throughout the form

warning about the interactions. For example, after part two, there was a cautionary note warning the taxpayer about the interaction between the child and dependent care credit and the young child credit. A similar cautionary note was repeated in part four of the schedule. The complexity of the form was compounded by incomplete instructions. The instructions did not contain information on how to fill out the health insurance credit or the credit for a child under one year old.

In response to this public release, IRS received 89 comment letters from a range of professional and public interest organizations, as well as interested individuals. IRS evaluated these comments and, where deemed appropriate, made changes in the form and instructions. For example, the income brackets in the tables used for calculating the credits were widened from \$25 to \$50 intervals. This reduced from seven to four the number of pages containing tables and made the tables easier to read.

IRS--through its contractor Booz, Allen, and Hamilton--then proceeded to test the new forms with 30 focus groups in 9 cities. Booz-Allen, with IRS approval, established selection criteria for focus group participants and--through local subcontractors--located individuals who satisfied the requirements. Focus group participants were selected who would most likely be affected by the new form. These were people largely eligible for the credit who had prepared their own tax return in the past.

Thus, the focus group test results represent a portion of the eligible population--individuals experienced in filling out their own tax returns. In addition, many of the focus group members had claimed the credit in the past. IRS wanted to test the form on experienced taxpayers, because prior tests of other tax forms indicated that taxpayers inexperienced with filling out their own returns provided few useful comments. While experienced taxpayers may provide much useful information, we believe that less experienced taxpayers may have offered useful suggestions that could have further simplified the form.

The focus groups also tested relatively simple and straightforward scenarios. Focus group participants were given copies of the form and instructions and one of 24 hypothetical tax scenarios to use in completing the form. In each scenario the taxpayer was eligible for the basic credit, and either the supplemental child credit or the health insurance credit. None of the scenarios covered individuals who had a child under one year old and also claimed the dependent care credit or individuals who had self employment income and had made health insurance payments. While IRS officials believe the scenarios involving interactions are the ones most likely to cause taxpayer confusion, they did not test for these interactions because the number of taxpayers involved is small. Furthermore, none of the

eligibility conditions were tested. IRS and the contractor made a decision to test only the difficulty of completing the form.

We reviewed audio tapes from 10 of the 30 focus group sessions, and observed two sessions. After participants completed the form, they discussed any problems they had with either the form or instructions and suggested changes. For example, they suggested a clearer indication of where the calculation for the health insurance credit and supplemental child credit begins. The latest version of the form includes several changes made as a result of comments received from the focus groups. We believe that IRS was responsive to the questions and concerns raised by the participants.

Of course, some suggestions made by focus group members did not result in changes. For example, focus group members were confused by the concept of nontaxable earned income--which is included in earned income for purposes of calculating the credit --and felt that more specific examples should be presented in the instructions. So far, IRS has not provided any additional guidance on this issue. Also, many focus group members said that one of the most confusing factors with the form was the need to keep going back and forth from one section of the form to another when completing the health insurance credit or supplemental child credit portions of the form. IRS has not changed the form to reduce this area of concern. However, such a change could be

difficult to make as long as the form is used to calculate all three credits.

While IRS appears to have tried to make the form and instructions as simple as it believes it can, it is not clear to us that the form is really necessary. First of all, the law only requires the name and age of a qualifying child, as well as the Social Security Number for a child over 1 year old. There is already a place on the tax return itself for the name and Social Security Number of each child. The tax return can be altered to capture the age(s). The only additional information required for the basic credit that is not on the tax return is non-taxable earned income. This item will affect only a small number of taxpayers, primarily those who receive military housing and subsistence allowances. There are other ways for IRS to acquire this information, for example, the military could be required to report this information on the W-2 form.

As to the supplemental credits, the only pertinent additional information would be the amount the taxpayer paid for health insurance during the tax year. IRS should be able to find space on the tax return for this number. The tax return already contains information on any interactions between the health insurance credit and the medical expense deduction, and between the young child credit and the dependent care credit. Thus, IRS could make any necessary adjustments regarding these interactions

on its own. IRS may not be able to calculate the interaction between the health insurance credit and the self-employed medical deduction, because in some circumstances there is not sufficient information on the tax return. Because IRS cannot calculate all the interactions and because taxpayers who wish to calculate the credit would still be confused by the complexity, the Department of Treasury has suggested that Congress change the law to eliminate these interactions. The staff of the Joint Committee on Taxation estimates that the total revenue loss of such a change would be about \$80 million over a 5-year period. The Department of Treasury estimated that no taxpayer's credit would be reduced by more than \$3.71 were the revenue loss offset by reducing basic credit rates.

While it may not be too late for the Congress to eliminate the interactions, it may be too late for IRS to make changes in the 1040 and 1040A for this tax year. If authorized, IRS still has time to change its procedures so that taxpayers filing returns who appear to be eligible but don't submit the additional form could still be granted the credit. This interim arrangement would allow IRS time to modify the 1040 and 1040A forms for next year.

NEW FORM WILL DELAY PROCESSING
OF RETURNS AND PAYMENT OF CREDIT

The requirement that taxpayers file the credit schedule to receive the credit means that IRS will have to make some significant changes to its returns processing procedures. These changes will add to IRS' processing costs and result in delayed refunds for many taxpayers. Under prior rules, IRS could calculate the credit using information reported on the income tax return for taxpayers who appeared to qualify for the credit but failed to claim it. For tax year 1990, IRS calculated the credit for about 540,000 taxpayers.

Under the new rules, IRS will not pay the credit without the form. Instead, IRS will correspond with taxpayers who appear to qualify to obtain all the information required on the form. This correspondence will take place after IRS has processed the taxpayer's tax return, which usually takes 4 to 6 weeks. IRS expects to correspond with about 1.3 million taxpayers who do not claim the credit but appear eligible. Taxpayers who do not respond to the IRS correspondence will not get the credit.

IRS has also established procedures for handling returns on which the taxpayer claimed the credit but did not attach the required form. Depending on where in the processing stream IRS discovers that the form is missing, IRS will either send the return back to

the taxpayer or suspend processing the return. For the suspended cases IRS will correspond with the taxpayer requesting the required form before processing the tax return. If the taxpayer does not respond to this request within 30 days, IRS will disallow the credit and process the return. The taxpayer will receive a notice stating that the credit was disallowed because the form was missing. However, the form will not be included in the envelope with the notice.

IRS is also in the process of establishing procedures to handle returns in which the taxpayer claims the credit but files an incomplete form. These procedures are expected to be the same as those for processing returns in which the taxpayer claimed the credit but did not file the form. So far, IRS has not decided what constitutes an incomplete form. It is considering corresponding with the taxpayer if the taxpayer does not include the child's full name, age, or Social Security Number.

Under prior procedures, IRS would usually grant the credit if the name and Social Security Number were missing from the tax return. IRS estimates that 15 percent of the taxpayers who claim the credit will either not submit the form or will submit the form with missing information. This means that IRS may have to correspond with 2 million taxpayers and, as a result, many will have their refunds delayed.

IRS OUTREACH EFFORTS

In response to the requirement in the 1990 Act, IRS increased its efforts to inform potential recipients about the credit. IRS has not embarked on new outreach programs as much as it has done more of its normal activities and done them sooner. These efforts include publicizing the credits through conventions and tax seminars and distributing brochures and handouts at conventions of social welfare professionals and others concerned with those potentially eligible for the credits. IRS not only distributes materials to interested groups, but also uses these groups as an integral part of its information and outreach program. In addition to dealing through these intermediaries, IRS is also developing news releases, fact sheets, posters, ads, and other such materials for getting the word out on the new credits directly to the general public.

IRS has no plans to target specific low income earners to inform them of the credit even though IRS has records which would allow it to do so. For example, IRS has information returns, such as Form W-2 wage statements, on almost 5 million people who failed to file a 1989 tax return. About 2.7 million of these nonfilers are being pursued at Service Centers through IRS' nonfiler program, whereby they are initially sent delinquency notices requesting them to file their tax returns. Many of the remaining 2.3 million people have an obligation to file but, because of

their low income, they owe no tax. They receive a reminder to file notice which is a brief description of who must file a return. This notice, as well as the delinquency notices do not mention that these individuals may be eligible for the earned income tax credit. At the very least, IRS could modify these notices to inform the taxpayer about the credit.

CONCLUSIONS

IRS has significantly increased its outreach efforts this year. Given the changes in the law and the complicated form that has emerged from IRS' development process, this outreach and information effort is especially important. Not only is it necessary to get as many eligible taxpayers into the system as possible, but all of those who received the credit in past years need to be brought up to date on the new credits and other aspects of the new law.

While outreach is an ongoing and important issue, we are most concerned about the form that IRS has produced and the procedures IRS intends to use for processing returns that may qualify for the credit. As we have stated, IRS is setting up procedures for returns that have incomplete supplemental forms or none at all. These procedures are likely to limit the number of taxpayers who will receive the credit and result in taxpayers who qualify for the basic credit either not receiving it or receiving it late.

Congress revised the law in a way that eliminated the need for a separate form for IRS to determine eligibility for the basic credit or its family size adjustment. However, Congress also added two new credits and the requirement, in the report on the bill, that a separate schedule be submitted to apply for the credit. IRS then produced, even with all its form development and testing efforts, a very complex and potentially intimidating form. In our view, IRS could grant the basic credit to those who qualify on the basis of information on their tax return. This raises the question as to whether the form is necessary for computing the basic credit. We do not believe it is.

We believe the requirement for a separate schedule should be reconsidered. For those who qualify for supplemental credits, we believe one change on the tax return would suffice. While it may be too late to change the 1040 and 1040A for the current tax year, we believe changes in IRS' procedures could be made that would allow payment of the credit to eligible individuals who do not submit the extra form. In addition, Congress could reduce many potential complications by deciding to eliminate the interactions among the credits which appear to amount to a fraction of a percent of credit payments.

This concludes my statement. We will be happy to answer any questions that you may have.