 Reduce Fraud in the Earned Income Tax Credit (EITC)

Heritage Recommendation:
Reduce fraud due to false income reporting in the Earned Income Tax Credit (EITC) program. This proposal saves approximately $8 billion annually, and $80 billion over 10 years.

Specifically, policymakers should change the law as follows:

- Require the IRS to fully verify income through a review of form W-2, form 1099, business licensing or registration, and relevant invoices before any refundable EITC payment is made.
- Require individuals claiming self-employment or small business income to:
  a. Provide a form 1099 documenting the income; or,
  b. Be a registered or licensed small business and provide invoices of payments received including date of service and identifying contact information from customers.
- Require the IRS to check the administrative records of the Temporary Assistance for Needy Families, Supplemental Nutrition Assistance Program, and subsidized housing programs to determine if the tax filer received benefits or a dependent child received benefits from the program during the calendar year and to determine whether the household composition and income reported on the claimant tax form is consistent with that reported to state agencies operating those programs.
- Provide a $2,000 penalty for any tax filing involving an erroneous claim for a refundable tax credit that is based on substantial misreported income.

Rationale:
The Earned Income Tax Credit is the nation’s largest means-tested cash welfare program. Although the EITC in some cases reduces federal income taxes owed, its major function is to provide “refundable” tax credits to low-income individuals. A “refundable tax credit” is simply a cash welfare grant to individuals who have no federal income tax liability. About 15 percent of the total expense of the EITC goes to tax reduction, while 85 percent goes to refundable cash credits.\(^{61}\) In 2012, 24.3 million individuals received refundable EITC payments at a cost of $56.2 billion.\(^{62}\)

Fraud is prevalent in this expensive welfare program. An IRS audit conducted from 2006 to 2008 found that 43 percent to 50 percent of tax returns claiming the EITC involved erroneous overclaims. These overclaims were not minor filing errors; the overwhelming majority of individuals making overclaims were not eligible for the credit at all. According to the IRS, the erroneous, often fraudulent, overclaims accounted for 28 percent to 39 percent of all EITC payments. The total overclaim amounts were estimated at $14 billion to $19.3 billion per year during the period.\(^{63}\)

The EITC differs favorably from other means-tested aid programs: Individuals must report earned income to receive cash aid. Thus, in certain income ranges, the EITC can encourage work effort. However, millions of individuals each year fraudulently report income to obtain EITC cash bonuses. These individuals invent fictitious income (or under-report earnings) to maximize their EITC welfare payments. According to the IRS, 30 percent of all EITC claims are based on false or erroneous income claims. In the 2006–2008 audit, 50 percent of the overclaim amount of $14 billion to $19.3 billion per year involved false income reporting.\(^{64}\)
If the income misreporting ratios from the 2006–2008 audits are applied to 2012 EITC payments, an estimated 8 million households engaged in false income reporting in that year, yielding roughly $10 billion in overclaimed refundable EITC credits. We project that this fraud could be reduced by 80 percent by implementing these proposed anti-fraud measures.

The IRS has an effective capability to detect false income claims. But typically, the IRS scrutinizes claims only in a small number of cases. Audits generally occur after the EITC cash payments have already been made. There are apparently current legal restrictions on the IRS, which require it to make EITC refunds prior to proper income verification. The Department of the Treasury’s “Agency Financial Report” for FY 2013 states that 30 percent of EITC overpayments are the result of detectable income misreporting. The report adds:

These [EITC payment] errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for EITC. The errors include both under-reporting and over-reporting of income by both wage earners and taxpayers who report that they are self-employed. Income reported through information returns such as Forms W-2, Forms 1099, etc., which can be used for verification of some income, becomes available only after tax returns are processed. Under law, the IRS must process income tax returns within 45 days of receipt or pay interest to taxpayers.65

Overclaims and overpayments can be significantly reduced by requiring the IRS to fully verify reported income before any refundable EITC payment is made.

Additional Reading:


Calculations:

Per the above explanations, estimated fraud due to false income reporting in the EITC amounts to about $10 billion per year. We estimate that this amount could be reduced by about 80 percent if the proposed anti-fraud measures are implemented, yielding $8 billion in annual savings.