

Updated April 19, 2011

## EARNED INCOME TAX CREDIT OVERPAYMENT AND ERROR ISSUES

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### Summary

The federal Earned Income Tax Credit, a tax credit for low- and moderate-income working families, has been widely hailed for its success in increasing work and lowering welfare receipt, reducing poverty, and making the tax code fairer. (See the box on page 2.) Census data indicate that the credit lifted 6.6 million individuals out of poverty in 2009, including more than 3 million children. The EITC lifts more children out of poverty than any other program.

The EITC is sometimes criticized, however, for having a high rate of overpayments. And the EITC does have a significant error rate that needs to be reduced. But in discussions of issues related to the error rate, several important points often are missed.

First, the commonly cited EITC error rate — 23 to 28 percent of EITC payments are said to represent overpayments — is likely to overstate the actual level of overpayments (although the overpayment level is clearly substantial). This is true for several reasons. First, as explained below, the 23 percent to 28 percent figure is based on IRS studies of tax data from 2001 and 2006 that suffer from some significant methodological problems. (The IRS is scheduled to complete and issue a new study of EITC overpayments in 2012, although the key methodological problem will remain.) Second, as also described below, the IRS has instituted various new enforcement actions and error-reduction techniques in the last several years that may be helping to reduce overpayments. Of particular note, the IRS has just launched a major enforcement initiative to reduce errors — including EITC errors — made on returns filed by commercial tax preparers, who now file nearly 70 percent of all tax returns claiming the EITC.

There also are further steps that Congress and the President could take. They could enact several EITC simplification proposals advanced by the Bush Administration, but never enacted, that would shrink overpayments. Simplification is key to reducing EITC errors, since the EITC's complexity is a major source of error. Congress also could devote more resources to improving tax compliance, including compliance with the EITC rules, in part by investing more heavily in state-of-the-art information technology. Progress in reducing EITC error rates will be impeded, however, if Congress cuts the IRS budget instead of bolstering it.<sup>1</sup>

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<sup>1</sup> H.R.1, the bill that the House of Representatives passed to cut \$61 billion in fiscal year 2011 funding from various federal programs and agencies, would cut the IRS budget by \$603 million.

## EITC Draws Praise Across the Political Spectrum

President Ronald Reagan proposed a major EITC expansion in 1985, and he went on to call the 1986 Tax Reform Act, which included the expansion, “the best antipoverty, the best pro-family, the best job creation measure to come out of Congress.”\*

The research bears them out. In a paper issued several years ago, Janet Holtzblatt, then an official in the Treasury’s Office of Tax Analysis and a widely recognized expert on the EITC, reviewed the research on the EITC’s impact on work and poverty. Holtzblatt reported:

Several recent studies have found that the EITC encourages work, as well as alleviates poverty.... Grogger (2003) concludes that the EITC may be the “single most important” policy parameter for explaining recent declines in welfare and increases in work and earnings among female-headed families. Meyer and Rosenbaum (2001) found that more than 60 percent of a nine percentage point increase in the employment of single mothers between 1984 and 1996 was due to expansions of the EITC. Dickert, Houser, and Scholz (1995) estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work. Eissa and Liebman (1996) find that the EITC expansion in the Tax Reform Act of 1986 significantly increased labor force participation among single mothers, especially less educated women.\*\*

Similarly, in the mid-1990s, at a time when Congress was considering proposals to cut the EITC, two of the nation’s leading conservative economists rallied to the EITC’s defense. In a 1996 Wall Street Journal column, conservative Harvard economist and then Journal contributing editor Robert J. Barro observed: “There exists a serious program in the form of the earned income tax credit that actually helps the working poor in a way that promotes work and discourages welfare. The EITC was originally a Republican idea — started by the Ford administration in 1975 and expanded by the Reagan administration during the glorious 1980s and the Bush administration in 1990. . . . Mr. Clinton’s support is not sufficient reason to regard the program as mistaken. In fact, it has a well conceived structure that ought to be retained and perhaps expanded.”\*\*\*

Similarly, in a 1996 Business Week article, Nobel laureate Gary S. Becker praised the EITC for aiding poor families without reducing employment, discouraging work, or increasing reliance on public assistance. Becker wrote that the EITC “rewards rather than penalizes poor families with working members. . . . Empirical studies confirm the prediction of economic theory that the EITC increases the labor force participation and employment of people with low wages because they need to work in order to receive this credit.” Becker also applauded the EITC for being “fully available to families with both parents present, even where only one works and the other cares for their children [i.e., for being available to low-income working families with stay-at-home mothers].”\*\*\*\*

\* The Chicago Tribune, October 23, 1986.

\*\* Janet Holtzblatt, “Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits,” 2004.

\*\*\* Robert J. Barro, “Workfare Still Beats Welfare,” Wall Street Journal, May 21, 1996.

\*\*\*\* Gary S. Becker, “How to End Welfare ‘As We Know It’ — Fast,” Business Week, June 3, 1996.

## Why Do EITC Overpayments Occur?

The IRS considers an EITC overpayment to have been made if a taxpayer whose EITC claim is selected for review does not substantiate his or her EITC claim to the IRS' satisfaction, or if the IRS specifically determines the filer was ineligible or received too large a credit. An overpayment of the EITC may occur as a result of either honest error or fraud; the majority of errors appear to be unintentional errors that often result from the EITC's complexity, especially with regard to families whose composition changes over the course of the year. IRS studies have acknowledged that the complexity of EITC rules contributes to the error rates, and analysis of IRS data by Treasury experts as well as studies by outside researchers indicate that a minority of EITC overpayments result from intentional action by tax filers.<sup>2</sup>

The EITC's complexity results in significant part from efforts by Congress to target the EITC carefully to intended recipients in order to minimize the budgetary cost. Overpayments often result from the interaction between the complexity of the EITC rules and the complexity of families' lives.

For example, where parents are divorced or separated, the EITC can be claimed only by the parent who has custody of the child for more than half of the year (provided the parent is otherwise eligible). Sometimes, however, a *non*-custodial parent may erroneously claim the EITC related to that child, especially if the non-custodial parent pays child support and thus has a perception of being eligible for the credit. This perception can be strengthened by the fact that a non-custodial parent who pays child support may be entitled, under the terms of a divorce agreement, to claim the child for the personal exemption and the Child Tax Credit. Under such a circumstance, a non-custodial parent may understandably assume that he can claim the child for the EITC as well, as he does for the other child-related tax benefits.

The EITC is rarely claimed for non-existent children; the IRS electronically screens — and automatically rejects — any tax return that includes an invalid Social Security number. Claims of fictional children thus are not a significant source of error. Rather, EITC overpayments most commonly result from misunderstanding of how to apply the EITC's intricate rules regarding who may claim a child, especially in changing family situations involving separated, divorced, or three-generation families. Errors also can result from incorrect information on a tax return about family composition or income levels.

It should be noted that tax filers who do not have a valid Social Security number are *ineligible* for the EITC. Tax filers also are barred from claiming any children for the credit who do not themselves have valid Social Security numbers. These measures bar undocumented immigrants from receiving the EITC. The databases the IRS uses in its enforcement activities, as described below, involve checking for valid Social Security numbers before EITC payments are made.

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<sup>2</sup> See Janet Holtzblatt and Janet McCubbin, "Issues Affecting Low-Income Filers," in Henry Aaron and Joel Slemrod, *The Crisis in Tax Administration*, Brookings Institution Press, November 2002; and Jeffrey Liebman, "Noncompliance and the EITC: Taxpayer Error or Taxpayer Fraud", Harvard University, November 1995.

### Refundability of EITC Not a Cause of Overpayments

There is no evidence that the refundable nature of the EITC contributes to overpayments. A 2000 study by Janet McCubbin, then a Treasury economist and now Director of Individual Tax Analysis at Treasury, found that the error rate among tax filers receiving the EITC entirely as a refund was less than one-third the error rate among tax filers for whom the EITC acted to reduce income tax liability. After conducting a sophisticated statistical analysis that took into account a variety of other factors, McCubbin found no evidence that the credit's refundable nature is related to the error rate.\* Analysis by the IRS' National Taxpayer Advocate has reached a similar conclusion.\*\*

\* Janet McCubbin, "EITC Noncompliance: The Determinants of the Misreporting of Children," *National Tax Journal*, Vol. 53, No. 4 Part 2 (December 2000), pp. 1135-1164.

\*\* Taxpayer Advocate Service, Internal Revenue Service, "The National Taxpayer Advocate's Report to Congress, FY 2009", December 31, 2009, Vol II, p. 81-85

### The Actual Level of Overpayments Is in Doubt

The Treasury estimates the EITC error rate at about 23 percent to 28 percent of EITC payments.<sup>3</sup> For several reasons, however, the actual overpayment rate is likely to be lower than this. The most recent data on EITC errors come from a sample of 2,200 EITC returns for 2006 that the IRS examined as part of its National Research Program. The IRS is currently engaged in a larger analysis of EITC claims for tax years 2006-2008, which it intends to issue next year and which will provide new estimates of EITC error rates that then will be updated each year.<sup>4</sup>

If the 23 percent to 28 percent estimate is still accurate today — and as explained below, there are reasons to believe it somewhat overstates the EITC error rate — it would represent a rate of noncompliance that, while certainly too high, is substantially lower than the noncompliance rate in a number of other parts of the tax code. For example, the IRS' most recent study of tax noncompliance generally (a study of 2001 tax returns), found that *51 percent* of rent and royalty income, *57 percent* of small business income, and *72 percent* of farm income went unreported. The IRS estimated the total cost to the federal government from such misreporting of business income at \$109 billion in 2001, or ten to fifteen times the size of estimated EITC overpayments that year.<sup>5</sup>

<sup>3</sup> TIGTA 2011-40-023 "Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year," February 7, 2011; and U.S. Department of the Treasury, "Performance and Accountability Report, FY 2010," November 15, 2010.

<sup>4</sup> The TIGTA report criticized the IRS for not currently having annual targets for EITC error reduction. The IRS has responded that it intends to set annual error-reduction targets based on its new, more comprehensive analysis and estimate of EITC errors, once that analysis is completed next year.

<sup>5</sup> These figures, which are for 2001 tax returns, represent the estimated impact of business underreporting in the *personal* income tax; they do not include underreporting or other sources of error in the *corporate* income tax. Internal Revenue Service, "Individual Income Tax Underreporting Gap Estimates, Tax Year 2001," February 2006.

## How Reliable Is the 23 Percent to 28 Percent Estimate?

Some experts who have examined IRS estimates of the EITC error rate, including the IRS' National Taxpayer Advocate, believe the estimates are compromised by methodological problems that likely cause the estimates to overstate the error rate. There are a few key concerns here.

- **The IRS studies on which the estimates are based assume that any EITC claims not documented to an IRS official's satisfaction are erroneous, but other evidence suggests such an approach significantly overstates the error rate.** The last three studies of EITC errors — those that looked at 1999, 2001, and 2006 tax returns — were based on random IRS examinations of EITC claimants. If, in the course of an examination, an EITC claimant was unable to document his or her EITC claim to the examiner's satisfaction, the claim was considered an overpayment.

That this approach likely results in an overstatement of errors has been shown by Nina Olson, the IRS' National Taxpayer Advocate. Olson's office has found that when the IRS asks for documentation to prove the validity of a filer's EITC claim, an extensive process involving numerous contacts between the IRS and the filer often is necessary to show that a claim that IRS officials initially have classified as erroneous — because it has not been documented to their satisfaction — is, in fact, valid. Many EITC recipients, however, cannot easily engage in such a process; most can't afford to hire lawyers or accountants to help them navigate an IRS examination and address all of the examiner's inquiries to the examiner's satisfaction. Olson reported that in the studies that estimate EITC overpayments, an adequate process of this nature has not been provided for claimants whose EITCs are being examined, and that this likely has resulted in incorrect judgments in many cases that EITC payments were made in error when, in fact, they were not.

As evidence for this conclusion, Olson pointed out in a report to Congress that in audits and other IRS actions where tax filers' EITC claims are questioned, "Taxpayers often obtain *completely different* [i.e., more favorable] results" than the initial IRS rulings when the taxpayers receive assistance from IRS' Taxpayer Advocate Service (which the National Taxpayer Advocate oversees) in understanding exactly what documentation the IRS is seeking and in assembling the appropriate documents. Olson reported that in *nearly half* of the cases where the IRS examiners classified an EITC claim as invalid and the filer subsequently requested and received assistance from the Taxpayer Advocate Service, the ruling that the EITC was paid in error was reversed. (Subsequent analysis has similarly found that large percentages of filers claiming the EITC who are ruled ineligible by IRS examiners are found, in fact, to be eligible when they request reconsideration of the ruling, see the appendix.)<sup>6</sup>

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<sup>6</sup> See Taxpayer Advocate Service, Internal Revenue Service, "The National Taxpayer Advocate's Report to Congress: Fiscal Year 2004 Objectives," June 30, 2003, pp. 20-21 (emphasis added), and Taxpayer Advocate Service, Internal Revenue Service, "The Nature Taxpayer Advocate's 2004 Annual Report to Congress, December 31, 2004, Vol. II, "Earned Income Tax Credit Audit Reconsideration Study," pp.1. This is not to suggest that the percentage of EITC claims ruled invalid by IRS examiners that were overturned on appeal represents the percentage of *all* EITC claims denied by examiners where the claim was indeed invalid. But these figures and related analyses by the National Taxpayer Advocate provide strong evidence that the methods used in the IRS studies from which EITC error-rate estimates are drawn almost certainly overstate the error rate.

Olson has cautioned that because IRS studies used to estimate EITC error rates do not provide for an adequate process of this nature, the IRS overpayment estimates are likely to reflect premature and incorrect judgments in a number of cases that EITC payments were made in error. In a report to Congress in 2003, Olson stated that for these reasons, she concluded that the IRS study of EITC error rates in 1999 “overstates the overclaim rate.”<sup>7</sup> (The IRS study of 1999 rates was the most recent such IRS study at the time Olson issued this report, but the subsequent studies used essentially the same approach with respect to the examination process.)

- **The error rate estimate does not account for offsetting underpayments.** The IRS study on which the 23 percent-to-28 percent estimate is based does not take into account that, in some cases where an EITC is wrongly claimed, another taxpayer may have been *rightfully* eligible for EITC but not have claimed it. Consider the case of a non-custodial parent who pays child support and mistakenly claims an EITC. If the custodial parent was eligible for the EITC but did not claim it because the non-custodial parent did (or the custodial parent’s claim was denied due to the other parent’s claim having already been paid), the IRS study would simply count the EITC the non-custodial parent received as an overpayment without netting out the EITC that the custodial parent should have received but did not. The loss to the Treasury is the net figure, not the gross figure.

## **Actions Since 2006 to Reduce EITC Overpayments**

Another reason that the 23-28 percent estimate of the error rate may be too high is that various steps have been taken since 2006 to reduce EITC errors.

On the legislative front, Congress acted in 2010 to eliminate the option for households to receive part of their EITC in their paychecks throughout the year. Studies by the Government Accountability Office (GAO) found considerable difficulty in reconciling these “advance” Earned Income Credit payments with the EITC amounts for which these households were found to qualify when they filed their tax returns. The elimination of this option should reduce the EITC error rate, although the resulting error reduction will be small because only a very modest percentage of EITC filers used the option.

- More significant are the administrative actions the IRS has taken in recent years. The IRS increasingly relies on automatic computer cross-checks to identify EITC claims that are questionable and should be subject to more intensive scrutiny. With over 80 percent of EITC claims now being filed electronically, these increasing technological capabilities enable the IRS to better identify questionable EITC claims before paying them, and the IRS has stepped up its pre-payment examination of questionable EITC claims as a consequence. In her most recent report to Congress, the National Taxpayer Advocate observes that in recent years “the IRS has taken significant steps to address many of the difficult problems historically associated with EITC compliance.”<sup>8</sup>

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<sup>7</sup> Taxpayer Advocate Service, Internal Revenue Service, “The National Taxpayer Advocate’s Report to Congress: Fiscal Year 2004 Objectives,” June 30, 2003, pp 20-21.

<sup>8</sup> Taxpayer Advocate Service, Internal Revenue Service, “The National Taxpayer Advocate’s Report to Congress: , Fiscal Year 2011 Objectives” June 30, 2010, p. 67

- The IRS reports that the amount of EITC overpayments it identified and prevented or recovered rose from \$2.6 billion in fiscal year 2006 to \$3.8 billion in fiscal year 2010.<sup>9</sup> For example, to improve its ability to identify questionable EITC claims, the IRS has developed a powerful database to help it identify cases in which an EITC claimant may be incorrectly claiming a child, and it now uses this system to identify nearly 500,000 questionable EITC claims each year that it examines before making payment. Many of these claims are denied or reduced as a consequence. This database combines data from several key sources:
  - The *Federal Case Registry*, a national database built in recent years that contains extensive information on custodial and non-custodial parent-child relationships (these data, based on child support cases, help the IRS identify cases in which a non-custodial parent is wrongfully claiming a child for the EITC); and
  - Several Social Security databases, including: *Kidlink*, a database of Social Security Administration records that contains the Social Security numbers not only of children born since 1998 but also of the children’s parents (this enables the IRS to ascertain whether an EITC claimant is the parent of the child he or she is claiming); *DM-1*, another database of Social Security numbers and Individual Taxpayer Identification Numbers, and *Numident*, which consists of Social Security Administration data that provide information from birth certificates, including parents’ names.

Each year, the IRS refines the methods it uses in applying these databases based on experience, to continuously enhance its ability to identify EITC claims likely to be erroneous.

The IRS has also substantially improved its automatic wage and earnings document matching system, and since 2006 has *more than doubled* the number of EITC returns that are subject to these matches. The number of claims subject to these matches — which are conducted *after* tax returns have been processed — reached 904,000 in 2010 and resulted in \$1.4 billion in overpayments being recovered, more than double the amount of revenue recovered as a result of such measures in 2006. (This \$1.4 billion in revenues is part of \$3.8 billion in EITC overclaims referred to above that the IRS prevented or recovered in 2010.)

Finally, as described immediately below, the IRS has launched a major new initiative to reduce errors on returns submitted by commercial tax preparers, which appear to account for a substantial majority of EITC errors.

### **New Initiative Focusing on Commercial Preparers**

This new initiative focuses on commercial tax preparers — including preparers who have submitted a significant volume of erroneous EITC claims in the past — and targets them for more intensive enforcement and education activities. Nearly 70 percent of EITC returns are filed by commercial tax preparers. There are 520,000 such preparers, and until now, they have had neither to fulfill any IRS competency requirements nor even to register as tax preparers with the IRS. The IRS believes most EITC errors occur on commercially prepared returns. Those who are

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<sup>9</sup> “Performance and Accountability Report, Fiscal Year 2010,” U.S. Department of Treasury, App. B, p. 279-280.

unscrupulous may see an opportunity for larger fees if they can inflate the tax refund that the filer receives. In addition, given the EITC's complexity, preparers who are untrained can easily make errors in preparing EITC claims.

Under the IRS initiative, paid preparers are now being required for the first time to obtain Preparer Tax Identification Numbers in order to file tax returns. This should enhance the IRS' ability to identify questionable preparers more quickly. The initiative will be substantially strengthened as the IRS issues new rules, which are now in development, for preparers to pass competency examinations and fulfill continuing professional education requirements.

The experience of IRS activities related to *volunteer* preparers participating in the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs is instructive. Unlike commercial preparers, these volunteer preparers have long been required to meet competency and continuing training requirements to ensure that they are up to date on tax rules and requirements. In addition, several years ago, the IRS developed a Quality Review Program to ensure greater accuracy in the returns prepared at volunteer tax sites, and the IRS continually reviews and improves its training materials and certification tests for volunteer preparers to better protect against errors. In 2010, an audit of IRS volunteer sites conducted by the Treasury Inspector General for Tax Administration (TIGTA) found that the volunteer sites tested achieved a 90 percent accuracy rate, a marked increase over the accuracy rate in years before the IRS instituted its Quality Review Program.<sup>10</sup> This suggests that IRS' new initiative to extend these types of activities to commercial preparers in order to reduce EITC and other errors made on commercially prepared returns ought to produce results.

This initiative will supplement other activities that the IRS has ramped up in recent years to reduce EITC errors on returns submitted by commercial preparers.<sup>11</sup> Last year, IRS visits to paid preparers who exhibited a pattern of past EITC filing errors resulted in EITC "due diligence" penalties being levied on 93 percent of the preparers visited; the dollar value and the number of the penalties increased *five times* over the prior year. Last year's effort involved 2,000 visits by IRS agents to preparers with high EITC error rates and 10,000 warning letters sent to other preparers who had submitted returns in the past where the IRS found significant errors, including errors involving the EITC, itemized deductions, and/or Schedule C income and expenses.<sup>12</sup> TIGTA has reported that *over three-quarters* of the preparers who received these EITC "due diligence" visits in fiscal year 2009 subsequently changed their behavior: over half were *not* considered noncompliant the following year, and another 20 percent no longer filed tax returns at all.

The President's fiscal year 2012 budget proposes to strengthen this initiative by increasing the "due diligence" penalties applied to preparers who submit erroneous EITC claims from \$100 per

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<sup>10</sup> TIGTA 2010-40-109, "Improvements to the Volunteer Program Are Producing Positive Results, but Further Improvements Are Needed to the Quality Assurance Process," September 3, 2010, p. 6. A subsequent TIGTA audit report issued in 2011 found a lower overall accuracy rate, but this was due to errors on issues rarely seen at volunteer sites, such as Health Savings Accounts. TIGTA reported the latest accuracy rate on EITC issues was 96 percent.

<sup>11</sup> TIGTA 2010-40-116, "Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims," September 14, 2010, p. 11.

<sup>12</sup> IRS Proposes New Registration, Testing and Continuing Education Requirements for Tax Return Preparers Not Already Subject to Oversight, IR 2010-1, January 4, 2010



### **Another Possible Error Reduction Tool?**

Congress has granted the IRS the authority to use the Federal Case Registry to identify non-custodial parents who claim the EITC and to *summarily deny* their EITC claims, using the IRS' "math error" authority. But the IRS has been unable to use this authority; it has found that the child support databases in a number of states are not sufficiently accurate and up-to-date to be used to summarily deny EITC claims. If these databases aren't up to date, they may fail to reflect recent shifts in parental custody, and their use to summarily deny EITC claims would cause the IRS to improperly reject some legitimate EITC claims. One issue that may warrant exploration is whether, if fiscal incentives were provided to states to upgrade the accuracy and timeliness of their child support databases, it might become possible to implement this authority, at least on a state-by-state basis as states meet the requisite criteria.

violation to \$500. This would bolster the initiative by providing stronger monetary incentives for preparers to be accurate in preparing returns that claim the EITC.

### **Other Efforts to Reduce EITC Errors**

In February 2011, the Office of Management and Budget announced that the Treasury Department would conduct an EITC pilot project designed to test new methods of using databases that contain verified eligibility information that is collected for other low-income programs, such as food stamps and the Temporary Assistance for Needy Families program. The pilot will examine whether matching EITC claims to such databases can identify inaccurate EITC claims before payment.

The IRS also uses other tools to address EITC overpayments. Tax filers found to have wrongly claimed the EITC both face significant monetary penalties and are *barred* from claiming the EITC in future years, unless and until they prove their eligibility for the credit by providing the IRS with a special EITC recertification form accompanied by extensive documentation of their eligibility. Tax filers must both meet this requirement and repay the EITC amounts they wrongly received, as well as paying any penalties.<sup>13</sup>

### **IRS Resource Constraints**

Despite the technological advances and new initiatives described above, the IRS does less than it could to reduce EITC errors for one basic reason — resource constraints. Most years, the IRS struggles to get its requested budget and is frequently cut back. (In 2010, the IRS even proposed to cut the funding it provides to low-income tax assistance programs in order to find money to adequately staff its toll-free information processing line.) IRS audits of EITC claims constitute a stunning *37 percent* of all IRS audits even though the EITC is claimed by only 17 percent of tax filers and the EITC dollar amounts in question often aren't large. The Treasury Inspector General for Tax Administration has urged more examinations of EITC returns, but the IRS has resisted shifting compliance resources from other tax-filing sectors to further increase the auditing of EITC claims, for good reason: as noted above, EITC overpayments represent a significantly lower rate of noncompliance than exists in various other portions of the tax code.

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<sup>13</sup> While the IRS does not have the resources to conduct a full audit of every recertification application, it subjects these taxpayers' returns to its various screening procedures to determine if there are any dubious aspects to their subsequent EITC claims.

For example, the 2001 IRS tax gap study estimated that nonfarm sole proprietors (as a group) report only 43 percent of their income. This means they don't pay taxes on the other 57 percent of their income, at a loss to the Treasury the IRS estimated at \$68 billion in 2001. This underreporting rate is considerably higher than the EITC error rate, and it flows from failure even to disclose income, as distinguished from errors that stem from such factors as the complexity of EITC rules regarding who may claim a child. The revenue loss from under-reporting of income by sole proprietors was four times greater in 2001 than the loss estimated from EITC errors.<sup>14</sup>

Moreover, IRS data indicate that the resources the IRS invests in curbing noncompliance in a number of other tax areas save greater amounts than the resources it invests in EITC enforcement. The average amount of revenue loss the IRS prevents when it conducts examinations of tax returns by EITC filers is a small fraction of the average amount saved when the IRS conducts examinations of tax returns filed by households at higher income levels. In 2010, some 37 percent of IRS examinations of tax returns involved returns claiming the EITC, while only 8 percent of examinations involved returns filed by households and businesses with incomes between \$200,000 and \$1 million. But although fewer than one-quarter as many examinations were conducted of tax returns filed by the higher-income group, those examinations saved more money for the Treasury than the examinations of EITC filers.<sup>15</sup>

This is not to suggest that the IRS should pull resources away from examining tax returns that claim the EITC; compliance with tax rules is important at all income levels. But it would not seem logical to shift resources being devoted to other areas of IRS compliance activity that provide a greater return to the Treasury in order to increase the already-high proportion of EITC examinations. To devote more compliance resources to the EITC, the IRS will need more funding from Congress for tax compliance work overall.

## **Simplification of Complex Rules Can Help Combat Error**

Simplification is essential to any strategy to shrink EITC errors. Treasury analysts have estimated that the number of tax returns either claiming the EITC in error or claiming too large an EITC fell by approximately 13 percent following implementation of a package of EITC simplification measures enacted in 2001.<sup>16</sup> Treasury followed that up by proposing additional simplifications to the EITC to reduce errors; these simplifications were included in President Bush's budgets in 2004, 2006, 2007 and 2008. Congress never acted on these proposals, but a number of them continue to have strong merit. Those proposals include the following:

- *Simplifying the rule governing how parents who are separated can claim the EITC.* Normally, married couples must file joint returns to claim the EITC, but for obvious reasons, separated parents often file their own returns. In such a case, a complex rule governs whether the custodial parent may claim the EITC if she files a separate return. For her to do so, she and her spouse must have lived apart for more than six months of the tax year, and she must have lived with

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<sup>14</sup> IRS, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," August 2007.

<sup>15</sup> Internal Revenue Service Data Book, 2010, Table 9a. Examination Coverage, p. 22.

<sup>16</sup> U.S. Department of the Treasury, "Performance and Accountability Report, Fiscal Year 2009," App. B, p. 219.

the qualifying child for more than six months of the year; this part of the rule is straightforward. But she also must be able to claim head-of-household filing status, and to do so, a parent must meet IRS' "household maintenance" test. This test is complicated, hard to apply, and poorly understood.<sup>17</sup> As a result, numerous errors result, with low-income working mothers who are separated but not yet divorced mistakenly claiming head-of-household status and the EITC.

Because low-income parents who separate may take a long time to obtain divorces or legal separations — especially if they have difficulty affording the legal expenses — such errors can continue for a number of years. The proposal the Bush Administration advanced would simplify these requirements by permitting a separated parent who lives with her child for more than six months of the year — and lives apart from her spouse for at least the final six months of the year — to claim the EITC without having to meet the complex head-of-household filing test. This simplification would lead to a significant reduction in EITC errors.

- *Allowing filers who live with a qualifying child but don't claim the child for the EITC to claim the smaller EITC for workers not raising a child.* Sometimes either of two adults who live in the same household with a child may qualify to claim the child for the EITC. This can occur, for example, when a mother, aunt, and child live together; the aunt may be eligible to claim the child for the EITC if the mother does not. If the mother does claim the EITC for the child, however, current rules prohibit the aunt from claiming the smaller EITC for very poor workers who are not raising a minor child, even if she otherwise qualifies. The Bush Treasury proposal would address this inequity by removing the disqualification that applies to the aunt in such a case. This proposal would reduce errors; under current rules, the aunt may mistakenly assume she can claim the EITC for childless workers, since she is not claiming a qualifying child for the EITC. If she claims the childless workers' EITC, however, an error is said to occur.

## The EITC's Strengths

The EITC is widely considered a highly effective program, as well as a program with very modest administrative costs. Policymakers from across the political spectrum have long saluted the EITC for its effectiveness in reducing poverty, inducing low-income parents to work, reducing reliance on welfare, and making the tax code fairer. As then-Treasury Secretary Henry M. Paulson said in 2007:

“The Earned Income Tax Credit helps Americans who work hard but need extra support to make ends meet — people who are often on the first step of the economic ladder, gaining the experience and skills to land a better job and earn a higher income in the future. . . . Our goal is not just to help people get by. Our goal is to help people get ahead.”<sup>18</sup>

Participation in the EITC among eligible taxpayers is generally high; studies indicate that the participation rate is probably in the range of 75 percent to 80 percent.<sup>19</sup> This is considerably higher

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<sup>17</sup> Among other things, the household maintenance test requires filers to show that they pay more than half of household expenses from their own income, and requires them not to count child support payments and public program benefits as part of that income even though such payments or benefits are commonly used for household expenses.

<sup>18</sup> “Paulson, IRS Launch Campaign to Help Low-Income Taxpayers Take Advantage of Tax Credit, Free Tax Help,” IRS News Release, IR-2007-24, February 1, 2007.

<sup>19</sup> IRS-2010-14, January 29, 2010; also see IRS EITC website, [www.eitc.irs.gov/central/abouteitc/](http://www.eitc.irs.gov/central/abouteitc/)

than participation in most other forms of means-tested assistance for working-poor families; for example, only about 55 percent of the people in low-income working households that qualify for food stamps actually receive them.<sup>20</sup> (Participation is high because most households eligible for the EITC need to file an annual tax return anyway, and they can claim the EITC when they file their return.)

The EITC thus is much more likely to reach its intended audience — particularly low-income working families with children — than other forms of assistance. This increases the EITC’s effectiveness both as a work incentive and as a measure that reduces poverty.

In addition, administrative costs are very low. At the federal level, despite a substantially increased enforcement effort, the IRS recently noted that EITC administrative costs remain *less than 1 percent* of total program expenditures. This is far below the comparable percentage for nearly all other major low-income benefit programs; the IRS has noted that administrative costs for social programs not delivered through the tax code can range as high as 20 percent of program expenditures.<sup>21</sup> If EITC administrative costs amounted to 20 percent of program expenditures, they would exceed \$11 billion, rather than being less than \$600 million — a very substantial difference. The large economies here in EITC operations are often overlooked.

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<sup>20</sup> U.S. Department of Agriculture, Food and Nutrition Service, “Trends in Supplemental Nutrition Assistance Program Participation Rates: 2001 to 2008,” June, 2010.

<sup>21</sup> Internal Revenue Service Report to the Treasury Inspector General for Tax Administration, June 14, 2010, p. 6.

## APPENDIX

### **Additional Evidence that the Examination Procedures Used in Studies from which the Error-Rate Estimates are Drawn Are Likely to Overstate the EITC Error Rate**

In a report sent to Congress on December 31, 2004, the National Taxpayer Advocate presented the results of a study on the accuracy of the procedures the IRS employs in conducting examinations of EITC claims. These are essentially the same procedures that the IRS uses in the studies that produce the EITC error-rate estimates.

The report to Congress stated:

“In this volume of the National Taxpayer Advocate’s 2004 Annual Report to Congress, we are releasing a study of taxpayers who sought audit reconsideration of their initial EITC audit results. The study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration. Where the taxpayer received additional EITC, he or she received, on average, 94 percent of the EITC amount claimed on the original return. Moreover, when Taxpayer Advocate Service (TAS) employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employee ....

“This study confirms what many low income taxpayer advocates have maintained for many years — that the manner in which the IRS conducts its audits of low income taxpayers impacts the audit outcomes. One can infer from the study that in many cases — 43 percent of 67,000 FY 2002 audit reconsiderations, or over 28,000 cases — taxpayers were entitled to virtually all of the EITC they claimed. That is, their original audit results did not accurately reflect their eligibility for the EITC. Rather, the audits merely show that the taxpayer flunked the IRS audit process.

“There are several aspects of this study that warrant further analysis. First, the study showed that taxpayers received dramatically better results when the Taxpayer Advocate Service contacted them by telephone to request documentation. The percentage of taxpayers who received EITC increased in direct proportion to the number of telephone contacts that TAS initiated.

“Overall, only 38 percent of taxpayers who went through the TAS-assisted audit reconsideration process but received no phone calls were awarded EITC. This percentage increased to 67 percent for taxpayers who received three or more calls. This finding suggests that the IRS needs to take a fresh look at the way it communicates with taxpayers to get the right answer in many of its programs, including the EITC.

“Second, 42 percent of the combined sample of TAS and Examination taxpayers fell into the ‘Late Response’ and ‘No Response’ categories. About 43 percent of this group had favorable outcomes from the audit reconsideration process, which is about the same as the favorable outcome rate for all taxpayers in the sample. They retained about 96 percent of the total amount of EITC they originally claimed on their returns. This finding suggests that taxpayers who do not respond are no more likely than responders to have made overclaims. Rather, non-responders seem to be deterred by the documentation process.

“It may be true that taxpayers who seek audit reconsiderations generally believe that the IRS has made a mistake and thus may be more likely than the general EITC population to obtain different results from the original audit. However, this fact does not diminish the finding that in 43 percent of audit reconsideration cases, the IRS did not make the correct determination the first time around ...”

Source: Taxpayer Advocate Service, Internal Revenue Service, The National Taxpayer Advocate’s 2004 Annual Report to Congress, December 31, 2004, Vol. II, “Earned Income Tax Credits Reconsideration Study,” pp.i-ii.