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# Verifying Incomes of All EITC Filers Would Delay Refunds, Raise Costs, Divert IRS Resources from More Effective Uses

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The fiscal year 2018 budget plan that the House Budget Committee approved in July calls for a major change in the Earned Income Tax Credit (EITC) that could adversely affect millions of low-income working families and cause serious problems for the IRS in processing tax returns. The budget would delay EITC payments each year until the IRS verifies *every EITC filer's* income.[1] This would entail the IRS corroborating the income information for 28 million tax returns each year, a massive undertaking that likely would require months of work and interfere with the IRS' ability to perform other functions, unless Congress raised IRS funding sharply.

The IRS now verifies income for filers selected for examination (i.e., for audit) because their tax returns appear questionable. Under the new proposal, that would remain the case for affluent filers. But *all* low-income filers who claim the EITC could effectively be subject to a quasi-audit, regardless of whether the IRS had reason to believe their returns were in error. Filers' EITC refunds would be withheld, potentially for months. Supplying the needed income documentation could prove especially challenging for the nearly 7 million small-business owners and other self-employed individuals who claim the EITC (see box).

## While Designed to Produce Savings, Proposal Might Do the Opposite

The IRS directs enforcement resources to areas where the return on investment is greatest — i.e., where the revenue protected or recovered is greatest per dollar of enforcement resources invested. The IRS already is greatly overstretched, however, especially since its funding has been cut by 18 percent since 2010, after adjusting for inflation (and the fiscal year 2018 House appropriations bill would shrink it further).

[1] The committee report accompanying the budget plan states that to reduce EITC errors, "This budget proposes requiring verification of income before these benefits are paid" and "using the resulting savings to eliminate marriage penalties." (See https://www.gpo.gov/fdsys/pkg/CRPT-115hrpt240/pdf/CRPT-115hrpt240.pdf.) CBPP will issue a subsequent analysis of the marriage penalty issue. Congress already has enacted several pieces of legislation since 2001 reducing marriage penalties in the EITC (and throughout the tax code), most recently in 2015. As with tax filers generally, some EITC filers face marriage penalties, while others receive marriage bonuses. Most academic research has found little or no effect of taxes on marriage rates, and evidence is lacking that the EITC has significant effects.

- Without a steep increase in the IRS budget, the new proposal would require the agency to shift resources *away* from areas with a higher return on investment; it would almost certainly compel the IRS to scale back other enforcement activities and sharply reduce audits and other compliance activities aimed at high-income households and corporate entities that are suspected of tax evasion, in order to free up resources to verify the incomes of 28 million EITC filers.

- EITC overclaims make up only 3 percent to 4 percent of the total tax gap (and 4 to 7 percent of the individual income-tax gap). And EITC audits already constitute 39 percent of all individual income tax audits the IRS conducts, but result in only 7 percent of the additional tax that audits find to be owed.[2]

Treasury estimates that every $1 devoted to tax compliance averts $6 in revenue losses.

- New mandates that require the IRS to redirect resources from existing compliance activities will necessarily lose revenue unless the return on investment from the new compliance activities is at least that high.

- But the income verification proposal has little chance of clearing that bar. The EITC amounts at stake are relatively modest; the average EITC claim is $2,483, and overclaim errors are often a few hundred dollars. Far larger sums are usually at stake in audits of questionable returns from filers with large incomes or profitable corporations.

The proposal might even increase EITC errors if the IRS had to shift resources now used for more intensive scrutiny of *questionable* EITC returns to rote verification of the income on *every* EITC return.

- That's because EITC errors involving the residence of children claimed for the EITC, or their relationship to the tax filer claiming them, are the single largest source of EITC overclaims — and are costlier and more complicated for the IRS to resolve than overclaims due to income-reporting errors. The IRS uses an array of "filters" to identify EITC claims likely to have child residency or relationship errors for further examination. (IRS' EITC compliance efforts averted or recovered $5.7 billion in EITC overclaims in 2016.[3])

- If the IRS is required to conduct income verification of every EITC return, that likely would substantially reduce the resources available for examinations of EITC claims with questionable residency or relationship information, potentially causing a net increase in EITC overpayments.

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[2] Leslie Book, David Williams, and Krista Holub, "Insights from Behavioral Economics Can Improve Administration of the EITC," September 7, 2017, http://taxprof.typepad.com/taxprof_blog/2017/09/insights-from-behavioral-economics-can-improve-admiinistration-of-the-eitc.html#. See also http://www.gao.gov/assets/680/677548.pdf.

[3] Department of the Treasury, "Agency Financial Report, Fiscal Year 2016," p. 224, https://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/Treasury%20FY2016%20AFR.pdf

In short, the proposal would save little and could even lose revenue, unless the new burdens and red tape it imposed on lower-income families deterred many eligible families from claiming the EITC (or led some of them to give up during the audit process), an all-too-real possibility. But adding to taxpayer burdens and deterring honest, eligible working-poor families from claiming a tax credit for which they qualify would not constitute sound tax policy.

## Delaying EITC Refunds for Months Would Carry High Cost for Many Low-Income Families

Research shows that many working-poor families with children catch up with, and pay back bills for, basic household expenses when their annual EITC arrives. A survey of EITC filers in 2015 found that 80 percent used their EITC refunds to pay utility or rent or mortgage bills or credit card debt, and nearly half repaid high-interest payday loans. Other research (reflected in Matthew Desmond's award-winning book *Evicted*) shows that the EITC helps many who have fallen behind on rent to avert eviction and that eviction rates fall significantly when EITC refunds arrive.

- As a result, multi-month delays in receiving the EITC would thus cause considerable hardship for large numbers — likely millions — of low-income working families.

- Such delays would almost certainly result in a rise in evictions and risk harm to substantial numbers of children.[4] The delays would place many more low-wage working families in financial jeopardy, the large majority of whom would ultimately be found to have reported their income honestly.

- These problems could be particularly acute for small-business and other self-employed filers (see box).

- Such delays also would likely lead to a return of exploitative "refund anticipation loans," in which filers essentially use part of their EITC to pay very high interest rates for loans to tide them over while waiting for their refunds.

The proposal also appears to ignore the battery of provisions to combat EITC errors and fraud enacted in late 2015 (as part of the PATH Act), which Senator Orrin Hatch called "the most robust improvements to address waste, fraud, and abuse in the tax code in nearly 20 years."

- Those provisions include a several-week delay — until after February 15 — in issuing EITC and Child Tax Credit refunds for those filing before that date, so the IRS can conduct basic document-matching (i.e., to W-2 and 1099 forms) before issuing the refunds. (The IRS also conducts this matching for all EITC and Child Tax Credit filers who file after February 15.) As a result, the IRS stopped nearly $1 billion in EITC and Child Tax Credit refunds it otherwise would have paid this filing season.

[4] This would be a particularly large problem in the first year the delays took effect, and would be a serious problem in all years for the millions of families with significant unpaid bills due to a substantial drop in their income. A large percentage of low-income families experience substantial income fluctuations from year to year.

- The House Budget Committee proposal, however, calls for imposing what would likely be *multi-month* delays — until long after February 15 — without waiting for the results of the 2015 measures, and without any pilot tests.

Nor would the proposal entail pilot-testing first.

- By contrast, in 2003-2005, the IRS conducted pilots in several locations to test the efficacy of requiring EITC claimants with children to provide, in advance, documents on the residency of the children they are claiming.

- The pilot results showed that would not be an efficient use of IRS compliance resources.

## Problems Magnified for Small-Business Owners and Other Self-Employed

To verify the income of the nearly 7 million self-employed filers and small-business filers who claim the EITC, the IRS would need to examine the net income that these filers report on their tax returns: their gross business income minus their business expenses, as reported on Schedule C, E, or F.

Mandating that the IRS verify all such income before issuing EITC refunds would likely require self-employed workers and small-business owners with modest incomes to navigate a new series of onerous paperwork requirements.

- They likely would have to include many more documents with their tax returns — documents that higher-income people with self-employment or business income do *not* have to supply.
- Moreover, it's generally difficult to attach separate documents to an electronic tax return; although more than 90 percent of EITC returns are now filed electronically, this requirement would likely force many self-employed and small-business filers to shift to slower, less accurate paper returns (which also are more costly for the IRS to process).

The proposal would affect large and growing numbers of self-employed and small-business filers, given the emergence of the "gig" economy and the growing number of workers employed outside traditional employer-employee relationships.[a]

- Substantial numbers of self-employed and small-business people have modest incomes that place them in the EITC range.
- Many more small-business owners receive the EITC than are in the top income-tax bracket.
- Adding to these concerns, many low-income self-employed workers are designated as "independent contractors" by those who engage them, and the entities or individuals engaging the workers often don't provide them with payment documentation such as a 1099. And 1099s don't have to be provided at all for payments of less than $600.

In IRS audits, self-employed filers can be asked to present logs of their business income and expenses in order to document their net income from self-employment. This undertaking, which can be highly labor intensive for both filers and the IRS, is appropriate for audits, but *not* for mass tax-return processing. Self-employed and small-business filers are not otherwise asked to attach income or expense documents, including 1099s, to their tax returns. (These filers list income and expense amounts on Schedule C. The small percentage of such filers who are selected for audit may then be required to provide such documents as part of the audit, but small-business and self-employed filers are *not* otherwise subject to such a requirement.)

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[a] The number of individuals filing tax returns reporting the operation of a nonfarm sole proprietorship increased by 34 percent from 2001 to 2014. Emilie Jackson, Adam Looney, and Shanthi Ramnath, "The Rise of Alternative Work Arrangements: Evidence and Implications for Tax Filing and Benefit Coverage," Treasury Office of Tax Analysis, January 2017, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-114.pdf.

## Proposal Overlooks Other, More Cost-Effective Ways to Reduce EITC Overpayments

President Trump's 2018 budget includes a request (also included in Obama Administration budgets) to give the IRS the authority it needs to reduce EITC errors by untrained or unscrupulous commercial preparers. Commercial preparers file close to 60 percent of all EITC returns, and the IRS has determined that the majority of EITC errors occur on those returns.

- Several years ago, the IRS launched an initiative to require preparers who lack professional credentials — the group of preparers among whom EITC errors are highest — to pass a competency examination to be certified to prepare tax returns.

- A small number of paid preparers challenged this initiative in court, arguing that the IRS lacked the necessary statutory authority to implement it. (Many other preparers supported the initiative.) In 2014, a federal court ruled in favor of the preparers who brought the suit, finding that the IRS needed authority from Congress to implement this error-reduction initiative.

- President Trump's budget requests such authority, which Congress should provide.