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The Earned Income Tax Credit (EITC): Legislative Issues

Christine Scott, Domestic Social Policy Division

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Abstract. The Working Families Tax Relief Act of 2004 (P.L. 108-311) created a more uniform definition of a child for tax purposes (beginning in tax year 2005), and temporarily altered the EITC to permit taxpayers to include combat pay as income for calculating the credit. The Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) will provide temporary fiscal assistance to low-income families affected by Hurricane Katrina by allowing them to use tax year 2004 income to compute their tax year 2005 EITC. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended the option to include combat pay in calculating the EITC through tax year 2006, extended the use of 2004 income in calculating 2005 EITC to taxpayers affected by Hurricane Rita, and clarified that the option to use 2004 income in calculating the tax year 2005 EITC was only available if income for 2005 was lower than for 2004. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the option to include combat pay in calculating the EITC through tax year 2007. Legislation has been introduced in the 110th Congress that would expand the credit to residents of Puerto Rico, create a new level of credit for families with three or more children, provide additional marriage penalty relief, expand usage of the advance payment option for the EITC, or make permanent the election to include combat pay for purposes of computing the EITC.

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The Earned Income Tax Credit (EITC): Legislative Issues

Christine Scott
Specialist in Social Policy
Domestic Social Policy Division

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 2005 data show a total EITC amount of $42.4 billion for 22.8 million tax returns, yielding an average tax credit of $1,864. Most of the EITC (88.3%) was received as a refund (EITC exceeded tax liability) by low-income workers.

The Working Families Tax Relief Act of 2004 (P.L. 108-311) created a more uniform definition of a child for tax purposes (beginning in tax year 2005), and temporarily altered the EITC to permit taxpayers to include combat pay as income for calculating the credit. The Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) will provide temporary fiscal assistance to low-income families affected by Hurricane Katrina by allowing them to use tax year 2004 income to compute their tax year 2005 EITC. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended the option to include combat pay in calculating the EITC through tax year 2006, extended the use of 2004 income in calculating 2005 EITC to taxpayers affected by Hurricane Rita, and clarified that the option to use 2004 income in calculating the tax year 2005 EITC was only available if income for 2005 was lower than for 2004. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the option to include combat pay in calculating the EITC through tax year 2007.

Legislation has been introduced in the 110th Congress that would expand the credit to residents of Puerto Rico, create a new level of credit for families with three or more children, provide additional marriage penalty relief, expand usage of the advance payment option for the EITC, or make permanent the election to include combat pay for purposes of computing the EITC. This report will be updated as legislative activity warrants.

The Earned Income Tax Credit (EITC)[1]

The EITC is a refundable tax credit available to eligible workers earning relatively low wages. Under current law there are two categories of EITC recipients: childless adults and families with children. Because the credit is refundable, an EITC recipient need not owe taxes to receive the benefits. 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 Issue. 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,

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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 Christine Scott.

[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.

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.[4]

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,[5] 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, 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.

EITC and Tax Preparers. A large number of tax returns are completed by paid tax preparers (41.6% of tax returns filed last filing season, through September 28, 2007).[6] However, use of a paid tax preparer does not guarantee an accurate tax return. Paid tax preparers also provide, through a refund anticipation loan (RAL), immediate access to tax refunds. The Consumer Federation of America[7] reports that EITC tax filers paid approximately $1.7 billion in tax preparation, RAL, and check cashing fees (or 4.3% of the total EITC amount). This estimate is based on fees of $120 for tax preparation, $32 for application or administration, $54 for check cashing, and $75 for a refund anticipation loan.

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

- language differences;
- literacy problems;

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[4] 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.

[5] 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].

[6] Internal Revenue Service, Filing Season Statistics, table 06ifss12.txt, available at [http://www.irs.gov/taxstats/article/0,,id=96629,00.html].

[7] Consumer Federation of America and the National Consumer Law Center, "Picking Taxpayer's Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income American's Hard-Earned Tax Refunds," January 31, 2005, p.6.

- 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.

Refund anticipation loans are often issued for a set cost and an expected time period for repayment (through assignment of the tax refund), resulting in a high effective rate of interest for the loan. If a tax filer uses a refund anticipation loan and the tax refund is not issued during the time period specified for the loan, the tax filer may be responsible for additional interest. If there is an error on the tax return which reduces or eliminates the tax refund, the tax filer may be responsible for repaying part, or all, of the principal amount of the loan. For low income tax filers with an EITC, IRS inquires about the relationship or residency of a qualifying child, may result in the tax filers refund being delayed for a significant period of time, or denied.

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 2007, two single parents, each with one child and earned income of $15,000 would each receive an EITC of $2,853 for a total of $5,706. If they marry, their combined income is $30,000, and with two children, the EITC is $2,060. The EITC marriage penalty for the couple is $3,646 (the difference between $5,706 and $2,060). 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. EGTRRA reduced the marriage penalty for this family by $421 in 2007. The EGTRRA provisions for marriage penalty relief in the EITC will sunset at the end of 2010.

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 2006, married couples with three or more children earning $20,000 a year have net income after taxes that is below the poverty threshold, whereas a similar couple with two children is above the poverty threshold.[9]

[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. For more on the marriage penalty and the proposed solutions, see CRS Report RL30419, *The Marriage Tax Penalty: An Overview of the Issues*, by Jane G. Gravelle.

[9] The poverty level threshold is the measurement by the U.S. Department of the Census, available at [http://www.census.gov/hhes/www/poverty/threshld/thresh06.html].

Table 1. Impact of Family Size on Net Income after Taxes Relative to Poverty Threshold, Tax Year 2006

	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) ($)	0	0	0
EITC ($)	3,864	3,864	3,864
Additional child credit (refundable portion of credit) ($)	1,305	1,305	1,305
Net tax refund after credits ($)	5,169	5,169	5,169
Payroll tax ($)	(1,530)	(1,530)	(1,530)
Net income after tax ($)	23,639	23,639	23,639
Poverty level ($)	20,444	24,059	26,938
Net income after tax as a percent of poverty level	115.6%	98.3%	87.8%

Source: Table prepared by the Congressional Research Service.

Certain childless adults, even if the adult receives the EITC, also may have a net income after tax that is lower than the poverty level. In tax year 2006, a childless adult working full-time (40 hours a week for 52 weeks) at the minimum wage (in 2006) of $5.25 would earn $10,920. That adult would receive an EITC of $92. However, when combined with a tax liability before credits of $246, and payroll taxes of $835, the adult has an after tax income of $10,177. This is 98.9% of the poverty level (for one adult) of $10,294.

Legislation in the 110th Congress

In the 110th Congress, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28) contained a provision requiring the Secretary of the Treasury to report to Congress within 180 days of enactment on a study of the impact on workers and business if all EITC recipients were to use the advance payment option and the steps needed to implement the advance payment option for all EITC recipients. H.R. 2 as amended and passed by the Senate contains a similar provision.

Several bills introduced in the 110th Congress would expand the EITC:

- H.R. 1339 would phase in use of the EITC by residents of Puerto Rico, and H.R. 3431 would make residents of Puerto Rico eligible for the EITC;
- H.R. 2222 and S. 1333 would increase the income thresholds at which the credit phases out for married couples and add a new credit level for families with three or more children;

- H.R. 2951, H.R. 3395, and H.R. 3970 would increase the amount of the credit for taxpayers without children;
- S. 1626 would expand the credit to non-custodial fathers that pay required child support; and
- S. 1133 would provide protections for EITC recipients from garnishment or attachment of their credit refund and require the Secretary of the Treasury to (1) develop and implement a program to expand usage of the advance payment option for the EITC and (2) enter into cooperative agreements with certain financial institutions to provide low- and moderate-income taxpayers the option of low-cost direct deposit accounts.

Combat Pay. The Working Families Tax Relief Act of 2004 (P.L. 108-311) provided taxpayers serving in the military the option of including combat pay in computing earned income for purposes of calculating the EITC. Combat pay is generally excluded from income for income tax purposes. As a result, a number of low-income military families faced losing the EITC as their income shifted from taxable military pay to nontaxable combat pay as the result of recent deployments. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended through tax year 2006 the option to include combat pay in calculating the EITC, and the Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the option through tax year 2007.

Legislation has been introduced in the 110th Congress (H.R. 393, H.R. 2222, H.R. 3529, H.R. 3736, H.R. 3827, H.R. 3933, H.R. 3997, H.R. 4085, S. 455, S. 516, S. 1111, S. 1333, and S. 1593) to make permanent the election to include combat pay for calculating the EITC. In addition, S.Con.Res. 21, the budget resolution, included a Senate amendment on permanently extending the option to include combat pay for calculating the EITC in tax relief.