MISCELLANEOUS RECOMMENDATIONS

Legislative Recommendation #53

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 to which a taxpayer is entitled 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] The EITC follows a bell-shaped curve, adjusting the credit amount to income, family composition, and filing status. For tax year (TY) 2019, the bell curve plateaued at $6,557 for a family of one adult with three children earning no more than $19,050.[2]

An individual must meet three primary requirements to be a "qualifying child." First, the individual must have a specific relationship to the taxpayer (son, daughter, adopted child, stepchild, foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or descendent of such a relative such as a grandchild, niece, or nephew). Second, the individual must share a residence with the taxpayer for more than half the year in the United States. 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.[3] "Tie-breaker" rules prioritize who can claim a qualifying child.[4]

REASONS FOR CHANGE

Enacted in 1975, the EITC is the federal government's largest benefits program for low-income workers.[5] In 2017, taxpayers filed more than 26 million returns for EITC benefits totaling nearly $64.5 billion.[6] While the EITC is widely considered to be an effective anti-poverty program, it suffers from several shortcomings. First, the eligibility requirements are complex. Some eligible taxpayers do not claim the EITC because they have difficulty figuring out how to do so, many taxpayers (and preparers) make inadvertent errors, and some taxpayers claim more EITC than they are entitled to receive. Second, the EITC was enacted at a time when two-parent families predominated. As alternative living arrangements have expanded, the credit eligibility rules in many cases no longer serve their intended purpose. Simplifying the eligibility requirements and modernizing the rules as they apply to non-traditional families could increase the participation rate among

1 IRC § 32.
2 IRS, Pub. 596, Earned Income Credit (EIC) 33 (Jan. 28, 2020).
3 The individual must also have a Social Security number that is valid for employment. IRC § 32(c)(3)(D) & (m).
4 If an individual may be claimed as a qualifying child by two or more taxpayers, the individual is treated as the qualifying child of the taxpayer who is (i) a parent or, (ii) if no parent claims the child, the taxpayer with the highest adjusted gross income for the taxable year. IRC §§ 152(c)(4)(A) & (C). If the parents claiming a qualifying child do not file a joint return, the child is treated as the qualifying child of (i) the parent with whom the child resided for the longest period of time during the taxable year, or (ii) if the child resided with both parents for the same amount of time during the taxable year, the parent with the higher adjusted gross income. IRC § 152(c)(4)(B).
5 IRS, About EITC, https://www.eitc.irs.gov/eitc-central/about-eitc/about-eitc (last visited Nov. 20, 2020).
6 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2020-40-008, *Authorities Provided by the Internal Revenue Code Are Not Effectively Used to Address Erroneous Refundable Credit and Withholding Credit Claims* (Feb. 26, 2020).

eligible taxpayers, allow guardians other than parents to receive benefits when they are principally caring for one or more children, and reduce "improper payments."[7]

RESTRUCTURE THE EITC AS TWO CREDITS: A WORKER CREDIT AND A CHILD BENEFIT

The National Taxpayer Advocate recommends restructuring the EITC into two credits: (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 worker credit would be structured to phase in as a percentage of earned income, reach a plateau, and then phase out.[8] Unlike the current EITC, the credit would be uniform for each worker at a given income level and not vary depending on the number of children the worker has or, if the worker is married or filing separately, the couple's combined income. This structure would target the credit to the lowest income taxpayers and help ensure that workers in low-wage jobs can meet their basic living expenses.[9] To prevent wealthy taxpayers with relatively low levels of earned income from claiming the credit, the credit could phase out based on adjusted gross income (a broader measure of income that includes unearned income like capital gains, dividends, rents, and royalties) or the current EITC provision that denies the credit to taxpayers with excessive investment income could be retained.[10] Since the IRS would have internal data to determine reported income, the credit should be easy to administer and improper payments could be nearly eliminated.

Child Credit

The child credit would be designed as a fixed amount per child, subject to an income phase-out, and would replace the portion of the existing EITC attributable to family size and the child tax credit. The current child tax credit (a smaller but similar benefit as the EITC) is a $2,000 credit that begins to phase out for joint filers with $400,000 of income and other filers with $200,000 of income.[11] The Additional Child Tax Credit, which is the refundable portion of the Child Tax Credit, currently phases out as earned income increases, limiting the benefit to the lowest income taxpayers.[12] Our proposed child credit would simplify

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7 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 FY 2019, the IRS estimates that approximately 25 percent of the total EITC program payments were improper. TIGTA, 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).

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

9 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*, *in* 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.

10 IRC § 32(i).

11 IRC § 24(h)(3).

12 IRC § 24(d).

the contentious qualifying child provisions of the current code. Providing a phased-out child benefit would acknowledge that families need a threshold level of resources to support their children.

EXPAND THE CHILDLESS WORKER CREDIT AND MAKE IT AUTOMATIC FOR ELIGIBLE TAXPAYERS

Separate from the earned income credit for families with children, there is currently a slimmed down credit for childless workers. The maximum amount of this "childless worker" credit will be $538 in 2020.[13] This is just eight percent of the $6,660 maximum credit for taxpayers claiming three children, which creates a troubling disparity.[14] Additionally, more Millennials head a household in poverty than any other age group.[15] And for calendar year 2019, the poverty rate is 8.9 percent for people aged 65 and older.[16] Yet the childless worker portion of the EITC is limited to workers between the ages of 25 and 64.[17] This age limitation harms significant segments of the population who could benefit from this income supplement because it does not reflect today's workforce.

When Congress initially implemented the EITC, one explanation for not making the EITC universally available to everyone was that students and retired individuals "often have low amounts of earned income because they work part-time or for short periods of time and may receive most of their support from family relatives or through social security or private pension plans."[18] However, only about 36 percent of Americans aged 25 years and older have a bachelor's degree or higher, indicating it is a mistake to assume taxpayers under age 25 are primarily students.[19] Furthermore, ignoring the needs of this population may go against the intent of the EITC since earnings can be tied to level of education (*i.e.,* those with less education will, on average, earn less).[20]

It is also no longer realistic to assume older taxpayers can safely rely on pensions and Social Security. One survey by the Board of Governors of the Federal Reserve System found that 25 percent of non-retired respondents had no retirement savings.[21] Additionally, the number of taxpayers over 65 in the workforce is increasing. The labor force participation rate for workers aged 65 to 74 is projected to be approximately

13 IRS, Earned Income Tax Credit Income Limits and Maximum Credit Amounts, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-tax-credit-income-limits-and-maximum-credit-amounts (last visited Nov. 23, 2020).

14 In TY 2020, the maximum credit for three or more children is $6,660. IRS, Earned Income Tax Credit Income Limits and Maximum Credit Amounts, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-tax-credit-income-limits-and-maximum-credit-amounts (last visited Dec. 16, 2020).

15 Pew Research Center, *Five Facts About Millennial Households* (Sept. 6, 2017). "Millennial" is defined as a person between the ages of 18 and 35 in 2016. *See also* National Taxpayer Advocate 2016 Annual Report to Congress 325-357 (Legislative Recommendation: *Tax Reform: Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden*).

16 U.S. Census Bureau, *Income and Poverty in the United States: 2019*, at 16 (Sept. 2020).

17 IRC § 32(c)(1)(A)(ii)(II).

18 *Tax Reduction Act of 1975: Report of the Sen. Comm. on Finance Together With Supplemental Views on H.R. 2166*, S. Rep. No. 94-36, at 33 (1975).

19 U.S. Census Bureau, *Educational Attainment in the United States: 2019*, Table 1, *Educational Attainment of the Population 18 Years and Over, by Age, Sex, Race, and Hispanic Origin*, https://www.census.gov/data/tables/2019/demo/educational-attainment/cps-detailed-tables.html (last visited Nov. 30, 2020).

20 While many factors can influence lifetime earnings, men with bachelor's degrees can expect to earn $655,000 more in median lifetime earnings than high school graduates and women with a bachelor's degrees can expect to earn $450,000 more in median lifetime earnings than high school graduates. Social Security Administration, *Education and Lifetime Earnings* (Nov. 2015), https://www.ssa.gov/policy/docs/research-summaries/education-earnings.html.

21 Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data From April 2020*, at 4 (May 2020).

30 percent in 2026, compared to only approximately 18 percent in 1996.[22] Meanwhile, the full retirement age for Social Security retirement benefits has increased to 66 for some taxpayers and 67 for others.[23] To ensure the EITC is getting to targeted taxpayers, the age of eligibility should be expanded to be more inclusive of today's workforce.

Furthermore, taxpayers who are otherwise eligible could automatically requalify from year-to-year. Most EITC recipients have at least some Form W-2, Wage and Tax Statement, wage income, and errors associated with this type of income are relatively small in dollar terms.[24] In TY 2018, about 16 percent of EITC recipients had both self-employment and W-2 income, while about 12 percent had only self-employment income.[25] Moreover, as a result of changes made by the Protecting Americans from Tax Hikes (PATH) Act, the IRS has more accurate and timely data it can use to detect and prevent any overclaims of the worker credit based on W-2 income.[26] The PATH Act requires employers to submit W-2s (and information returns for nonemployee compensation like Form 1099-NEC, Nonemployee Compensation) by January 31 and requires the IRS to hold refunds until February 15 if the taxpayer claims the EITC or the refundable portion of the child tax credit.

These legislative changes were made in part to prevent "refund fraud related to fabricated wages and withholdings."[27] Prior to the PATH Act, the IRS generally did not receive and match W-2s against tax returns until after refunds had been paid and the filing season had concluded. Now, the IRS receives the overwhelming majority of W-2s by early February and matches tax returns against the W-2s before paying refunds. As of February 10, 2020, the IRS had received about 236 million W-2s, which constituted about 90 percent of the number it had received during all of calendar year 2019.[28] Assuming payouts of the worker credit are also held until February 15, this additional data would minimize improper payments of the credit associated with W-2 income, although improper payments associated with self-employment income would still exist.

MODERNIZE THE DEFINITION OF A QUALIFYING CHILD

The qualifying child rules of the current EITC structure often do not reflect the real-life living arrangements between children and adults. A 2016 study by the Tax Policy Center found that the number of households

22 U.S. Bureau of Labor Statistics, *Labor Force Participation Rate for Workers Age 75 and Older Projected to Be Over 10 Percent by 2026*, https://www.bls.gov/opub/ted/2019/labor-force-participation-rate-for-workers-age-75-and-older-projected-to-be-over-10-percent-by-2026.htm (May 29, 2019). For workers age 75 and older, the labor force participation rate has doubled since 1996. In 2026, the rate is projected to be nearly 11 percent, compared with nearly five percent in 1996. *Id.*

23 Social Security Administration, *Retirement Benefits*, https://www.ssa.gov/benefits/retirement/planner/agereduction.html (last visited Dec. 8, 2020).

24 *See* National Taxpayer Advocate Fiscal Year 2020 Objectives Report to Congress vol. 3, at 14 (*Earned Income Tax Credit: Making the EITC Work for Taxpayers and the Government*).

25 IRS, Compliance Data Warehouse Individual Returns Transaction file and the Information Returns Master File through cycle 43 of 2020 (Oct. 22, 2020).

26 *See* Pub. L. No. 114-113, Division Q, Title II, § 201 (a) & (b), 129 Stat. 2242, 3076 (2015) (codified at IRC §§ 6071(c) and 6402 (m)).

27 IRS, New Federal Tax Law May Affect Some Refunds Filed in Early 2017; IRS to Share Details Widely With Taxpayers Starting This Summer, https://www.irs.gov/tax-professionals/new-federal-tax-law-may-affect-some-refunds-filed-in-early-2017 (last visited June 10, 2018).

28 IRS, IDT and IVO Modeling Analysis - MAIN Performance Report, slide 11 (Oct. 7, 2020). See IRC § 6402(m), which prevents the IRS from issuing certain refunds before Feb. 15 each year. The increase in timely received Form W-2 data, in conjunction with two other changes, likely resulted in more returns being released earlier in the process this year compared to last year. One change is the newly adopted systemic release feature that allows returns to be released back into normal processing systemically rather than waiting for an IRS employee to manually release the refund. The other is the availability of third-party documentation daily rather than weekly.

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.[29] 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.[30] Since the EITC and other refundable credits are intended to support low-income working families, their eligibility rules should be revised to more accurately reflect the circumstances of their target population.

The Tax Court case of *Cowan v. Commissioner* illustrates how the current definition of a qualifying child does not match up with the taxpayers who truly care for children.[31] In this case, Ms. Cowan was the legal guardian of a child, Marquis. Under state law, the guardianship automatically terminated when Marquis turned 18, which occurred in 2004. However, Ms. Cowan continued to provide Marquis with a home after he turned 18, and they continued to regard themselves as a family unit. Ms. Cowan never adopted Marquis and did not understand the legal significance of that status. Later, Marquis had a daughter, and they both lived with Ms. Cowan. In 2011, Ms. Cowan claimed Marquis's daughter as her granddaughter for the EITC. The court disallowed the claim since she and Marquis are not legally related. However, Ms. Cowan and Marquis believed and acted as if they are family.[32]

Instead of focusing on biological relationship, the definition of a qualifying child should consider which adult provides primary care for the child. This could include things such as who makes medical appointments for the child, who prepares meals for the child, and who is the contact for the child at school.[33]

RECOMMENDATIONS

- Consolidate the numerous family status provisions into two: (i) a refundable EITC that would be awarded per individual worker and provide a work incentive and subsidy for low-income workers, and (ii) a refundable Child Credit that would reflect the cost of maintaining a household and raising a family.
- Expand the eligibility age for the modified refundable EITC to include workers 18 years of age and older with no age cap.
- Amend IRC § 152(c) to redefine and modernize the definition of a qualifying child to reflect the experiences of primary caregivers and their children. Things to consider would include which adult performs caregiving efforts and makes caregiving decisions.

29 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*).

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

31 T.C. Memo. 2015-85.

32 For other illustrations of this problem, see National Taxpayer Advocate Fiscal Year 2020 Objectives Report to Congress vol. 3, at 8 (*Earned Income Tax Credit: Making the EITC Work for Taxpayers and the Government*).

33 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*).