Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

Q. How does the federal tax system affect low-income households?

A. Most low-income households do not pay federal income taxes, typically because they owe no tax (as their income is lower than the standard deduction) or because tax credits offset the tax they would owe. Some receive substantial rebates via refundable tax credits. However, nearly all low-income workers are subject to the payroll tax.

WHAT FEDERAL TAX RATES DO LOW-INCOME HOUSEHOLDS PAY?

Low-income households typically pay some federal tax. The largest tax burden for households in the bottom income quintile (the bottom fifth) tends to come from the payroll tax, followed by excise taxes and a small amount of corporate tax. The average federal tax burden tends to be much lower for low-income households than for high-income households.

The Urban-Brookings Tax Policy Center estimates that in 2020, households in the lowest income quintile have a *negative* average income tax rate as a result of refundable credits—namely the earned income tax credit (EITC) and the child tax credit (CTC). That is, the payments the lowest-income households receive from refundable credits exceed any income tax they owe.

In contrast, the average payroll tax rate for households in the lowest income quintile is 6.9 percent (the same as the 6.9 percent average rate for all households). The payroll tax is by far the most significant federal tax for households in the lowest income quintile, in terms of how much they pay.

Of course, low-income households pay federal excise taxes on specific products, including cigarettes, alcohol, and gasoline. Low-income households also indirectly pay some corporate income tax, to the extent that corporations pass tax burdens back to workers' wages.

WHAT SHARE OF LOW-INCOME HOUSEHOLDS OWE FEDERAL INCOME OR PAYROLL TAX?

About 12 percent of households in the bottom income quintile will pay federal income tax in 2020. In contrast, 64 percent of households in the lowest income quintile will owe payroll taxes. Combined, 65 percent of households in the lowest income quintile will owe federal income or payroll taxes.

In many cases, low-income households owe no income tax. All households can claim a standard deduction to reduce their taxable income, and many families with children can offset income taxes with the child tax credit. In 2020, the standard deduction is $24,800 for married couples, $18,650 for single parents, and $12,400 for singles. Prior to the Tax Cuts and Jobs Act, families could also reduce the amount of income they owed tax on by a per-person exemption. The TJCA reduced the personal exemption to $0. Households with

How does the federal tax system affect low-income households?

income above the standard deduction often still do not owe federal income because they can claim child tax credits, which can offset up to $2,000 of taxes for each child under 17 and $500 for other dependents, including older children.

WHY DO LOW-INCOME HOUSEHOLDS FACE NEGATIVE AVERAGE FEDERAL INCOME TAX RATES?

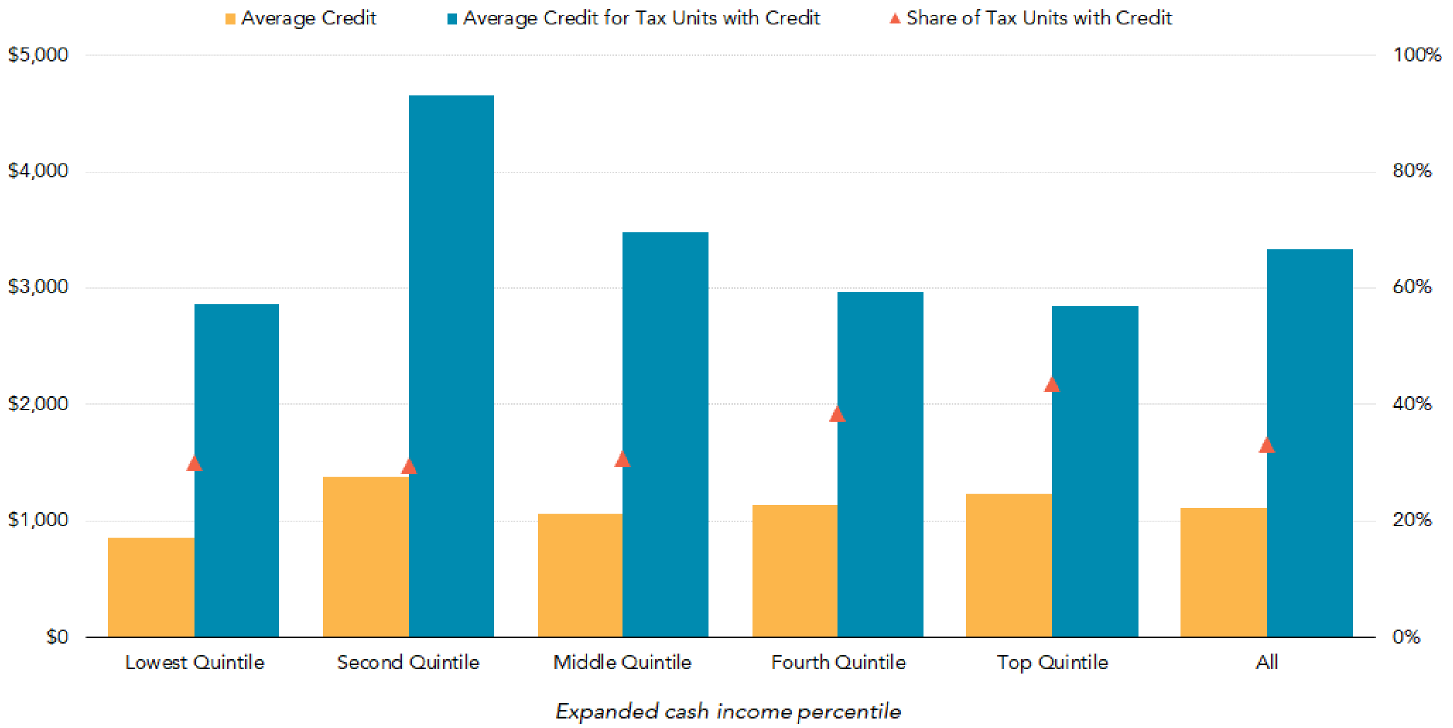
Households can have negative federal income tax rates if they receive refundable tax credits. The EITC is a refundable credit that subsidizes earnings, particularly for workers with children. The CTC provides workers with children a credit of up to $2,000 per child under age 17, up to $1,400 of which can be received as a refund. Together, these credits deliver substantial assistance to low-income families with children. (A small EITC is also available to childless workers.) If refundable credits exceed taxes owed, households receive the excess as a payment. The net refunds created by these credits show up as negative average tax rates.

The Tax Policy Center estimates that in 2020, the CTC and the EITC together will average $860 for households in the lowest income quintile. About 30 percent of households in the lowest quintile will receive one or both refundable credits (figure 1).

FIGURE 1

Distribution of Child Tax Credit and Earned Income Tax Credit

2020



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0319-2).

Key Elements of the U.S. Tax System

TAXES AND THE POOR

How does the federal tax system affect low-income households?

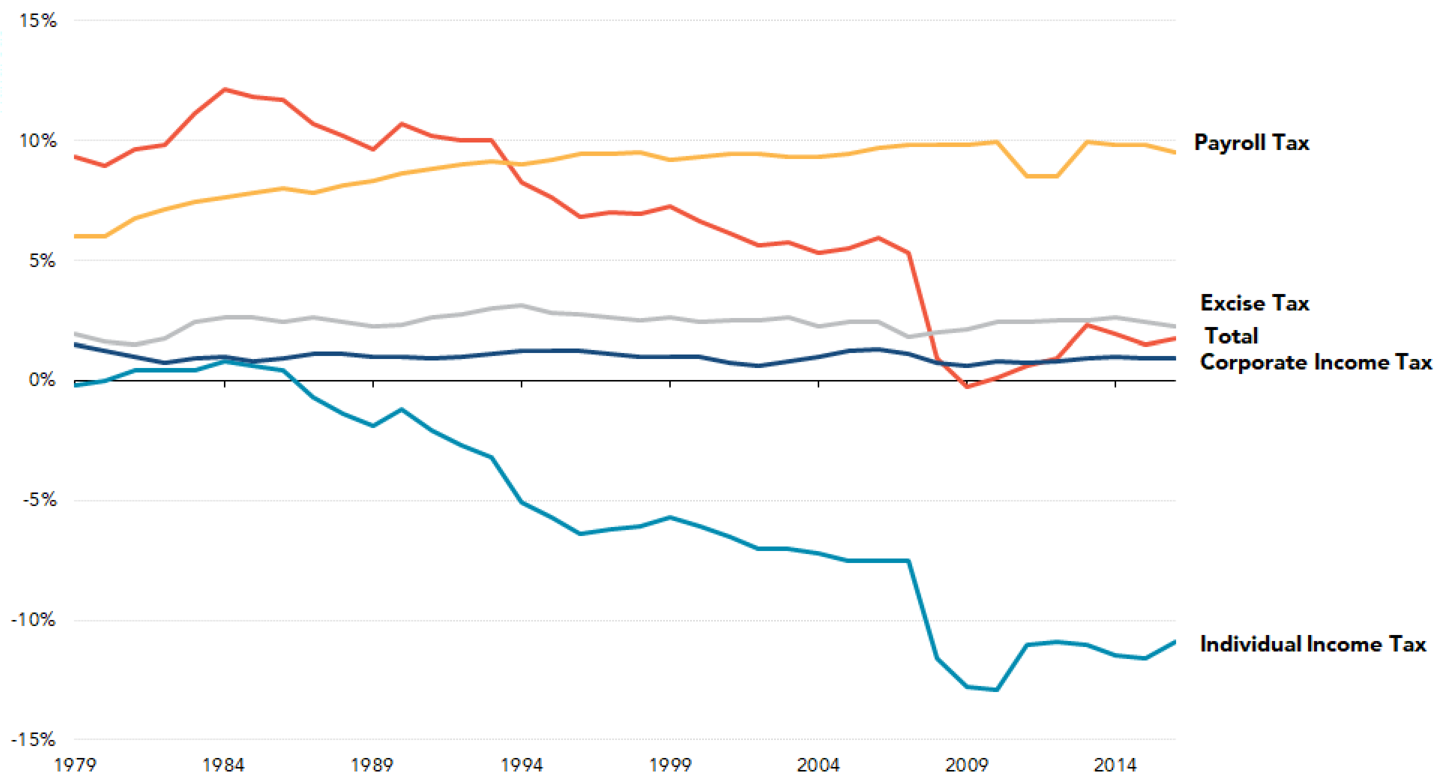
HOW HAVE EFFECTIVE TAX RATES FOR LOW-INCOME HOUSEHOLDS CHANGED OVER TIME?

Average tax rates for low-income households have changed markedly over the past quarter-century. Creation of the CTC and expansion of the EITC both lowered the effective individual income tax rate for low-income households from about 0.5 percent in the early 1980s to its negative value today (figure 2). In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over the same period (setting aside the temporary payroll tax reduction in 2011 and 2012). The effective corporate income tax rate borne by low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.

FIGURE 2

Average Federal Tax Rates

Lowest quintile of households, 1979–2016



Source: Congressional Budget Office (2019).

Updated May 2020

How does the federal tax system affect low-income households?

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0319-2."

———. Table T20-0103. "Distribution of Federal Payroll and Income Taxes by Expanded Cash Income Percentile, 2020."

Further Reading

Berube, Alan. 2006. "The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s." Washington, DC: Brookings Institution.

Burman, Leonard E., Jeff Rohaly, and Elaine Maag. 2005. "Tax Credits to Help Low-Income Families Pay for Child Care." Tax Policy Issues and Options Brief 14. Washington, DC: Urban-Brookings Tax Policy Center.

Congressional Budget Office. 2019. "The Distribution of Household Income and Federal Taxes, 2016." Washington, DC: Congressional Budget Office.

Gale, William G., J. Mark Iwry, and Peter Orszag. 2005. "Making the Tax System Work for Low-Income Savers: The Saver's Credit." Tax Policy Issues and Options Brief 13. Washington, DC: Urban-Brookings Tax Policy Center.

Hamersma, Sarah. 2005. "The Work Opportunity and Welfare-to-Work Tax Credits." Tax Policy Issues and Options Brief 15. Washington, DC: Urban-Brookings Tax Policy Center.

Maag, Elaine. 2006. "Analyzing Recent State Tax Policy Choices Affecting Low-Income Working Families: The Recession and Beyond." Perspectives on Low-Income Working Families Brief 3. Washington, DC: Urban Institute.

Maag, Elaine, and Deborah Kobes. 2003. "Tax Burden on Poor Families Has Declined over Time." *Tax Notes*. February 3.

Q. What is the difference between refundable and nonrefundable tax credits?

A. Taxpayers subtract both refundable and nonrefundable credits from the taxes they owe. If a refundable credit exceeds the amount of taxes owed, the difference is paid as a refund. If a nonrefundable credit exceeds the amount of taxes owed, the excess is lost.

REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The maximum value of a nonrefundable tax credit is capped at a taxpayer's tax liability. In contrast, taxpayers receive the full value of their refundable tax credits. The amount of a refundable tax credit that exceeds tax liability is refunded to taxpayers.

Most tax credits are nonrefundable. Notable exceptions include the fully refundable earned income tax credit (EITC), the premium tax credit for health insurance (PTC), the refundable portion of the child tax credit (CTC) known as the additional child tax credit (ACTC), and the partially refundable American opportunity tax credit (AOTC) for higher education. With the EITC, PTC, and ACTC, taxpayers calculate the value of these credits and receive the credit first as an offset to taxes owed, with any remainder paid out as a refund. With the AOTC, if the credit fully offsets taxes owed, 40 percent of the remainder can be paid out as a refund.

BUDGET TREATMENT OF REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The federal budget distinguishes between the portion of a tax credit that offsets tax liability and the portion that is refundable, classifying the latter as an outlay. Most of the EITC—an estimated $65.6 billion of the 2019 total of $68.3 billion—was refunded. Much less of the child tax credit ($40.1 billion out of $115 billion) was refunded (figure 1). The 2017 Tax Cuts and Jobs Act substantially changed the child tax credit for 2018 through 2025, including doubling the maximum credit to $2,000 per child under age 17 while limiting the maximum refund to $1,400 (this amount will increase with inflation up to $2,000.) The TCJA also created a nonrefundable credit worth $500 per dependent not qualifying for the full $2,000 credit. Before this change, expenditures on the child tax credit totaled $54.3 billion, with just over half delivered as refunds. In FY2019, expenditures from the CTC totaled an estimated $115 billion; of which 35 percent was refundable.

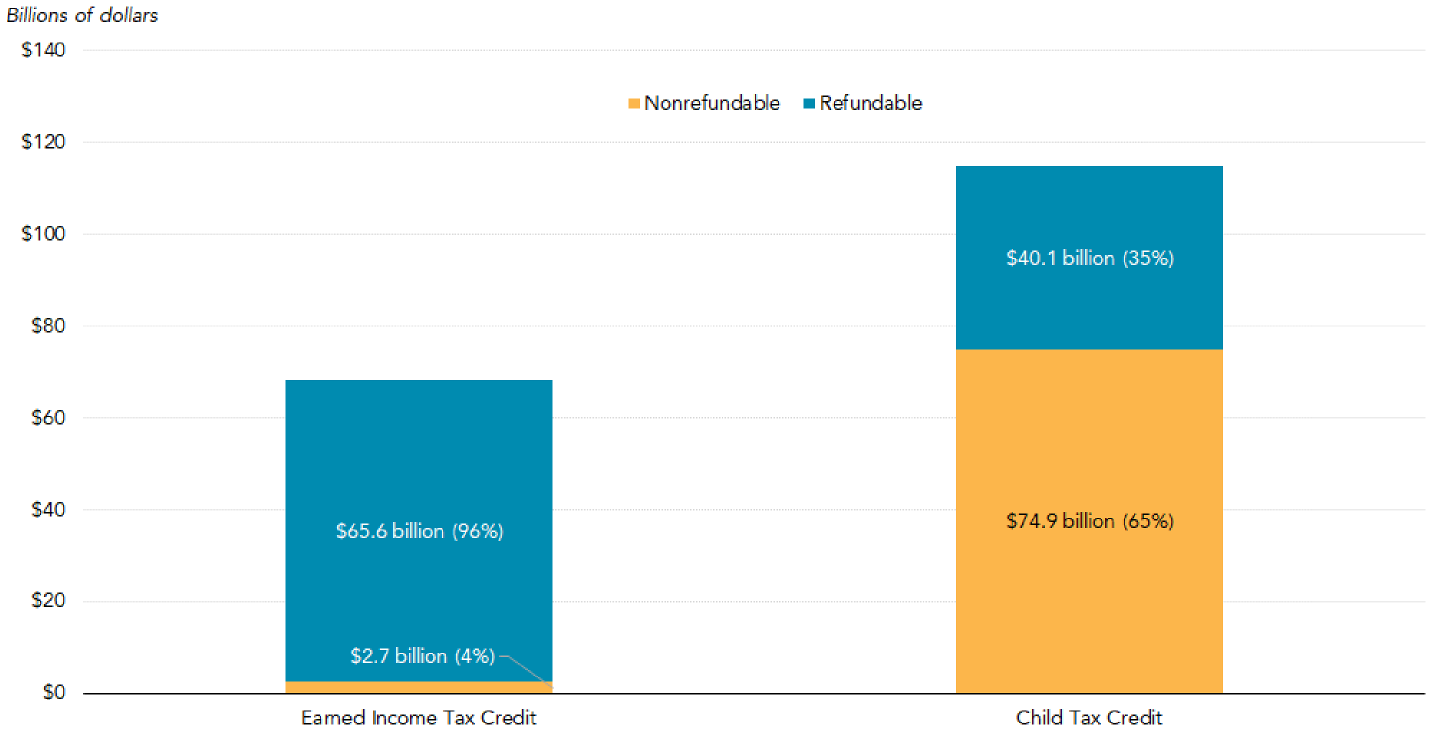
Key Elements of the U.S. Tax System

What is the difference between refundable and nonrefundable tax credits?

FIGURE 1

Earned Income Tax Credit and the Child Tax Credit

Refundable and nonrefundable shares, fiscal year 2019



Source: Office of Management and Budget. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2021: Tax Expenditures.* Table 13–1. "Estimates of Total Income Tax Expenditures for Fiscal Years 2019–2029."

ADVANTAGES AND DISADVANTAGES OF REFUNDABLE CREDITS

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. This is especially true for the EITC and the CTC: if the credits were not refundable, low-income households most in need of assistance would not benefit from them. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits, for their part, raise a host of objections:

- The tax system should collect taxes, not redistribute income.
- The government should not use the tax system to carry out social policies.
- Everyone should pay some tax as a responsibility of citizenship.
- Refundable credits increase administrative and compliance costs, and encourage fraud.

What is the difference between refundable and nonrefundable tax credits?

Updated May 2020

Data Sources

Office of Management and Budget. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2021: Tax Expenditures.* Table 13–1. "Estimates of Total Income Tax Expenditures for Fiscal Years 2019–2029."

Further Reading

Batchelder, Lily L., Fred T. Goldberg, and Peter R. Orszag. 2006. "Efficiency and Tax Incentives: The Case for Refundable Tax Credits." *Stanford Law Review* 59 (23): 2006.

Sammartino, Frank, Eric Toder, and Elaine Maag. 2002. "Providing Federal Assistance for Low-Income Families through the Tax System." Washington, DC: Urban-Brookings Tax Policy Center.

Can poor families benefit from the child tax credit?

Q. Can poor families benefit from the child tax credit?

A. Yes. Low-income families can receive a refundable child tax credit equal to 15 percent of earnings above $2,500, up to a maximum credit of $1,400.

HOW THE CHILD TAX CREDIT WORKS

Taxpayers can claim a child tax credit of up to $2,000 per child under age 17. The credit is reduced by 5 percent of adjusted gross income over $200,000 for single parents ($400,000 for married couples). If the credit exceeds taxes owed, taxpayers can receive up to $1,400 of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The ACTC is limited to 15 percent of earnings above $2,500. For other dependents, including children ages 17–18 and full-time college students ages 19–24, the CTC provides a nonrefundable credit of up to $500.

Families of nearly all incomes benefit from the CTC. In 2020, the largest average benefits (about $2,940) will go to families in the middle-income quintiles. Families in the lowest income quintile receive the smallest average credit ($1,320) because many have earnings too low to qualify for the full $2,000 credit, and instead receive some of their CTC as a refundable credit, which is limited to $1,400 per child under 17. The average credit value for families in the highest income quintile is about $2,140. Families in this income range can have their credits limited by its phasing out, which begins at $200,000 for single parents and $400,000 for married couples (figure 1).

Neither the credit amount nor the phaseout point is indexed for inflation. Over time, the value of the credit will decline in real terms and as incomes grow, more people will be subject to the credit's phaseout. The $1,400 limit on the refundable credit, however, is indexed for inflation after 2018 until it reaches $2,000—the full value of the regular credit. The credit grows in $100 increments. As of 2020, inflation had not been high enough to push the refundable portion of the credit to $1,500.

Updated May 2020

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0319-2."

Further Reading

Center on Budget and Policy Priorities. 2019. "Policy Basics: The Child Tax Credit." Washington, DC: Center on Budget and Policy Priorities.

Can poor families benefit from the child tax credit?

Maag, Elaine. 2019. "Shifting Child Tax Benefits in the TCJA Left Most Families About the Same." Low-Income Working Families Research Report. Washington, DC: Urban Institute.

Maag, Elaine. 2015. "Reforming the Child Tax Credit: How Different Proposals Change Who Benefits." Low Income Working Families brief. Washington, DC: Urban Institute.

Maag, Elaine. 2013. "Child-Related Benefits in the Federal Income Tax." Low-Income Working Families Brief 27. Washington, DC: Urban Institute.

Maag, Elaine, and Lydia Austin. 2014. "Implications for Changing the Child Tax Credit Refundability Threshold." Tax Notes. July 24.

Maag, Elaine, Stephanie Rennane, and C. Eugene Steuerle. 2011. "A Reference Manual for Child Tax Benefits." Discussion Paper 32. Washington, DC: Urban-Brookings Tax Policy Center.

Why do low-income families use tax preparers?

Q. Why do low-income families use tax preparers?

A. Many low-income families owe no income tax but still must file a tax return to receive refundable tax credits, including the earned income tax credit. Those who do file often seek help, which nearly always comes from a paid preparer. The cost of that help erodes the net value of refundable credits. That cost might be worth bearing if preparers helped their clients claim tax benefits that otherwise might be missed, but many don't.

TAX PREPARATION FOR LOW-INCOME FAMILIES

Most people fill out their tax returns with assistance from paid preparers. In 2010, 56.8 percent of all returns were completed this way. That proportion is slightly lower for lower-income families: 54.5 percent for returns with adjusted gross incomes below $30,000 (table 1). A very small proportion of low-income families reported using Volunteer Income Tax Assistance clinics.

TABLE 1

Tax Preparation Method

By adjusted gross income, 2010

AGI (thousands of dollars)	Tax returns (millions)	Tax Preparation Method				
		No identified preparer	Paid preparer	IRS prepared	Volunteer income tax assistance	Tax counseling for the elderly
Under 30	65.7	41.8%	54.5%	0.2%	1.7%	1.7%
30–50	25.6	42.3%	55.7%	0.1%	0.9%	1.0%
50–100	30.7	40.9%	58.2%	0.0%	0.4%	0.5%
Over 100	18.2	36.6%	63.2%	0.0%	0.1%	0.1%
Total	142.8	40.9%	56.8%	0.1%	1.0%	1.1%

Source: Tax Policy Center tabulations of 2010 Statistics of Income Public Use File.

Why do low-income families use tax preparers?

DO PAID PREPARERS FILL OUT MORE ACCURATE RETURNS?

Except in a handful of states, paid preparers are not regulated. The Government Accountability Office found that returns completed by preparers were not more accurate than self-prepared returns and included errors in calculating a tax filer's earned income tax credit (EITC)—a problem specific to low- and moderate-income families.

In a small sampling performed by the Government Accountability Office, only 2 of 19 returns showed the correct refund amount. On 13 tax returns in the sample, preparers overestimated the total refund by $100 or more (McTigue 2014). A larger-scale study of Internal Revenue Service (IRS) data showed that paid preparers had a higher estimated error rate—60 percent—than returns prepared by taxpayers themselves. Some of these errors are made by the preparer; some are the result of the taxpayer providing incorrect or incomplete information (McTigue 2014).

When it comes to returns with the EITC, a recent study showed that unenrolled return preparers were more likely to make errors than other paid preparers. An unenrolled return preparer is someone other than an attorney, a CPA, or an enrolled agent—agents licensed by the IRS. Unenrolled preparers completed 43 percent of the EITC returns made by paid preparers, while national tax preparation firms completed 35 percent of these returns (IRS 2014).

One clear benefit of paid preparation: an earlier study showed that if low-income workers already know about the EITC, they are more likely to receive it if they use a paid preparer than if they fill out their returns themselves (Maag 2005). Moreover, some preparers not only inform their low-income clients of their EITC eligibility, but further help them by identifying other forms of assistance for which they might qualify. Some even assist in the application process.

USE OF REFUND ANTICIPATION LOANS AND REFUND ANTICIPATION CHECKS

Before 2012, low-income tax filers who used paid preparers could get their tax refunds faster with a refund anticipation loan (RAL). RALs were high-cost immediate cash loans from private lenders, backed by the tax refunds the borrowers claimed on their prepared returns (Theodos et al. 2011). RALs proliferated after 1999 when the IRS reinstituted the debt indicator program, which disclosed whether a tax refund would be redirected by the IRS to pay debts.

The IRS has since discontinued use of the debt indicator, essentially eliminating the RAL market. However, most consumers who formerly received a RAL now appear to be using a similar product, the refund anticipation check (RAC). The RAC appears to cost less than the RAL but it can still be quite expensive. RACs are temporary bank accounts opened by paid preparers, where tax filers direct their refunds. Tax filers are allowed to pay fees out of their RACs. When the IRS deposits the refund, the paid preparer subtracts fees from the account, and then the tax filer can access the remainder.

In 2014, the National Consumer Law Center reported that more than 21 million consumers obtained RACs. Unlike RALs, RACs do not allow consumers faster access to anticipated refunds (Wu 2015). The vast majority of RAC consumers—about 83 percent—have low incomes. In fact, about half are EITC recipients (Wu 2015).

Beginning in 2017, a second generation of RALs became available, advertised as having no fees or risks to borrowers. The National Consumer Law Center reports that, as of 2020, interest bearing RALs have returned and put risk back on the consumer. Moreover, fees associated remain opaque, and potentially quite costly for consumers.

Key Elements of the U.S. Tax System

Why do low-income families use tax preparers?

Updated May 2020

Data Sources

Internal Revenue Service. "2010 Statistics of Income Public Use File."

Further Reading

Berube, Alan. 2006. "The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s." Washington, DC: Brookings Institution.

Guyton, John L., Adam K. Korobow, Peter S. Lee, and Eric Toder. 2005. "The Effects of Tax Software and Paid Preparers on Compliance Costs." Washington, DC: Urban-Brookings Tax Policy Center.

IRS (Internal Revenue Service). 2014. "Compliance Estimates for the Earned Income Tax Credit Claimed on 2006–2008 Returns." Research, Analysis and Statistics Report 5162. Washington, DC: Internal Revenue Service.

Maag, Elaine. 2005. "Paying the Price: Low-Income Parents and the Use of Paid Tax Preparers." New Federalism: National Survey of America's Families Report B-64. Washington, DC: Urban-Brookings Tax Policy Center.

National Consumer Law Center. 2020. "2020 Tax Season: More Delays and Higher Costs for Struggling Taxpayers", Washington, DC: National Consumer Law Center. January.

McTigue, James R., Jr. 2014. "Paid Tax Return Preparers: In a Limited Study, Preparers Made Significant Errors." Testimony before the Senate Committee on Finance, Washington, DC, April 8.

Theodos, Brett, Rachel Brash, Jessica F. Compton, Nancy M. Pindus, and C. Eugene Steuerle. 2011. "Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks." Washington, DC: Urban Institute.

Wu, Chi Chi. 2015. "Taxpayer Beware: Unregulated Tax Preparers and Tax-Time Financial Products Put Taxpayers at Risk." Washington, DC: National Consumer Law Center.

How does the earned income tax credit affect poor families?

Q. How does the earned income tax credit affect poor families?

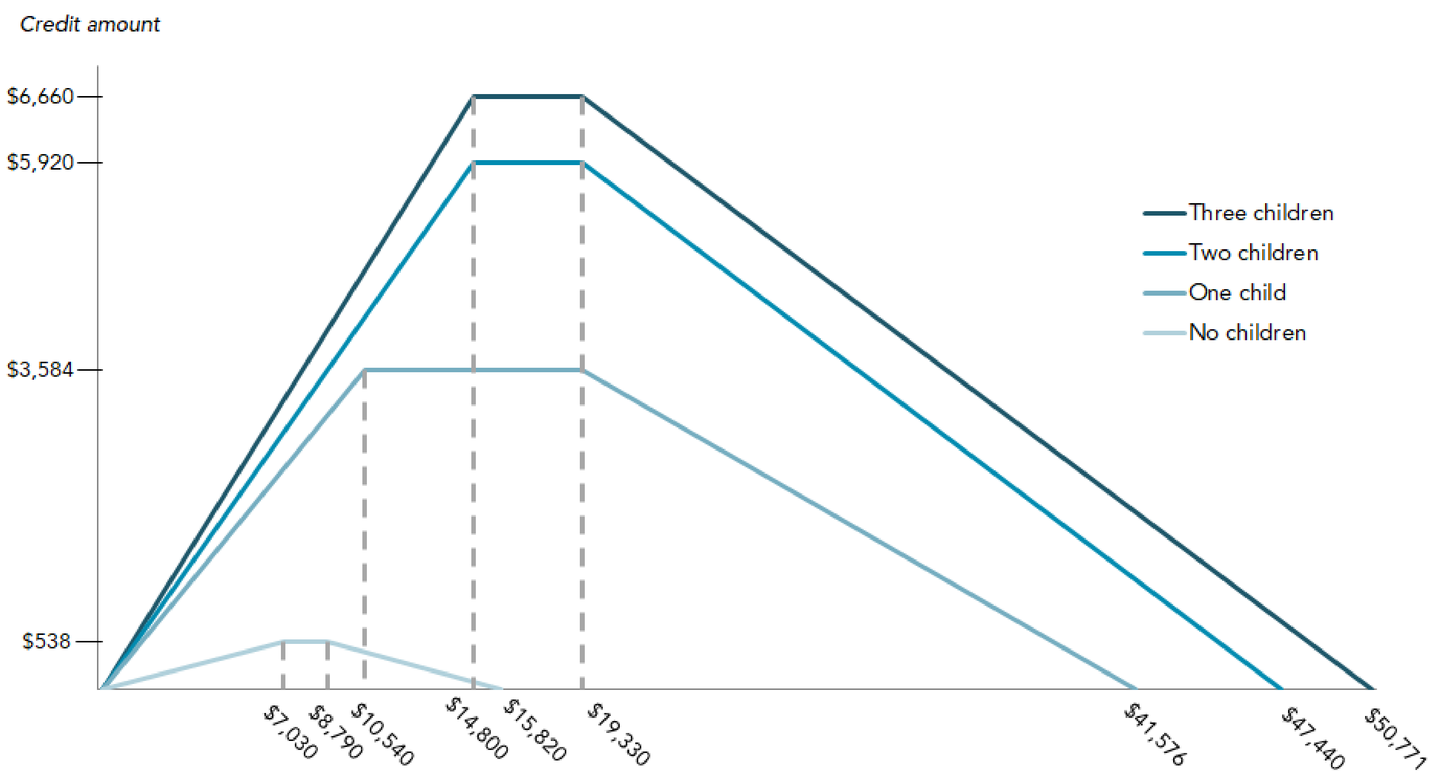
A. The EITC is the single most effective means tested federal antipoverty program for working-age households—providing additional income and boosting employment for low-income workers.

In 2020, the earned income tax credit (EITC) will provide maximum credits ranging from $538 for workers with no children to $6,660 for workers with at least three children (figure 1).

FIGURE 1

Earned Income Tax Credit

2020



Source: Urban-Brookings Tax Policy Center (2020). Internal Revenue Procedure 2019-44, Internal Revenue Service.
Notes: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,890 higher than shown.

Key Elements of the U.S. Tax System

How does the earned income tax credit affect poor families?

POVERTY AND THE EITC

Official estimates of poverty compare the before-tax cash income of families of various sizes and compositions with a set of thresholds. The official poverty measure excludes the effect of federal tax and noncash transfer programs on resources available to the family. Thus, although the EITC adds income to poor households, it does not change the official number of those living in poverty.

To understand how the social safety net changes resources, the US Census Bureau has developed a supplemental poverty measure that includes additional resources available to families (and additional expenses) not captured in the official measure (Fox 2019). To determine how well off a family is, the supplemental poverty measure compares resources available to resources needed, taking into account regional differences.

Resources needed include not only basic items such as food and housing, but also taxes and expenses such as those associated with work and health care. Resources available include government transfers, including noncash transfers, and refundable tax credits such as the EITC. Official Census publications show that together, the child tax credit and the EITC lifted 8.9 million people out of poverty in 2018 (Fox 2019). The Center on Budget and Policy Priorities separates the effects of the EITC and the child tax credit and calculates that the EITC was responsible for lifting 5.6 million people out of poverty in 2018 (CBPP 2019). This makes the EITC the single most effective program targeted at reducing poverty for working-age households.

REDUCING POVERTY BY ENCOURAGING WORK

Substantial research confirms that the EITC encourages single people and primary earners in married couples to work (Dickert, Houser, and Scholz 1995; Eissa and Liebman 1996; Meyer and Rosenbaum 2000, 2001). The credit, however, appears to have little effect on the number of hours people work once they are employed. Although the EITC phaseout could cause people to reduce their work hours (because credits are lost for each additional dollar of earnings, effectively a surtax on earnings in the phaseout range), there is little evidence that this actually happens. (Meyer 2002).

The most recent relevant study found that a $1,000 increase in the EITC led to a 7.3 percentage point increase in employment and a 9.4 percentage point reduction in the share of families with after tax and transfer income in poverty (Hoynes and Patel 2015). If this employment effect were included in census estimates of poverty reduction (rather than just the dollars transferred through the credit), the number of people lifted out of poverty would be much greater.

Updated May 2020

Data Sources

Urban-Brookings Tax Policy Center. T20-0090. "Earned Income Tax Credit; Baseline: Current Law; Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2019."

Further Reading

Bipartisan Policy Center. 2013. "Bipartisan Policy Center (BPC) Tax Reform Quick Summary." Washington, DC:

How does the earned income tax credit affect poor families?

Bipartisan Policy Center.

CBPP (Center for Budget and Policy Priorities). 2019. "Policy Basics: The Earned Income Tax Credit." Washington DC: Center for Budget and Policy Priorities.

DaSilva, Bryann. 2014. "New Poverty Figures Show Impact of Working-Family Tax Credits." *Off the Charts* (blog). October 17.

Dickert, Stacy, Scott Houser, and John Karl Scholz. 1995. "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation." *Tax Policy and the Economy* 9.

Eissa, Nada, and Jeffrey B. Liebman. 1996. "Labor Supply Response to the Earned Income Tax Credit." *Quarterly Journal of Economics* 111 (2): 605–37.

Executive Office of the President and US Department of the Treasury. 2014. "The President's Proposal to Expand the Earned Income Tax Credit." Washington, DC: Executive Office of the President and US Department of the Treasury.

Fox, Liana. 2019. "The Supplemental Poverty Measure: 2018." Current Population Reports P60-268 (RV). Washington, DC: US Census Bureau.

Hatcher Group. "Tax Credits for Working Families."

Hoynes, Hilary, and Ankur J. Patel. 2015. "Effective Policy for Reducing Inequality? The Earned Income Tax Credit and the Distribution of Income." NBER Working Paper 21340. Cambridge, MA: National Bureau of Economic Research.

Internal Revenue Service. 2014. "Compliance Estimates for the Earned Income Tax Credit Claimed on 2006–2008 Returns." Washington, DC: Internal Revenue Service.

Maag, Elaine. 2015a. "Earned Income Tax Credit in the United States." *Journal of Social Security Law* 22 (1).

———. 2015b. "Investing in Work by Reforming the Earned Income Tax Credit." Washington, DC: Urban-Brookings Tax Policy Center.

Meyer, Bruce D. 2002. "Labor Supply at the Extensive and Intensive Margins: The EITC, Welfare, and Hours Worked." *American Economic Review* 92 (2): 373–79.

Meyer, Bruce D., and Dan T. Rosenbaum. 2000. "Making Single Mothers Work: Recent Tax and Welfare Policy and Its Effects." *National Tax Journal* (53): 1027–62.

———. 2001. "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers." *Quarterly Journal of Economics* 116 (3): 1063–1114.

Pergamit, Mike, Elaine Maag, Devlin Hanson, Caroline Ratcliff, Sara Edelstein, and Sarah Minton. 2014. "Pilot Project to Assess Validation of EITC Eligibility with State Data." Washington, DC: Urban Institute.

President's Advisory Panel on Federal Tax Reform. 2005. Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System. Washington, DC: President's Advisory Panel on Federal Tax Reform.

Q. What are error rates for refundable credits and what causes them?

A. The IRS estimates two types of error rates for the earned income tax credit (EITC): the improper payment rate and the over-claim rate. The former includes IRS enforcement activities while the latter does not. The IRS has estimated an EITC improper payment rate of between 22 and 26 percent of EITC payments and an over-claim rate of between 29 and 39 percent of dollars claimed.

IMPROPER PAYMENTS IN THE EITC

Extrapolating from the IRS's National Research Program compliance study of individual income tax returns for tax year 2009, the US Treasury Department projected that in fiscal year 2013, between 22.1 percent and 25.9 percent of total earned income tax credit (EITC) program payments were improper (US Department of the Treasury 2013). The Office of Management and Budget identified the EITC as having the highest improper payment rate and the second-highest improper payment amount among 13 "high-error" programs.

Errors can stem from intentional fraud or innocent mistakes made by taxpayers—the latter, a likely result of complex rules associated with the EITC. Studies by Treasury analysts indicate that only a minority of improper payments stem from fraudulent actions (Holtzblatt and McCubbin 2003).

The estimated 22.1–25.9 percent range is likely higher than the actual error rate. A 2004 study by the Taxpayer Advocate found that, in 2002, among 67,000 people who sought reconsideration of their audit results, 43 percent were owed the entire or almost entire EITC claim that had initially been denied.

EITC OVER-CLAIMS

A more recent IRS study of returns claiming the EITC found that from 2006 to 2008, between 28.5 and 39.1 percent of all EITC dollars claimed were over-claims totaling between $14.0 billion and $19.3 billion (IRS 2014). The largest source was error in classifying children as "qualified." Roughly 75 percent of all tax returns with qualifying-child errors violated the requirement that children live with the taxpayer in the United States for more than six months of the year (IRS 2014). The IRS receives no administrative data that can verify where a child resided for most of the year, making it difficult for the agency to monitor compliance. Attempts to use administrative data from other programs to verify child residence have not proven successful (Pergamit et al. 2014).

What are error rates for refundable credits and what causes them?

IRS RESPONSE

The IRS is combating improper payments by implementing due diligence requirements for paid preparers (IRS 2015). The IRS has tried to strengthen paid-preparer regulation before, but the courts ruled in 2012 that the agency had overstepped its authority and would not be allowed to require competency tests of some preparers (Taxpayer Advocate Service 2013).

To reduce fraud, the Protecting Americans from Tax Hikes Act of 2015 requires the IRS to delay tax refunds for taxpayers who claim an EITC or an additional child tax credit on their returns until at least February 15. Delaying refunds was paired with a requirement that third-party income documents related to wages and income be provided to the IRS by January 31 (in prior years, this information was due the last day of February for paper filing and March 31 for electronic filing, and employers requesting a 30-day extension for filing some information returns were automatically granted an extra 30 days to file). As a result, information needed to verify wages often got to the IRS well after the first returns had been processed. Together, these measures allowed earlier systemic verification of EITC claims, which protected more revenue than in prior years (Treasury Inspector General for Tax Administration 2018).

Updated May 2020

Further Reading

Book, Leslie. 2014. "H&R Block CEO Asks IRS to Make It Harder To Self-Prepare Tax Returns and Why That's a Good Idea." *Forbes, Procedurally Taxing* (blog). December 1.

Holtzblatt, Janet, and Janet McCubbin. 2003. "Issues Affecting Low-Income Filers." In *The Crisis in Tax Administration*, edited by Henry Aaron and Joel Slemrod, 148–87. Washington, DC: Brookings Institution Press.

IRS (Internal Revenue Service). 2014. "Compliance Estimates for the Earned Income Tax Credit Claimed on 2006–2008 Returns." Publication 5162. Washington, DC: Internal Revenue Service.

———. 2015. "Due Diligence Law and Regulation." Accessed August 3, 2015.

———. 2017. "Preparer Compliance: EITC & Other Refundable Credits." Accessed September 28, 2018.

Liebman, Jeffrey. 1995. "Noncompliance and the EITC: Taxpayer Error or Taxpayer Fraud." Cambridge, MA: Harvard University.

Maag, Elaine, Michael Pergamit, Devlin Hanson, Caroline Ratcliffe, Sara Edelstein, and Sarah Minton. 2015. "Using Supplemental Nutrition Assistance Program Data in Earned Income Tax Credit Administration: A Case Study of Florida SNAP Data Linked to IRS Tax Return Data." Washington, DC: Urban-Brookings Tax Policy Center.

Pergamit, Mike, Elaine Maag, Devlin Hanson, Caroline Ratcliff, Sara Edelstein, and Sarah Minton. 2014. "Pilot Project to Assess Validation of EITC Eligibility with State Data." Washington, DC: Urban Institute.

Taxpayer Advocate Service. 2004.*The National Taxpayer Advocate's 2004 Annual Report to Congress*, vol. 2, *Earned Income Tax Credit (EITC) Audit Reconsideration Study.* Washington, DC: Internal Revenue Service.

———. 2013. "Regulation of Return Preparers." In *2013 Annual Report to Congress*, vol. 1, 61–74. Washington, DC: Internal Revenue Service.

Treasury Inspector General for Tax Administration. 2018. "Employer Noncompliance with Wage Reporting

Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims before Refunds Are Paid." Reference No. 2018-40-015. Washington, DC: Department of the Treasury.

US Department of the Treasury. 2013. Agency Financial Report: Fiscal Year 2013. Part 3, Section E: IPIA (as amended by IPERA) Reporting Details, 204–14. Washington, DC: US Department of the Treasury.

How do IRS audits affect low-income families?

Q. How do IRS audits affect low-income families?

A. The IRS audits a disproportionate (but still small) share of tax returns that include EITC claims. The agency has found that average discrepancies between taxes owed and taxes paid are smaller on EITC returns than on all returns.

IRS AUDITS OF EARNED INCOME TAX CREDIT RETURNS

In FY 2018, the IRS audited 1.1 million of the almost 196 million returns filed, less than 1 percent of the total. Returns claiming an earned income tax credit (EITC) were audited at a rate more than twice that of all individual income tax returns: 1.4 percent compared with 0.6 percent. Almost all these audits (94 percent) were correspondence audits, meaning the tax filer was notified and could respond by mail.

The IRS selects which returns to audit based in part on a statistical formula that identifies returns most likely to be at risk of having an error (Guyton et al. 2018). For all individual income tax returns audited in FY 2018, the IRS recommended no change on 10 percent of all returns and on 10 percent of returns with an EITC. The average amount of money the IRS attempted to collect on all audited individual income tax returns was $10,144. The average amount on audited returns with an EITC was $4,878.

Recent analysis demonstrates that correspondence audits decrease the likelihood that a person will claim an EITC the year following the audit by over 30 percentage points. That effect persists to some degree for multiple years (Guyton et al. 2018).

Updated May 2020

Data Sources

Internal Revenue Service. 2019. *Internal Revenue Service Data Book, 2018*. Washington, DC: Internal Revenue Service.

Further Reading

Guyton, John, Kara Leibel, Dayanand S. Manoli, Ankur Patel, Mark Payne, and Brenda Schafer. 2018. "Tax Enforcement and Tax Policy: Evidence on Taxpayer Responses to EITC Correspondence Audits." NBER Working Paper No. 24465. Cambridge, MA: National Bureau of Economic Research.