Social Welfare Considerations of EITC Qualifying Child Noncompliance

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The Problem

- Many years of compliance research finds a high level of EITC noncompliance. For FY 2020:
  - 24% improper payment rate
  - Estimated $16 billion in improper payments
- Aggregate statistics do not tell us how to fix the problem.
- Improper payment statistics do not tell us enough about the social welfare loss of noncompliance.
  - What value might we place on an EITC dollar paid in error?
  - How might this value compare to the costs of reducing errors, through enforcement or policy changes?
- We explore these social welfare considerations by looking more closely at errors associated with qualifying children.

EITC Error Rate

- Treasury reports improper payments estimates for refundable tax credits to be compliant with the Improper Payment Information Act of 2002 (IPIA), as amended. Under OMB guidance, refundable tax credits are considered "payments."
- The term "payment" means "any transfer or commitment for future transfer of Federal funds such as cash, securities, loans, loan guarantees, and insurance subsidies to any non-Federal person or entity or a Federal employee, that is made by a Federal agency, a Federal contractor, a Federal grantee, or a governmental or other organization administering a Federal program or activity."
- The term "improper payment" means "any payment that should not have been made or that was made in an incorrect amount, including an overpayment or underpayment, under a statutory, contractual, administrative, or other legally applicable requirement and includes any payment to an ineligible recipient."
- A payment program is defined as being susceptible to significant improper payments when improper payments exceed 1) both 1.5 percent of program outlays and $10 million of all payments or 2) $100 million at any percent of program outlays. Agencies are required to estimate improper payments for these programs and report the causes of, and the steps taken to reduce, improper payments.
- IRS already estimates noncompliance with EITC and other refundable credits in its Tax Gap estimates.

EITC Rules (2017)

- Taxpayers with qualifying children (QC) receive a larger credit. QC must meet several tests:
  - SSN – must have a valid Social Security number
  - Residency – must live with taxpayer for over half the year
  - Relationship – son/daughter, stepchild, foster child, sibling, or descendent of these
  - Age – under age 19, student under age 24, or disabled
  - Joint Return – cannot file a joint return except for claiming a refund
  - Tiebreaker rules for children who are the qualifying child of more than one taxpayer.

- Must have earned income. Credit phases in and then out as income increases.

- Married couples must file jointly and credit is phased out on combined income, starting at a higher threshold.

Previous Research on EITC Errors

Type of Error	Percent of Returns with Errors	Percent of Dollars Clamed in Error
Income only	51	25
Qualifying child (QC) only	15	26
QC and income	6	12
QC in other combinations	8	15
Other errors and combinations (no QC)	19	21
Total	100	100
Any QC error, alone or in combination	**30**	**53**

Source: Kara Leibel, *Taxpayer Compliance and Sources of Error for the Earned Income Tax Credit Claimed on 2006-2008 Returns*, Internal Revenue Service, August 2014.

- Returns with qualifying child errors account for about 30% of returns with errors and over half of EITC dollars claimed in error.

Our Research

- Who are the taxpayers that claim children incorrectly for the EITC?
  - Do taxpayers who claim the EITC in error live with the children they claim for any length of time?
  - Are taxpayers who claim the EITC in error related to the children they claim?

- Why don’t the “correct” parents claim the EITC?

- What is the social welfare loss and the net revenue loss caused by the “wrong” person claiming the credit?

IRS National Research Program Data

- Random sample of individual income tax returns subjected to audit.
  - Does not represent non-filers or suspected fraudulent returns that are stopped by the IRS.

- Sample includes over 2,000 returns per year claiming EITC, sufficient to produce a topline annual improper payment rate.
  - Data also include information on specific EITC eligibility criteria and reasons for audit changes.

- We combine samples for six years, 2006 – 2011, providing over 12,000 observations for more detailed analysis.

- We also use Social Security records, the population of individual income tax returns, and the population of certain information returns (e.g. W2s).

- We report annual averages; sample observations are weighted to represent the populations.

Types of QC Errors, 2006 - 2011

Type of Error	Average Number of Children Per Year (Million)	Percent of Children with Qualifying Child (QC) Errors (%)
Residency error	3.8	79
Relationship error	0.6	14
Tiebreaker error	0.4	8
Other (age, SSN, married, unclear)	1.4	29
Total (any qualifying child error)	4.8	100
Residency, relationship or tiebreaker error	4.0	85
Residency, relationship or tiebreaker error, and no other qualifying child error	**3.4**	**71**

- About 31.4 million children were claimed per year; 4.8 million in error. (Since each child can be linked to more than one type of error, the sum of children across all categories is more than the total.)

- About 3.4 million children per year could potentially be claimed by another taxpayer; they account for about 38 percent EITC dollars claimed in error.

Q1: Who Are the Taxpayers Incorrectly Claiming EITC?

Relationship and Residency of Children with QC errors
(Average of 3.4 million children per year who fail residency, relationship or tiebreaker tests and no other QC tests)

Relationship as determined by examiner	Percentage of Children with QC Errors			
	Substantiated Months of Residency			Total
	None	Up to ½ year	More than ½ year	
Son/daughter	39	5	2	47
Other qualifying relative	32	3	1	37
Ineligible relationship/ not related/ no information	12	1	4	16
Total	83	9	7	100

Q2: Why Don't the "Correct" Parents Claim the EITC?

- Strategy: match children claimed in error to their non-claiming parents.
- Step 1: Use Social Security records to identify the parents of children claimed in error.
  - Can we find a parent other than the taxpayer audited in the NRP?
- Step 2: Search for the tax and information returns of these other parents.
  - Did they file a tax return?
  - Did they claim the EITC?
- Step 3: Could they have claimed the EITC?

Q2: Why Don't the "Correct" Parents Claim the EITC?

- Steps 1 and 2: Did we find another parent? Did they file? Claim EITC?

Result of Search for Other Parent SSN	Average Number of Children per Year (Million)	Percent of QC with Errors (%)
No parent SSN found in SSA data	0.7	21
Only parent(s) found are on NRP return (as taxpayer or dependent)	0.7	20
At least one parent different from NRP taxpayer is found in the SSA data but not on any tax return	0.6	19
Parent return also claimed the child as a dependent and for EITC	0.1	4
Parent return did not claim the child for EITC	**1.2**	**36**
Total Children with Residency, Relationship, or Tiebreaker Error but No Other Qualifying Child Error	3.4	100

Q2: Why Don't the "Correct" Parents Claim the EITC?

- Step 3: Could they have claimed the EITC?

Evaluation of Potential EITC Claim	Percent of Parent Returns (%)		
	2006-2008	2009-2011	2006-2011
Already claimed max. number of EITC children	40	9	23
Income ineligible	21	20	21
Other Issues	20	16	19
Any of the above issues	71	38	53
None of the above issues	**29**	**62**	**47**
Addendum: Average number of returns per year (million)	1.06	1.25	1.15

Nearly 1.2 million parents linked to over 1.2 million children claimed in error appear potentially eligible for EITC. After further investigation, 0.5 million parents linked to 0.6 million children appear eligible to claim the EITC.

Q3: What Is the Net Revenue Loss?

	Amount per Year ($ Million)		
	2006-2008	2009-2011	2006-2011
Total forgone EITC, (1)	332	790	561
EITC claimed in error for the 0.6 million children, (2)	668	2,231	1,449
Ratio of forgone EITC to EITC error, (1)/(2)	50%	35%	39%
EITC error attributed to all returns with the three QC errors, (3)	4,986	6,665	5,825
Ratio of forgone EITC to EITC error, (1)/(3)	7%	12%	10%

Are Families Tax Minimizing?

	Number of Taxpayers per Year (Million)		
	2006-2008	2009-2011	2006-2011
NRP taxpayer would have a larger EITC	0.85	0.91	0.88
No difference (within $100)	0.05	0.05	0.05
Non-claiming parent would have a larger EITC	0.06	0.16	0.11
Total	0.96	1.12	1.04
	Percent (%)		
	2006-2008	2009-2011	2006-2011
NRP taxpayer would have a larger EITC	89	81	85
No difference (within $100)	5	5	5
Non-claiming parent would have a larger EITC	6	14	10
Total	100	100	100

Conclusions

- Official EITC improper payment rates overstate the revenue loss to the government because they do not take account of forgone claims.
  - However, the amount of overstatement we identified (perhaps about $1 billion per year today) is small relative to the total amount of EITC error (about $16.8 billion in 2016).

- Most children claimed in error are claimed by a relative, not a stranger or friend. About 11% are claimed by a relative who live with the child all or part of the year.

- Some errors appear accidental whereas in most cases taxpayer behavior is consistent with credit maximizing motive.

- For about 2 million children of the 3.4 million children claimed in error, we couldn’t find anyone else (i.e., a tax-filing parent) who could have claimed the EITC for the child.
  - Likely that some of these children are not the intended beneficiaries of the EITC.
  - More information needed to speculate on social welfare loss.