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The Honorable Xavier Becerra
House of Representatives

Subject: Earned Income Credit: Noncompliance Relative to Other Components of the Income Tax Gap

Dear Mr. Becerra:

This letter responds to your request that we compare noncompliance and associated Internal Revenue Service (IRS) enforcement issues for Earned Income Credit (EIC) claimants and other taxpayer groups, such as the self-employed. Your question is a follow-up to our May 1997 testimony on EIC noncompliance before the House Committee on Ways and Means.[1] As you requested, the data presented are summarized from our previous work.

RESULTS IN BRIEF

IRS estimated that 25.8 percent of EIC, or $4.4 billion, was overclaimed in tax year 1994. This is a relatively high error rate, but the gross dollar amount is lower than that of some other taxpayer groups. For example, underreporting of income by self-employed individuals accounted for nearly $30 billion of the estimated $128 billion in taxes owed but not voluntarily paid for tax year 1992.

In general, the simpler the tax rules and the more visible tax information is to the IRS, the higher the compliance. Consistent with this, the overclaim rate among EIC recipients is relatively high, in large part, because taxpayers determine their own eligibility. Similarly, noncompliance among the self-employed is relatively high because their business income is neither subject to withholding nor generally covered by information reporting.

EIC NONCOMPLIANCE

As used in connection with the EIC, noncompliance occurs when taxpayers either claim credits to which they are not entitled or claim credits in excess of the amount to which they are entitled. IRS' study of tax year 1994 EIC filers

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

showed that, of $17.2 billion in EIC claimed, $4.4 billion (25.8 percent) was overclaimed. IRS determined that, if this noncompliance rate were adjusted to reflect new enforcement efforts and procedures implemented after tax year 1994, the overall noncompliance rate would have been about 21 percent.

As we noted in our testimony, much of EIC noncompliance is rooted in taxpayers' self-determination of eligibility combined with IRS' limited ability to verify eligibility before issuing a refund. Erroneous EIC claims are frequently related to taxpayers claiming EIC-qualifying children who, in fact, do not qualify as such or to choosing the wrong filing status.[2] In both instances, IRS cannot easily verify the information on the return without using field resources to determine taxpayer eligibility in a fashion similar to that used by organizations administering welfare programs. However, IRS has taken several steps in the past few years to combat EIC noncompliance, with some resulting success. These efforts have focused primarily on identifying missing, invalid, and duplicate Social Security numbers.

NONCOMPLIANCE FROM OTHER SOURCES

The income tax gap is the difference between income taxes owed and those voluntarily paid. IRS data suggest that U.S. taxpayers voluntarily pay about 83 percent of the income taxes they owe. IRS estimates that its enforcement programs, including audits and document matching have, on average, recovered about 4 percent of all individual and corporate income taxes due, but not voluntarily paid, in any particular tax year.[3] Thus, IRS estimates that overall compliance reaches about 87 percent after IRS enforcement programs. However, because of the time consumed by these programs and by any subsequent appeals and litigation, the 87 percent compliance level cannot be reached until a number of years after the taxes were due.

As shown in table 1, the estimated gross income tax gap for tax year 1992 totaled $128 billion.[4] IRS attributed about three-fourths of the gap to individuals and one-fourth to corporations. For tax year 1992, the gross individual income tax gap primarily consisted of individuals underreporting their income on filed tax returns ($59 billion of the $95 billion estimate). Nonfilers and taxpayers overstating offsets to tax (including

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

[3]IRS' 1996 estimate for individuals noted that IRS enforcement programs recovered about $15 billion of the $95 billion gross income tax gap for 1992, leaving a net gap of $80 billion.

[4]IRS made its most recent estimate of the individual income tax gap in 1996 for tax years 1985, 1988, and 1992. IRS last updated its corporate income tax gap estimate in 1990. It included a projection for tax year 1992 that did not reflect the most recent compliance audit data for small corporations, which showed that their income tax compliance dropped from 81 percent in 1980 to 61 percent in 1987.

tax credits, deductions, and exemptions) each accounted for tax gap amounts in excess of $10 billion.

Table 1: Gross Income Tax Gap Estimates for Tax Year 1992

Tax gap component	Tax gap amount (dollars in billions)	Tax gap distribution (percent)
Individual tax gap	**$95.3**	**74.3%[c]**
Unreported income on filed returns	58.6	45.6
Overstated offsets[a]	14.4	11.2
Nonfilers	13.8	10.7
Individual remittance gap	8.4	6.5
Math errors	0.1	0.1
Corporate tax gap	**33.1**	**25.8[c]**
Large corporations	23.7	18.5
Small corporations	7.0	5.5
Other[b]	0.4	0.3
Corporate remittance gap	2.0	1.6
Total	**$128.4**	**100.0%[c]**

[a]Includes subtractions for erroneous deductions, exemptions, credits (including the EIC), and other adjustments.

[b]Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

[c]Percentages do not add to totals due to rounding.

Source: Income Tax Compliance Research, IRS Pub. 1415 (7-88); Income Tax Compliance Research, IRS Pub. 1415 (4-90); and Federal Tax Compliance Research, IRS Pub. 1415 (4-96).

Table 2 provides a more detailed breakdown of the underreporting and offset portions of the individual, gross income tax gap. Underreporting of income by the self-employed–informal suppliers and other sole proprietors–accounted for nearly $30 billion in unpaid taxes for 1992.[5] Overstated credits, including the EIC, accounted for about $6 billion of the 1992 tax gap.

[5]Informal suppliers are self-employed individuals who operate informally, on a cash basis.

Table 2: 1992 Individual Income Tax Gap by Source of Underreported Income and Overstated Offsets

Tax gap component	Gross tax gap amount (dollars in billions)	Percentage of income or offset reported correctly
Underreported income		
Informal suppliers[a]	12.3	18.6%
Other sole proprietors	16.9	67.7
Other income	7.6	75.1
Rents and royalties	3.7	82.8
Partnership and small business corporation income	3.6	92.5
Farm income	3.4	67.8
Wages and salaries	3.2	99.1
Capital gains	2.5	92.8
Pensions and annuities	1.8	96.0
Dividends	1.3	92.2
Interest	0.9	97.7
Sales of Business Property (IRS Form 4794)	0.7	72.0
Taxable unemployment	0.3	93.1
Taxable Social Security	0.2	95.8
Alimony	0.1	86.7
State tax refund	[b]	99.2
Overstated offsets		
Credits	6.2	59.8
Deductions	5.1	95.6
Exemptions	2.9	95.5
Adjustments to income	0.2	98.0
Total	$73.1[c]	

[a]Self-employed individuals who operate informally on a cash basis.

[b]Less than $0.1 billion dollars.

[c]Total does not add due to rounding.

Source: Federal Tax Compliance Research, IRS Pub. 1415 (4-96).

As with the EIC, making tax information visible to IRS is key to improving voluntary compliance. IRS data show that compliance is highest under tax withholding, a little lower without withholding but with information reporting to IRS, and much lower when neither system is in place. For example, IRS estimates that

- persons whose wages are subject to tax withholding (the most systematic method for making income visible to IRS) report 99 percent of their wages, and that

- individuals report 98 percent of their interest income and 92 percent of their dividend income, most of which is subject to tax information reporting but not tax withholding requirements.

In contrast, IRS estimates that

- sole proprietors who formally operate businesses other than farms report about 68 percent of their business income, which is neither subject to withholding nor generally covered by information reporting, and

- informal suppliers, who are even less likely to have income reported to IRS on information returns, report an estimated 19 percent of their business income.

In addition to the relative visibility of the income to tax administrators, other factors also influence the level of compliance. For example, complex tax laws lead to more noncompliance.

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We will send copies of this letter to the Chairman and Ranking Minority Member of the Committee on Ways and Means, the Chairman and Ranking Minority Member of the Senate Committee on Finance, the Secretary of the Treasury, and the Commissioner of Internal Revenue. We will also make copies available to others on request.

Deborah Parker Junod was the major contributor to this letter. If you or your staff have any questions, please contact me at (202) 512-9110.

Sincerely yours,

James R. White

James R. White
Associate Director, Tax Policy
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