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

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).

Key Elements of the U.S. Tax System

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).

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