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The Earned Income Tax Credit (EITC): An Overview

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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. Childless adults in 2003 received an average EITC of $214, families with one child received an average EITC of $1,662, and families with two or more children received an average EITC of $2,560.

A low-income worker must file an annual income tax return to receive the EITC and meet certain requirements for income and age. A tax filer cannot be a dependent of another tax filer and must be a resident of the United States unless overseas because of military duty. The EITC is based on income and whether the tax filer has a qualifying child.

The EITC interacts with several nonrefundable federal tax credits to the extent lower income workers can utilize the credits to reduce tax liability before the EITC. Income from the credit is not used to determine eligibility or benefits for means tested programs. However, 13 states and the District of Columbia now offer an EITC for state taxes, and most of them are based on the federal EITC. Any change in the federal EITC would flow down to impact the state EITC.

Policy issues for the EITC, which reflect either the structure, impact, or administration of the credit include the work incentive effects of the credit; the marriage penalty for couples filing joint tax returns; the anti-poverty effectiveness of the credit (primarily a family size issue); and potential abuse (i.e., compliance with credit law and regulations).

The National Taxpayer Advocate heads an independent program within the Internal Revenue Service (IRS) to handle taxpayer problems not resolved through normal channels, and to identify issues that create problems for taxpayers. As part of identifying problems for taxpayers, the National Taxpayer Advocate prepares a report each year to Congress summarizing at least 20 of the most serious problems faced by taxpayers with recommendations to resolve the problems. In the reports for recent years (2002 through 2005), EITC related problems have been included among the "most serious problems." This report will be updated annually.

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The Earned Income Tax Credit (EITC): An Overview

The Earned Income Tax Credit (EITC) program began in 1975 as a temporary and small (6.2 million recipients) program to reduce the tax burden on working low-income families. The program has grown into the largest federal anti-poverty program with 22.1 million tax filers receiving $39.2 billion in tax credits for tax year 2003. **Appendix 1** outlines the history of the EITC and **Appendix 2** shows how the parameters for calculating the EITC have changed since the original enactment in 1975.

Eligibility

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.

Families with Children. For a family to receive the EITC, the family must have adjusted gross income (AGI) and earned income below the amount which reduces the EITC to $0, and have investment income no greater than $2,200 (indexed for inflation). Investment income includes interest income (including tax-exempt interest), dividends, net rent and royalties that are from sources other than the filer's ordinary business activity, net capital gains, and net passive income.

Earned income includes wages, tips, and other compensation included in gross income and self-employment income after the deduction for self-employment taxes. Earned income does not include pension or annuity income; income for nonresident aliens not from a U.S. business; income earned while incarcerated (for work in prison); and to the extent subsidized, earnings from a mandatory state work program.

The family must reside in the United States unless in another country because of U.S. military duty. For tax year 2004, the child (or children) must meet the three requirements for a qualifying child:

- relationship — the child must be: a son, daughter or descendant of such (grandchild); a brother, sister, or descendent of such (niece or nephew) cared for by the taxpayer; or foster child;
- residence — the child must live with the taxpayer for more than half the year; and

- age — the child must be under age 19 (or age 24, if a full-time student) or be permanently and totally disabled.

If a child qualifies for more than one tax filer, the natural parent claims the child. If the natural parent is not one of the tax filers, the tax filer with the highest AGI claims the child for the EITC. If both tax filers are natural parents, the parent the child resided the longest with during the tax year claims the child. If the child resided with each parent for the same period of time, the filer with the larger AGI must claim the child.[1]

Beginning in tax year 2005, the EITC, along with other tax provisions used by families (child tax credit, head of household filing status, and dependent care tax provisions) are linked to a more uniform definition of a child under the personal exemption tax provision changes made by the Working Families Tax Relief Act of 2004 (P.L. 108-311). The definition of a child and the rules for when more than one party may claim a child for these tax provisions are the same as the rules for the EITC in tax year 2004. In effect, the changes in the tax code for a more uniform definition of a child will not impact eligibility for the EITC.

Another change made by P.L. 108-311 will impact families in which the taxpayer or spouse is in the military. Although gross income for tax purposes does not generally included certain combat pay earned by members of the armed forces, P.L. 108-311 allowed members of the armed forces to include combat pay for purposes of computing the earned income credit for tax years that ended after October 4, 2004 and before January 1, 2006 (generally tax years 2004 and 2005). The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended the option to include combat pay for calculating the credit for another year (tax year 2006, or tax years ending before January 1, 2007).

The Katrina Emergency Relief Act (P.L. 109-73) provided that taxpayers affected by Hurricane Katrina may use their tax year 2004 earned income to compute their 2005 EITC. P.L. 109-135 also extended the option of using 2004 income to compute 2005 EITC to taxpayers affected by Hurricane Rita, and clarified that to use this election, the taxpayer's 2005 income had to be less than the taxpayer's 2004 income.

Childless Adults. Childless adults must reside in the United States unless in another country because of U.S. military duty. A childless adult must be at least 25 years of age, but not more than 64 years of age to be eligible for the EITC, and cannot be claimed as a dependent on another person's tax return. Childless adults may include married couples if both persons meet eligibility requirements. Eligibility is restricted to those with both earnings and AGI below the income amount which

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[1] An eligibility rule that an unmarried filer must meet the requirements for "head of household" tax filer status to be eligible for the EITC was dropped by Omnibus Budget Reconciliation Act (OBRA) of 1990. This status was difficult for many low-income working mothers to meet since many of them received more than half their cash income from AFDC, which is not regarded as self-support income by the IRS in determining "head of household" status.

reduces the EITC to $0, and investment income (as defined above) not in excess of $2,200 (indexed for inflation).

Credit Amount

Calculation of EITC Amount. Claimants receive an EITC in one of four ways:

- as a reduction in income tax liability;
- as a year-end cash payment from the Treasury if the family has no income tax liability;
- as a combination of reduced taxes and direct payments; or
- as advance payments by adjusting withholding.[2]

To receive an EITC, a person must file an income tax return at the end of the tax year, together with a separate schedule (Schedule EIC) if claiming a qualifying child. An eligibility certificate (Form W-5) must be filed with the employer to receive advance credits through the employer's payroll.

If the family (or childless adult) is eligible for the credit, the credit is based on the credit rate, which varies with the number of children, and the earned income. Up to the maximum earned income amount, the credit equals the earned income times the credit rate. During this phase-in period for the credit, for each additional $1 of earned income the recipient receives an additional credit equal to the credit rate. For example, in tax year 2006 for a family with one child, for each additional $1 of earnings (up to a total earned income of $8,080) the family receives an additional 34 cents in EITC.

For earned income between the maximum earned income amount and the phase-out income level, the EITC is constant at the maximum credit. Above the phase-out income level, for each additional $1 of income the recipient loses credit at the phase-out rate. In tax year 2006, for a family with one child, for each $1 of income above the phase-out level of income ($16,810 for married couples, $14,810 for others), the recipient loses 15.98 cents of EITC. Graphically, the phase-in period for the credit is steeper than the phase-out period because the credit is increased faster during the phase-in than the credit is reduced during the phase-out.

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 (beginning at the phase-out income level) gradually decreases to zero as earnings continue to increase. **Figure 1** provides a graphic representation of EITC levels, by income level for a single parent family with one child.

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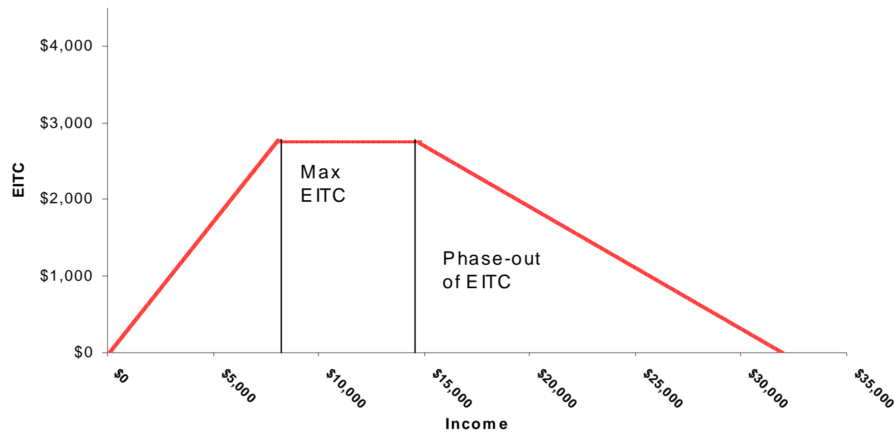
[2] Childless adults cannot receive the EITC through advance payments.

Figure 1. EITC Levels by Income, Single Parent Family with One child, Tax Year 2006



Source: Figure prepared by the Congressional Research Service (CRS).

The parameters for calculating the EITC (credit rates, phase-out rates, maximum earned income amount, maximum credit amount, phase-out income level, and disqualifying investment income level) for tax years 2004, 2005 and 2006 are shown in **Table 1**.

The EITC is taken against total tax liability (regular, alternative minimum, and self-employment taxes) after several nonrefundable tax credits. Because the EITC is a refundable credit, on the tax return the line for the EITC can be found in the payment section after the lines for withholding and estimated tax payments. The individual income tax return booklet presents the EITC amounts in tables by income brackets (in $50 increments). This allows a tax filer to look up the correct amount of the EITC based on income, filing status, and number of children.

Table 1. EITC Parameters for Tax Years 2003-2005

	2004	2005	2006	Credit Rate	Phase-Out Rate
No children	—	—	—	7.65%	7.65%
Maximum earned income amount	$5,100	$5,220	$5,380	—	—
Maximum credit	$390	$399	$412	—	—
Phase-out income level	$6,390	$6,530	$6,740	—	—
Phase-out income level for married filing joint	$7,390	$8,530	$8,740	—	—
Income where EITC = $0	$11,490	$11,750	$12,120	—	—
Income where EITC=$0 for married filing joint	$12,490	$13,750	$14,120	—	—
One child	—	—	—	34.00%	15.98%
Maximum earned income amount	$7,660	$7,830	$8,080	—	—
Maximum credit	$2,604	$2,662	$2,747	—	—
Phase-out income level	$14,040	$14,370	$14,810	—	—
Phase-out income level for married filing joint	$15,040	$16,370	$16,810	—	—
Income where EITC = $0	$30,338	$31,030	$32,001	—	—
Income where EITC=$0 for married filing joint	$31,338	$33,030	$34,001	—	—
Two or more children	—	—	—	40.00%	21.06%
Maximum earned income amount	$10,750	$11,000	$11,340	—	—
Maximum credit	$4,300	$4,400	$4,536	—	—
Phase-out income level	$14,040	$14,370	$14,810	—	—
Phase-out income level for married filing joint	$15,040	$16,370	$16,810	—	—
Income where EITC = $0	$34,458	$35,263	$36,348	—	—
Income where EITC=$0 for married filing joint	$35,458	$37,263	$38,348	—	—
Disqualifying investment income level	$2,650	$2,700	$2,800	—	—

Source: Table prepared by the Congressional Research Service (CRS).

Notes: To reflect the statutory language for calculating the inflation adjusted EITC parameters, the maximum earned income amount and the phase-out income level are rounded to the nearest $10, whereas the disqualifying income level is rounded to the nearest $50. In preparing their tax returns, tax filers will use a table with $50 increments of income to look up their EITC amount.

A formula presentation of the EITC calculation follows (where category reflects EITC factors based on the number of children and filing status as in **Table 1**, and adjusted gross income (AGI) is equal to gross income from all taxable sources such as earned income, dividends, taxable interest, alimony, capital gains, taxable pensions, etc. less statutory adjustments).

EITC =

Lesser of: earned income or maximum earnings amount $_{\text{category}}$

times

credit rate$_{\text{category}}$

minus

Greater of 0 or [earned income (or AGI whichever is larger) *minus* phase-out income level$_{\text{category}}$ *times* phase-out rate$_{\text{category}}$]

The following three examples for a married couple with 2 children in tax year 2006, illustrate how the EITC is calculated.

Example 1. For a family receiving less than the maximum allowable credit, with earned income and AGI of $10,000 (which is less than the maximum earned income amount):

EITC = $10,000 *times* 40% = $4,000

Example 2. For a family receiving the maximum allowable with earned income and AGI of $16,000 (which is greater than the maximum earned income amount but less than the phase-out income level):

EITC= $11,340 (the maximum earned income amount) *times* 40%

= $4,536 (the maximum credit)

Example 3. For a family subject to the phase-out of EITC with earned income and AGI of $20,000 (which is greater than the maximum earned income amount and the phase-out income level):

EITC = $11,340 (the maximum earned income amount) *times* 40% or $4,536 (the maximum credit)

minus

($3,190 (the amount by which income exceeds the phase-out income level[$16,810] *times* 21.06%)

or $672

= $3,864

Indexing. With everything else held constant, when inflation increases income, taxes increase. In periods of high inflation, this may result in increases in taxes which many view as a windfall to the government. To reduce the impact of inflation on taxes certain tax provisions, such as the personal exemption amount, are increased each year by the rate of inflation. The Tax Reform Act of 1986 (P.L. 99-514) began indexing of the maximum earned income and the phase-out income levels for the EITC. The structure of the EITC combined with indexing results in the largest annual percentage increases in EITC going to higher income EITC eligible taxpayers.[3] The effect of indexing on the EITC between year 1 and year 2 can be defined for four groups of taxpayers:

- Tax filers below the year 1 maximum earned income level will have no increase in the EITC between year 1 and year 2.
- Tax filers above the year 1 maximum earned income amounts and below the year 1 phase-out income level will have an increase in EITC equal to the change in the maximum credit amount (the credit rate times the change in the maximum earned income).
- Tax filers above the year 1 phase-out income amount but below the year 2 phase-out income amount, will have an increase in EITC equal to the change in the maximum credit *plus* the year 1 phase-out reduction in the EITC (the amount by which their year 1 income exceeded the year 1 phase-out income *times* the phase-out rate).
- Tax filers above the year 2 phase-out income level, will have a change in the EITC that is fixed at every income level until the end of the phase-out range. The change is calculated as:

Change in EITC (above phase-out income level)=

Change in Maximum Credit

plus

Change in Phase-out Income Level *x* Phase-out Rate

Marginal Tax Rates. Marginal tax rates reflect the additional tax paid for each additional $1 of income earned (or subject to tax). Economic theory suggests that the higher the marginal tax rate, the lower the incentive to work to increase income. The structure of the EITC (phase-in, plateau, and phase-out) creates a wide range of marginal tax rates for EITC recipients based on income. The marginal tax rate for an EITC recipient, excluding interactions with other credits, can be broken down into four ranges that correspond to the structure of the EITC:

- During the phase-in, when income is below the maximum earned income, the marginal tax rate is negative and equal to the credit rate because for each additional dollar of income the EITC recipient pays

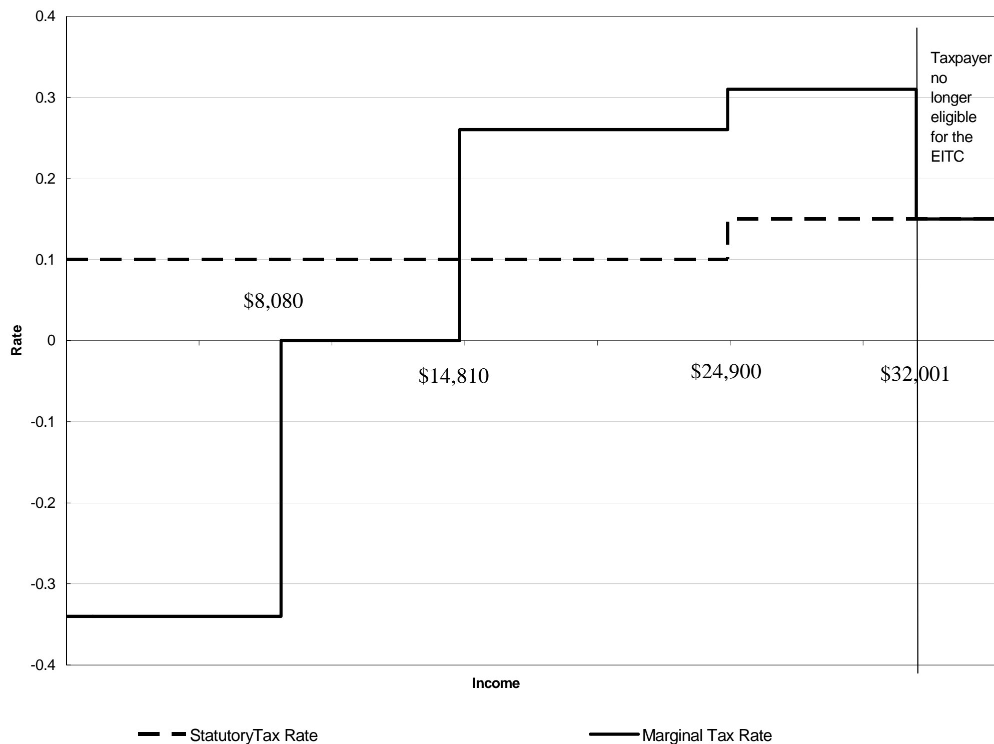
[3] The impact of indexing on the changes to the EITC is outline in CRS Report RS21352, *The Earned Income Tax Credit (EITC): Changes for 2005 and 2006*, by Christine Scott.

no income tax and receives an increase in the EITC equal to the credit rate times the additional income.

- Once the income reaches the plateau level, the marginal rate is zero while there is no tax liability and no change in the EITC amount (which is at the maximum).
- During the phase-out of the EITC, for each additional dollar of income the EITC recipient will pay taxes at the marginal tax rate and have a reduction in the EITC at the phase-out rate creating a marginal tax rate equal to the sum of the two changes. This results in a marginal tax rate that is significantly higher than the statutory tax rate.
- At the end of the phase-out of the EITC, when the EITC equals zero, the marginal and statutory tax rates for the taxpayer are equal.

Figure 2 shows the statutory and marginal tax rates, in tax year 2006, as income increases for a single parent family with one child. The marginal tax rates reflect the combined impact of the statutory tax rate and the EITC phase-out and do not reflect the use of any other tax credits.

Figure 2. Statutory and Marginal Tax Rates, Single Parent Family with One child, Tax Year 2006



Source: Figure prepared by the Congressional Research Service (CRS).

Participation

The EITC program has grown significantly since its inception in 1975. In 1975, there were 6.2 million recipients for a total of $1.2 billion in EITC, with 72.0% of the EITC received as a refund, and an average EITC of $201. For tax year 2003, a total of 22.1 million tax filers received an EITC, for a total of $39.2 billion. In 2003, the average EITC was $1,772, and 88.0% of the EITC was received as a refund. Estimates of the percentage of EITC eligible families participating in the EITC program (i.e., receiving an EITC) ranged from 80%-86% in a 1993 study[4] using 1990 data to 93%-96% for families with children in a 2001 study[5] by the General Accounting Office using 1999 data.

Table 2 provides the total EITC, refunded portion, number of recipients (tax filers), and average credit for 1975 through 2003.

Table 2. EITC and Recipients 1975-2003

Tax Year	Total EITC ($ millions)	Refunded portion of EITC ($ millions)	Number of Recipients (thousands)	Average EITC ($)
1975	$1,250	$900	6,215	$201
1976	1,295	890	6,473	200
1977	1,127	880	5,627	200
1978	1,048	801	5,192	202
1979	2,052	1,395	7,135	288
1980	1,986	1,370	6,954	286
1981	1,912	1,278	6,717	285
1982	1,775	1,222	6,395	278
1983	1,795	1,289	7,368	224
1984	1,638	1,162	6,376	257
1985	2,088	1,499	7,432	281
1986	2,009	1,479	7,156	281
1987	3,391	2,930	8,738	450
1988	5,896	4,257	11,148	529
1989	6,595	4,636	11,696	564
1990	7,542	5,266	12,542	601

[4] John Karl Sholz, "The Earned Income Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, Mar. 1994, vol. 47, no. 1, pp. 63-87.

[5] U.S. General Accounting Office, *Earned Income Tax Credit Participation*, GAO-20-290R, Dec. 14, 2001.

Tax Year	Total EITC ($ millions)	Refunded portion of EITC ($ millions)	Number of Recipients (thousands)	Average EITC ($)
1991	11,105	8,183	13,665	813
1992	13,028	9,959	14,097	924
1993	15,537	12,028	15,117	1,028
1994	21,105	16,598	19,017	1,110
1995	25,956	20,829	19,334	1,342
1996	28,825	23,157	19,464	1,481
1997	30,389	24,396	19,391	1,567
1998	32,340	27,175	20,273	1,595
1999	31,901	27,604	19,259	1,656
2000	32,296	27,803	19,277	1,675
2001	35,784	29,043	19,593	1,704
2002	37,786	33,258	21,574	1,751
2003	39,186	34,508	22,112	1,772

Sources: U.S. Congress, House Committee on Ways and Means. 2004 Green Book. Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means, 108th Congress, 2nd session, WMCP 108-6, Mar. 2004, p.13-41. Internal Revenue Service. Total File, United States, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2003. Expanded unpublished version.

Note: The number of recipients is the number of tax filers.

Characteristics of Tax Year 2003 EITC Tax Returns

Number of Children. In tax year 2003, the majority of the EITC (62.0%) went to families with two or more children, which represented 42.5% of the returns. **Table 3** shows the percent distribution of returns and total EITC by number of children. **Table 4** shows the number of recipients, amount of EITC, and average EITC by number of children for tax year 2003.

Table 3. Percent Distribution of Returns and Total EITC by Number of Children, Tax Year 2003

	Percent of Total Returns[a]	Percent of Total EITC
No children	19.9	2.4
One child	37.5	25.6
Two or more children	42.5	62.0
Total	100.0	100.0

Source: Table prepared by the Congressional Research Service (CRS) from data provided by the Joint Committee on Taxation. Detail may not sum to total due to rounding.

a. Total returns is all returns claiming an EITC.

Table 4. EITC by Number of Children, Tax Year 2003

Number of Children	Number of Recipients (tax filers)	Total EITC ($ thousands)	Average EITC	Percent of EITC Refunded
None	4,394,000	940,000	$214	69.7
One	8,269,000	13,745,000	$1,662	86.0
Two or More	9,364,000	23,970,000	$2,560	92.2

Source: Table prepared by the Congressional Research Service (CRS) from data provided by the Joint Committee on Taxation.

Filing Status. Heads of Household represented 52.6% of the EITC returns and 64.9% of the total EITC on returns in 2003, whereas single filers represented 22.7% of the returns and only 9.0% of the EITC. **Table 5** shows the percent distribution of returns and total EITC by filing status.

Table 5. Percent Distribution of Returns and Total EITC by Tax Filing Status, Tax Year 2003

Filing Status	Percent of Total Returns[a]	Percent of Total EITC
Single	22.7	9.0
Married joint	24.7	26.0
Head of household	52.6	64.9
Total	100.0	100.0

Source: Table prepared by the Congressional Research Service (CRS) from data provided by the Joint Committee on Taxation. Detail may not add to total due to rounding.

a. Total returns is all returns claiming an EITC.

Geographic Distribution. The distribution of EITC by state is a function of the relative populations and income levels of the states. In general states with larger populations or a large number of lower income workers will have more EITC recipients. The number of federal EITC returns, the total EITC, average EITC, and percent of the credit refunded by state for tax year 2003 are shown in **Table 6.**

Table 6. Federal EITC Recipients and EITC Amount By State, Tax Year 2003

State	Number of Returns	Total EITC ($ thousands)	Average EITC	% of EITC Refunded
Alabama	484,769	980,940	$2,024	90.9%
Alaska	38,730	57,882	$1,495	87.5%
Arizona	399,721	709,960	$1,776	89.8%
Arkansas	278,230	528,519	$1,900	89.8%
California	2,510,046	4,382,294	$1,746	85.3%
Colorado	267,260	425,764	$1,593	86.5%
Connecticut	167,877	262,708	$1,565	88.1%
Delaware	56,939	97,001	$1,704	90.9%
District of Columbia	51,748	87,017	$1,682	91.5%
Florida	1,575,803	2,807,471	$1,782	86.7%
Georgia	845,172	1,643,024	$1,944	89.8%
Hawaii	85,590	132,899	$1,553	88.9%
Idaho	101,277	171,652	$1,695	87.0%
Illinois	855,109	1,500,697	$1,755	88.2%
Indiana	425,837	718,264	$1,687	90.0%
Iowa	172,426	270,896	$1,571	87.3%
Kansas	177,484	295,386	$1,664	89.0%
Kentucky	342,656	588,693	$1,718	88.8%
Louisiana	534,828	1,115,615	$2,086	91.6%
Maine	86,942	135,316	$1,556	84.0%
Maryland	349,585	586,038	$1,676	88.3%
Massachusetts	307,954	468,495	$1,521	86.0%
Michigan	644,881	1,101,553	$1,708	88.4%
Minnesota	258,529	396,726	$1,535	86.0%
Mississippi	372,725	777,020	$2,085	92.0%
Missouri	436,100	750,276	$1,720	89.3%
Montana	74,495	120,992	$1,624	86.0%
Nebraska	110,383	181,161	$1,641	88.0%
Nevada	160,089	264,730	$1,654	90.3%
New Hampshire	62,038	92,940	$1,498	83.4%
New Jersey	495,578	838,235	$1,691	87.1%
New Mexico	198,576	356,519	$1,795	90.4%
New York	1,496,689	2,601,465	$1,738	83.8%
North Carolina	750,951	1,374,127	$1,830	90.3%
North Dakota	39,850	63,161	$1,585	87.0%
Ohio	786,642	1,344,140	$1,709	89.4%
Oklahoma	313,632	567,461	$1,809	88.6%
Oregon	225,019	360,464	$1,602	87.4%
Pennsylvania	773,232	1,254,599	$1,623	89.2%
Rhode Island	65,419	107,672	$1,646	88.4%
South Carolina	423,517	789,538	$1,864	91.4%
South Dakota	55,442	90,251	$1,628	87.9%
Tennessee	546,625	987,536	$1,807	88.5%

State	Number of Returns	Total EITC ($ thousands)	Average EITC	% of EITC Refunded
Texas	2,161,725	4,253,730	$1,968	87.9%
Utah	139,710	237,692	$1,701	88.5%
Vermont	38,323	56,368	$1,471	82.2%
Virginia	500,464	856,908	$1,712	89.7%
Washington	354,648	572,553	$1,614	88.1%
West Virginia	145,936	243,260	$1,667	90.5%
Wisconsin	293,418	465,069	$1,585	87.9%
Wyoming	34,479	54,933	$1,593	88.1%
U.S. Total	22,075,098	39,127,610	$1,772	88.0%

Source: Internal Revenue Service, Total File, All States, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2002, Expanded unpublished version.

Interaction With Other Tax Provisions

Other Federal Tax Credits. On the tax return, the EITC is calculated after total tax liability and several nonrefundable credits. The nonrefundable tax credits, which are taken against (reduce) tax liability, include credits for education, dependent care, savings, and the child credit. To the extent an EITC eligible family has a tax liability and can utilize one or more of these credits, the refundable portion of the family's EITC is higher. This is because using one or more of the tax credits reduces tax liability before the EITC, but does not affect the calculation of the EITC.

For tax filers in the plateau or phase-out period of the EITC, pre-tax contributions to savings for retirement, education or medical purposes can increase the amount of the EITC by reducing the amount of "earned income" used to calculate the EITC, in addition to reducing tax liability before the EITC if the contributions also qualify for a nonrefundable credit. This is because the earned income for the EITC, like the income subject to tax, does not include these pre-tax contributions as income.

Means Tested Programs. By law, the EITC cannot be taken into account for purposes of determining eligibility or benefits for food stamps, low-income housing, and Medicaid and Social Security Income (SSI). Under Temporary Aid to Needy Families (TANF), the states have the authority to determine if the receipt of an EITC is taken into consideration in determining eligibility or benefits. Currently, no state does so. However, an EITC refund that is saved may become an asset and could be used in determining TANF eligibility and benefits.

State EITC Provisions. In tax year 2005, 14 states and the District of Columbia offered an EITC for state taxes. Of these jurisdictions, three have a nonrefundable EITC, 11 have a refundable EITC, and one (Maryland) has both a refundable and nonrefundable EITC. One jurisdiction in Maryland, Montgomery County, has a refundable EITC. In addition, eight states (Arkansas, Arizona, Hawaii, Idaho, Minnesota, New Mexico, Pennsylvania, and Virginia) have a credit that provides some tax relief to low-income families, ranging from a refundable low income credit to a grocery, family size, or tax forgiveness credit. For states with an EITC that is calculated based on the federal EITC, a change in the federal EITC will

generally flow through and change the state EITC unless the state takes positive legislative action to alter or prevent the change.

Issues

The structure, impact, and administration of the EITC are reflected in the major policy issues — work incentives, marriage penalty, anti-poverty effectiveness (family size), compliance, and the use of paid tax preparers.

Work Incentives. Although the original purpose of the EITC was to return payroll taxes to low-income workers, in its current form as a cash transfer program it provides assistance to working low income families to meet basic needs. As such it may be viewed as creating an incentive to work, both in participating in the labor force (beginning to work), and increases in work effort (more hours). Economic theory suggests that the phase-in range of the EITC (when income is below the maximum earned income) would create an incentive to begin work, and to work more hours by increasing the marginal return to work after taxes. This is because the EITC increases as work increases and is reflected in the negative marginal tax rate during the phase-in range of the credit.

Conversely, the phase-out range of the EITC would create a disincentive to work because the more the individual works and earns the greater the individual is penalized (although the after-tax income is higher). The individual not only has to pay taxes at the statutory rate, but the earned income credit is reduced by the phase-out rate. This is reflected in a marginal tax rate for the phase-out period that is higher than the statutory tax rate. In the phase-out range, an individual may attempt to maintain a level EITC by reducing work hours (substituting leisure for work). However, many workers do not have the flexibility (in their jobs) to reduce hours.

Alternatively, the EITC can be viewed as a wage supplement for lower income workers. The wage supplement increases the hourly wage rate over the phase-in range, the supplement remains steady over the plateau range, and over the phase-out range the wage supplement is reduced, reducing the hourly wage down to the level actually paid by the employer.

In evaluating the work incentives of the EITC it is important to remember that all of the benefits and costs of work are not reflected in the marginal tax rate. A family receiving TANF benefits may be required to work a stated number of hours to maintain certain non-cash benefits. However, by working those hours the family earns income that may reduce other non-cash benefits such as food stamps or housing allowances, and may require additional cash expenditures for child care, clothing, etc.

Studies on the EITC and labor force participation have concluded that the EITC has a significant positive impact on participation in the labor force, particularly

for single mothers.[6] Some studies have concluded that there is a negative impact on work hours at the higher levels of income, but that the impact is not significant.[7]

Marriage Penalty. The structure of the EITC may, depending on the relative income levels of both parties, impose a "marriage penalty"[8] on single low-income parents if they choose to marry. For example, in tax year 2006 two single parents, each with one child and earned income of $15,000 would receive an EITC of $2,717 each for a total of $5,434. If they marry, their combined income is $30,000, and with two children, the EITC is $1,758. The EITC marriage penalty for the couple is $3,676. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) reduced the marriage penalty for the family by $421 in 2006. The EGTRRA provisions for marriage penalty relief in the EITC will sunset at the end of 2010.

Empirical research has concluded that the structure of the EITC, through the phase-out and the marriage penalty, has a negative impact on the labor market participation of nonworking spouses in two-parent families at higher income levels (levels of income in the plateau or phase-out range of the EITC).[9]

Anti-Poverty Effectiveness (Family Size). 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 threshold (or level). The structure of the EITC with respect to family size has not changed since 1990. Although 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 2004 is shown in **Table 8**.

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[6] Bruce D. Meyer and Dan T. Rosenbaum, "Making Single Mothers Work: Recent Tax and Welfare Policy and Its Effects," *National Tax Journal*, vol. 53 (Dec. 2000), pp. 1027- 1043. Robert Moffitt, *Welfare Programs and Labor Supply*, National Bureau of Economic Research, Working Paper 9168, Sept. 2002.

[7] Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *Tax Policy and the Economy*, James M. Poterba ,ed. (National Bureau of Economic Research and the MIT Press,1995), pp. 1-50. V. Joseph Hotz and John Karl Sholz, *The Earned Income Credit*, National Bureau of Economic Research, Working Paper 8078, Jan. 2001.

[8] 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.

[9] Nada Eissa and Hillary Williamson Hoynes, "The Earred Income Tax Credit and the Labor Supply of Married Couples," National Bureau of Economic Research, Working Paper 6856, 1998. V. Jospeh Holz and John Karl, "In-Work Benefits in the United States: The Earned Income Credit," *The Economic Journal*, vol. 106, no. 434 (Jan. 1996), pp. 156-169.

Table 8. Impact of Family Size on Net Income after Taxes Relative to Poverty Level, 2004

	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	0	0	0
Child credit (regular credit limited to tax before credits)	0	0	0
EITC	(3,255)	(3,255)	(3,255)
Additional child credit (refundable portion of credit)	(1,425)	(1,425)	(1,425)
Net tax	(4,680)	(4,680)	(4,680)
Payroll tax	1,530	1,530	1,530
Net income after tax	23,150	23,150	23,150
Poverty level	19,157	22,543	25,241
Net income after tax as a percent of poverty level	120.8%	102.7%	91.7%

Source: Table prepared by the Congressional Research Service.

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%. This over-claim rate however, did not reflect any later efforts by the IRS to collect on the over payments. Later studies by the IRS have resulted in lower over-claim rates. The 1997 and 1999 tax return studies[9] 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 filers's qualified child. The most common qualifying child error was that the child did not meet the residency test, six months or one year depending on relationship. The second most common was the child not meeting the

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

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 filers's own child.

After errors in claiming an unqualified child, errors in income reporting accounted for 21.4% of the over-claims. Most frequent income reporting errors were underreporting of earned income and modified adjusted gross income. Another 17.2% of known errors were for a qualifying child also being the qualifying child of another tax filer.

As a result of the over-claim rates, there have been several legislative changes to improve EITC compliance. Among them are: the requirement that dependents have identification numbers (social security numbers); prohibitions of 2 to 10 years on receiving the EITC after improperly or fraudulently receiving the credit; for tax preparers due diligence requirements (maintaining certain paperwork); and permission for the IRS to match tax filers to the Federal Case Registry of Child Support Orders. (Maintained by the Department of Health and Human Services.)

In addition, some of the EGTRRA changes to the EITC definition of a qualifying child and the tie-breaker rules (rules for when more than one person can claim a child), may help in the future to reduce these problems. However, the general rate of over-claims has not changed significantly since 1990.

To reduce the complexity created by the different definitions of a child, proposals were 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. The Working Families Tax Relief Act of 2004 (P.L. 108-311) created a more uniform definition of a child for tax purposes, including the EITC. This new definition became effective with tax year 2005.[2]

In 2003, the IRS announced plans to conduct a pre-certification effort for the tax year 2003 returns, in which tax filers expecting to claim the EITC would need to pre-certify that any child claimed for the EITC met the residency requirement (had resided with the tax filer for at least half of the tax year). The pre-certification effort was converted to a study of approximately 25,000 returns expected to claim the EITC, and combined with two other compliance studies related to the EITC: (1) a study of filing status; and (2) an automated underreporter (income) study. The Consolidated Appropriations Act of 2004 (P.L. 108-199) required a report to Congress on the qualified child study (the pre-certification of a child for the EITC residency requirement).

According to the IRS,[10] the three studies uncovered and prevented payment of more than $275 million in erroneous claims for the EITC, with approximately

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[2] For information on the new definition of a child, see CRS Report RS22016, *Tax Benefits for Families: Changes in the Definition of A Child*, by Christine Scott.

[10] The final report of the EITC initiative can be found on the IRS website at [http://www.irs.gov/pub/irs-utl/irs_earned_income_tax_credit_initiative_final_report_to_congress_october_2005.pdf].

$250 of the $275 million from the automated underreporter study. In the automated underreporter study, the IRS manually reviewed 300,000 tax returns that claimed the EITC in tax year 2003, that also had indications of income misreporting for tax year 2002. Approximately 83% of the tax returns had a reduction or disallowance of the EITC as a result of the manual review.

National Taxpayer Advocate's "Most Serious Problems"

Each year the National Taxpayer Advocate[11] must report to Congress and analyze at least 20 serious problems taxpayers have with the tax system. The reports for recent years (2002 through 2005) have included EITC related problems among those listed as the "most serious problems" encountered by tax filers. In the most recent report for 2005, included among the problems for the EITC are the documentation requirements, the length of time taken to complete examinations (particularly exams conducted through correspondence with the taxpayer), the taxpayer response rate for examinations, and delays in the re-certification process. It is important to note that while including the time to complete the examination process (an average of 181 days in FY2005), the Taxpayer Advocate noted that the time had declined each year since FY2002 (when the average time for completion of an EITC examination was 220 days).

The Taxpayer Advocate Service (TAS) also did a study of TAS cases with refunds frozen by Criminal Investigation (by the Questionable Refund Program), which is an IRS program designed to stop fraud. The Taxpayer Advocates notes that of the 473 returns selected for the study, 75% claimed the EITC and that 80% of the returns selected for the study eventually received at least a partial refund. The Taxpayer Advocate has made several recommendations for the CI program related to the freezing of refunds including (1) that the IRS conduct a study of returns with refunds frozen by CI that were not TAS cases; (2) notify taxpayers soon after their refunds are frozen that their refunds are frozen and will not be released until a determination is made (currently taxpayers are not notified); and (3) shorten the time period (currently six months) during which other IRS organizations (such as TAS) cannot help taxpayers with respect to frozen refunds.

On January 24, 2006, IRS Commissioner Mark Everson announced that he had directed a review of the program, and that in the near future the IRS will announce plans "to institute notification procedures as well as significant improvements to minimize the number of taxpayers whose refunds are frozen unnecessairly".[12]

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[11] The National Taxpayer Advocate heads an independent program with the Internal Revenue Service (IRS) known as the National Taxpayer Service. The program is designed to handle taxpayer complaints not resolved through normal IRS procedures and to analyze problems encountered by taxpayers with the IRS and suggest solutions for the problems.

[12] Internal Revenue Service, news release, available at [http://www.irs.gov/newroom/article/0,,id=15813,00.html]

In addition to the problems listed by the National Taxpayer Advocate, the Treasury Inspector General for Tax Administration, released a report,[13] finding that taxpayers were not treated consistently by the service centers regarding the two-year ban, and that the can notice and other material related to the ban and re-certification needed more clarification for taxpayers.

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[13] Treasury Inspector General for Tax Administration, *Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers*, 2004-40-015, Dec. 2004.

Appendix 1. Legislative History of the EITC[14]

The idea that became the EITC first arose during congressional consideration of President Nixon's 1971 welfare reform proposal. Nixon's proposal, the Family Assistance Plan, would have helped working poor, two-parent families with children by means of a federal minimum cash guarantee that would have replaced the federal-state welfare program of Aid to Families with Dependent Children (AFDC).

Work Bonus Plan (1972-1974 Proposals)

The EITC was patterned after a proposal, then known as a work bonus for the working poor, recommended by the Senate Finance Committee in April 1972. Though the idea originated as an alternative to the proposed Family Assistance Program, the work bonus provision was advocated as a "refund" of Social Security taxes paid by employers and employees on low annual earnings and was to have been available only for wages subject to Social Security taxation.

The Senate approved the work bonus plan in 1972, 1973, and 1974, but the House did not accept it until 1975.

Enactment of EITC in 1975

The Tax Reduction Act of 1975 (P.L. 94-12) included a provision that established, in Section 32 of the Internal Revenue Code, a refundable credit to tax filers with incomes below $8,000. This "earned income credit" was to equal 10% of the first $4,000 of any earnings (including earnings not subject to Social Security taxation) and thus could not exceed $400 per year. The credit was to be phased out, at a rate of 10%, for adjusted gross income (AGI) above $8,000.

Extensions of EITC (1975-1977 Laws)

The Revenue Adjustment Act of 1975 (P.L. 94-164), Tax Reform Act of 1976 (P.L. 94-455), and Tax Reduction and Simplification Act of 1977 (P.L. 95-30) each extended the EITC by one year.

Permanent Status for EITC and Rise in Maximum Credit (1978 Law)

The Revenue Act of 1978 (P.L. 95-600) made the EITC permanent and increased the maximum credit to $500 and the eligibility limit to $10,000, provided for EITC payments in advance of the annual tax filing, and simplified eligibility determinations.

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[14] This legislative history of the EITC is a shortened version of the more detailed history in CRS Report 95-542, *The Earned Income Tax Credit: A Growing Form of Aid to Low-Income Workers*, by James R. Storey.

Under the 1978 law, the EITC was set at 10% of the first $5,000 of earnings (including net earnings from self-employment). The maximum credit of $500 was received for earnings between $5,000 and $6,000. For each dollar of AGI above $6,000, the EITC was reduced by 12.5 cents, reaching $0 at an AGI of $10,000.

Rise in Maximum Credit (1984 Law)

The Deficit Reduction Act of 1984 (P.L. 98-369) raised the maximum credit by 10%, from $500 to $550 by establishing the EITC at 11% of the first $5,000 of earnings. Earnings between $5,000 and $6,500 qualified for the maximum credit of $550. For each dollar of AGI above $6,500, the law required that the EITC be reduced by 12.22 cents. As a result, the credit was completely phased out when AGI reached $11,000.

Indexation of EITC and Rise in Maximum Credit (1986 Law)

Effective with tax year 1987, the Tax Reform Act of 1986 (P.L. 99-514) increased the EITC from 11% of the first $5,000 of earnings to 14% of the first $5,714 of earnings. The act also began indexing the credit for inflation. This was done by indexing the maximum earned income eligible for the credit and phase-out income level by using the change in the average Consumer Price Index (CPI) for the 12-month period ending August 31 of each year, from the CPI for the 12-month period ending August 31, 1984. In addition, the starting point of the phase-out income level was increased for 1987 and 1988. The 1986 Act also lowered the phase-out rate from 12.22% to 10% beginning with the 1987 tax year.

The increase in the maximum earned income for the credit and the credit rate raised the EITC, while the reduction in the phase-out rate reduced the marginal tax rate on recipient earnings. The combination of a higher EITC and a lower phase-out rate increased the income eligibility level from $11,000 in 1984 to $14,500 (in 1984 dollars) for 1987. During debate on the Tax Reform Act of 1986, it was said that "the liberalization of the earned income credit will help to assure that low-income citizens are no longer taxed into poverty."[15]

Rise in Maximum Credit and Establishment of Family-Size Adjustment and Supplemental Credits (1990 Law)

Basic EITC. Because the EITC was originally established as a work bonus and advertised as an offset to the Social Security tax, it had not been designed to vary by family size. Thus, the larger the family, the less it met the family's needs. Proposals were introduced in the 101st Congress to vary EITC credit amounts by number of children, up to a maximum of two, three, or four children depending on the bill. These proposals intended to increase EITC's welfare role while continuing its provision of payroll tax relief and work bonuses. However, no one proposed that

[15] In floor statement of Senator Matsunaga, *Congressional Record*, daily edition, Sept. 26, 1986, p. S13818.

EITC family-size variations be modeled after AFDC, which varied for much larger family sizes.

The EITC expansion enacted in the Omnibus Budget Reconciliation Act (OBRA) of 1990 (P.L. 101-508) took effect in 1991 and was to be completed in 1994. An adjustment for family size was introduced and the credit and phase-out rates for each of the family sizes (one child , two or more children) were increased each year. However, the planned rate increases for 1994 were superseded by a 1993 law. (See below.)

Supplemental Young Child Credit. Numerous proposals were introduced in the 101st Congress to establish refundable tax credits for families with young children. These proposals would have set credit amounts based on earned income and number of qualifying children. Both House and Senate passed such provisions in competing versions of child care legislation. These measures were seen as aiding lower income families in need of child care for preschool children.

Final action in OBRA of 1990 limited additional credits for young children to those under one year of age. Eligible families with such children had an extra 5.0 percentage points added to their credit rate in computing the EITC amount. This extra credit had a maximum amount in 1993 of $388, and was phased out by adding 3.57 percentage points to the family's phase-out rate. Thus, in 1993 families with one or more children under age 1 had a combined credit rate of 23.5% or 24.5%, depending on total number of children, and a combined phase-out rate of 16.78% or 17.50%.

This extra credit was ended effective for tax year 1994 by OBRA of 1993 (P.L. 103-66).

Supplemental Health Insurance Credit. A new refundable credit aimed at helping parents finance health insurance for their children was included in the Senate-passed OBRA of 1990. The House did not include such a provision, but it was accepted by House-Senate conferees. The supplemental health insurance credit applied to earnings up to the maximum amount to which the EITC applied and was then reduced over the same income range used for the EITC phase-out. The rates set for the child health insurance credit and its phase-out were 6.0% and 4.285%, respectively. These percentages were added to those that applied to a family for the basic EITC and, if eligible, the young child credit. The maximum amount of the supplemental health insurance credit in 1993 was $465. The credit could not exceed the health insurance premiums actually paid by a family during the tax year. Unlike the basic EITC, this supplemental credit could not be received in advance of the annual tax filing.

The health insurance credit was ended, effective in 1994, by OBRA of 1993.

Expansion of Credits, Coverage of Childless Adults, and Repeal of Supplemental Credits (1993 Law)

President Clinton began his term in office in 1993 with a pledge to use the EITC to eliminate poverty for families with a member working full-time at the minimum wage in order to "make work pay." Fulfillment of his pledge required a proposal to raise the EITC credit rates, especially for families with two or more children. His proposal was enacted as part of OBRA of 1993 (P.L. 103-66) with little change by Congress. President Clinton also proposed extending the EITC for the first time to low-income working adults with no children to offset tax increases in OBRA of 1993, and Congress adopted this proposal with only minor changes. To offset part of the EITC expansion's cost, and to meet the criticism of the EITC's growing complexity, Congress also passed the President's proposal to repeal the supplemental credits for young children and for child health insurance premiums as part of OBRA of 1993.

Credit for Families. The EITC parameters for families were significantly changed by OBRA 1993. The credit rates were increased from 23% to 34% in 1996 for a family with one child, and from 25% to 40% for a family with two or more children. The phase-out rate for families with one child was slightly lowered (from 16.43% to 15.98%) and the phase-out rate for families with two or more children was increased from 17.86% to 21.06%.

Extension of EITC to Childless Households. The Clinton Administration proposal enacted in OBRA of 1993 extended the EITC for the first time to workers who have no children. The main rationale for this credit was to offset partly the effect on low-income workers of a gasoline tax increase included in OBRA of 1993. The 1993 law provided, effective in 1994, a credit of 7.65% of the first $4,000 of annual earnings, for a $306 maximum credit. It is phased out at a 7.65% rate, beginning at an income level of $5,000 and ending at $9,000. The maximum earned income and the phase-out income level are adjusted annually for inflation.

This credit applies to adults ages 25 to 64 who are not claimed as dependents on anyone's tax return. The age limits were imposed by Congress to exclude two groups (students under age 25, retirees over age 64) whose incentive to work was not regarded as an important priority.

Coverage of Overseas Military Personnel (1994 Law)

Before 1995, the EITC had always been restricted to families residing in the United States. This rule excluded from EITC otherwise eligible lower income American military families living in foreign countries. A provision in the 1994 legislation to implement the General Agreement on Tariffs and Trade (P.L. 103-465) provides EITC eligibility for qualifying families outside the United States if their foreign residence is because of a U.S. military assignment. This provision became effective in 1995.

This law also included measures to: (1) deny the EITC for wages earned by prison inmates; and (2) deny eligibility to anyone who spent part of the tax year as a nonresident alien.

Eligibility Limit Based on Investment Income (1995 Law)

Limitation of EITC eligibility by a filing unit's income has always been based on the greater of AGI or earnings. However, following up on a proposal in President Clinton's FY1996 budget, Congress enacted in 1995 (P.L. 104-7) a new limitation tied to investment income. This provision prohibits EITC claims by tax filers whose annual investment income exceeds $2,350. Investment income is defined to include taxable interest and dividend income, tax-exempt interest income, and net income from rent and royalties not derived in the normal course of the filer's business. This provision took effect in 1996. (It was modified in August 1996 action. See discussion below.)

Revisions of EITC in the Welfare Reform Bill (1996 Law)

Although not proposing specific legislation, the FY1997 congressional budget resolution (H.Con.Res. 178) "assumes reforms of the Earned Income Credit ... to eliminate fraud and abuse within the program, to better target to low-income working families with children, and to coordinate the credit with the $500 per child tax credit that also is assumed in this budget." In followup, Congress included EITC savings in the welfare reform measure (H.R. 3734) signed by President Clinton on August 22, 1996 (P.L. 104-193). These provisions are described below.

Deny EITC to Undocumented Workers. This provision requires tax filers to have valid taxpayer identification numbers (usually Social Security numbers) to be eligible for the EITC. Social Security numbers are issued only to persons who can document their age, identity, and U.S. citizenship or legal alien status. It becomes effective for tax returns due more than 30 days after the enactment date. This measure helps the Internal Revenue Service (IRS) gain compliance from tax filers lacking valid numbers before accepting their EITC claims.

Disqualified Income. Congress acted in March 1995 (see earlier discussion) to exclude from EITC eligibility all filers with "disqualified income," defined as income in excess of $2,350 a year from interest (taxable and tax-exempt), dividends, and net rents and royalties. The welfare reform bill broadened this definition to include net capital gains and net passive income. The maximum allowance for disqualifying income was reduced from $2,350 to $2,200 for 1996 and indexed for inflation in later years.

Broaden Income Used in EITC Phase-out. The EITC is phased out when the greater of earnings or AGI exceeds a certain level ($11,610 in 1996 for families with children). Broadening the definition of income used for EITC phase-out reduces the EITC for persons with income from the sources to be included. Effective for 1996, the welfare reform bill expanded the income used to phase out the EITC by netting out certain losses that are normally taken into account in calculating

AGI. These losses are net capital losses, net losses from estates and trusts, net losses from nonbusiness rents and royalties, and half of net business losses.

Allow State Welfare Programs to Count EITC. The 1996 welfare reform bill (Personal Responsibility and Work Opportunity Reconciliation Act, P.L. 104-193) repealed AFDC. And in its place created the Temporary Assistance to Needy Families (TANF) program, a state-run system funded partly by federal block grants. This conversion to state control alters the EITC-welfare relationship. Federal law had required that the EITC be disregarded as income in determining eligibility for AFDC, Food Stamps, Medicaid, Supplemental Security Income (SSI), and housing aid. Lump-sum EITC payments had to be ignored in comparing applicants' assets to program asset limits for the month of receipt and the next month. (The Food Stamp program must ignore lump-sum EITC payments for one year.) Ending AFDC eliminates federal restrictions on states' treatment of the EITC for cash welfare (TANF) recipients. States may count the EITC as income available to families aided by TANF programs and reduce their welfare accordingly. Lump-sum EITC receipt may be counted by states as assets immediately available to state-aided families, thereby denying them that aid if counting the EITC causes their assets to exceed state asset limits. States adopting such policies may spend less on aid to needy families from their federal grants, in effect substituting the federal EITC for state welfare and lowering the income of those affected.

Denying Credit Based on Prior Claims (1997 Laws)

To improve compliance related to the EITC, the Taxpayer Relief Act of 1997 (P.L. 105-34), denied the EITC to tax filers for a specified period of time if the tax filers had previously made a fraudulent or reckless EITC claim. A tax filer is denied the EITC for two years after it has been determined that the tax filer made a reckless claim, and ten years after a determination that a tax filer has made a fraudulent claim. The Balanced Budget Act of 1997 (P.L. 105-33) provided initial funding for a five-year initiative by the IRS to improve compliance for the EITC.

Reduction of Marriage Penalty and Simplification of the EITC (2001 Law)

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), to reduce the marriage penalty, increased the phase-out income levels for married couples filing a joint return by $1,000 for tax years 2002 through 2004, $2,000 for tax years 2005 through 2007, and $3,000 beginning in tax year 2008 (indexed for inflation). The bill also simplified the definition of earned income to reflect only compensation included in gross income; based the phase-out of the credit on adjusted gross income instead of expanded (or modified) gross income; and eliminated the reduction in the EITC for the alternative minimum tax.

Uniform Definition of a Child and Combat Pay (2004 Law)

The Working Families Tax Relief Act of 2004 (P.L. 108-311) created a more uniform definition of a child for tax purposes. The EITC, along with other tax provisions used by families (child tax credit, head of household filing status, and

dependent care tax provisions) are linked to this more uniform definition of a child under the personal exemption tax provision. The definition of a child and the rules for when more than one party may claim a child for these tax provisions are the same as the rules for the EITC in tax year 2004. In effect, the changes in the tax code for a more uniform definition of a child will not impact eligibility for the EITC. In addition, P.L. 108-311 allowed members of the armed forces to include combat pay for purposes of computing the earned income credit for tax years that ended after October 4, 2004 and before January 1, 2006 (generally tax years 2004 and 2005).

Hurricane Relief (2005 Law)

The Katrina Emergency Relief Act (P.L. 109-73) provided that taxpayers affected by Hurricane Katrina may use their tax year 2004 earned income to compute their 2005 EITC.

Extension of Combat Pay & Hurricane Relief (2005 Law)

The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended the option to include combat pay for calculating the credit for another year (tax year 2006, or tax years ending before January 1, 2007).

P.L. 109-135 also extended the option of using 2004 income to compute 2005 EITC to taxpayers affected by Hurricane Rita, and clarified that to use this election, the taxpayer's 2005 income had to be less than the taxpayer's 2004 income.

Appendix 2. History of the EITC Parameters

Since its inception in 1975, the EITC has evolved from a small program to refund a portion of social security taxes to the largest anti-poverty entitlement program. The credit has change through changes in eligibility and in the values of the parameters used to calculate the credit. **Table 9** shows the changes to the parameters for the EITC for tax years 1975 through 2006.

Table 9. EITC Parameters, 1975 — 2006

	Credit Rate (%)	Maximum Earned Income	Maximum Credit[a]	Phase-Out Rate (%)	Phase-Out Income Level	Income Where EITC=$0
For families with children:						
1975	10.0	4,000	400	10.0	4,000	8,000
1976	10.0	4,000	400	10.0	4,000	8,000
1977	10.0	4,000	400	10.0	4,000	8,000
1978	10.0	4,000	400	10.0	4,000	8,000
1979	10.0	5,000	500	12.5	6,000	10,000
1980	10.0	5,000	500	12.5	6,000	10,000
1981	10.0	5,000	500	12.5	6,000	10,000
1982	10.0	5,000	500	12.5	6,000	10,000
1983	10.0	5,000	500	12.5	6,000	10,000
1984	10.0	5,000	500	12.5	6,000	10,000
1985	10.0	5,000	500	12.22	6,500	11,000
1986	10.0	5,000	500	12.22	6,500	11,000
1987	14.0	6,080	851	10.0	6,920	15,432
1988	14.0	6,240	874	10.0	9,840	18,576
1989	14.0	6,500	910	10.0	10,240	19,340
1990	14.0	6,810	953	10.0	10,730	20,264

	Credit Rate (%)	Maximum Earned Income	Maximum Credit[a]	Phase-Out Rate (%)	Phase-Out Income Level	Income Where EITC=$0
For families with one child:						
1991	16.7	7,140	1,192	11.93	11,250[a]	21,250[a]
1992	17.6	7,520	1,324	12.57	11,840[a]	22,370[a]
1993	18.5	7,750	1,434	13.21	12,200[a]	23,050[a]
1994	26.3	7,750	2,038	15.98	11,000	23,750
1995	34.0	6,150	2,094	15.98	11,290	24,396
1996	34.0	6,350	2,152	15.98	11,650	25,100
1997	34.0	6,500	2,210	15.98	11,950	25,800
1998	34.0	6,650	2,271	15.98	12,300	26,500
1999	34.0	6,800	2,312	15.98	12,500	26,950
2000	34.0	6,900	2,353	15.98	12,700	27,450
2001	34.0	7,100	2,428	15.98	13,100	28,300
2002	34.0	7,350	2,506	15.98	13,550[b]	29,250[b]
2003	34.0	7,490	2,547	15.98	13,730[b]	29,666[b]
2004	34.0	7,660	2,604	15.98	14,040[b]	30,338[b]
2005	34.0	7,830	2,662	15.98	14,370[c]	31,030[c]
2006	34.0	8,080	2,747	15.98	14,810[c]	32,001[c]
For families with two or more children:						
1991	17.3	7,140	1,235	12.36	11,250[a]	23,122[a]
1992	18.4	7,520	1,384	13.14	11,840[a]	22,370[a]
1993	19.5	7,750	1,511	13.93	12,200[a]	23,050[a]
1994	30.0	8,425	2,528	17.86	11,000	25,300
1995	36.0	8,600	3,110	20.22	11,290	26,673
1996	40.0	8,890	3,556	21.06	11,650	28,495
1997	40.0	9,100	3,656	21.06	11,950	29,290
1998	40.0	9,350	3,756	21.06	12,300	30,095
1999	40.0	9,500	3,816	21.06	12,500	30,580
2000	40.0	9,700	3,888	21.06	12,700	31,152
2001	40.0	10,000	4,008	21.06	13,100	32,121

	Credit Rate (%)	Maximum Earned Income	Maximum Credit[a]	Phase-Out Rate (%)	Phase-Out Income Level	Income Where EITC=$0
2002	40.0	10,350	4,140	21.06	13,550[b]	33,150[b]
2003	40.0	10,510	4,204	21.06	13,730[b]	33,666[b]
2004	40.0	10,750	4,300	21.06	14,040[b]	34,458[b]
2005	40.0	11,000	4,400	21.06	14,370[c]	35,263[c]
2006	40.0	11,340	4,536	21.06	14,810[c]	36,348[c]
For childless adults:						
1994	7.65	4,000	306	7.65	5,000	9,000
1995	7.65	4,100	314	7.65	5,130	9,230
1996	7.65	4,200	323	7.65	5,300	9,500
1997	7.65	4,300	332	7.65	5,450	9,750
1998	7.65	4,450	341	7.65	5,600	10,050
1999	7.65	4,500	347	7.65	5,700	10,200
2000	7.65	4,600	353	7.65	5,800	10,400
2001	7.65	4,750	364	7.65	5,950[b]	10,750[b]
2002	7.65	4,900	376	7.65	6,100[b]	11,100[b]
2003	7.65	4,990	382	7.65	6,240[b]	11,230[b]
2004	7.65	5,100	390	7.65	6,390[b]	11,490[b]
2005	7.65	5,220	399	7.65	6,530[c]	11,750[c]
2006	7.65	5,380	412	7.65	6,740[c]	12,120[c]

Source: Table prepared by the Congressional Research Service.

a. The credit maximums for 1991-1993 do not include the two supplemental credits that were available to some EITC recipients in those years. The young child supplement added 5 percentage points to a family's credit rate; the child health insurance supplement added up to 6 points.

b. For this tax year the phase-out income level for a married couple filing a joint tax return is $1,000 higher than shown in the table.

c. For this tax year the phase-out income level for a married couple filing a joint tax return is $2,000 higher than shown in the table.