University of Nevada, Reno

**The Earned Income Tax Credit: An Analysis of Potential Fraud And Undesirable Behaviors**

A thesis submitted in partial fulfillment
of the requirements for the degree of

Bachelor of Science in Business Administration
Majors of Accounting and Information Systems and the Honors Program

by

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We recommend that the thesis
prepared under our supervision by

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## Abstract

The Earned Income Tax Credit (EITC) is one of the largest anti-poverty programs in the United States. Last year alone, nearly $62 billion of EITC was paid out for 2011 tax year returns (IRS 2013). The amount of total credit claimed continues to increase every year, but the rate of error (number of claims in percent of total that are filled out incorrectly) still remains constant at 21 to 26 percent (IRS 2012). This implies about 13 billion of tax credit was paid in error at the minimum for last year. Even though the credit was created based on the intention of offsetting the burden of social security taxes and providing incentives to work for low to moderate income families, deficiencies within the rules lead to tax fraud and undesirable behaviors. This thesis first examines deficiencies of EITC and some of the potential consequences through research in governmental publications and scholarly works; then provides a list of possible tax policy solutions which can assist in future law making.

**Acknowledgement**

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## Part I: Introduction

The Earned Income Tax Credit (EITC) is designed for lower income working families and individuals. It was approved in 1975 by Congress and is a refundable tax credit,  which means that the credit can generate cash refunds that exceed the taxpayer's tax liability. For the taxpayers who are eligible to claim the credit, several factors must be taken into consideration when calculating the amount of the credit. The two most important are the level of one's earned income (i.e. wages and salary income) and the number of qualifying children. As of 2012, the cutoff point for eligibility for the EITC is $45,060 ($50,270 if filing as married jointly). The maximum EITC for an individual/family with no qualifying children is $475; on the other hand, an individual/family can receive up to $5,891 if they have three or more qualifying children (IRS, 2013). The EITC is a noble idea which encourages people to get off of welfare and start working. However, it can lead to fraud and undesirable behaviors because of deficiencies within the rules and taxpayer manipulations. The purpose of this thesis is to discuss and examine some of the negative consequences of this law and to propose tax policy that improves taxpayer compliance and discourages both fraud and undesirable behaviors.

With regard to deficiencies of the rules for EITC, this thesis is divided into two main parts; one chapter discusses the issue of tax fraud while the other explains how the credit leads to undesirable behaviors. Each part is separated into several subsections. In the "Fraud" chapter, I have examined the following subjects: first, problems with reporting earned income without official tax forms including self-employment income; second, the requirements on households with undocumented aliens, how the requirements put these households in difficult situations, and possible consequences of it; third, marriage fraud, in terms of tax penalties on married couples; and fourth, the role of qualifying children in determining the amount of EITC and the unlawful activity of “borrowing” and “lending” qualifying children. As for the second part, “Undesirable Behaviors”, I provide detailed discussions on the limitations of unearned/disqualified income (i.e. investing), the marriage penalty, and the parts of the law that create a disincentive to work. While both parts concentrate on taxpayers’ behaviors, it is important to note that the first part focuses on outlawed behaviors, and the latter part deliberates uninvited activities of some taxpayers which are not prohibited by law but considered undesirable in society’s view (also known as “unintended consequences”). With a close analysis of the law, this thesis will both point out problems within the law and provide possible solutions to those problems.

By utilizing governmental publications and scholarly research, I intend to deliver results that are helpful in both future legislation/implementation and research. The findings of this thesis are important because they are relevant to lawmakers, tax professionals, and scholarly researchers as well as the general public. The results should be of interest to government officials for two reasons: first, those who write and enforce the law need to understand how their laws affect taxpayer behaviors. Second, by pointing out deficiencies within the law, law makers can modify certain rules and/or their implementation so future tax laws will be more just and rigorous. Tax professionals will also find this study helpful because it assists them in the process of identifying fraudulent clients, and it will be beneficial for them to better understand potential fraud and unethical behaviors. Academic researchers will also appreciate a broader review of the impact of the EITC. And finally, the general public will find the study valuable because taxpayers need to know the possible negative impacts of fraudulent and undesirable behaviors. Honest taxpayers would like to know if other people cheat on their taxes and would hopefully be in favor of changing the law. And the general public can react to this information by putting pressure on lawmakers and enforcers.

This thesis is not presented as empirical research; instead, it is a critical thinking study. In the research for this thesis, I have examined Title 26 of the United States Code, the Internal Revenue Code (IRC) (primarily Section 32), and used Congressional reports, IRS publications, the IRS website, and scholarly articles to help me answer my research questions. Past studies on the EITC mainly concentrated on fraud with some mentioning of the marriage penalty (which falls under undesirable behaviors). This thesis provides a more complete view of deficiencies of the EITC law, including the disincentive to work and invest, as well as a more complete discussion of the impact of the law on families with undocumented members.

## Part II: Deficiencies within the Law: Potential Fraud

In this chapter, I will explore whether the EITC induces fraudulent behaviors. I will start my discussion by providing a definition of tax fraud and outline what the repercussions are for taxpayers who are found guilty of committing tax fraud. Second, I will explain how the structure of the EITC creates an incentive for tax fraud. Then, I will provide detailed information outlining what kind of fraud can be (and has been) committed by taxpayers who wanted to increase their credit amount. And lastly, I will discuss a number of possible solutions that could be helpful in reducing both the overpayment rate[1] and fraudulent behaviors.

According to the IRS, tax fraud is defined as intentional wrongdoings on the part of taxpayers, with the specific purpose of evading a tax known or believed to be owed (IRM §25 (1)(1)(2)). Tax fraud contains two parts, a tax due/owed and an intention to commit fraud. If a taxpayer is found guilty of tax fraud, s/he must first pay the taxes that s/he did not pay originally plus interest and fines associated with it, and s/he could face a sentence to the federal prison.

Figure 1 (on next page) illustrates that the EITC has a three stage structure, which contains phase-in, plateau, and phase-out stage. In between the three stages, there are two kink points. In the phase-in stage, the more earned income a taxpayer has the more credit s/he will receive. Under this circumstance, taxpayers are more likely to stay employed and to earn more income (or report more income)

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[1] Overpayment rate in this thesis refers to the 21 to 26% error rate of EITC payment published by the IRS. It is called the overpayment rate because the fact that there is more credit given than there should be given. Thus, the IRS is "overpaying" the taxpayers.

because the higher their (reported) earned income the bigger their tax benefit will be. Once the earned income of a taxpayer reaches a certain amount, s/he will face the first kink point and the taxpayer is now in the second stage, the plateau. In this neutral territory, the amount of EITC is at its maximum and stays constant until it reaches the second kink point. The second kink point marks the start of the last stage, the phase-out stage, where the amount of EITC gradually decreases until it reaches zero. Taxpayers that are in the third stage have a disincentive to earn or report more income, because the more they earn the less tax benefit they will get.

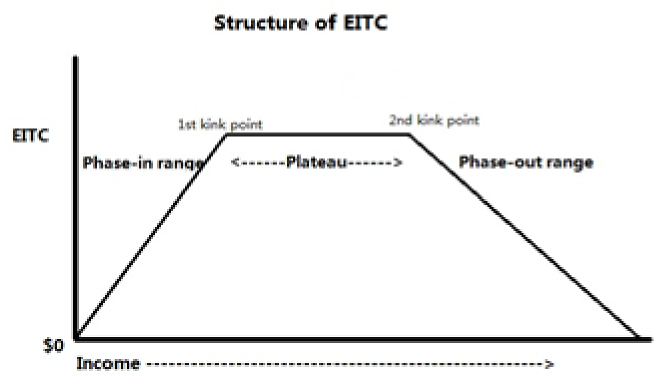


Figure 1. "Structure of the EITC"

It is also important to note that the number of dependents is more influential in determining the level (dollar amount) of the first kink point, and the amount of the second kink point is more based on taxpayer's filing status (primarily marital status). Referring to Table 1 on next page (using 2012 tax data), if taxpayers have no qualifying children, $6,200 of earned income will be their first kink point; if they have one qualifying child, the amount will be $9,300; and if they have more than two qualifying children, the amount will be $13,050. This applies to both married and unmarried taxpayers. As stated previously, the dollar amount of the second kink point depends on the taxpayer's marital status. For unmarried taxpayers with or without qualifying children, the phase-out starting point will be $17,100 or $7,800 respectively. Similarly for married taxpayers, the phase-out starts at $22,300 (with qualifying children) or $13,000 (without qualifying children).

| Filing status | Single, head of household, or qualifying widow(er) | | | | Married filing jointly | | | |
|---|---|---|---|---|---|---|---|---|
| Number of qualifying children | No children | One child | Two children | Three children | No children | One child | Two children | Three children |
| Phase-in range | $1 to $6,200 | $1 to $9,300 | $1 to $13,050 | $1 to $13,050 | $1 to $6,200 | $1 to $9,300 | $1 to $13,050 | $1 to $13,050 |
| First kink point | $6,200 | $9,300 | $13,050 | $13,050 | $6,200 | $9,300 | $13,050 | $13,050 |
| Plateau | $6,200 to $7,800 | $9,300 to $17,100 | $13,050 to $17,100 | $13,050 to $17,100 | $6,200 to $13,000 | $9,300 to $22,300 | $13,050 to $22,300 | $13,050 to $22,300 |
| Second kink point | $7,800 | $17,100 | $17,100 | $17,100 | $13,000 | $22,300 | $22,300 | $22,300 |
| Phase-out range | $7,800 to $14,000 | $17,100 to $36,950 | $17,100 to $41,950 | $17,100 to $45,100 | $13,000 to $19,200 | $22,300 to 42,150 | $22,300 to $47,200 | $22,300 to $50270 |

Table 1. “EITC parameters” *Created based on 2012’s tax law and information provided in Form 1040 Filing Instructions*

Taxable earned income, as one of the factors that determine the amount of EITC, includes wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer’s net earnings from self-employment (IRC §32(c)(2)(A)). If taxpayers’ investment income, such as interest, dividends, and capital gains, exceeds $3,200 (for the tax year of 2012), they are ineligible for the credit. This type of income is classified as unearned income or disqualified income (IRC §32(i)(2)). Example 001 illustrates how the EITC works for a family with one child using 2012’s tax rules:

*Example 001. <u>Calculating the EITC in the phase-in stage:</u> Mary and Joe are married and have one qualifying child, Sam. They have no disqualified income and are filing as married filing jointly. Their earned income is $9,350, and using the formula for the EITC, the credit is calculated as follows:*

*$9,350 X 34% = $3,169.*[2]

The example illustrates that the amount of credit is about one third of what taxpayers have earned, so they do have a large monetary incentive to earn more income. Under this circumstance, each additional dollar taxpayers earned is effectively worth $1.34.[3] Once their earned income exceeds $9,350 (first kink point), the amount of credit stays at $3,169 until their earned income reaches $22,300 (second kink point). After this point, a phase-out amount will be calculated with a percentage of 15.98 % (IRC §32 (b)(1)(A)). And to compute the final amount of EITC, the phase-out amount is subtracted from the maximum EITC credit ($3,169). This means for taxpayers that are in the third stage, each additional dollar earned is only worth about ¢84.[4]

*Example 002. <u>Calculating the EITC in the phase-out stage:</u> instead of $9,350, Mary and Joe together earned $29,800. Because their earned income in the phase-out stage, the phase-out amount is calculated as follow:*

*$29,800- $22,300 = $7,500*

*$7,500 x 15.98% = $1,198.50 (Phase-out amount)*

*And their final of EITC will be:*

[2] Phase-in percentage is from IRC §32 (b)(1)(A)
[3] Assuming that they would not be subject to any federal, state, or local income taxes.
[4] Again, assuming that there are not any other taxes levied on their income.

*\$3,169 - \$ 1,198.50 = \$1,970.50*[5]

And lastly, at the amount of $42,150 of earned income, the credit will be completely phased out (IRC §32 (b)(2)(A)). The two examples highlight that it is most beneficial to have one's earned income near or in between the two kink points. Usually taxpayers will report their income with honesty, and sometimes errors are made due to the complexity of the law, but there are taxpayers that intentionally disregard the law and manipulate their tax information so they can receive higher tax benefits (IRS, 2010). The IRS estimates that between 21 to 26 percent of the EITC is paid in error (IRS, 2010). And in 2011, the total amount of EITC is about $62 billion. This implies that at minimum, about 13 billion of EITC is wasted for 2011 alone. Other research suggests that the rate of overpayment is not as high as the IRS stated and that the majority of errors are made unintentionally due to the complexity of the tax law (Wancheck and Greenstein, 2011). Alternatively, there are also people who think billions of dollars are claimed by fraudulent taxpayers. For example, Bruce (2000) believes that at least $4.4 billion were falsely claimed for EITC payments in 1994. Both sides of this debate have their argument, but it is important to find a middle ground between the two extremes. It is true that the rules for EITC are not very simple and easy to understand; therefore, the estimated 26% error rate likely is a combination of unintentional errors and fraudulent behaviors. The amount of EITC, both individually received by each taxpayer and total amount that is distributed by the government, is increasing every year. For instance, the total amount of EITC for

[5] Phase-out percentage is from IRC §32 (b)(1)(A)

2009 was about $57.7 billion, and for 2011 the total raised to $62 billion. On average, each EITC recipient received about $2,227 in 2009 and $2,296 in 2011(IRS, 2013). The average inflation rate is -0.4% for 2009, and 1.6% for 2010 (U.S. Department of Labor, 2013). After adjustment with respect to inflation, the average individual amount of EITC should be around $2,254 for 2011. But the real average is about $40 higher, therefore, inflation might be one of the main reasons of the increase in the amount of EITC, but it is not the only reason. While the amount of credit in total and per individual taxpayer increased, the percentage of overpayment remained about constant at 21 to 26 percent (IRS, 2012). This implies that each year a larger total dollar amount of the credit is paid to people who should not receive it. In the following pages, I will identify some possible variables of fraudulent behaviors that likely have contributed to the overpayment of the credit.

## Fraud #1: Manipulations of One's Earned Income

As mentioned previously, the amount of EITC for which one is eligible is largely determined by three main factors: number of qualifying children, filing status, and the amount of earned income. Earned income is taxable income earned from working, which includes wages, salaries, gross income received as statutory employee, and net earnings from self-employment. Income from self-employment, compared to other types of income, can be manipulated most easily. This income is calculated by using Schedule C on Form 1040 and relies on the taxpayer to deduct the expenses from gross income and figure out the actual amount of net income. Manipulation of business expenses can adjust earned income. Consequently, it will affect the eligibility and the amount of the EITC a taxpayer can receive. It is the taxpayers' responsibility to report the most accurate information to the IRS, but when income is earned without an official tax related form (e.g. W-2, 1099, etc.), some taxpayers might decide to deceive. All self-employed individuals, whether eligible for the EITC or not, have incentives to "stretch the truth" a little bit with regard to tax deductions. Furthermore, there is a grey area and the line between "aggressive tax reporting" and "cheating" is not always clear. Because the IRS does not have the corresponding document (e.g. W-2, 1099, etc.), dishonest taxpayers can choose whether to report their income to the IRS or not and they can decide how much to report.[6] Essentially, the difference between a self-employed taxpayer without the EITC and one with the EITC is that the incentive (i.e., potential tax benefit) is higher for the second taxpayer. For taxpayers without EITC, each dollar not reported (or additional deduction reported) will result in a benefit of $1 x tax rate. For taxpayers with EITC, each dollar not reported (or additional deduction reported) will have different benefits, which depends on whether the taxpayer is before or after the second kink point of the EITC.

With regard to the EITC, taxpayers have incentives to either increase or decrease the amount of their reported income and/or business expenses depending on the stage in which they are (see Figure 1). For instance, a taxpayer in the phase-in stage will have an incentive to decrease his/her business expense so s/he can report a higher earned income and receive a higher tax benefit. On the other

[6] However, if these taxpayers are audited by the IRS, they have the burden of proof. There are risks related to their actions.

hand, taxpayers in the phase-out stage will have an incentive to increase their expenses so their income will be lower and they can get back to the second kink point and receive the highest benefit.[7]

Schmidt and Werner (2005) found that the earned income of EITC recipients tends to cluster near the two kink points, and this is especially true for head of household taxpayers. Even though the results of this study do not necessarily imply fraud (taxpayers intentionally adjusting their earned income so they are nearby the kink points), it does describe how taxpayers react to tax incentives. As the amount of EITC increases, the part that is being falsely claimed might also be growing, and a portion of this part might very well be manipulation of one's earned income. I will discuss some possible solutions to this problem in the end of this chapter.

## Fraud #2: Households with an Undocumented Alien

There is a difference between being eligible for and actual claiming/receiving a tax credit. A taxpayer can be eligible for a credit but may not be able to claim it because s/he fails meet the additional requirements. For the EITC, the IRS has one additional requirement that a taxpayer must provide in order to claim the credit: a valid social security number. To many taxpayers, this makes no difference since a social security number is a common thing. But there is a group of people that will struggle because of this rule, and they are households with an undocumented alien.

[7] Increasing self-employment income also could mean a higher self-employment tax if the income is higher than $400. Although EITC could still provide higher benefit, the benefit of increasing self-employment income is not as high as the benefit of increasing other income.

Undocumented aliens are immigrants without proper legal documentations. Households with undocumented alien(s) refer to families that have one or more members who are undocumented. Within these households, some members might have the legal documentations that allow them to work while others do not. The problem with respect to the EITC is that instead of Social Security Numbers (SSNs), undocumented aliens will receive Individual Taxpayer Identification Numbers (ITINs). Unlike SSNs, ITINs are issued by the IRS. And since the IRS is a federal tax agency, ITINs can be only used for federal tax reporting purposes. Taxpayers cannot use ITINs or ATINs (Adoption Taxpayer Identification Numbers) to claim the EITC, and if the taxpayer, his/her spouse, or both of them have ITINs, they are ineligible to receive the credit, even if their dependents have valid SSNs (IRC §32 (c)(1)(E)). Interestingly, the IRS does not provide justification for this rule. But one can guess a reason by referring back to the objectives behind the creation of this credit according to which the EITC is a credit that serves as an incentive for people to become and stay employed (IRS, 2012). People with ITINs are not eligible to work legally in the U.S., so the logic behind this decision might be that if people cannot work, they will not have any earned income and the EITC will not matter to them.

When households with an undocumented alien file their tax returns, they will be ineligible to receive the credit. This puts them in a difficult situation where they have to choose between telling the truth and not being eligible for the credit, or not reporting the undocumented alien to the IRS and receiving the tax benefit.

In this situation, the question becomes “does the law induce fraud for households with one or more undocumented aliens?”

If such a household chooses to file as married filing jointly, they are eligible for the credit, but unable to claim it because valid SSNs are needed. According to the IRS website, the intention behind creating the EITC is to help low to moderate income working individuals to keep more of what they have earned and to encourage people to get off welfare and to start working (George, 2011). But in the case of households with undocumented alien(s) the law gives them two hard choices. To these households, telling the truth is the right thing to do, but this also means that they will lose the credit completely. On the other hand, if they choose to file as Head of Household, and not mention the existence of undocumented alien spouses, the taxpayers would be committing fraud. And in this situation, they do have an incentive to commit fraud.

## Fraud #3: Marriage Fraud

Married taxpayers have two choices for their filing status. They can file jointly or they can file separately. There are some exceptions where an abandoned spouse or a widow/widower can file as head of household (IRC §2 (b)). Generally, married couples would receive higher tax benefits in many aspects if they pretended not to be married and both file as head of household. For some situations, this can be also true if they both file as single. This concept also applies when it comes to the EITC.

*Example 003. <u>EITC benefit of married couples vs. unmarried:</u> last year, Mary and Joe (from examples above) each earned $10,000 dollars. They have two qualifying* *children, Sam and Pam. If they file jointly, they will receive $5,236 of EITC.*[8] *If they each file as head of household and each claim one child as their dependent, they will each get $3,169*[9]*, totaling $6,338.*

Furthermore, in order for married couples to be eligible for the EITC, they must file as married filing jointly, the status of married filing separately is ineligible for the credit (IRC §32 (d)). The IRS tries to prevent possible fraudulent behaviors by limiting only one head of household per house. Although the tax code does not directly state this, the law requires head of household taxpayers to pay more than half the cost of maintaining a home for both themselves and their dependents (IRC §2 (1)(A)). Thus, there can be only one head of household per house. In addition, taxpayers who use this status must be unmarried or considered unmarried (IRC §2). Taxpayers who are circumventing these rules are committing “marriage fraud.”

Abrams (2012) noted that marriage fraud is committed largely due to the penalty some of the tax laws have put on married couples. Marriage penalty is the fact that in some circumstances married couples have to pay higher taxes or receive less tax benefits. In Example 003, there is a $1,100 difference ($5,236 vs. $6,338) in tax benefit as a penalty to taxpayers that file joint tax returns (as opposed to filing two head of household returns). In order to avoid this kind of penalty, some couples choose to get divorced at the end of a tax year and remarry

[8] The couple’s total income falls in between the plateau for their status ($13,050 to $22,300), therefore, they receive the maximum credit.

[9] For unmarried taxpayers with one qualifying child, the plateau is between $9,300 and $17,100， so the couple each receive the maximum allowed for their status, $3,169.

after they filed their tax returns. Note that if couples are getting legally divorced and legally remarried, the term marriage fraud does not apply because according to the tax law unmarried individuals cannot file jointly. However, this situation is not common because a lot of times the paperwork and fees involved would outweigh the tax benefit. The average cost of a divorce in the United States range from $15,000 to $30,000 (Hoffman, 2006) which is much larger than the average EITC amount received by taxpayers in 2011, $2,296 (IRS, 2013). Marriage fraud, under the concept of tax, applies to couples that are trying to get divorced and remarried in an illegal manner. The Supreme Court Case, Boyter vs. Commissioner of Internal Revenue (1981), is a good example of marriage fraud. The couple, in this case, was trying to avoid tax penalties by filing divorce in the end of two consecutive tax years (1975 and 1976). But the Supreme Court ruled that they were considered legally married, as residents of Maryland, because the divorces they purported (a Haitian divorce in 1975 and a Dominican Republic divorce in 1976) are invalid under the law of Maryland. Since their divorces are noncompliant with the state law, they were committing marriage fraud. While some taxpayers would choose to get an “invalid” divorce, there are also ones who just file as Head of Household without doing anything legally. And IRS has noted this matter in the Fraud section of their EITC website (IRS, 2010).

After a legal divorce, married couples would be classified as unmarried. If they are truly divorced and are moving to different households, each with at least one qualifying child, and then each claim the credit, they are not committing fraud. However, if they are using fictitious addresses and not really living apart, then they would be committing fraud. A lot of times, married couples commit marriage fraud because they believe they were treated unfairly in terms of tax benefit. Marriage penalty has been and still is a hot topic which many researchers have studied. It is often discussed in terms of dollar value, such as how much more tax married couples have to pay or how much less will married couple receive as tax benefit. From the Example 003 in the beginning of this section, there is a difference of 20 to 25 percent in the EITC benefit which is not a small amount.

### Fraud #4: "Borrowing" and "Lending" Qualifying Children

*Example 004. Impact of qualifying children on the EITC: assume Mary and Joe (from example 001, 002, and 003 above) have one qualifying child, Sam. For 2012, they have an earned income of $15,600. Another couple, Zoe and Tim, have the same amount of income but they have no children. Mary and Joe will receive $3,169[10], whereas Zoe and Time will only receive $277[11]. That is a $2,892 difference, and it is about one fifth of the couples' earned income.*

The definition of a qualifying child, as a major determinant of the amount of the EITC, can be manipulated in a number of ways. Interestingly, although both sections exist in the Tax Code, the general definition of a qualifying child in §152(c) is not exactly the same as a qualifying child for EITC purposes (§32). In general, a qualifying child must pass four tests, which are the relationship, age, residence, and the support test (IRC §152(c)). But for the EITC, the support test is replaced by the joint return test. The rules for EITC did not contain the support test

[10] The couple's total income falls in between the plateau for their status ($9,300 to $22,300), therefore, they receive the maximum credit.
[11] Figure from IRS Publication 596 (2013) Earned Income Tax Credit Table.

because Congress believed that not all taxpayers' living or family arrangements could satisfy the "qualifying child" tests (IRS, 2012). Yet, a qualifying child without meeting the constraint of a support test may invite the fraudulent behaviors of "borrowing" and "lending" qualifying children. In other words, one can claim a child as a qualifying child for EITC purposes if the child meets the following requirements:

- First, the child has to be one's descendent or descendent of one's siblings;
- Second, the child is under the age of 19, 24 if s/he is a full time student, or is permanently disabled;
- Third, the child has to live with the taxpayer for more than half of the tax year unless s/he is a student and lives on campus;
- Fourth, the child is not filing a joint return for the tax year (IRC §152(c) and §26(c)(3)(A)).

The problem with these rules is that the law does not require the taxpayer to provide any support to his/her qualifying children. In fact, the IRS website, under qualifying child for EITC, specifically states that "taxpayer is no longer required to care for a foster child, sibling, or sibling's descendant as one's own child" and "a qualifying child does not have to meet the support test." The support test requires that the child cannot provide more than half of his/her own support; else the child would be ineligible to be claimed as a qualifying child. Even though this test did not specifically state that the taxpayer who is claiming the child has to provide support, it does eliminate unwanted situations such as children support their own living and others get to earn free tax benefit on them.

The amount of EITC received between a couple with no qualifying child and a couple with one qualifying child is significantly different. Therefore, taxpayers do have significant monetary incentives to commit fraud, which in this case is to "borrow" qualifying children from others. As stated earlier, the law does not require taxpayers to give support to their qualifying children and it does not say that qualifying children cannot provide their own support. This indicates that taxpayers can "borrow" children that have the same residence as they do and receive a tax benefit. This issue can be very complex, because it involves both fraudulent behaviors and deficiencies of the law. If taxpayers manipulate their information, such as using false addresses for tax return purposes so that it looks like they live at the same place, it would be considered fraud. But if all the requirements for the qualifying child are met, the action of "borrowing" and "lending" might not be considered as fraud under legal definition because some might argue that they are fully compliant with the law. Now the issue becomes a deficiency within the law that allows fraudulent taxpayers to earn free tax benefit, and this deficiency may very well lead to possible fraudulent behaviors that will have corrupt impact on both society and the tax system.

## Possible Solutions to Fraudulent Behaviors

As elaborated above, the three determining factors of the EITC amount (amount of earned income, filing status, and number of qualifying children) can be and are manipulated by taxpayers to increase the amount of tax benefits received. In this sub-section, I am proposing some tax law and/or tax policy changes that combat this problem. For the issue of manipulation of one's earned income, a possible solution might be to increase investigation (audit rates) and punishment for taxpayers who are caught committing fraud, but this also means more spending of tax dollars. In this situation, the best solution might be to increase in publicity and provide more information on the credit. Not everyone who is eligible for the credit knows of its existence, and a good tax/credit should be transparent and visible to the public (Fiore, 2002). IRS should spend more on the part of education, so taxpayers know this credit exists, the intentions behind it, and who is eligible for it. With better publicity, more credit will go to taxpayers that are eligible, and those with fraudulent intentions will know what punishment is waiting for them if they commit fraud.

Referring to the guidelines of a good tax policy, a good tax should be just and fair (Fiore, 2002). In another word, taxpayers that have similar situations (e.g. income, filing status, etc.) should be taxed similarly. Vice versa, a good tax credit should provide the same amount of tax benefit to taxpayers of similar situations. In the case of households with an undocumented alien, the only difference between these households and other EITC recipients is that they have family members without valid social security numbers. But other than that, they are no different. They pay the same amount of tax like other taxpayers in similar positions but are held ineligible when it comes to tax benefit. One possible way to resolve this issue is to accept ITINs when it comes to determine the eligibility of claiming the credit. This way, these households can have the same tax benefits like other taxpayers. This also will decrease the potential of fraudulent behaviors.

Marriage fraud continues to occur largely because of the existent of marriage penalty. Right now, there is a large gap between the amount of tax benefit (EITC) received by a couple filing jointly and two people that file independently (single and head household). Even though this problem can probably be solved by simply removing the penalty, the gap in between should not be closed completely because it will be unfair to unmarried taxpayers. Married taxpayers usually incur less expense than two single taxpayers because they share a household. Therefore, the gap should not be close but actions should be taken to decrease the size of it. This way, fraudulent taxpayers will have less incentive to commit fraud, which will help to reduce overpayment rate and fraudulent behaviors.

"Borrowing" and "lending" qualifying children is not something that just started in recent years. In her research in 2000, McCubbin looked more into the fraud issue by examining the eligibility criteria of qualifying children and other factors that lead to noncompliance of tax law (filing status, income reporting, and complexity of law). While examining the issue with qualifying children, she pointed out that to reduce errors made unintentionally and to decrease fraudulent claims that are made intentionally, enhancement on the effectiveness of IRS enforcement is highly needed. In this situation, some might suggest to reduce overall payment of EITC. With a smaller benefit, fraudulent taxpayers will be less likely to commit fraud, but this method also hurts honest taxpayers. To provide a solution to this problem, the support test or a variation of the test should be included in the requirements of a qualifying child for EITC. Further, there should be additional requirements that involve taxpayers to give some support to their qualifying children. The requirement is different from the "support test" because it requires the one who claims the child to give support, whereas the support test only involves the child not providing too much of his/her own support.

## Part III: Deficiencies within the Law: Undesirable Behaviors

In this chapter, I will explore whether the EITC induces undesirable behaviors. Similar to the previous chapter, I will first provide a definition of undesirable behavior and explain how it is different from tax fraud. Then, I will illustrate how the rules for EITC incentivize taxpayers that behave undesirably. The different types of undesirable behaviors will be presented in details in the following sub-sections. Lastly, I will discuss some possible tax law changes and policy solutions that can help to reduce this type of behavior.

Undesirable behavior in the context of tax law refers to conducts of some taxpayers which are not prohibited by law but could negatively affect the society and economy. This kind of behavior has been described as following the letter of the law but not the spirit of the law. For taxpayers in this category, often times their intention is not to deceive, but to achieve the largest tax benefit possible without lying about their information. Undesirable behaviors are closely related to incentives and disincentives that the tax law has created.

Unlike tax fraud, taxpayers with undesirable behaviors are not dishonest. Therefore, their actions, although considered undesired by both lawmakers and society, will not be subject to legal punishment. When compared with fraud, undesirable behavior seems to be a bigger problem, because it is very hard to solve and avoid. For fraud, lawmakers usually establish punishment and the general public recognizes fraud as a crime. But for undesirable behavior, the issue becomes much more complicated. Some taxpayers might argue that as long as their actions are not violating any law, they are free to do whatever they want. Although the behavior is not illegal, it can lead to unintended consequences that could have harmful impacts which I will discuss in details in the following sub-sections.

For this chapter, limitations on unearned/disqualified income (i.e. investing), the marriage penalty, and parts of the law that creates a disincentive to work will be examined. Even though taxpayers in the following situations are not necessarily breaking the law, their behaviors points out deficiencies within the law which can lead to corrupting impacts and should be noted by lawmakers.

## Undesirable Behaviors #1: Unearned/Disqualified Income

In general, taxpayers receive no EITC if the combined amount of unearned/disqualified income for the taxable year exceeds a certain amount. This amount is adjusted every year for inflation, and for the tax year of 2012, the amount is $3,200. This type of income consists of interest income (both taxable and tax exempt), dividend income, net rent and royalty income, net capital gains, and net passive income that is not generated through self-employment (IRC §32(i)(2)). It is important to note that if the income mentioned previously is profits of self-employment, it will not be seen as disqualified income. Furthermore, taxpayers are disqualified from EITC only if their disqualified income is more than the specific amount. For disqualified income, it is an “all or nothing” rule. There is no phase-out if a taxpayer has unearned income above the threshold amount. Many rules in the tax code have phase-outs (or phase-ins) but not this one. And interestingly, the IRS or Congress does not provide a justification for not having a phase-out.

Nevertheless, the rules for the EITC have put a limitation on how much disqualified income a taxpayer can have. If a taxpayer receives unearned income above this limit, s/he will be ineligible for the credit. One of the reasons of the existence of this limit might be that the concept of disqualified income contradicts the intention of EITC. As stated earlier, EITC is a credit that encourages people to get off of welfare and stay-employed. In another word, the credit is used to promote taxpayers to earn more "earned income" through working. But disqualified income, unlike earned income, is generated without one being employed. Lawmakers might see this type of income as unwanted, especially compared to earned income. Moreover, unearned income generally has a "lower status" for many tax rules.[12] As for the dollar amount of this limit, Congress/lawmakers might assume that low to moderate income families have very little investment. Also, another reason for having this rule in place is to avoid situations where taxpayers have hundreds of thousands of dollars of unearned income, because they invest heavily, and very little earned income to receive the EITC. This would be unfair to other taxpayers because a person with such high level of income would be considered upper middle class or rich in most people's views. However, by putting a limitation on investment type income, a message is communicated to taxpayers telling them that they should not invest too much. Consequently, some taxpayers might be less likely to invest their money because they do not want to lose their EITC benefit.

This limit, in some way, is unnecessary. Generally, taxpayers fall into two categories; either they do not have much investment income or their investment surpass

[12] Examples of tax laws that view unearned income as lower-status income: "passive activity loss rule", "personal holding company tax rules", "excess net passive income tax", etc.

the limit. For those who have more disqualified income than the limit, it can seem unfair. As many of us know, investment income has an inconsistent nature, and many cannot be depended on it to support their daily expenses. It can be a one-time only occurrence, but if this occurrence leads to the disqualification of EITC, taxpayers might cease to invest. This is undesirable because less investment has a negative impact on the economy. When people have to choose between an income that is unpredictable and a tax credit that will always provide benefit to them, the second option will probably be more welcomed. Small investments such as savings account and CDs are least likely to be affected by the limit. Taxpayers who are eligible for the credit are probably less likely to invest in high-risk high growth stock because they probably cannot afford to lose their investment. Even though investors have some control over when and how much capital gains to recognize, the amount of income for this type of investment is not always controllable. Some might believe the limit on the unearned income is relatively high and difficult to exceed, with today's economic condition. So it should not be a problem. But if the complete disallowance of the EITC is tied to a certain level of investment income, taxpayers may not want to invest above this threshold. Additionally, this limit can reduce taxpayers' desire to invest; this may lead to cut-offs on investment which hurts the economy.

This should be a concern to law makers because it contradicts the concepts of general welfare. General welfare promotes investment, since it is beneficial to both individuals and the general public. The EITC serves as an incentive to taxpayers that stay-employed, and it is one of the tools which helped many families to stay above the poverty line. Investment, similar to employment, can also help these low to moderate income families to generate more income, which will improve their circumstances and strengthen the economy. While earned and unearned income are not contradicting, the limit on investment income is still necessary because there is the issue mentioned previously where a taxpayer could get the EITC when at the same time having a high level of income. That would also be undesirable. As a possible solution, instead of setting an absolute dollar limit on investment income, a percentage could be utilized in determining one's eligibility to the credit. The percentage would represent the portion of a taxpayer's total income which can be unearned. For instance, if the percentage is 15% and a taxpayer has a total income of $30,000, $4,500 would be the limit. A percentage is more unbiased than a specific dollar amount because if taxpayers have more earned income they probably will invest more. This percentage should be less than 20% to ensure EITC recipients will still spend most of their time working.

## Undesirable Behaviors #2: Marriage Penalty

Marriage penalty, as mentioned in the previous chapter, is the fact that sometimes married couples have to pay higher tax or receive less tax benefit, and the EITC can be seen as one of the tax laws where married couples are "penalized" because married couples usually receive less amount of credit than unmarried ones (single and head of household[13]). Example 005 illustrates how the rules for EITC create penalties for married couples using 2012's tax law:

[13] The amount of EITC remains the same for single, head of household, and qualifying widow(er) taxpayers, if they have same number of qualifying children and level of income.

*Example 005.*<u>*Marriage penalty:*</u> *Mary and Joe are married with two qualifying children and together they have earned income of $22,200. Zoe and Tim is another couple but they decide stay unmarried. They each earned $11,100, totaling $22,200, and they also have two qualifying children. Mary and Joe must file jointly, or else they will be ineligible to receive the credit. For them the amount of EITC benefit will be $5,236*[14]*, which is roughly 24% of their income. On the other hand, the couple that stayed unmarried, Zoe and Tim, decides to file their tax return separately and each file as Head of Household with one qualifying child. They will each receive $3,169*[15]*, and together, their total EITC benefit is $6,338.*

This example illustrates how the two couples with the same amount of total income and same number of qualifying children but with a different marital status receive a different amount of EITC. Even though Mary and Joe did the "right thing" – in the society's view (stay married and file jointly) – they are receiving less tax benefit. Thus, some people see the one thousand dollar difference between married filing jointly and two head of household as a penalty to married couples.

Furthermore, the debate on whether the rules of EITC in terms of the phase-out point are fair to married couples is also a hot topic. Referring back to the previous chapter, the phase-out point marks the start of the phase-out range. If taxpayers' earned income surpasses this point, the amount of their EITC benefit

[14] The couple's total income falls in between the plateau for their status ($13,050 to $22,300), therefore, they receive the maximum credit.

[15] For unmarried taxpayers with one qualifying child, the plateau is between $9,300 and $17,100， so the couple each receive the maximum allowed for their status, $3,169.

will start to decrease until it is completely phased out. This point is different for married and unmarried taxpayers. Even though the phase-out point for married couples is higher than for those who are not married, some believed that the point is not high enough. For the tax year of 2012, the phase-out point for married couples is at an earned income of $22,300, and for those are not married (single and head of household), it is at $17,050 (a difference of about $5,000). Some researchers see this as bias against married taxpayers. For instance, Carpenter and his colleagues (2012) believed that if the law of EITC is really fair to every taxpayer, the phase-out point for married couples should be twice as much as unmarried taxpayers. In other words, instead of $17,050, the phase-out point for married couples should be at $34,100 ($17,050 x 2). When filing tax returns, limitations are often different for single and married taxpayers, and to many taxpayers, this makes perfect sense. Married couples share a household, so their expenses would be less than the amount of two single households. This is one of the reasons of why the limitation amount for married taxpayers is not doubled. But in terms of phase-out point for EITC, I believe the limit for married taxpayers is too low, especially when compared with unmarried taxpayers. The limit should not be doubled because it would be unfair to single taxpayers; instead, it should be somewhere in between.

While there are researchers who think the penalty that has been put onto married couples might negatively affect marital stability (Carpenter et. al., 2012), others believe that getting married/divorced depends on things more than just the amount of tax benefit. Tax benefits may not have the significant effect on marriage as some researchers stated, but it may affect the timing of taxpayers to become married. For instance, some couples might choose to not get married until the beginning of next tax year. This way, they can still file as single for the current tax year and receive greater tax benefit. In the past years, Congress has made several reductions on marriage penalty. The phase-out amount for married couples was increased by $1,000 in tax years of 2002-2004, $2,000 in 2005-2007, and $3,000 after 2007 (IRC §32(b)(3)(B)). Even though some action has been taken to reduce the penalty, there is still a large gap between unmarried and married couples.

In Example 005, the couple that stays unmarried and getting higher tax benefit is not necessarily committing fraud, but it can seem unfair to the couple that stays married. In order to make the tax law more just, this issue should be noted by law makers. Marriage penalty can be found in other tax provisions, and although it is hard to be completely removed, it should be eliminated as much as possible.

## Undesirable Behaviors #3: The Phase-out Stage

The intention behind the creation of the EITC is to encourage working, but in reality, those who earn more than the phase-out point will get smaller tax benefits because they keep working and have more earned income. In the phase-out stage, the amount of EITC is gradually decreasing as taxpayers' earned income is increasing. After a certain amount of earned income, the credit will be completely phased out. Although taxpayers in this stage still have incentives to keep working (their total income is increasing), they have less after-tax income as percentage of pre-tax income compared with ones that are in the phase-in stage. In the phase-in stage, each additional dollar earned is effectively worth $1.34, because taxpayers' earned income is multiplied by 34% to calculate their final amount of EITC. On the other hand, each additional dollar earned in the phase-out range is only worth about ¢84, since there is a 15.98% phase-out percentage[16]. When taxpayers earn more than the phase-out point, s/he is getting "punished" for continuing to work (lower effective pay). Therefore, as a possible consequence, some taxpayers might stop working on, before, or near the phase-out point; that way, they will not get "penalized."

When discussing the issue of disincentive to work, it is essential to examine taxpayers' behaviors when tax benefit is taken under consideration. Schmidt and Werner (2004) have found that the earned income of EITC recipients tend to surround the two kink points, at which their EITC benefit tends to be the largest. This is an interesting situation, which is not a coincidence and does not necessarily imply fraud. The study's results have demonstrated that some taxpayers do act to achieve what is best for them; in this case it is to receive the greatest EITC benefit. This type of behavior can have negative impacts to the society since working and employment directly correlate with productivity. If people decide to stop working at a certain point because they do not want to lose their benefit or they do not want to receive a lesser benefit, this will have a negative impact on the economy as a whole.

Because the phase-in percentage (34%) is much larger than the phase-out (15.98%), many researchers believe the positive incentives of EITC outweigh the disincentive part. However, it is important to note that the phase-out range affects more people (Trampe, 2007). More taxpayers are affected by the phase-out stage because it includes bigger range of income than the phase-in and plateau. If taxpayers in the phase-

[16] Assume that in either situation the taxpayer will not be paying an income tax (or self-employment tax).

out stage want keep their current tax benefit, they have two options; one is not to report any more income, which falls into the category of fraud, and the other one is to stop working. In a way, the rules for EITC have given incentives to some taxpayers who behave undesirably.

Another possible negative consequence of the disincentive is that it can keep some taxpayers trapped into a certain range of income. Because EITC will eventually be phased out completely at a certain amount of earned income, some taxpayers may never want to surpass this amount. And this can also be true for taxpayers who want to keep the largest tax benefit. In this case, the phase-out point will be the limit for them. This is not good for both the taxpayers and to the society. To taxpayers, by staying within a range, they are not moving up. And to the society, this means slower progress.

While parts of the EITC encourage people to work, there are also parts that create a disincentive to work. The phase-out range should not be removed, because people with lower income should receive more tax benefits than ones with higher income. Instead, education seems to be the best solution. When people have to choose between continued employment and receiving a larger tax credit, it is crucial for them to understand that reaching above the threshold is not necessarily a bad thing. One dollar more, even after taxes, is still better. By doing so, they are bettering both themselves and the society as a whole. EITC should not be seen as free tax benefit, it is a promoting factor that encourages progress and help millions of families to do better.

## Part IV: Conclusion

This thesis is focused on the deficiencies of the rules for the EITC in terms of taxpayer behaviors. Two distinct types of behaviors were examined closely: fraud and undesirable behaviors. The research aimed to identify problems within the law which lead to the two types of behaviors. As primary resources, the Internal Revenue Code and Congressional Reports provided information about the intention behind the creation of this tax law, reasons for its requirements, and actions done by the Congress to implement it. This information was used as the basis for the critical thinking study. Secondary resources obtained from IRS publications, the IRS website, and academic literatures were utilized to provide a broader view of the whole picture.

Based from the examination of governmental publications and analysis of past research, I identified the parts of the law which induce both fraudulent and undesirable behaviors. Both types of behaviors often occur because the law provides incentives to do so. Besides tax incentives, sometimes certain interpretation by the taxpayers can also increase the chance of the behaviors. For example, if taxpayers believe they were treated unfairly, fraudulent and uninvited actions could be one of the outcomes.

With regards to fraudulent behaviors, my study makes several important points. First, taxpayers with self-employment income usually do not receive official tax related forms, which makes it easier for those with intention to deceive to adjust their earned income to receive the highest benefit. Second, the requirement of valid social security numbers has put families with undocumented aliens in very difficult situations. To these families, telling the truth means losing the credit completely, and hiding the existent of undocumented family members from the IRS could potentially (if discovered) result in legal punishment because it is classified as fraud. Third, marriage fraud, which in the thesis refers to pretending to get divorced and remarried but really not doing it, takes place mainly because the existence of marriage penalty. And fourth, the unlawful actions of "borrowing" and "lending" qualifying children were committed because the number of qualifying children is a major determinant of the final amount of EITC and the law does not require taxpayers to provide support to their qualifying children.

The section of undesirable behaviors described behaviors which are not classified as illegal but considered unwanted in society's view (also known as the law’s unintended consequences). Under this category, three causes and their possible consequences were identified and discussed. First is the limitation on the disqualified income, which can lead to decrease of investment activity and will hurt the economy in the long run. Second is the marriage penalty in terms of lower benefit received by married taxpayers compared to unmarried couples. And the last one is the phase-out stage which some taxpayers interpreted as being punished for continuing to work and earn more income.

With these above issues in mind, I made several suggestions with regard to policy making and to future research. Since there is a basic difference between fraudulent and undesirable behaviors, one is illegal and the other is not, suggestions on ways to decrease them have been made separately. Problems with undocumented aliens should be addressed first because it is a special case. This issue has never been discussed previously. And to resolve this, law makers may want to reconsider the requirement of valid social security numbers for claiming the EITC. The principles of good tax policy state that taxpayers with similar financial characteristics should be treated the same; treating undocumented alien differently only because they do not have social security numbers violates this principle. As for general fraudulent behaviors, policy and law makers should keep in mind that the key point to reduce (or even eliminate) such behavior is to increase publications on both the benefit of the credit and punishments associated with fraudulent actions. By publicizing the information, more credits will go to taxpayers who are eligible and it can assist in reducing the rate of fraudulent behaviors such as falsely claim of earned income, marital status, and qualifying children. In addition, actions should be taken to strengthen IRS enforcement, especially on areas associated with fraud examination and punishment.

Unlike fraud, issues with undesirable behaviors can be much more complicated because they are not punishable by law. Considerations should be taken with respect to both creating a percentage as the basis of limit on disqualified income and decreasing marriage penalty in the policy making process. Currently, most of the public and taxpayers who commit the behavior do not see or understand the corrupt impact and consequences of it. Therefore, there should be publications on how undesirable behaviors hurt both the economy and society. As for the disincentive created by the phase-out stage of the EITC, education will be the key. Through education, taxpayers can have a better understanding of the role of the credit. As stated above, the EITC is a credit which assists low to moderate income families to move up and should not be seen as free tax benefit.

During the research for the thesis, I have noticed there are very few studies on the disincentive part of the EITC. As a suggestion to future research, I believe more studies should be done on this part especially with regard to the population that actually stopped working because of EITC benefit.

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26 U.S.C. Sections 2, 26, 32, and 152.

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