The Tax Law Center NYU LAW

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Rebalancing Reporting on Sources of the Tax Gap

Summary:

- **Refundable credits (EITC, ACTC, AOTC, etc.) cause just 15 percent of the individual income tax under-reporting gap – the gap between federal taxes paid and taxes owed – while the highest-income 1% of filers alone are responsible for about 28% of it, in large part due to their unreported business income**.
- Yet currently, **Treasury and IRS report more frequently and in more detail on refundable tax credits compliance issues than on the contributions of high-income filers and businesses to the tax gap.**[i]
- **This imbalance is because prior Administrations took the view that refundable credits are subject to rigorous statutory reporting requirements for "improper payments."** This is an ill-suited regime for reporting on refundable credit error, because it is intended to capture weaknesses in internal control systems within federal agencies for payment accuracy (such as benefits awards or contractor payments being made erroneously to deceased people or those found guilty of prior federal tax fraud),[ii] which Treasury has concluded are not the root cause of refundable tax credit overclaims.[iii] Instead, improper payments of the refundable credits are caused by "factors beyond [Treasury and IRS's] control, such as the statutory design of the RTCs, the complexity of the eligibility requirements, the reliance on taxpayers' self-certification of the accuracy of their returns, and the lack of third-party data for verification."[iv]
- **The application of the improper payments regime to the EITC, ACTC, and AOTC leads to line-drawing with no connection to the purpose of the regime, or to the policy aim of reducing the tax gap.** Refundable credits were thought to be subject to the improper payments regime because a portion of them are delivered as outlays (in the form of tax refunds). Yet for the EITC – the refundable credit with the highest improper payment rate and the largest dollar amount of improper claims – the regime reports on *all* sources of error, including the portion of the credit that is not delivered via refunds and is instead delivered as reductions against taxes owed.[v] Further, many "non-refundable" credits, deductions, and other subsidies delivered through the tax code are *not* treated as "payments" under the regime, because they can only reduce a filer's tax liabilities and cannot be distributed as refunds. However, improper claims of refundable credits have the *exact same impact*, dollar for dollar, on the fisc as non-refundable tax credits, deductions, and other subsidies[vi] (with the former increasing outlays and the latter reducing revenues collected). This differential treatment of economically identical contributors to the tax gap is arbitrary and inequitable, as tax credits and deductions benefiting higher-income filers and businesses should not face less scrutiny than those serving low- and moderate-income families.[vii] In contrast, the tax gap

reporting framework is designed to capture all factors that lead to fiscal loss through the tax system, without arbitrary distinctions between refundable and non-refundable tax credits. Reporting within Treasury/IRS structures would also allow proportional focus to denials of credits to otherwise eligible filers through administrative burdens or audit barriers, consistent with EO 13985 (on advancing racial equity) and EO 14058 (on improving federal service delivery).[viii]

- **Under Secretary Mnuchin, the Treasury Department revisited these prior decisions and correctly concluded that "refundable tax credit refunds that result in overclaims should not be reported under the improper payments framework"** as defined in the Payment Integrity Information Act of 2019 (PIIA) and stated that "they are more appropriately addressed in the tax gap."[ix]

  Former IRS Commissioner Rettig has said that IRS estimates of the tax gap are "outdated, under-inclusive, and are based on limited types of detected information."[x]

  Tax gap reporting should be made more detailed, timely, and comprehensive, and the IRS has committed to doing so. Tax gap reporting should also be accompanied by improved reporting on administrative burdens that prevent filers from taking up tax benefits, and Treasury and the IRS has also made commitments on these fronts consistent with EO 13985 (on advancing racial equity).

  Funding and other support for the National Research Program and SOI can help further improve this reporting and analysis, and improve oversight of resources and authorities intended to reduce the tax gap.

<u>Agency Reporting Requirements on Compliance Issues for Refundable Credits vs. Other Tax Gap Contributors:</u>

	Refundable Tax Credits – EITC, ACTC, Education Tax Credits, and Others	**Other Contributors to Tax Gap**
Share of Individual Income Tax Under-Reporting Gap[xi]	**All Refundable Credits: 15%** • EITC: 10% • CTC/ACTC: 3% • Education tax credits: 2% • All other tax credits: 1%	**All other parts of the tax gap: 85%, including:** • Business Income Tax Underreporting: 47%[xii] • Highest-income 1% of filers: About 28%[xiii]
Regularity of reporting on compliance issues	**Annual** reporting in Treasury's Agency Financial Report (AFR).[xiv] **Quarterly** reports documenting Treasury's progress on various EITC, ACTC, and AOTC-related enforcement initiatives.[xv] TIGTA and Treasury OIG reports auditing Treasury's compliance with the annual reporting requirements under PIIA.[xvi]	**Generally, multi-year gaps between reports**. Most recent reports cover:[xvii] TY 2001 (issued in 2007), TY 2006 (issued in 2012), TY 2008-2010 (issued in 2016), TY 2011-2013 (issued in 2019). TY2014-2016 (issued in 2021)[xviii]
Lag between year of data and year of report	**About two years –** the most recent Treasury AFR, issued in November 2022, includes estimates for tax year 2020.[xix]	**Generally, a five to six-year lag.**
Legal requirement for agency reporting on compliance issues	**Asserted to be statutory, based on questionable interpretation** of the Payment Integrity Information Act of 2019 (PIIA).[xx] + OMB designation of EITC, ACTC, and AOTC as high-priority programs[xxi] and OMB guidance on reporting requirements for those programs (Appendix C to OMB Circular A-123).[xxii] + EO 13520 in 2009 requiring further focus on high-priority programs.[xxiii]	**None.** Tax Gap estimates are a voluntary IRS national research project undertaking.

	Refundable Tax Credits – EITC, ACTC, Education Tax Credits, and Others	Other Contributors to Tax Gap
Level of Detail Required in Reporting on Compliance Issues	**Annual** disclosure for EITC, ACTC, and AOTC of:[xxiv] • Rate and $ amount of improper payments • Explanations of root causes for improper payments • Actions taken to reduce overpayments • A discussion of any limitations to the IRS's ability to reduce improper payments The IRS quarterly scorecards provide additional details on actions taken by the agency to reduce overpayments.[xxv] Draws on reports giving even more detail: 1999 Compliance Study, TY2006-2008 Compliance Study.[xxvi]	**No** regularly reported detail beyond tax gap studies and ad hoc NRP or SOI releases. No regularly reported targets for reducing the overall tax gap or components of it.
Characteristics of Estimates	**In Annual AFR reporting under PIIA: Estimates of improper payments include overclaims that were ultimately recovered by the IRS.** **Also:** No study or estimate on the extent to which those who do not make it through audit (and are classified as filing in error) would have been able to claim the credit if given assistance to navigate the audit process. No indication of whether audit ROI is adjusted for this possibility. Does not include netting of underclaims (from wrong parent claiming the child, or no parent filing).	**Net overall tax gap number excludes unpaid taxes that were ultimately recovered by IRS.** The gross tax gap does not, but both figures are reported equally.

[i] In a previous report, Sam Washington notes this disparity and details the racial equity implications of the disproportionate scrutiny EITC claimants face by tax enforcement authorities. See: Sam Washington, "Race, Tax Enforcement and the Social Compact," The Kalmanovitz Initiative for Labor and the Working Poor at Georgetown University, 2021, https://lwp.georgetown.edu/news/race-tax-enforcement-and-the-social-compact/.

[ii] See discussion of the "Do Not Pay" initiative: Garrett Hatch, "Improper Payments and Recovery Audits: Legislation, Implementation, and Analysis," Congressional Research Service, October 18, 2013, https://fas.org/sgp/crs/misc/R42878.pdf.

[iii] See pages 246-247: Department of the Treasury, "Agency Financial Report: Fiscal Year 2020," December 30, 2020, https://home.treasury.gov/system/files/266/Treasury-FY-2020-AFR.pdf. See also, page 259: Department of the Treasury, "Agency Financial Report: Fiscal Year 2021," November 15, 2021, https://home.treasury.gov/system/files/266/Treasury-FY-2021-AFR.pdf.

[iv] Department of the Treasury, "Agency Financial Report: Fiscal Year 2021," November 15, 2021, https://home.treasury.gov/system/files/266/Treasury-FY-2021-AFR.pdf.

[v] In recent years, Treasury has only reported the improper payment rate for the refundable portion of the Child Tax Credit – the ACTC – rather than the full credit. For more on how the improper payment rate for the EITC is calculated, see here: Department of the Treasury, "Agency Financial Report: Fiscal Year 2020," December 30, 2020, https://home.treasury.gov/system/files/266/Treasury-FY-2020-AFR.pdf; Treasury Inspector General for Tax Administration**, "**The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements**,"** December 29, 2014, https://www.taxnotes.com/tax-notes-today-federal/tax-system-administration/efforts-improper-eitc-payments-are-progressing-tigta-says/2015/01/08/fp2s. Note that claims recovered through IRS enforcement activity are no longer subtracted from the estimate of total improper payments.

[vi] These tax benefits are also called "tax expenditures," which are "revenue losses attributable to provisions of Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." See: Department of the Treasury, "Tax Expenditures: FY2023," December 9, 2021, https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2023.pdf.

[vii] Center on Budget and Policy Priorities, "Policy Basics: Tax Expenditures," updated December 8, 2020, https://www.cbpp.org/research/federal-tax/federal-tax-expenditures.

[viii] Kathleen Bryant, Chye-Ching Huang, Leslie Book, T. Keith Fogg, and Nina E. Olson "Exclusionary Effects of the IRS Correspondence Audit Process Warrant Further Study," The Tax Law Center at NYU Law and the Center for Taxpayer Rights, February 18, 2022, https://www.law.nyu.edu/sites/default/files/TLC%20CTR%20Memo%20on%20Need%20for%20EITC%20Audit%20Study.pdf.

[ix] Department of the Treasury, "Agency Financial Report: Fiscal Year 2020," December 30, 2020, https://home.treasury.gov/system/files/266/Treasury-FY-2020-AFR.pdf.

[x] U.S. Senate Finance Committee, "The IRS's Fiscal Year 2022 Budget," Full Committee Hearing, June 8, 2021, https://www.finance.senate.gov/hearings/the-irss-fiscal-year-2022-budget. Transcript accessed via ProQuest.

[xi] Melanie R. Krause, Barry W. Johnson, Peter J. Rose, and Mary-Helen Risler, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016," Internal Revenue Service, August 2022, https://www.irs.gov/pub/irs-pdf/p1415.pdf.

[xii] Ibid.

[xiii] Andrew Johns and Joel Slemrod, "The Distribution of Income Tax Non-Compliance," National Tax Journal, Vol. 63 No. 3, September 2010, https://webuser.bus.umich.edu/jslemrod/Article%2001-Slemrod.pdf. See also: Jason DeBacker, Bradley Heim, Anh Tran, and Alexander Yuskavage, "Tax Noncompliance and Measures of Income Inequality," Tax Notes, February 17, 2020, https://www.taxnotes.com/tax-notes-federal/compliance/tax-noncompliance-and-measures-income-inequality/2020/02/17/2c3y5.

[xiv] Department of the Treasury, "Agency Financial Report: Fiscal Year 2021," November 15, 2021, https://home.treasury.gov/system/files/266/Treasury-FY-2021-AFR.pdf.

[xv] See payment integrity scorecards for EITC, ACTC, and AOTC: Office of Management and Budget, "High-Priority Programs and Programs over $100M in Monetary Loss," accessed April 28, 2022, https://www.paymentaccuracy.gov/payment-accuracy-high-priority-programs/.

[xvi] Treasury Inspector General for Tax Administration, "Improper Payment Rates for Refundable Tax Credits Remain High," TIGTA Report Number: 2021-40-036, May 10, 2021, https://www.tigta.gov/reports/audit/improper-payment-rates-refundable-tax-credits-remain-high; Department of the Treasury, Office of Inspector General, "Audit of Treasury's Compliance With the PIIA Requirements for Fiscal Year 2020," OIG-21-028, May 28, 2021, https://oig.treasury.gov/sites/oig/files/2021-07/OIG-21-028.pdf.

[xvii] See also, earlier reports from 1988, 1990, 1993, and 1996: Internal Revenue Service, "The Tax Gap," accessed April 28, 2022 https://www.irs.gov/statistics/irs-the-tax-gap. See also: Department of the Treasury, "The American Families Plan Tax Compliance Agenda," May 2021, https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf.

[xviii] This tax gap report also includes preliminary projections for tax years 2017-2019.

[xix] U.S. Treasury Department, Agency Financial Report Fiscal Year 2022, https://home.treasury.gov/system/files/266/Treasury-FY-2022-AFR.pdf.

[xx] See pg. 244: Department of the Treasury, "Agency Financial Report: Fiscal Year 2020," December 30, 2020, https://home.treasury.gov/system/files/266/Treasury-FY-2020-AFR.pdf; Department of the Treasury, "Agency Financial Report: Fiscal Year 2021," November 15, 2021, https://home.treasury.gov/system/files/266/Treasury-FY-2021-AFR.pdf; Payment Integrity Information Act of 2019, PL 116-117, March 2, 2020, 134 Stat 113.

[xxi] Office of Management and Budget, "High-Priority Programs and Programs over $100M in Monetary Loss," accessed June 10, 2021, https://www.paymentaccuracy.gov/payment-accuracy-high-priority-programs/; Treasury Inspector General for Tax Administration, "Improper Payment Rates for Refundable Tax Credits Remain High," TIGTA Report Number 2021-40-036, May 10, 2021, https://www.tigta.gov/reports/audit/improper-payment-rates-refundable-tax-credits-remain-high.

[xxii] Office of Management and Budget, "Requirements for Payment Integrity Improvement," Appendix C to OMB Circular A-123, March 5, 2021, https://www.whitehouse.gov/wp-content/uploads/2021/03/M-21-19.pdf.

[xxiii] Reducing Improper Payments, 74 FR 62201.

[xxiv] Treasury Inspector General for Tax Administration, "Improper Payment Rates for Refundable Tax Credits Remain High," TIGTA Report Number 2021-40-036, May 10, 2021, https://www.tigta.gov/reports/audit/improper-payment-rates-refundable-tax-credits-remain-high. The IRS is exempt from PIIA's requirement to report annual reduction targets for improper payments of the refundable credits, because the complexity of their statutory design and other barriers have consistently prevented the IRS from reducing improper payments below PIIA's target of 10%. In FY2021, OMB stated that Treasury Department will determine in FY2022 whether improper payments of the refundable credits have reached a tolerable rate, defined as "the improper payment and unknown payment estimate achieved with a balance of payment integrity risk and processes to mitigate that risk." See: Department of the Treasury, "Agency Financial Report: Fiscal Year 2021," November 15, 2021, https://home.treasury.gov/system/files/266/Treasury-FY-2021-AFR.pdf.

[xxv] See, for example: "EITC Payment Integrity Scorecard Q1," https://www.cfo.gov/wp-content/uploads/2021/03/Earned%20Income%20Tax%20Credit%20Payments%20Integrity%20Scorecard%20FY%202021%20Q1.pdf. See Footnote 8: Treasury Inspector General for Tax Administration, "Improper Payment Rates for Refundable Tax Credits Remain High," TIGTA Report Number 2021-40-036, May 10, 2021, https://www.tigta.gov/reports/audit/improper-payment-rates-refundable-tax-credits-remain-high.

[xxvi] Internal Revenue Service, "Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns," February 28, 2002, https://www.irs.gov/pub/irs-soi/compeitc.pdf; Internal Revenue Service, "Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns," August 2014, https://www.irs.gov/pub/irs-soi/EITCComplianceStudyTY2006-2008.pdf.