MISCELLANEOUS RECOMMENDATIONS

Legislative Recommendation #56

Restructure the Earned Income Tax Credit (EITC) to Make It Simpler for Taxpayers and Reduce Improper Payments

PRESENT LAW

The Earned Income Tax Credit (EITC) is a refundable credit for low- and moderate-income working individuals and families. Eligibility for the EITC and the amount of EITC a taxpayer may claim are based on a variety of factors, including the taxpayer's earned income, the number of qualifying children, and the taxpayer's filing status.[1] For tax year (TY) 2020, the EITC plateaued at $6,660 for a family of one adult with three children earning between $14,800 and $19,349.[2]

An individual must meet three primary requirements to be a taxpayer's "qualifying child" for the EITC.[3] First, the individual must have a specific blood or legal relationship to the taxpayer.[4] Second, the individual must share a residence in the United States with the taxpayer for more than half the year.[5] Third, the individual must be under the age of 19 (or under age 24 if a full-time student) or be permanently and totally disabled.[6]

Taxpayers without children may also claim the EITC.[7] Prior to 2021, the "childless" EITC was limited to taxpayers aged 25 to 64. In TY 2020, the credit plateaued at $538 for married taxpayers with no qualifying children filing jointly earning between $7,000 and $9,199, and at the same $538 amount for single taxpayers without qualifying children earning between $7,000 and $8,749. The American Rescue Plan Act of 2021 (ARPA) raised the maximum EITC from $538 to $1,502 and raised the income eligibility cap to $27,379 for married taxpayers filing jointly and to $21,429 for single taxpayers.[8] ARPA temporarily expanded the age range of childless workers eligible for the EITC to include younger adults aged 19 to 24 (excluding students under 24 attending school at least part time) and temporarily removed the upper age limit (previously age 64) for TY 2021.[9] Qualified former foster youth and qualified homeless youth also temporarily became eligible to claim the EITC at age 18.[10]

Unemployment compensation (UC),[11] while based on a taxpayer's earned income and included in adjusted gross income (AGI), is not generally included in earned income and thus does not count in computing the amount of EITC for which a taxpayer is eligible.[12]

1 IRC § 32.
2 IRS, Pub. 596, Earned Income Credit (EIC) 33-34 (Jan. 26, 2021).
3 Where there are competing claims for the same child, "tie breaker" rules prioritize the claims. IRC § 152(c)(4)(B).
4 IRC §§ 32(c)(3)(a) & 152(c)(2).
5 IRC § 32(c)(3)(c).
6 IRC §§ 32(c)(3)(A) & 152(c)(3). The individual must also have a Social Security number that is valid for employment. IRC § 32(c)(3)(D) & (m).
7 IRC § 32(c)(1)(A)(ii).
8 ARPA, Pub. L. No. 117-2, § 9621, 135 Stat. 4, 152-153 (2021) (codified in IRC § 32(n)).
9 IRC § 32(n).
10 IRC § 32(n)(1)(B)(iii).
11 IRC § 85; Treas. Reg. § 1.85-1(b)(1). Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or a state.
12 IRC § 32(c)(2); Treas. Reg. § 1.32-2(c)(2).

REASONS FOR CHANGE

Enacted in 1975, the EITC is one of the federal government's largest anti-poverty programs for low-income workers.[13] For TY 2020, taxpayers filed about 25 million returns claiming EITC benefits worth about $62 billion.[14] The EITC is considered to be an effective anti-poverty program. However, the eligibility requirements are complex, and as a result, the program suffers from a relatively high rate of improper payments that could be reduced if the eligibility requirements were simplified.[15] In addition, the EITC was enacted at a time when families with biological or legal relationships with the claimed children predominated. Modernizing the eligibility requirements to recognize non-traditional families could increase the participation rate among eligible taxpayers, allow guardians other than parents to receive benefits when they are the principal caretakers, and reduce improper payments. Finally, the credit should be made available to taxpayers who enter the workforce at age 19 and taxpayers who remain in the workforce after age 65.

Restructure the EITC as Two Credits: A Worker Credit and a Child Credit

The National Taxpayer Advocate recommends restructuring the EITC into two credits where the taxpayer is claiming qualifying children: (i) a refundable *worker credit* based on each individual worker's earned income, irrespective of the presence of a qualifying child, and (ii) a refundable *child credit* that would reflect the costs of caring for one or more children.

Worker Credit

Much like the current EITC, the credit would phase in as a percentage of earned income, reach a plateau, and then phase out.[16] Unlike the current EITC, the credit amount would depend solely on income and would not vary based on whether the taxpayer is claiming one or more qualifying children. Increasing the worker component of the EITC would provide a greater incentive to work, which is a main objective of the credit. This structure also would target the credit to the lowest-earning taxpayers, based on AGI (a broader measure of income that includes unearned income like capital gains, dividends, rents, and royalties).[17] This would be similar to the current EITC provision that denies the credit to taxpayers with excessive investment income.[18]

This change could also substantially reduce improper payments. The IRS receives Forms W-2 and other information reporting documents directly from employers and other payors of income. For that reason, it can accurately verify income amounts for EITC recipients who are employees, by far the largest group of EITC claimants.[19]

13 IRS, About EITC, https://www.eitc.irs.gov/eitc-central/about-eitc/about-eitc (last visited Nov. 2, 2021).

14 IRS, Statistics for Tax Returns With the Earned Income Tax Credit (EITC), https://www.eitc.irs.gov/eitc-central/statistics-for-tax-returns-with-eitc/statistics-for-tax-returns-with-the-earned-income (updated Dec. 6, 2021) (showing data as of December 2020).

15 An improper payment is defined as "any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements" and "any payment to an ineligible recipient." Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111–204, § 2(e), 124 Stat. 2224 (2010), amending Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (2002) (striking § 2(f) and adding § (f)(2)). For fiscal year 2019, the IRS estimates that approximately 25 percent of the total EITC program payments were improper. Treasury Inspector General for Tax Administration, Ref. No. 2020-40-025, *Improper Payment Reporting Has Improved; However, There Have Been No Significant Reductions to the Billions of Dollars of Improper Payments* 2 (Apr. 30, 2020).

16 For examples regarding how to structure a per-worker credit, see Elaine Maag, *Investing in Work by Reforming the Earned Income Tax Credit* (2015).

17 Some experts caution that without a minimum wage, employers would reduce and capture the benefit of an increased EITC. *See* Austin Nichols & Jesse Rothstein, *The Earned Income Tax Credit*, Economics of Means-Tested Transfer Programs in the United States, vol. 1, at 137 (Robert A. Moffitt ed., 2016). Therefore, many proposals couple an increased childless EITC or worker credit with an increased minimum wage. *See* Isabel V. Sawhill & Quentin Karpilow, *Raising the Minimum Wage and Redesigning the EITC*, Brookings Inst. (Jan. 30, 2014), https://www.brookings.edu/research/raising-the-minimum-wage-and-redesigning-the-eitc.

18 IRC § 32(i).

19 A relatively small percentage of EITC claimants are self-employed individuals. The IRS receives somewhat less information from third-party payors with respect to self-employed individuals.

Unemployment Compensation

Taxpayers who receive UC based on their employment earnings cannot use their UC income to qualify for the EITC. The apparent rationale for not counting UC is that the EITC was designed largely to provide a work incentive. However, UC is paid exclusively to individuals who were working and became separated from their jobs due to no fault of their own. Most recently, millions of individuals who had been employed lost their jobs during the COVID-19 pandemic when certain segments of the economy, such as restaurants, hotels, and airlines, substantially reduced their workforces. In other instances, local disasters such as hurricanes adversely affect segments of the economy and lead to mass layoffs. Because UC is effectively a replacement for a portion of the wages working individuals would have earned if they had not been separated from their jobs and because UC benefits are only paid for a limited number of months, treating UC as EITC-qualifying income would maintain the nexus between working and receiving EITC.[20]

Child Credit

The child credit would be designed as a fixed amount per qualifying child, subject to an AGI phase-out, and would replace the portion of the existing EITC that is based on the number of qualifying children the taxpayer claims. This could be accomplished by retaining ARPA's changes to the Child Tax Credit (CTC) and by modernizing the definition of qualifying child. Some of ARPA's CTC changes include increasing the maximum credit amount from $2,000 to $3,000 ($3,600 for children under six), making the credit fully refundable for certain taxpayers, increasing a qualifying child's age from 17 to 18, and changing the income phase-outs.

Modernize the Definition of a Qualifying Child

The qualifying child rules of the current EITC structure may not reflect real-life living arrangements. A 2016 study by the Tax Policy Center found that the number of households made up of "traditional families" (married parents with only biological children) has declined, while alternative family types, such as families led by single parents or cohabitating adults, have increased.[21] Only 51.6 percent of children living in families with incomes at or below 200 percent of the Federal Poverty Level were in families headed by married couples. Low-income children were more likely to live with a single parent or in a multigenerational household, a cohabiting household, or a family with at least one non-biological child, as compared with higher income families.[22] Since the EITC is a credit for lower income families, its eligibility should more accurately reflect its target population.[23]

RECOMMENDATIONS

- Separate the refundable EITC into two components: a worker credit and a child credit.
- Permanently expand the expiring age eligibility for the EITC to individuals who have attained age 19 (age 18 in the case of qualified former foster youth or qualified homeless youth and age 24 for specified students), with no upper age limit.

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20 Note: we recognize an unintended consequence of UC being included in AGI is that it may diminish a taxpayer's EITC claim, and in some instances, may make taxpayers ineligible to claim the EITC.

21 Elaine Maag, H. Elizabeth Peters & Sarah Edelstein, *Increasing Family Complexity and Volatility*: *The Difficulty in Determining Child Tax Benefits* 10 (2016). *See also* National Taxpayer Advocate 2016 Annual Report to Congress 334 (Legislative Recommendation: *Tax Reform*: *Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*).

22 Elaine Maag, H. Elizabeth Peters & Sarah Edelstein, *Increasing Family Complexity and Volatility*: *The Difficulty in Determining Child Tax Benefits* 10 (2016).

23 For more discussion on modernizing the definition of "qualifying child," see National Taxpayer Advocate Fiscal Year 2020 Objectives Report to Congress vol. 3, at 17-19 (*Earned Income Tax Credit*: *Making the EITC Work for Taxpayers and the Government*).

- Amend IRC § 32(c)(2)(A)(i) to include unemployment compensation as EITC-qualifying earned income.
- Amend IRC §§ 32(c) and 24(c) to modernize the definition of a qualifying child in IRC § 152(c), to reflect evolving family units.[24]

24 Relevant considerations should include which adult performs caregiving and makes caregiving decisions for the child, including factors like who prepares meals, who transports the child to school, and who makes medical appointments for the child. For a more detailed discussion on modernizing the definition of a "qualifying child," see National Taxpayer Advocate Fiscal Year 2020 Objectives Report to Congress vol. 3, at 17-19 (*Earned Income Tax Credit*: *Making the EITC Work for Taxpayers and the Government*).