Happy 45th Anniversary to the Earned Income Tax Credit. Thoughts on One of the Most Expensive Costing Credits in the U.S. Tax Law

Richard Lahijani
The City University of New York

The earned income tax credit ("EITC") or what was known as the "work bonus plan" was originally enacted as part of the Tax Reduction Act of 1975 (Pub. L. 94- 12). At the time, the law was intended to be enacted on a temporary basis to assist low income families with children. However, over its 45-year history, this credit has evolved and been amended numerous times by different presidential and congressional administrations in efforts to improve it. This article will explore the legislative history of this credit, the original intent, and whether the law has had positive or negative implications for American taxpayers.

Keywords: Earned Income Credit, Tax Credits, Refundable Credit

INTRODUCTION

The "work bonus plan" which was the prelude to the EITC was part of the 1975 Tax Reductions Act ("TRA"). It provided for a ten percent tax credit on the first $4,000 of taxable earnings. This would equate to a maximum credit of $400, which adjusted for inflation would be approximately $2,000 today. There was an income phase-out range between $4,000 and $8,000, equating to $15,000 to $30,000 in the year 2020. The credit was also intended to spur economic growth in the already brewing deep recession of 1974. It was supposed to help low income taxpayers with the ever increasing cost of food and energy expenses. It also paved the way for Congress to pass other legislation in the form of refundable tax credits for other purposes. These included the child tax credit, the American opportunity tax credit, and the premium assistance tax credit.

LEGISLATIVE HISTORY

Numerous legislative changes have been made to this credit over the past 45 years. These changes either sought to increase the amount of credit by changing the credit formula or changed the eligibility rules for the credit.

Some of the major laws that increased the amount of the credit include the following: The Omnibus Budget Reconciliation Act of 1990 Pub. L. 101-508 , which adjusted the credit amount for family size and created a credit for workers with no qualifying children. This was enacted under the George H.W. Bush presidency. The Omnibus Budget Reconciliation Act of 1993 Pub.L. 103-66, which increased the maximum credit for tax filers with children and created a new credit formula for certain low-income, childless tax filers; this legislation was enacted under the guidance of the Clinton administration. The

Economic Growth and Tax Relief Reconciliation Act of 2001, Pub.L. 107-16 , which increased the income level at which the credit phased out for married tax filers in comparison to unmarried tax filers (referred to as "marriage penalty relief"); was instituted under President George W. Bush. Finally the American Recovery and Reinvestment Act of 2009 Pub.L. 111-5, under the Obama administration, increased the credit amount for families with three or more children and expanded the marriage penalty relief enacted as part of P.L. 107-16. Other legislative changes changed the eligibility rules for the credit. Major laws that changed the eligibility rules of the credit include the following: P.L. 103-66, which expanded the definition of an eligible EITC claimant to include certain individuals who had no qualifying children. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub.L. 104-193 , which required tax filers to provide valid Social Security numbers (SSNs) for work purposes for themselves, spouses if married filing jointly, and any qualifying children, in order to be eligible for the credit; and the Taxpayer Relief Act of 1997, Pub.L. 105-34 , which introduced additional compliance rules to reduce improper claims of the credit.

CURRENT LAW

Fast forwarding to the 2019 tax year, which taxpayers would typically file in 2020, the Internal Revenue Service has provided much needed guidance with publication 596. Per Pub596, there are seven main rules that a taxpayer must meet in order to be eligible for the EITC. It is important to note that all 7 tests must be met in order to qualify. They include:

1. **Adjusted Gross Income (AGI) Limits:** The taxpayers AGI must be less than the below amounts depending on their filing status.
    - $50,162 ($55,952 for married filing jointly) if you have three or more qualifying children,
    - $46,703 ($52,493 for married filing jointly) if you have two qualifying children,
    - $41,094 ($46,884 for married filing jointly) if you have one qualifying child, or
    - $15,570 ($21,370 for married filing jointly) if you don't have a qualifying child.
2. **You Must Have a Valid Social Security Number (SSN)**
   The taxpayer and his/her spouse (if applicable) must have a valid social security number. Any dependent must also have a valid SSN. The SSN must be obtained (if already not in their possession) on or before the due date of your 2019 return (including extensions), which would be April 15, 2020 or October 15, 2020 this year.
3. **Your Filing Status Cannot Be "Married Filing Separately"**
   If a taxpayer is legally married, then in order for them to claim the EITC they must file a joint tax return. A taxpayer may also file as "head of household" and still may be able to claim the EITC.
4. **You Must Be a U.S. Citizen or Resident Alien All Year**
   The EITC is not available for non-resident aliens.
5. **You Cannot File Form 2555**
   Form 2555 is typically filed by taxpayers who would like to claim a foreign income exclusion. If the taxpayer would like to exclude any income earned in a foreign country during the taxable year, they preclude themselves from claiming the EITC. For purposes of this test, a US possession is NOT considered to be a foreign country. It is important to note taxpayers living in Puerto Rico, or the Unites States Virgin Islands would still be able to qualify.
6. **Your Investment Income Must Be $3,600 or Less**
   If your investment income during the taxable year is more than this threshold amount, your EITC would be denied. For purposes of this test, investment income is generally defined as interest, dividends, capital gains, rents received, and royalties.

7. **You Must Have Earned Income**
   In order for the taxpayer to qualify, they must have income that is "earned." Generally speaking earned income will include income from working at a job, where the taxpayer would receive a form W-2 at the end of the tax year. Tips received are also included in this category. Finally, income from self-employment will count as earned income for purposes of this test. A taxpayer should keep in mind that non-taxable income such as social security disability income and the likes are not earned income, and therefore not eligible for purposes of this test.

Based on the latest tax return information available (the 2018 tax returns) the Center on Budget and Policy Priorities estimated that over 22 million working families and individuals in America received the EITC. This equates to approximately 7% of the current American population. The effect that this credit is having on working families cannot be underestimated. Study after study have shown that the EITC together with the child tax credit can have a powerful impact on removing Americans out of poverty and into the working class. Based on figure one, 28.1 million Americans were either lifted out of poverty or made less poor because of these tax credits. Of this amount, approximately 12 million were children. It is important to also note that the earned income tax credit is what is called a "refundable credit." As a general rule tax credits reduce the amount the taxpayer owes the Internal Revenue Service dollar for dollar. For example if the taxpayer owes the IRS a tax debt of $500 but has a tax credit of $600, the credit reduces the amount of the debt to zero. If however this tax credit is what is called a "refundable tax credit" not only will the amount of tax debt be reduced to zero, in this hypothetical case, the taxpayer will receive an additional $100 back. There are a few refundable tax credits in the US tax regime, the EITC is one of them.

While, a lot has been done to mitigate the effects of poverty and lift people out of this terrible epidemic, a recent article by USA Today shows a lot more can be done. Millions of Americans that are otherwise eligible for this tax credit have not claimed it. Reasons range from lack of knowledge, to being scared of the tax man. The result of this scenario is that billions of dollars are left unclaimed in the United States Treasury. As a general rule, if the taxpayer is due a refund he or she would have 3 years from the date the tax return would have been due to go back and claim a refund. Under this approach we would be nearing the end of the availability to go back and claim a refund from the 2016 Federal tax return.

One of the most critical aspects of this tax credit is undoubtedly the cost to implement. FIGURE 2 shows that over the course of its inception, the cost to taxpayers have increased tremendously. While this can be an area of valid concern, the benefits clearly outweigh the costs. The EITC promotes workforce participation especially amongst the more vulnerable Americans. Working single mothers and single fathers have benefited from this credit. The valid expansion of the EITC in the early 1990's was responsible for a 34% increase in employment among single mothers in the years leading up to the new century. According to the Tax Foundation, both rural areas in the United States and urban cities have benefited from this tax credit. Both the farmer in Texas, and the factory worker in upstate New York, will receive an equal share of benefits.

There are valid weaknesses with this tax credit and we should address them and fix the underlying issues with them. Firstly, like numerous tax provisions in the tax law, the EITC is extremely complicated and convoluted. A lot of taxpayers who prepare their own tax returns are not sure how to answer the questions for eligibility and therefore just skip that question. FIGURE 3 clearly shows the error rate. While the decline in error rate was welcoming during the years of 2009-2013 it still has an awesome complexity and error rate. Further complicating matters is what is known as the "marriage penalty" which penalizes a taxpayer into a higher tax bracket when they combine both their own and their spouses' income into one tax return. FIGURE 4 is evidence of this severe issue which still needs to be addressed by Congress.

CONCLUDING REMARKS

The original purpose of the EITC related to the debate about reforming welfare in the late 1960s and 1970s. This was known at the time as Aid to Families with Dependent Children (AFDC). During this time in our history, there was increasing concern over growing welfare rolls. As a result, Senator Russell Long proposed a "work bonus" plan that would supplement the incomes of poor workers with families. This in effect, would encourage the working poor to enter the labor force, reducing the number of families needing AFDC. As this legislation has evolved based on economic, political, and social implications, its purpose has also evolved. In its current state, the law only benefits a small demographic of low to middle income Americans, and its benefits are often lost due to the complexity of tax requirements. The simplistic structural inception in which the earned income tax credit tried to help Americans is anything but simple in today's world. The hope is that this article will provide insight into further research and education of this important tax area. Therefore, more Americans can gain benefit from this tax credit, upholding its historical intentions to benefit as many taxpayers as possible.

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26 U.S. Code § 32 https://www.usatoday.com/story/money/2020/02/12/earned-income-tax-credit-2020/4721830002/

26 U.S. Code § 6511

26 U.S. Code § 32

APPENDIX

FIGURE 1
EARNED INCOME TAX CREDIT AND CHILD TAX CREDIT HAVE ANTI-POVERTY IMPACT

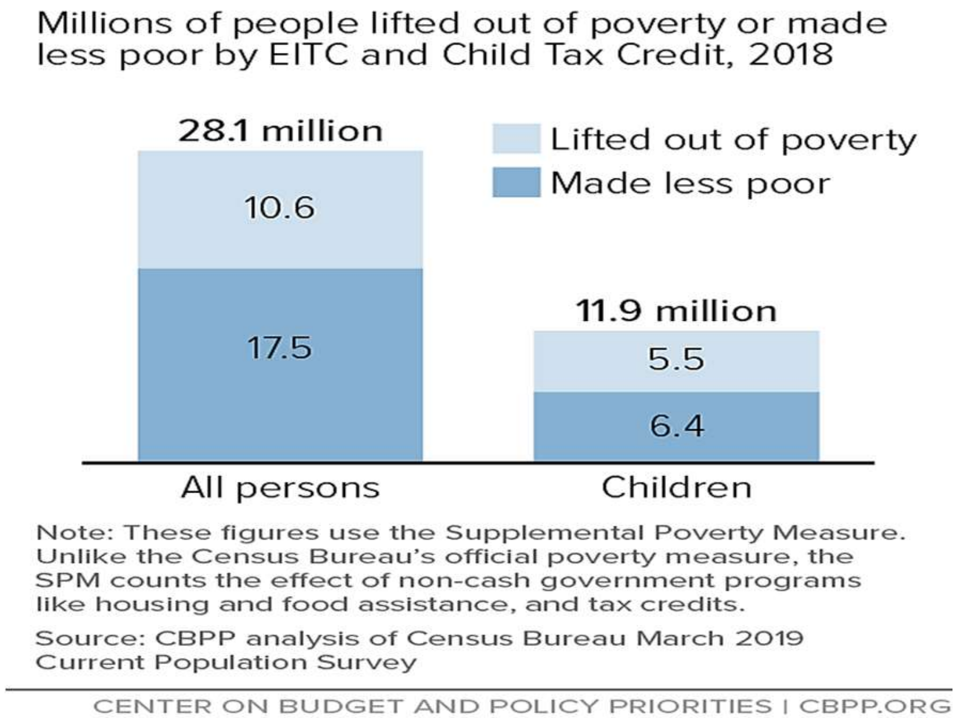

FIGURE 2
EITC GROWTH OVER TIME

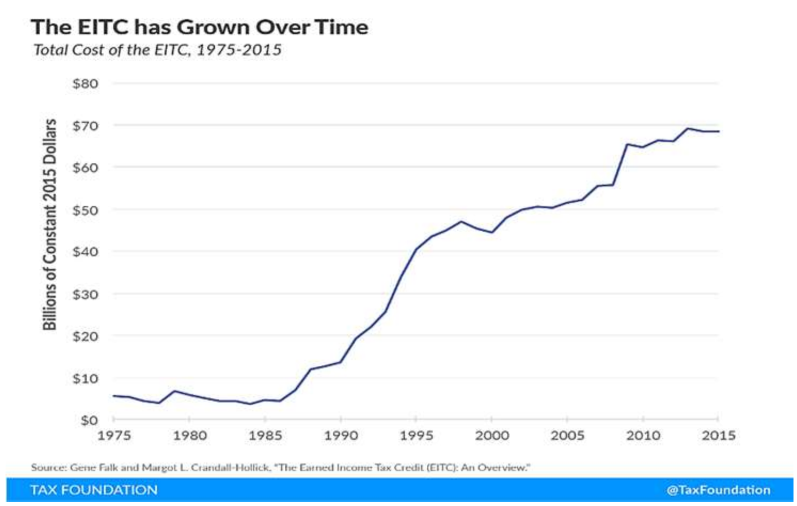

FIGURE 3
EITC HIGH ERROR RATE

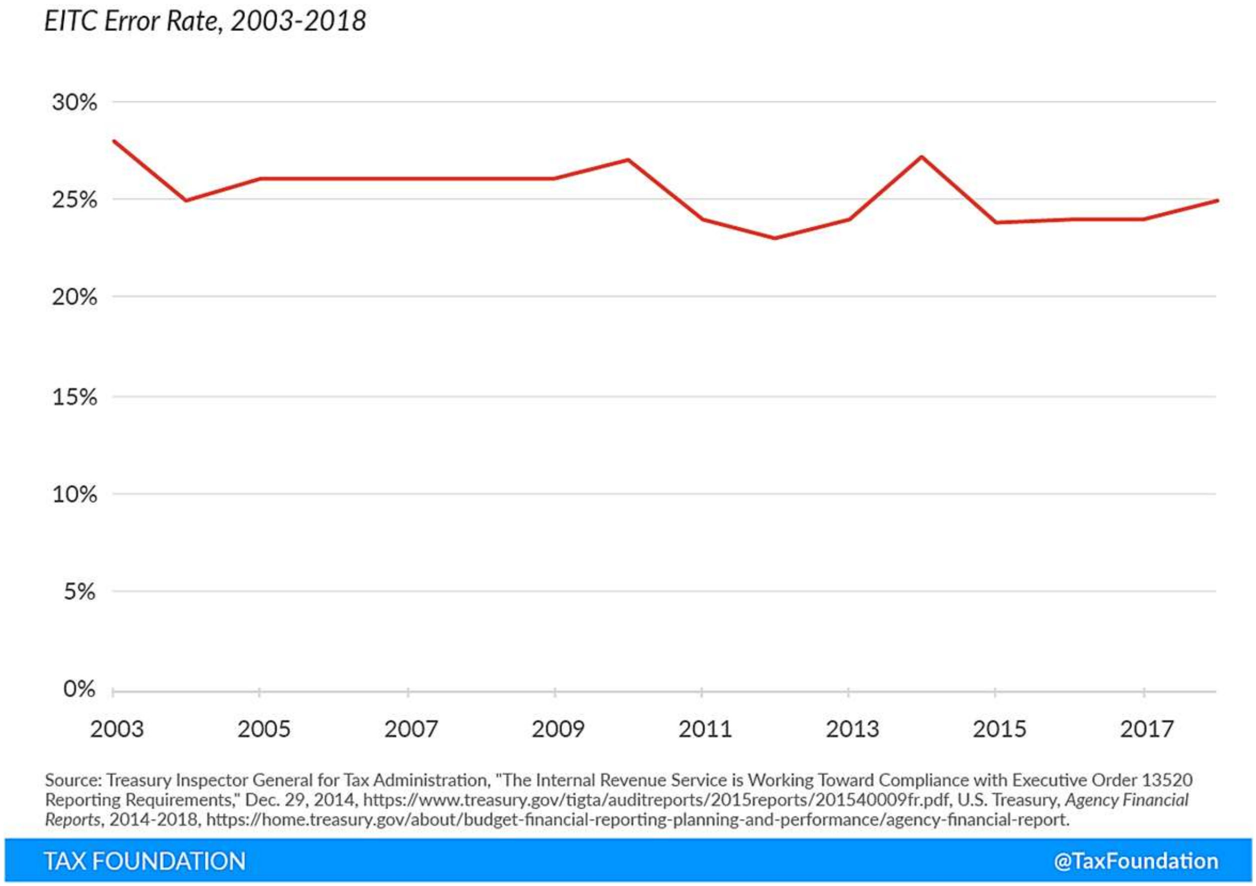

FIGURE 4
LOW-INCOME COUPLES THAT RECEIVE EITC CAN FACE MARRIAGE PENALTY