GUIDE TO THE ISSUES

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END ABUSE OF THE EARNED INCOME TAX CREDIT

The Earned Income Tax Credit (EITC) serves as a tax credit for low-income individuals and families. While the credit incentivizes work, significant mismanagement and erroneous claims plague the program. Congress should combat abuse of the EITC.

Quick Take

The EITC is one of the Federal Government's largest welfare assistance programs, with over 25 million households claiming the EITC in 2019 and over $60 billion in total program outlays.

The EITC accounted for $17.4 billion in improper payments or 9.9 percent of all federal improper payments in FY2018.

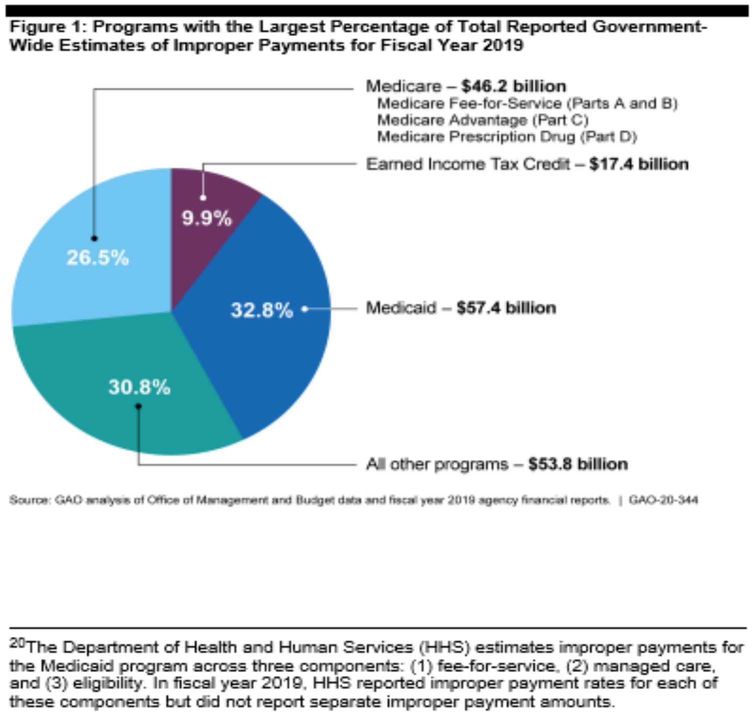
BACKGROUND

The EITC is one of the Federal Government's largest welfare assistance programs, with over 25 million households participating in 2019 and over $60 billion in total program outlays.[1] The EITC operates as a refundable tax credit given to families and individuals whose income falls below 125 percent of the federal poverty level, depending on marital status and number of children.[2]

The EITC incentivizes employment by limiting benefits to filers with earned income. For example, in tax year 2020, a single individual filing as head of household making less than $41,756 with one qualifying child could receive a credit of $3,584. With three qualifying children, the credit increases to $6,660. By comparison, a married couple filing jointly making less than $53,330 with two children could receive a credit of $5,920.[3]

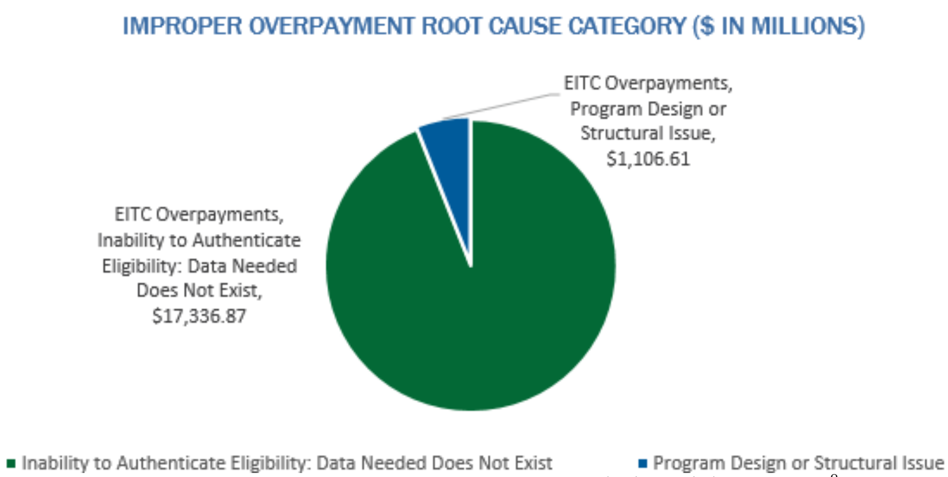
Erroneous Claims and Mismanagement

According to the Government Accountability Office (GAO), the EITC accounted for $17.4 billion in improper payments or 9.9 percent of all federal improper payments in Fiscal Year (FY) 2019.[4] GAO has consistently designated the EITC as among the highest-risk federal programs since 2003, indicating it is among the top programs "where the government can achieve the greatest return on investment for the taxpayer by ensuring that improper payments are eliminated."[5]



Source: GAO-20-344[6]

The EITC program has longstanding issues with improper payments. In its most recent analysis of EITC compliance, the Internal Revenue Service (IRS) concluded that from 2006 to 2008, at least 43 percent of all EITC claims — or 28.5 percent of the dollar value of credits paid out — were erroneous.[7] The chart below illustrates the root causes of EITC improper payments:



Source: Treasury Department FY18 Annual Financial Statement[8]

EITC claim errors mostly result from the following:

- **Misreporting -** Misreporting, the most common error, occurs in two-thirds of returns and accounts for the second highest amount of overclaimed dollars. From 2006 to 2008, half of total EITC overclaims included income misreporting. In 2015, income misreporting was a factor in roughly $9.4 billion in erroneous overclaimed EITC credits.[9]

- **Widening the Tax Gap -** The Tax Gap refers to the difference between the amount of taxes owed and the amount that taxpayers actually pay on time.[10] The Internal Revenue Service (IRS) develops estimates of the tax gap "to measure overall compliance with the current tax system,"[11] and designates three primary sources of noncompliance.[12] Underreporting accounts for the highest of the three primary sources for the estimated gross tax gap at $352 billion, according to 2019 Treasury estimates of the 2011 to 2013 timeframe. Total tax credits accounted for 17 percent of the individual income tax underreporting tax gap, of which the EITC accounted for 11 percent.[13]

- **Inadequate Income Verification -** Currently, EITC payments are issued before the IRS has complete information necessary to verify income.[14] The Protecting Americans from Tax Hikes (PATH) Act of 2015[15] requires the IRS to wait to issue a tax credit of the EITC until after February 15.[16] The Department of Treasury's 2018 annual financial report states that this bill does allow them to receive Form W-2 sooner, yet the payer information still may not be available until after the IRS filing season or even not at all.[17]

INDIVIDUAL INCOME TAX UNDERREPORTING TAX GAP ESTIMATES FOR TAX CREDITS: TY 2011 – 2013 ($ IN BILLIONS) [(1)]

Tax Return Line Items	Tax Gap	Share of Gross Tax Gap	Share of Individual Income Tax Underreporting Tax Gap
Gross Tax Gap	**$441**	**100%**	**N/A**
Individual Income Tax Underreporting Tax Gap	**$245**	**56%**	**100%**
Total Credits	**$42**	**10%**	**17%**
Child Tax Credit and Additional Child Tax Credit	$9	2%	3%
Earned Income Tax Credit	$27	6%	11%
Education Credits (Including AOTC)	$5	1%	2%
All Other Credits	$1	[(2)]	1%

[(1)] The estimates are the annual averages for the TY 2011 – 2013 timeframe.

[(2)] Less than 0.5 percent.

Note: Individual amounts may not add to total due to rounding.

Source: Treasury OIG, FY 2019 Annual Financial Statement

- **Underestimated Improper Payments Rate -** A 2018 GAO report found that the IRS removed recovered overpayments when calculating its estimated improper payments for the EITC program.[18] The IRS previously subtracted *recovered* overpayments from the EITC improper payment estimate, which understated the estimate, misrepresented the efficacy of the program's management, and limited the ability to prevent improper payments. To remedy this, GAO recommended the IRS revise its methodology to include recovered payments in its estimate for EITC improper payments, in accordance with OMB guidance.[19] Although the IRS concurred and the recommendation is considered closed, the total amount of EITC improper payments must be considered a conservative estimate.

- **Qualifying Child Errors -** Claims where a child failed to meet the program's residency test accounted for 30 percent of overclaim errors between 2006 and 2008. These errors resulted in at least $7.2 billion in improper payments and account for "by far" the most dollars of overclaims.[20,21] The relationship test represents the second-highest qualifying child error, with over 3 percent of erroneously claimed children.[22]

    - Each qualifying child must reside with the beneficiary for at least six months of the year and be younger than 19 or younger than 24 and a full-time student.[23] Currently, there is no requirement to demonstrate that the beneficiary is financially responsible for the child and no opportunity to officially document or verify the six-month residency requirement.

- The following list of relatives are eligible to file for EITC benefits: [24]

  - Married couples;
  - Single parents with legal custody;
  - Parents without legal custody;
  - Stepparents;
  - Other adult relatives such as a child's grandparent, aunt, uncle, and other siblings and/or stepsiblings.

CONSTITUTIONAL AUTHORITY AND REPUBLICAN PRINCIPLES

Congress has the authority to lay and collect taxes, including the determination of individuals that may be exempt from paying taxes.[25] Congress also has the authority to address these issues as a matter of general welfare with many families living in poverty in the United States.[26]

Welfare programs are most effective to empower individuals and confer dignity to beneficiaries when they support intact families and incentivize work.

POLICY SOLUTIONS

Congress should introduce legislation requiring the IRS to fully verify income before issuing any refundable EITC payment. Legislation should require individuals claiming self-employment income to provide a Form 1099 or be a licensed small business and provide invoices of payments received.[27]

Congress should also block residency fraud by limiting eligibility to parents with legal custody, adoptive parent(s), legal guardian(s), or foster parent(s). Adult relatives, stepsiblings, and non-custodial unmarried parents without direct financial or legal responsibility for a child should not receive the EITC.

Please contact Cameron Smith or Kelsey Wall with the Republican Policy Committee at (202) 225-4921 with any questions.

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[1] EITC Fast Facts, taken from the December 2019 Calendar Year Report, *Earned Income Tax Credit and Other Refundable Credits with the Internal Revenue Service* (Feb. 21, 2020), https://www.eitc.irs.gov/partner-toolkit/basic-marketing-communication-materials/eitc-fast-facts/eitc-fast-facts.

[2] Overview of EITC, *Earned Income Tax Credit and Other Refundable Credits with the Internal Revenue Service* (Dec. 14, 2018), https://www.eitc.irs.gov/eitc-central/eitc-information-for-press/overview-of-eitc/overview-of-eitc.

[3] *2020 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, Internal Revenue Service (Feb. 21, 2020), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts.

[4] Government Accountability Office, GAO-20-344, *Payment Integrity: Federal Agencies' Estimates of FY 2019 Improper Payments* (March 2020), https://www.gao.gov/assets/710/705016.pdf

[5] Report to Congressional Committees, *HIGH-RISK SERIES Substantial Efforts Needed to Achieve Greater Progress on High-Risk Areas* (Mar. 2019), https://www.gao.gov/assets/700/697245.pdf.

[6] *Supra* at 4.

[7] Kara Leibel, *Taxpayer Compliance and Sources of Error for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (March 2014), Internal Revenue Service, https://www.irs.gov/pub/irs-soi/15rpeitctaxpayercompliancetechpaper.pdf.

[8] *Annual Agency Financial Report FY2018*, Department of the Treasury, pg. 196 (2018), https://home.treasury.gov/system/files/236/AFR_Full%20111518_clean_508.pdf.

[9] Jamie Hall, Robert Rector, *Reforming the Earned Income Tax Credit and Additional Child Tax Credit to End Waste, Fraud, and Abuse and Strengthen Marriage*, The Heritage Foundation (Nov. 16, 2016), pg. 6, 9, https://www.heritage.org/welfare/report/reforming-the-earned-income-tax-credit-and-additional-child-tax-credit-end-waste.

[10] Annual Agency Financial Report FY2019, Department of the Treasury, pg. 151 https://home.treasury.gov/system/files/236/Treasury-FY-2019-AFR-Final-111519-508-FINALrevised.pdf

[11] *Id.*

[12] Annual Agency Report FY2019 at 151 and 152. According to Treasury's annual report, the three primary sources from 2011 to 2013 are: 1) *Non-filing tax gap,* or the tax not paid on time by those who do not file required returns on time (estimated $39 billion); 2) *Underreporting tax gap,* or the net understatement of tax on timely filed returns (estimated $352 billion); and 3) *Underpayment tax gap,* or the amount of tax reported on timely-filed returns that is not paid on time (estimated $50 billion).

[13] Annual Agency Financial Report FY19 at 154.

[14] Ag*ency Financial Report FY2015*, Department of the Treasury, pg. 204 (Nov. 16, 2015), https://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/AFR%20FY15%20FINAL%20508.pdf.

[15] Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, div. Q.

[16] *PATH Act Tax Related Provisions*, Internal Revenue Service (Jun. 28, 2019). https://www.irs.gov/newsroom/path-act-tax-related-provisions.

[17] Treasury, *supra,* note 8, at 197.

[18] *Improper Payments: Actions and Guidance Could Help Address Issues and Inconsistencies in Estimation* Processes (GAO-18-377), Government Accountability Office (May 31, 2018), https://www.gao.gov/products/GAO-18-377.

[19] *Id.*

[20] Leibel, *supra,* note 7, at iv.

[21] Additionally, in their updated Annual Financial Report for FY2019, the Treasury Department states that "'qualifying child' errors account for the most significant EITC overclaims in terms of dollars; failure to meet" eligibility requirements in "the 'residency test' and the 'relationship test' are the two primary factors that result in these overclaims." Annual Agency Financial Report FY2019, Department of the Treasury, pg. 199, https://home.treasury.gov/system/files/236/Treasury-FY-2019-AFR-Final-111519-508-FINALrevised.pdf

[22] Leibel, *supra,* note 7, at 39.

[23] *Qualifying Child Rules*, Internal Revenue Service (Jul. 10, 2019), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/qualifying-child-rules.

[24] Hall, *supra,* note 9, at 11.

[25] U.S. Const. art. 1, § 8.

[26] *Id.*

[27] Hall, *supra,* note 9, at 10.