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The Earned Income Tax Credit (EITC): Policy and Legislative Issues

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Summary

The Earned Income Tax Credit (EITC or EIC) began in 1975 as a temporary program to return a portion of the social security taxes paid by lower income taxpayers, and was made permanent in 1978. In the 1990s, the program became a major component of federal efforts to reduce poverty, and is now the largest anti-poverty entitlement program. Preliminary 2001 data show a total for the EITC of $32.5 billion and 19.4 million recipients, yielding an average tax credit of $1,680. Most of the EITC (83.7%) was received as a refund to low income workers.

Legislation has been introduced in the 108th Congress related to three policy issues for the EITC: the marriage penalty (H.R. 210, H.R. 407, H.R. 1612, S. 96, S. 120, S. 135); family size adjustment (H.R. 936, H.R. 1782, and S. 448); and compliance (H.R. 22, H.R. 936, H.R. 1661, H.R. 1782, H.R. 1894, S. 448, S. 685, S. 755, S. 1173, S. 1174, and H.R. 1308 as amended by the Senate). This report will be updated as legislative activity warrants.

The Earned Income Tax Credit (EITC)[1]

The EITC is a refundable tax credit available to eligible workers earning relatively low wages. Under current law there are two categories of EITC recipients: childless adults and families with children. Because the credit is refundable, an EITC recipient need not owe taxes to receive the benefits. An EITC eligible family may also receive a portion of the credit in the form of advanced payments. Eligibility for, and the size of, the EITC is based on income, age, residence, and the presence of qualifying children.

[1] A more detailed description of EITC eligibility and the calculation of the credit are in CRS Report RL31768, *The Earned Income Tax Credit (EITC): an Overview*, by Christine Scott.

Policy and Legislative Issues

Legislation has been introduced in the 108th Congress reflecting three policy issues related to the EITC – marriage penalty, family size adjustment (anti-poverty effectiveness), and compliance.

Marriage Penalty. In general, the EITC amount increases with earnings up to a point (the maximum earned income eligible for the credit), then remains unchanged for a certain bracket of income (the plateau), and then gradually decreases to zero as earnings continue to increase (the phase-out range). This structure may, depending on the relative income levels of both parties, impose a "marriage penalty" on single low income parents if they choose to marry. The "marriage penalty" is the difference between the tax liability for a married couple (filing a joint tax return) and the sum of the tax liabilities for each person if they each filed using the single filing status. Two examples of the marriage penalty are:

- *Example 1*. In tax year 2002 two single parents, each with one child and earned income of $15,000 would receive an EITC of $2,265 each for a total of $4,530. If they marry, their combined income is $30,000, and with two children, the EITC is $875. The EITC marriage penalty for the couple is $3,655.
- *Example 2*. In tax year 2002, a single parent with one child and income of $15,000 would receive EITC of $2,265. If this single parent marries an individual with no children and $15,000 of income, their combined income is $30,000, and with one child the EITC is $28. The EITC marriage penalty for the couple is $2,237.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) began reducing the marriage penalty by increasing the phase-out income level for married couples by $1,000 in tax years 2002 through 2004, $2,000 for tax years 2005 through 2007, and by $3,000 in tax years 2008 and later. The EGTRRA provisions for marriage penalty relief will sunset at the end of 2010. EGTRRA reduced the marriage penalty for the couple in the first example by $210 in 2002, for the couple in the second example by $28.

Whether a family has a marriage penalty will depend upon the particular circumstances of the family including the number of earners (one earner or two earners). For example, a non-working single parent with one child would not receive an EITC because the parent has no earnings. If the parent marries an individual with $15,000 in income, the married couple would have an EITC of $2,265. In this case there is a "marriage bonus".

In the 108th Congress, S. 120 and S. 135 would provide acceleration of the marriage penalty relief provisions of EGTRRA, and eliminate the sunset for the marriage penalty provisions. H.R. 210, H.R. 407, H.R. 1612, and S. 96 would eliminate the sunset for the marriage penalty provisions

Family Size Adjustment (Anti-Poverty Effectiveness). While the EITC is available at incomes above the federal poverty levels, to the extent the EITC is an anti-poverty program, one goal may be to keep families above the poverty level. The structure

of the EITC with respect to family size has not changed since 1990, with the categories for family size being one child or two or more children. While benefits for most poverty related programs are related to family size, the family size adjustment for the EITC is capped at two children. As a result, a low income family with two children may remain above the poverty level because of the EITC, while families with three or more children at the same income level and EITC may slip below the poverty level. An example for tax year 2002 is shown in **Table 1**.

Table 1. Impact of Family Size on Net Income after Taxes Relative to Poverty Level, 2002

	Family 1 two adults, two children	Family 2 two adults, three children	Family 3 two adults, four children
Income	20,000	20,000	20,000
Federal tax before credits	15	0	0
Child credit (regular credit limited to tax before credits)	15	0	0
EITC	(2,981)	(2,981)	(2,981)
Additional child credit (refundable portion of credit)	(965)	(965)	(965)
Net tax	(3,946)	(3,946)	(3,946)
Payroll tax	1,530	1,530	1,530
Net income after tax	22,416	22,416	22,416
Poverty level (*)	18,244	21,469	24,038
Net income after tax as a percent of poverty level	122.9%	104.4%	93.3%

Source: Table prepared by the Congressional Research Service.

Note: (*) The official poverty level for 2002 is not yet available, this is an estimate based on poverty thresholds in 2001.

In the 108th Congress, H.R. 936, S. 448 would create a new category for the EITC related to family size for families with three or more children.

Compliance

Compliance with the EITC provisions has been an issue for the program since 1990, when the Internal Revenue Service (IRS), as part of the Taxpayer Compliance Measurement Program (TCMP), released a study on 1985 tax year returns with the EITC. The study concluded that there was an over-claim rate of 39.1%. The over-claim rate represents the percentage of claimed EITC that was invalid. Some of these over-claims were recovered after the study by IRS collection efforts. Later studies by the IRS have

resulted in lower over-claim rates. The 1997 and 1999 tax return studies[2] estimated that the unrecovered over-claim rates were 23.8% to 25.6%, and 27.0% to 31.7%. These studies presented the rates as upper– and lower-bound estimates because a number of individuals contacted as part of the study did not respond. The lower bound assumes that the over-claim rate for the nonrespondents is the same as for respondents, while the upper bound assumes that all the nonrespondents are over-claims.

In the 1999 study, 24.9% of over-claims (with errors known) were due to the child claimed not being the tax filer's qualified child. The most common qualifying child error was that the child did not meet the residency test which was 6 months in the case of certain blood relatives, or 1 year for other individuals. The second most common was the child not meeting the relationship test, particularly in the case of foster children where the child did not live with the tax filers for the full year or was not cared for as the tax filer's own child.

The FY2004 budget request for the Internal Revenue Service (IRS) contains additional funds ($100 million) for a new EITC compliance initiative that would establish a pre-certification process for EITC claimants. This pre-certification initiative, to begin in 2003, would select tax filers for whom the qualifying child's relationship or residency requirements could not be verified using existing data resources, and is estimated to involve 45,000 tax filers in 2003 and up to 2 million in 2004. These tax filers will be asked to provide documentation on the qualifying child's relationship and residency prior to filing their annual tax return.

Currently, if the qualifying child's relationship or residence cannot be verified with existing data resources for a return claiming the EITC, the return is selected for audit and the tax refund is not paid until the audit is completed. If a tax filer has been pre-certified for the qualifying child's relationship or residence, the tax refund would not be held on audit for this reason (a return may be audited for other reasons). In essence, the IRS performs the audit before the tax return is filed rather than after the tax return is filed.

In the 108th Congress, H.R. 1894 would prohibit the IRS from implementing a pre-certification program that is not authorized in law.

EGTRRA expanded the EITC definition of a qualifying child to include certain relatives related by blood (nephews, nieces, step-nephews, step-nieces, and descendants of such relatives cared for as the taxpayer's own child) or marriage (step-grandchildren), and eliminated the residence requirement for foster children. EGTRRA also provided new tie-breaker rules (rules for when more than one person can claim a child):

- If one party is the child's parent, the parent claims the child for the EITC.
- If neither party is the child's parent, the party with the highest adjusted gross income for the tax year claims the child for the EITC.
- If both parties are the child's parents, the parent the child resided with longer during the tax year claims the child for the EITC.

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[2] Internal Revenue Service, Department of the Treasury, "Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns," Feb. 28, 2002, p. 18.

- If the child resided with both parents for the same amount of time during the tax year, the parent with the highest adjusted gross income claims the child for the EITC.

These changes, particularly the tie-breaker rules may help in the future to reduce problems with a qualifying child. However, the general rate of over-claims has not changed significantly since 1990.

The definition of a child for purposes of the EITC is different from the requirements to claim a child as a dependent for the personal exemption. In general, for the personal exemption and the child credit, a dependent must have more than half of the support provided by the taxpayer, and to be considered a child of the taxpayer, the dependent must be a son, daughter, stepson, or stepdaughter of the taxpayer, and be under age 19 (24 if a student).[3] As a result of the difference in requirements for the personal exemption and EITC, a single parent living in a multi-generational household may be able to claim the child for the EITC, while the grandparent or the child's nonresident parent may be able to claim the child for the personal exemption and child credit.

To reduce the complexity created by the different definitions of a child, proposals have been made by both the U.S. Department of the Treasury and the Joint Committee on Taxation to conform the definition of a child for purposes of the personal exemption, child credit, EITC, dependent care, and head of household filing status. In the 108th Congress, H.R. 22, H.R. 936, S. 448, S. 755, S. 1173, S. 1174, and H.R. 1308 as amended by the Senate, would provide uniformity in the definition of a child.

In addition to complexity with respect to the definition of a child, there are problems for some married individuals. Under current law married taxpayers must file a joint return to be eligible for the EITC. Certain married individuals are unable or unwilling to file a joint return, creating difficulties for the other married partner in claiming the EITC. H.R. 1661 and H.R. 1782 would alter the EITC requirements to permit married individuals in certain circumstances to be considered unmarried for EITC purposes.

H.R. 1661 would also exclude from the calculation of a taxpayer's earned income any income exempt from tax because it is derived from: (1) activity related to fishing rights secured by treaty; (2) restricted or allocated land under the Indian General Allotment Act; or (3) land held under Acts or treaties with an exception provision similar to the Indian General Allotment Act. The bill also eliminates the investment income limitation for the EITC and contains language that may prevent pre-certification of the EITC.

According to the National Taxpayer Advocate,[4] in the 2000 processing year, paid tax preparers filed 44% of the paper returns and 82% of the electronic returns claiming an

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[3] Depending on the relationship to the taxpayer, a child may also have to meet certain residence, income, and citizenship tests.

[4] National Taxpayer Advocate, Internal Revenue Service, Department of the Treasury, FY2002 Annual Report to Congress, p. 70.

EITC. A study by the Consumer Federation of America[5] estimates that $994 million of the EITC is spent on tax preparation, electronic filing, check cashing, and refund anticipation loan fees. This estimate is based on fees of $85 for tax preparation, $40 for electronic filing, $67 for check cashing, and $75 for a refund anticipation loan.

There are a number of reasons why EITC recipients may use paid preparers including:

- language difference;
- literacy problems;
- IRS's close review of EITC returns;
- less effort (work) by the tax filer;
- the belief that use of a pair preparer prevents errors; and
- the belief that refunds are received faster.

The use of electronic filing will result in a faster refund, other things being equal, but use of a paid tax preparer does not necessarily result in fewer errors. In the 2000 processing year, of the EITC returns selected for examination (based on probability rules that the return contains unallowable or misreported items), 66.9% were done by paid tax preparers.

H.R. 1661 also provides a provision that would impact the use of refund anticipation loans by taxpayers claiming the EITC. The bill prohibits the Secretary of the Treasury from providing a direct deposit indicator[6] for any taxpayer to a tax return preparer, financial institution, or any other entity that charges the taxpayer interest rates, including fees, on refund anticipation loans that is higher than the consumer loan usury rate limit in the taxpayer's home state. S. 685 provides for registration of tax preparers and refund anticipation loan providers by the Secretary of the Treasury, with penalties for non-compliance with the registration requirement.

The Budget Resolution

The House and Senate have agreed to the conference report on the budget resolution which contains a provision which may impact the EITC in the future. H.Con.Res. 95. provides that most committees submit to the Budget Committee chairmen by September 2, 2003 recommendations which would target waste, fraud, and abuse to reduce the direct (mandatory or entitlement) spending under the committee's jurisdiction to by levels to be specified by the Budget Committee chairmen by May 16, 2003. These recommendations are to be used for development of future budget resolutions.

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[5] Consumer Federation of America and the National Consumer Law Center, "Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed From the Working Poor and the U.S. Treasury," Jan. 31, 2002, p.10.

[6] The direct deposit indicator is a flag for taxpayers with outstanding liabilities which are part of the tax intercept program such as child support and federal or state income taxes.