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# The American Earned Income Tax Credit and Cyberfraud

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The earned income tax credit (EITC) has been a part of the American federal income tax system since 1976. Designed originally as a mechanism to remove the extreme regressivity of the taxes imposed by the Federal Insurance Contribution Act (FICA), revenues from which fund the Social Security retirement and disability programs, the EITC has now grown into a major wealth redistribution device targeted at the working poor having one or two children. The EITC is a negative income tax that has had bipartisan political support in the United States. From 1976 to 1999 the maximum amount of the EITC has grown to $3,816 (for taxpayers with two or more children and earned income of $9,450 to $12,460). The current EITC is indexed for inflation and will continue growing each year that there is inflation.

Critics of the EITC have pointed out that the nature of the credit rewards those individuals who are willing to lie about earning income that they have not actually earned. During the 1995 filing season for the year 1994, the General Accounting Office estimates that the Internal Revenue Service (IRS) made erroneous EITC payments in the amount of $4-5 billion. Since 1995 IRS, after receiving additional enforcement appropriations and after Congress amended the law to require the use of social security numbers for children, the amount of erroneous refunds has probably declined. IRS estimates that a substantial percentage of the erroneous refunds are due to fraud.

During the 1995 filing season, IRS promoted electronic filing of returns and also supported a program where those taxpayers entitled to refunds could secure loans from banks in anticipation of the tax refund. Under the electronic filing program, refunds were typically authorized within one or two days. Where a taxpayer had secured a refund anticipation loan from a bank, IRS made an electronic fund transfer directly to the bank under a system where the electronic return directed the refund to the lending bank. The rate of electronic filing and the use of refund anticipation loans was very high for those returns claiming the EITC, much higher than other returns. The popular press reported that unscrupulous commercial return preparers combed through poor neighborhoods inducing taxpayers to file fraudulent returns. Of course, the return preparers charged very high fees for these returns and often had very low costs because they used computers, computer software, and electronic filing.

Since the 1995 filing season, IRS has discontinued the refund anticipation loan program for returns claiming the EITC. In addition, IRS has delayed issuing refunds on those returns where the EITC exceeds the amount of tax due on the return. Finally, IRS has started questioning a higher percentage of returns that have suspicious characteristics. Congress, in the meantime, changed the law to require that all taxpayers claiming the EITC based on one or two children provide the social security number of each child. The additional requirement of providing a social security number for children has improved enforcement, but only in cases where more than one individual is claiming the same child. The IRS computers now compare and cross-check social security numbers. In this way, the IRS computer identifies cases where more than one taxpayer has claimed the same child as the basis for the credit. Under the existing system, however, there is no way to make any further checks to determine the child's age or relationship to the taxpayer. As a result, it remains a common practice for unscrupulous return preparers to go through poor neighborhoods and pay individuals for the social security numbers of children who are not currently being claimed by anyone. This practice is very difficult for IRS to detect when the children are children of parents who are not working or who are members of the underground economy and not filing returns.

Unless and until computer systems change, IRS can enforce compliance in these situations only through traditional audit techniques. These audits are very expensive and often ineffectual because IRS cannot locate the taxpayer who claimed and received the refund. When a taxpayer is found and audited, the method for determining that the claimed child is a "qualifying" child under the law involves examination of birth, school, and medical records. These records are not always conclusive because the law merely requires that the child, if not related to the taxpayer, is a member of the taxpayer's household and receives over half of his or her support from the taxpayer. Birth, school, and medical records do not conclusively show this. As a result, the auditor may just have to take the taxpayer's "word" that the child meets the requirements outlined in the law.

This aspect of EITC compliance remains a problem for IRS. To at least address the cases where taxpayers erroneously, but non-fraudulently, claim the EITC, IRS has launched a major public education campaign. Unfortunately, the law remains complicated and difficult to understand. The pamphlet explaining the EITC, although written in simple language, is about thirty pages and requires close study. Because of the complexity of the EITC, many taxpayers claiming it go to commercial return preparers. Because of their experience, commercial return preparers are more likely to understand the requirements of the EITC and reduce the number of innocent mistakes. Where the return preparer is unscrupulous, the return will be fraudulent and the fraud will be difficult for IRS to detect. Most of the fraudulent returns still involve electronic filing. If IRS had better computers and a better data base, electronic filing would actually speed up anti-fraud efforts because an electronic return provides information faster and more cheaply than a paper return.

The current level of fraud remains high but unknown. Estimates are in the $500 million to $4 billion per year range. Because the maximum amount of the EITC has increased, the dollars lost to fraud may actually be increasing while the number of fraudulent returns decreases. IRS has just begun a multi-year study to measure the amount of fraud using sampling techniques. Based on the results of the study, IRS will devise new anti-fraud devices.

The United Kingdom is in the process of launching the Working Families Tax Credit (WFTC) to replace the current Family Credit. The British system will involve an application process where the claimant will fill out forms and send them to Inland Revenue to determine qualification for the WFTC. The maximum credit amount will be £4,513.60 per year—a large sum. Initially, Inland Revenue will make the payments to the claimants and verify a claimant's employment. Self-employed individuals will be eligible. As a result, these individuals will have an incentive to make-up fictional income but to not report too much because the WFTC phases out at a rate of 55p for every £1 earned in excess of £90 per week. Inland Revenue will also launch electronic filing in 1999. It is unlikely, however, that the claimants will be able to claim the WFTC through electronic filing. It will be interesting to see if Inland Revenue faces the same fraud problems that IRS has faced and whether the magnitude is comparable.

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