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WHERE THE MONEY ISN'T

Misplaced focus of tax enforcement could be remedied by simplifying credits for children

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The Earned Income Tax Credit (EITC) has garnered praise for enhancing work incentives and helping poor families, but it has also drawn accusations that many of its claimants apply for more benefits than they are entitled to under the law. The intense focus on purported fraud in the EITC exaggerates the extent of the problem and is misplaced if the goal is more efficient recovery of unpaid income taxes. Because changes in the budget outlook over the past two years have put more of a premium on revenue recovery, heightened tax enforcement in other areas would be a more productive pursuit for the Internal Revenue Service.

One way of responding to the EITC's critics and reducing the supposed fraudulent claims for benefits would be through the adoption of an expanded, simplified refundable tax credit for families with children. One such tax credit, the Simplified Family Credit (SFC), has been proposed (Glenn 2000) as a replacement for the EITC and a set of other confusing tax benefits, specifically the dependent exemption for children and the Child Tax Credit (CTC). (See Cherry and Sawicky (2000) for a full explanation of the SFC.)

The reality of the current tax situation is that taxpayers with children confront complex rules for the definition of a "qualifying child." This complexity is compounded by the fact that three different facets of the individual income tax provide tax benefits to families solely for having children: the dependent exemption, the CTC, and the EITC.

Many families, however, do not fit the common mold in which a child related by birth resides in the home with both parents year-round. The most challenging part of filing taxes for these families is determining the benefits for which their children are eligible. In fact, *The Taxpayer Advocate* (2001) ranks this as the second most serious deficiency of tax administration. The same list ranks difficulty in determining EITC eligibility as the third most serious problem.

Eligibility determination is the source of most errors in claiming the EITC, and these errors are used to justify political demands for disproportionate enforcement efforts aimed at low-income taxpayers (Johnston 2000). Many low-income claimants use professional tax preparers, but the IRS has found that they are no less likely to commit errors in filing than those who prepare their taxes themselves (Stratton 2000).

Even after establishing whether or not a filer is qualified for a child credit, there remains the onerous task of applying for separate benefits: reading and understanding instructions, doing calculations, using look-up tables, and filling out forms. Compliance with the relevant provisions can require reference to up to 12 publications with a total of 200 pages of material dealing with child-related benefits (*Taxpayer Advocate* 2001).

To address this problem, the Secretary of the Treasury has called for the unification of eligibility criteria for tax-based benefits for children, a change that would simplify taxes for 52 million taxpayers. Such a change has also been advocated by the Joint Committee on Taxation (2001) of the U.S. Congress, the IRS *Taxpayer Advocate* (2001), and members of the Senate Finance Committee (Hamilton 2002). A ready solution is simply to combine what are now three separate, child-related benefits (the dependent exemption, the CTC, and the EITC) into the single, proposed Simplified Family Credit. Alternative proposals that would merely unify the eligibility requirements for child-related benefits, but still maintain them as three separate benefits, beg the question: What is the rationale for three separate benefits that each have the same eligibility rules?

EITC noncompliance: Who, how much, and how important?

The latest IRS study of errors associated with claims for the EITC finds a high proportion of taxpayers filing "over-claims" (IRS 2002). Such claims are commonly branded fraud, or cheating, but *there is no evidence in these studies of deliberate, criminal fraud.* All data pertain to what the IRS describes as "noncompliance." No estimates of errors or "over-claims" are able to separate the extent of deliberate fraud from unintended errors (McCubbin 2000). The errors in question are not necessarily founded on nonexistent children or false income reporting, but could be due to the wrong parent in a broken family claiming the credit for a given child. Hence, this money is still likely to be received by a low-income household with some connection to children in other low-income households (Liebman 2000).

The EITC is not the only feature of the income tax beset with confusion. The *Taxpayer Advocate* (2001) reports that "the deduction for exemptions, a benefit area affected by the Internal Revenue Code provisions for a qualifying child, ranks third on this year's list of 'most litigated' [tax] issues," but, naturally, no one calls for the elimination of exemptions merely because they present thorny problems for tax administration.

To some unknown extent, over-claims spring from failure to understand the rules described in IRS publications such as Publication 596, *Earned Income Credit* (50 pages), or *EITC: Earned Income Tax Credit 2001 Tax Professional Kit* (48 pages).

Simple logic suggests that most filers would not make a deliberate attempt to defraud the IRS by using information that can be easily and automatically verified. Mistakes are the more likely reason behind many EITC claim discrepancies, but such mistakes in filing for the EITC can be particularly costly to the taxpayer. If found guilty of "reckless or intentional disregard" of the law, a tax filer can be denied credit eligibility for two years; a subsequent offense can bring a 10-year suspension of credit eligibility (Center on Budget and Policy Priorities 2000).

It is also very much worth stressing that the number of households *not* receiving benefits for which they are eligible is comparable to the number receiving benefits for which they are not eligible (Wasow 2002). This fact only reinforces the idea the problem is the huge complexity of the tax code, not willful fraud by filers.

Who gets audited?

One controversial aspect of federal tax administration is that poor families are more likely to be audited by the IRS than are families with incomes over $100,000 (TRAC 2002; Tax Analysts 2000; Johnston 2000; Jones 2000). In fact, two-thirds of IRS audits are aimed at taxpayers claiming the EITC.

In these instances, EITC claimants receive a letter from the IRS notifying them of errors found in their returns and requesting additional documentation (Hamilton 2000). These are called “correspondence audits.” The dreaded “service center audits” entail taxpayer visits to the IRS office, with personal or business records in tow. An EITC correspondence audit is not quite the same thing as a taxpayer who is asked to bring tax records from present and past years to the IRS office, possibly accompanied by an accountant or attorney.

Some argue that the IRS devotes the bulk of its examination and audit resources to higher-income taxpayers, although the IRS has never released data that would substantiate this claim. Others argue that EITC audits are numerous because they are easy to conduct via correspondence, while the greatest weight of IRS scrutiny still falls on higher-income taxpayers. Whatever the truth of the matter, simplification of rules surrounding the EITC and other benefits for children would relieve both taxpayers and authorities of the burdens arising from misunderstandings of tax law. Elimination of these misunderstandings would free up IRS resources to be deployed more productively elsewhere.

Where the money is and isn’t

An honest zeal for tax enforcement would pursue loss of revenue due to noncompliance in areas of greatest revenue loss. Until just recently, there was an actual decrease in the scrutiny of non-EITC taxpayers (i.e., the wealthy). In 1990, for instance, over 5% of taxpayers with income over $100,000 were audited; by 2000, the proportion was down below 1% (TRAC 2002).

In September 2002, the IRS announced that it would make more concerted efforts to scrutinize higher-income taxpayers who may be concealing income in foreign accounts (Johnston 2002). This matter alone could account for $20 to $40 billion in lost revenue (Wasow 2002). The cost of EITC over-claims in 1999 was $11 billion. The IRS estimate of total unpaid taxes for 1998 was $195 billion (Herman 1998).

The availability of computerized records can reduce the need for audits. But the increased incidence of certain transactions, such as taxpayers net gains or losses from sales of financial assets, currently are not easy to track. If Congress wants the IRS to pursue noncompliance seriously and fairly, it will facilitate the collection of information on the income of proprietors and the self-employed, and on transactions in financial assets. In contrast, information on child support has already been amassed to facilitate tax enforcement in the area of tax-based benefits for families with children.

Conclusion

One dimension of simplicity is *transparency*. Is tax law clear enough for the average taxpayer to understand the tax consequences of working, marrying, or having children? With multiple, complex provisions, few taxpayers are in a position to understand such matters. The new Child Tax Credit alone entails a tax offset component, a cash refund component, and an "additional child credit" component, all of which are linked in a way that most taxpayers would find opaque. From this standpoint, simplification would allow taxpayers to make better financial decisions and participate more intelligently in public debates on tax reform.

Granted, important progress could be made without adopting the Simplified Family Credit, merely by unifying and simplifying the eligibility criteria for all three existing provisions. But such unification, albeit an improvement over the present system, would not eliminate the burden on the taxpayer of calculating allowable credits, and it would not enhance the transparency of what are now multiple, overlapping benefits.

A commitment to tax simplification is one of the most compelling reasons to consider the Simplified Family Credit. Combining tax-based benefits for children into one credit would ease compliance for the taxpayer and, at the same time, would ease the task of enforcement for the federal government. It could improve the efficiency of tax administration by reducing enforcement costs in areas that, from a revenue standpoint, are relatively unproductive. Low-income working families with children are not where the money is; they are where the money should wind up.

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