1. Complexity of EITC Rules Accounts for Many EITC Errors

The EITC is one of the most complex elements of the tax code that individual taxpayers face. The IRS instructions for the credit are nearly twice as long as the 13 pages of instructions for the Alternative Minimum Tax, which is widely viewed as difficult. The EITC's complexity results in significant part from efforts by Congress to target the credit to families in need and thereby minimize its budgetary cost.

EITC overpayments often result from the interaction between the complexity of the EITC rules and the complexity of families' lives. **The Treasury Department estimates that 70 percent of EITC improper payments stem from issues related to the EITC's residency and relationship requirements,** which are complex; filing status issues, which can arise when married couples file (often following a separation) as singles or heads of households; and other issues related to who can claim a child in non-traditional family arrangements. *(Department of the Treasury, Agency Financial Report (AFR), fiscal year 2014, p. 198; http://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/508%20FY%2014%20AFR%20FINAL.pdf.)*

For example, where parents are divorced or separated, only the parent who has custody of the child for more than half of the year can claim the EITC. Sometimes a *non*-custodial parent may erroneously claim the EITC related to that child, especially if he pays child support and thus has a perception of being eligible for the credit. For example, 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; he may understandably but incorrectly assume that he can claim the child for the EITC as well.

In addition, families' living arrangements can be complicated, with working grandparents or aunts and uncles living with working parents and their children. More than one working adult in such families may potentially qualify to claim a given child for the EITC. Neither they nor, in too many cases, their tax preparers may fully understand the complex rules that determine who is entitled to claim the EITC in such circumstances. Mistakes can result.

IRS studies note that the complexity of EITC rules contributes to the error rate. Analysis of IRS data by Treasury experts and studies by outside researchers suggest that **most EITC overpayments do not result from intentional action by tax filers**.
(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.)

2. Actual Overpayment Rate Is Likely Lower Than IRS Estimate

The IRS estimates an EITC improper payment rate of about 22 percent to 26 percent for fiscal year 2015. This estimate is derived from a study based on IRS audits of a sample of tax returns for tax year 2011. If, in the course of the audit, a claimant was unable to document his or her claim to the examiner's satisfaction, the claim was considered an overpayment.
Evidence suggests that this approach overstates the error rate. Most EITC recipients cannot afford to hire lawyers or accountants to help them navigate an IRS audit, and many have trouble documenting their claim to the examiner's satisfaction. **The IRS National Taxpayer Advocate, Nina Olson, has reported that in over 40 percent of the cases where IRS examiners classified an EITC claim as invalid but the filer later received assistance from the Taxpayer Advocate Service (a component of the IRS that the National Taxpayer Advocate oversees) in appealing the ruling, the ruling was reversed.**

Many of the EITC claimants in the recent IRS study (and most filers whom the IRS audits) did not have this assistance. Olson has testified that because the IRS studies used to estimate EITC error rates do not provide for a process of this nature, their overpayment estimates are likely overstated.

Olson also has noted that when confronted with this process, "low-income taxpayers have considerable difficulty documenting relationship and residence because of a lack of clarity from the IRS as well as their present circumstances." She has criticized the IRS for "inconsistency as to what documents the IRS will accept (a document may be accepted in one office, but not in another) and inflexibility in accepting proof (i.e., a failure to accept other types of documents where the taxpayer cannot provide standard documentation)."

Two other cautions apply to the IRS estimate. First, its improper payment rate does not include significant areas of likely *under*payments. For example, if a non-custodial father claims an EITC mistakenly, the father's EITC counts as an overpayment, but the amount that the mother was eligible to claim but didn't is not taken into account. In such cases, the actual loss to the Treasury is the net amount — specifically, the EITC that the father received minus the EITC that the mother qualified for but did not receive — rather than the gross amount that the IRS study counts. (Tracking down the amount that the other parent was eligible to receive in such circumstances was beyond the scope of the IRS study, so the study wasn't able to produce a net loss calculation.)

Second, the IRS study does not fully reflect the impact of several new enforcement measures that the IRS has implemented since 2010 (see below).

3. Error Rate is LOWER for the Refundable Portion of the EITC Filers

It is also worth noting that the EITC's "refundability" (the fact that tax filers whose credit exceeds their federal income tax liability receive the difference in the form of a refund) is not the driver of overpayments. If it were, one would expect overpayments to be more common for EITCs claimed as refunds than for EITCs that simply lower the filer's income tax liability. A sophisticated analysis by a senior Treasury economist found, however, that the overpayment rate was lower for EITCs claimed as refunds. The National Taxpayer Advocate independently reached a similar conclusion.
(See: 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.; and Taxpayer Advocate Service, Internal Revenue Service, "The National Taxpayer Advocate's Report to Congress, FY 2009," December 31, 2009, Vol. II, p. 81.)

4. Recent Congressional Action Aims at Reducing Key Sources of EITC Overpayments

At the end of 2015, Congress enacted legislation that included a set of "program integrity" measures designed to improve compliance in claims for refundable credits. Two in particular will strengthen compliance in the EITC:

- **Improved matching of earnings statements.** This new provision requires forms W-2, and Form 1099-MISC, to be filed with IRS on or before January 31 by employers and payors. EITC and ACTC refunds will be held until February 15 to provide time for the IRS to review and match the income statements provided by both filers and employers. The provision is effective for the 2017 tax filing season.
- **Increased the penalty on paid tax preparers who engage in willful or reckless conduct.** The penalty is now the greater of $5,000 or 75 percent of the preparer's income from the return. 60 percent of EITC returns are filed by commercial tax preparers. The IRS launched an initiative in 2010, requiring preparers to register and pass a competency exam, which held promise of lowering EITC error rates. However, the DC Circuit Court upheld a challenge by several preparers that IRS lacked the statutory authority to implement these regulations, so this promising initiative has largely been halted. Before Court action halted the program, IRS had begun offering the competency exam, which about 80,000 return preparers took. About 25 percent of them failed the exam.

5. **IRS Actions Since 2010 to Reduce EITC Overpayments**
    - 90 percent of EITC claims are now filed electronically, better enabling IRS to identify questionable EITC claims before paying them.
    - A powerful IRS database identifies questionable EITC claims for children, targeting nearly 500,000 claims annually for examination.
    - The value of EITC overpayments prevented or recovered rose from $2.6 billion in fiscal year 2006 to almost $3.5 billion in fiscal year 2014.
    - The IRS established a new Preparer Tax Identification Number (PTIN) registry, allowing it to more accurately track returns filed by about 400,000 unenrolled preparers. Such preparers previously could use various Social Security numbers or employer identification numbers when signing returns, making it difficult for IRS to assemble information on preparers attempting to avoid scrutiny.
    - In 2014, the IRS identified 18,000 preparers with high error rates in the EITC claims they filed. It carried out a range of "real time" interventions with these preparers before and during the 2014 filing season, including educational visits by IRS agents. This preparer strategy averted an estimated $550 million in erroneous EITC and Child Tax Credit claims, according to the IRS. Even so, the larger and most important part of the initiative to improve accuracy by preparers has been sidelined by the court ruling.
    - The IRS has successfully implemented the EITC paid preparer due diligence program, strengthened by Congress in 2011. In 2013, over 700,000 EITC returns filed by paid preparers failed to include the required Form 8867 due diligence checklist — about five percent of all EITC claims. But by 2015, only 4,200 of the more than 13 million EITC claims submitted by paid preparers failed to include the checklist.

It is vital to reduce EITC overpayments. It should also be noted, however, that the noncompliance rate is lower for the EITC than various other parts of the tax code. An IRS study found that *56 percent* of business income that was supposed to be reported on individual tax returns went unreported in 2006, costing $122 billion in uncollected revenues. That was about ten times the estimated EITC overpayments that year. *(These figures, which are for 2006 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, "Tax Gap for Tax Year 2006: Overview," January 6, 2012, http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf.)*