The Earned Income Tax Credit (EITC): 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 was transformed into a major component of federal efforts to reduce poverty, and is now the largest anti-poverty entitlement program. Tax year 2009 data show a total EITC amount of $59.7 billion for 27.2 million tax returns, yielding an average tax credit of $2,195. Most of the EITC (87.1%) was received as a refund (EITC exceeded tax liability) by low-income workers.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-116) made several changes to the credit, including simplifying the definition of earned income to reflect only compensation included in gross income; basing the phase-out of the credit on adjusted gross income (AGI) instead of expanded (or modified) gross income; and eliminating the reduction in the EITC for the alternative minimum tax (AMT).

The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) created the category for families with three or more children, with a credit rate of 45%, for tax years 2009 and 2010 only. The ARRA also increased the phase-in amount for married couples filing joint tax returns so that it is $5,000 higher than for unmarried taxpayers in tax year 2009, and $5,010 in tax year 2010.

The changes to the credit made by EGTRRA and ARRA were set to expire on December 31, 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the EGTRRA and ARRA provisions for two years (through 2012).

The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) permanently extended the EGTRAA provisions, but extended the ARRA provisions for only five years. The expiration of the ARRA provisions for the EITC is one of the legislative issues for Congress.

This report will be updated as legislative activity warrants.

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The Earned Income Tax Credit[1]

The Earned Income Tax Credit (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. However, a low-income individual or family must file a tax return to receive the EITC. An EITC-eligible family may also receive a portion of the credit in the form of advanced payments.[2] Eligibility for, and the size of, the EITC is based on income, age, and the presence of qualifying children. Several policy and legislative issues are associated with the EITC: compliance, the use of refund anticipation loans, marriage penalty, and poverty relief (family size).

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[3] estimated that the unrecovered over-claim rates were 23.8% to 25.6%, and 27.0% to 31.7%, respectively. These studies presented the rates as upper- and lower-bound estimates because a number of individuals contacted as part of the studies did not respond.

In the 1999 study, 24.9% of over-claims (with the errors known) were due to the child claimed not meeting the EITC requirements for a qualified child. The most common qualifying child error was that the child did not meet the residency test (living with the tax filer for at least six months in the case of certain blood relatives, or one year for other individuals). The second most common error was the child not meeting the relationship (to the tax filer) 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 definition of a child prior to tax year 2005 for the EITC was different from the definition of (or requirements to claim) a child as a dependent for the personal exemption. As a result, a single parent living in a multi-generational household may have been able to claim the child for the EITC, while the grandparent or the child's nonresident parent may have been able to claim the child for the personal exemption and child credit and not the EITC.

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)

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[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 (name redacted).

[2] Only a small number of EITC recipients elect the advance payment option for the EITC.

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

created a more uniform definition of a child for tax purposes, including the EITC. This new definition became effective with tax year 2005.

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, the three studies uncovered and prevented payment of more than $275 million in erroneous claims for the EITC, with approximately $250 million 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, which 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.

Paid Tax Preparers

A large number of tax returns are completed by paid tax preparers (51.8% of individual tax returns received in the most recent (tax year 2011) current filing season, through June 8, 2012, were electronic returns prepared by tax practitioners).[4] However, use of a paid tax preparer does not guarantee an accurate tax return as tax preparers vary in terms of training and experience.

In an effort to improve the quality of services provided to taxpayers by paid tax preparers and to assist in compliance efforts, IRS began (on January 1, 2011) to require paid tax preparers to register and receive a Preparer Tax Identification Number (PTIN). Paid tax preparers must renew their registration each year. Beginning in 2012, certain paid tax preparers will have to pass a competency test and meet continuing education requirements.[5]

EITC recipients may use paid preparers for a number of reasons, including

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

[4] Internal Revenue Service, Filing Season Statistics, available at http://www.irs.gov/newsroom/article/0,,id=240347,00.html.

[5] For more information on these requirements, see the IRS website at http://www.irs.gov/taxpros/article/0,,id=221009,00.html.

Marriage Penalty

The structure of the EITC may, depending on the relative income levels of both parties, impose a "marriage penalty"[6] on single low-income parents if they choose to marry. For example, in tax year 2012, two single parents, each with one child and earned income of $15,000 would each receive an EITC of $3,169 for a total of $6,338. If they marry, their combined income is $30,000, and with two children, the EITC is $3,614. The EITC marriage penalty for the couple is $2,724 (the difference between $6,388 and $3,614). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) provided marriage penalty relief for the EITC by raising the phase out income level of the EITC for married couples. The American Recovery and Relief Act of 2009 (ARRA; P.L. 111-5) temporarily increased the marriage penalty relief for the EITC by raising the phase out income level by $5,000 for married couples in 2009 and indexing the $5,000 for tax year 2010. While the American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) made the EGTRRA provisions for marriage penalty relief permanent, the increase in marriage penalty relief to $5,000 (indexed for inflation) made by ARRA was extended for only five years (the expansion will sunset on December 31, 2017).

EITC and Poverty Relief

The differential in the EITC based on the number of children, combined with the annual inflation adjustment, is designed to help families stay above the poverty threshold over time. However, because the EITC adjustment for family size is limited to two children, over time larger families may not be kept above the poverty threshold. As shown in **Table 1**, for tax year 2011, married couples with children earning $25,000 a year have net income after taxes that is above the poverty threshold. However, the extent to which income exceeds the poverty threshold declines as the number of children increases.[7]

Certain low-income childless adults may not receive the EITC, even if working full time at the minimum wage. In tax year 2011, a childless adult working full-time (40 hours a week for 50 weeks) at the current minimum wage of $7.25 would earn $14,500. That adult would receive an EITC of $0. However, when combined with a tax liability before credits of $510, and payroll taxes of $819 (reflecting the temporary payroll tax holiday), the adult has an after tax income of $13,171. However, this is 114.7% of the 2011 poverty threshold for one person ($11,484).

The ARRA (P.L. 111-5) created a new credit rate for taxpayers with three or more eligible children, and this new credit rate was extended through tax year 2017 by ATRA (P.L. 112-240). For tax years 2009 through 2017 only, taxpayers with three or more eligible children will use a credit rate of 45% to calculate their EITC.

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[6] 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. For more on the marriage penalty and the proposed solutions, see CRS Report RL33755, *Federal Income Tax Treatment of the Family*, by (name redacted).

[7] The poverty level threshold is the measurement by the U.S. Census Bureau.

Table 1. Impact of Family Size on Net Income After Taxes Relative to Poverty Threshold, Tax Year 2011

	Family 1: Two Adults, Two Children	Family 2: Two Adults, Three Children	Family 3: Two Adults, Four Children
Income ($)	25,000	25,000	25,000
Federal tax before credits ($)	0	0	0
Child credit (regular credit limited to tax before credits) ($)	0	0	0
EITC($)	5,036	5,666	5,666
Additional child credit (refundable portion of credit) ($)	2,000	3,000	4,000
Net tax refund after credits ($)	7,036	8,666	9,666
Payroll tax ($) (See notes)	(1,413)	(1,413)	(1,413)
Net income after tax ($)	30,624	32,254	33,254
Poverty threshold ($)	22,811	26,844	30,056
Net income as a percentage of poverty threshold ($)	134.2%	120.2%	110.6%

Source: Table prepared by the Congressional Research Service.

Note: Payroll tax amounts reflect the temporary payroll tax holiday (2%) in 2011.

Expiring Provisions

The EGTRRA (P.L. 107-16) made several changes to the EITC that were scheduled to expire on December 31,2010. Changes to the EITC that were scheduled to expire include

- changing the definition of earned income for the EITC so that it does not include nontaxable employee compensation;
- eliminating the reduction in the EITC for the alternative minimum tax (AMT); and
- simplifying the calculation of the credit through use of AGI rather than modified AGI.

ATRA (P.L. 112-240) made these EGTRRA changes permanent. The ARRA created the category for families with three or more children, with a credit rate of 45%, for tax years 2009 and 2010 only. The ARRA also increased the phase-in amount for married couples filing joint tax returns so that it is $5,000 higher than for unmarried taxpayers in tax year 2009, and indexed for inflation beginning in tax year 2010. The ARRA changes were also scheduled to expire on December 31, 2010.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the ARRA provisions for two years (through 2012).

ATRA (P.L. 112-240) extended the ARRA provisions for five years (through tax year 2017).

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