MISCELLANEOUS RECOMMENDATIONS

Legislative Recommendation #51

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

SUMMARY

- *Problem:* The Earned Income Tax Credit (EITC) is one of the federal government's largest anti-poverty programs, but its eligibility requirements are complex. As a result, millions of eligible taxpayers fail to claim the EITC, while other taxpayers claim amounts for which they are not eligible, leading to a high "improper payments" rate.
- *Solution:* Simplify the EITC by separating it into a "worker credit" and a "child credit," remove age limits for claiming the EITC, and treat unemployment compensation as earned income.[1]

PRESENT LAW

The EITC is a refundable tax credit for low- and moderate-income working individuals and families.[2] 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. The EITC is not available to taxpayers who have disqualified income (*e.g.*, investment income such as dividends, capital gains, and rental income) that exceeds the applicable limit ($11,600 for tax year (TY) 2024).[3] Taxpayers without qualifying children may claim the EITC (commonly referred to as the "childless EITC"), but only if they are between the ages of 25 and 64.[4]

The EITC is structured so that as earned income rises, the credit phases in, plateaus at a maximum amount, and then phases out. The phase-in, maximum, and phase-out amounts depend on the taxpayer's filing status and the number of qualifying children. The maximum credit for TY 2024 is $632 if the taxpayer has no qualifying children, $4,213 with one qualifying child, $6,960 with two qualifying children, and $7,830 with three or more qualifying children.[5]

An individual must meet three primary requirements to be a taxpayer's qualifying child for the EITC.[6] First, the individual must have a specific blood or legal relationship to the taxpayer.[7] Second, the individual must

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1 The National Taxpayer Advocate also recommends that Congress simplify and update the definition of "qualifying child" as used in the EITC and other tax provisions to reflect modern family structures. *See Adopt a Consistent and More Modern Definition of "Qualifying Child" Throughout the Internal Revenue Code*, *infra*.

2 IRC § 32.

3 IRS, Earned Income and Earned Income Tax Credit (EITC) Tables (Aug. 26, 2024), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-and-earned-income-tax-credit-eitc-tables.

4 IRC § 32(c)(1)(A)(ii).

5 IRS, Earned Income and Earned Income Tax Credit (EITC) Tables (Aug. 26, 2024), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-and-earned-income-tax-credit-eitc-tables.

6 Where there are competing claims for the same child, "tie breaker" rules prioritize the claims. IRC § 152(c)(4)(B).

7 IRC §§ 32(c)(3)(A), 152(c)(2).

share a residence in the United States with the taxpayer for more than half the year.[8] 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.[9]

Unemployment compensation (UC) is based on a taxpayer's earned income and is included in adjusted gross income (AGI) under IRC § 85, but it is generally *not included* in earned income under IRC § 32 and thus does not count in computing the amount of EITC for which a taxpayer is eligible.

REASONS FOR CHANGE

Enacted in 1975, the EITC is one of the federal government's largest anti-poverty programs for low-income workers.[10] For TY 2022, taxpayers filed over 23 million returns claiming EITC benefits worth about $61 billion.[11] Overall, the EITC is considered to be an effective anti-poverty program, but its eligibility requirements are complex. As a result, some taxpayers who are eligible for the credit fail to claim it, missing out on this important benefit.[12] At the same time, the program suffers from a relatively high rate of improper payments that could be reduced if the eligibility requirements were simplified.[13]

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

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 phase in as a percentage of earned income, reach a plateau, and then phase out.[14] 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 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, who constitute by far the largest group of EITC claimants.[15]

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. It could be consolidated with or replace the Child Tax Credit (CTC). This could be accomplished in various ways, and proposals to expand the CTC might provide a starting point for developing the new

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8 IRC § 32(c)(3)(C).

9 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).

10 *See*, *e.g.*, Nicardo McInnis et al., *The Intergenerational Transmission of Poverty and Public Assistance: Evidence from the Earned Income Tax Credit* 5-6 (Nat'l Bureau of Econ. Rsch., Working Paper No. 31429, 2023), https://www.nber.org/papers/w31429 (highlighting analyses of the credit's impacts on low-income workers).

11 IRS, Compliance Data Warehouse, Individual Return Transaction File, TY 2022 (Aug. 22, 2024).

12 Approximately 20 percent of eligible taxpayers do not claim the EITC. *See* IRS, EITC Participation Rate by States Tax Years 2014 through 2021 (Aug. 9, 2024), https://www.eitc.irs.gov/eitc-central/participation-rate-by-state/eitc-participation-rate-by-states.

13 An improper payment is generally "any payment that should not have been made or that was made in an incorrect amount, including an overpayment or underpayment, under a statutory, contractual, administrative, or other legally applicable requirement" and includes "any payment to an ineligible recipient." 31 U.S.C. § 3351(4). For fiscal year 2023, the IRS estimates that nearly 33 percent of the total EITC program payments were improper. Payment Accuracy, Fiscal Year 2023 (Jan. 23, 2024).

14 For examples regarding how a per-worker credit might be structured, see Elaine Maag, Urban Inst., Investing in Work By Reforming the Earned Income Tax Credit (2015), https://www.urban.org/research/publication/investing-work-reforming-earned-income-tax-credit.

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

credit.[16] The National Taxpayer Advocate also recommends that Congress standardize and modernize the definition of "qualifying child" used in the tax code, which is discussed in a separate Legislative Recommendation.[17]

Remove Age Eligibility Restrictions

As described above, the childless EITC is generally available only to taxpayers between the ages of 25 and 64. For 2021 only, Congress expanded the age range of eligible workers to include adults over the age of 18 (age 24 for students) and made qualified homeless and former foster youth eligible to claim the credit at age 18.[18] The National Taxpayer Advocate recommends making the 2021 changes permanent. There are an estimated 33 million individuals under the age of 25 and over the age of 64 who are participating in the workforce, which includes about 22 million individuals under the age of 25 and about 11 million individuals over the age of 64.[19] Consistent with the EITC program's dual mission of alleviating poverty and providing a work incentive, individuals who are over the age of 18 (age 24 for students) should not be excluded from EITC eligibility. Further, the age limit should be reduced to age 18 for qualified homeless and former foster youth due to the particular challenges these individuals face.

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. During the COVID-19 pandemic, for example, millions of individuals lost their jobs when certain segments of the economy, including restaurants, hotels, and airlines, substantially reduced their workforces. In other instances, local disasters such as hurricanes, tornadoes, and wildfires 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 earned income solely for purposes of the EITC would provide additional support for low-income families, while still maintaining the nexus between working and receiving the EITC.[20]

RECOMMENDATIONS

- Separate the EITC into two refundable components: a worker credit and a child credit.[21]

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16 *See*, *e.g.*, American Family Act, H.R. 3899, 118th Cong. § 2 (2023); Working Families Tax Relief Act of 2023, S. 1992, 118th Cong. § 201 (2023); Press Release, Office of Sen. Mitt Romney, *Romney, Burr, Daines Announce Family Security Act 2.0* (June 15, 2022), https://www.romney.senate.gov/romney-burr-daines-announce-family-security-act-2-0.

17 *See Adopt a Consistent and More Modern Definition of "Qualifying Child" Throughout the Internal Revenue Code*, *infra*.

18 American Rescue Plan Act of 2021, Pub. L. No. 117-2, § 9621, 135 Stat. 4, 152-153 (2021) (codified at IRC § 32(n)).

19 U.S. Bureau of Lab. Stat., Employment Projections: Table 3.1, Civilian labor Force By Age, Sex, Race, and Ethnicity (modified Aug. 29, 2024), https://www.bls.gov/emp/tables/civilian-labor-force-summary.htm. Note that the data include workers who are 16, 17, and 18 years old. This legislative recommendation would not apply to these individuals except for 18-year-olds who are qualified homeless and former foster youth.

20 We recognize an unintended consequence of including UC in earned income is that it may diminish a taxpayer's EITC claim, and in some instances, may make taxpayers ineligible to claim the EITC.

21 The National Taxpayer Advocate also recommends that Congress simplify and modernize the definition of "qualifying child" as used throughout the code. *See Adopt a Consistent and More Modern Definition of "Qualifying Child" Throughout the Internal Revenue Code*, *infra*.

- Expand the age eligibility for the EITC to individuals who have attained age 19 (age 18 in the case of qualified homeless or former foster youth and age 24 for specified students), with no upper age limit.[22]
- Amend IRC § 32(c)(2)(A)(i) to include UC as EITC-qualifying earned income.

22 For legislative language generally consistent with this recommendation, see Working Families Tax Relief Act of 2023 § 101(a), (b), 118th Cong. (2023). Other bills would allow the childless EITC for working individuals who are age 18 and older. *See, e.g.*, Lower Your Taxes Act, H.R. 5953 § (3)(e), 118th Cong. (2023); EITC Age Parity Act of 2023, H.R. 5689 § 2, 118th Cong. (2023); EITC Modernization Act, H.R. 5421 § 3(f), 118th Cong. (2023); Worker Relief and Credit Reform Act of 2023, H.R. 1468 § (2)(b), 118th Cong (2023). *See also* EITC for Older Workers Act of 2024, H.R. 9361 § 2, 118th Cong. (2024) (repealing the upper age limit).