Simplification of the EITC through Structural Changes

Submission to the Joint Committee on Taxation
for its Study of the Overall State of the Federal Tax System*

By Annette Nellen, Esq. CPA
San José State University

I. Introduction

The earned income tax credit (EITC) is one of the most complex provisions of the federal income tax law, yet its purpose is to provide a benefit to low-income taxpayers who should not be facing such complexity. While there have been various proposals over the past several years to simplify the EITC, few changes have been made and recent law changes, such as the enactment of the child credit, have made the EITC even more complex for many of the individuals who claim it. In addition to complexity, the EITC is also prone to fraud and additional provisions have been added to combat this.

At credit levels of 7.65%, 34% and 40% depending on the type of individual claiming the EITC, the credit results in a refund of all or some portion of the employee's share of FICA and Medicare taxes. In these situations, the EITC is basically a mechanism to refund a tax that perhaps just as easily could not have been withheld in the first place. Such a result could be achieved by using a system similar to the income tax withholding system that doesn't begin until a certain income level is reached. If further simplifications were made to conform definitions used for the EITC, such as "qualifying child," to other definitions used in computing federal taxable income, such as "dependent," the structural change would be more feasible and further simplification could be achieved.

The EITC could be restructured to be an immediate offset of payroll taxes in more than one way. For example, all employees could have an exemption from Social Security (FICA) and Medicare taxes (referred to in this paper as "payroll taxes") on a specified amount of wages. Of course, to offset the reduction in tax collections, the tax rates and maximum amount of earned income subject to payroll taxes would need to be adjusted. Another alternative would be to have payroll taxes computed on a graduated rate basis tied to the worker's wage base (similar to how federal income tax withholding is computed). Because the current EITC structure can result in refunds greater than the worker's payroll tax amount,[1] additional changes would be needed to maintain the current level of benefit provided by the EITC to taxpayers with one or more qualifying children. These changes might be achieved through increased dependency exemptions or child credits for individuals with specified amounts of earned income.

Beyond simplification, an additional potential benefit of an alternative structure and simplification of qualifying status requirements would be that it might make it easier to move to a

[1] For example, in 2000 the maximum EITC for an individual with two or more qualifying children is $3,888 when earned income is between $9,720 and $12,690. The employee's share of payroll taxes on $12,690 of income is only $971 ($12,690 x 7.65%).

(408) 924-3508 or nellen_a@cob.sjsu.edu

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return-free tax system. Structural changes as described above would also serve to provide the EITC benefit to low-income taxpayers in each paycheck without a need for individuals to apply to receive an advance EITC. In addition, these structural changes could be implemented in a manner so as to reduce the current high marginal tax rates that result from the phase-out provision of the EITC.

Format of the Paper

Section II of this paper provides a brief background to the EITC as relevant to appreciating and evaluating appropriate structural changes. Section II reviews the history and rationale of the EITC, issues surrounding it (many of which stem from the complexity of the EITC), and relevant data on the usage of the EITC to better understand who it applies to and its effects to low-income individuals. Section III examines the possible mechanics and feasibility of an alternative structure for the EITC that would simplify the operation of this program and provide an effective and low-cost benefit to low-income individuals.

Focus on Simplicity

The focus of the change proposed in this paper is simplification of the EITC. Thus, there is little discussion of making changes to modify the social and economic policies underlying the EITC. This is not to say that non-tax policy aspects of the EITC are not important, but to emphasize that this paper has been prepared for inclusion in a tax law simplification study.

However, the underlying policy cannot completely be ignored and the discussion of the advantages and disadvantages of the proposals outlined in this paper does note some of these issues. Broader discussions of EITC reform should include a review of the welfare function of the credit. Under today's EITC structure, the amount of the benefit received is dependent on a worker's marital status and number of children (with the benefit capped at two children). The EITC does not provide equivalent benefit to all low-income workers with respect to whether they earn above or below the poverty line for their family size. Also, while the EITC has been viewed by many as an effective tool in increasing employment of low-income workers,[2] perhaps more so than other welfare policies, the use of the tax law to provide welfare benefits beyond the level necessary to remove individuals with income below the poverty level from federal income and payroll taxes should be evaluated in any major EITC reform effort. The rationale for such evaluation includes the fact that the EITC has grown in complexity with its expansion over the years and the fact that it is a program administered by the Internal Revenue Service, rather than an agency with expertise in the administration of welfare programs. Also, the amount of the benefit provided has increased significantly since the EITC was first introduced in 1975, and the incidence of fraud and error in claiming the credit has increased. In addition, any major reform of the EITC system could also be judged in terms of how it would comport with any possible Social Security tax reform.

Reasons for Simplifying the EITC

Key reasons for simplifying the EITC include:

a. To reduce the number of errors that occur in computing the credit.

b. To better ensure that eligible individuals claim the credit.

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[2] See "Should EITC Benefits Be Enlarged For Families With Three or More Children?" prepared by the Center on Budget and Policy Priorities, July 10, 2000.

c. To make it more likely that individuals claiming the credit can be included in a return-free system that we may move to in the future.[3]

d. To reduce the administrative and compliance costs associated with the current EITC.

e. To reduce or eliminate the problems associated with the high marginal tax rates that result from the phase-out feature of the EITC.

II. Brief Background on the Earned Income Tax Credit (EITC)

Eligibility and Computation Basics

IRC §32 provides for an earned income tax credit (EITC). The EITC is a refundable credit available to individuals with specified amounts of earned income. The credit is intended to provide tax relief to certain low-income individuals. Thus, if the individual's earned income exceeds a specified threshold, the amount of the credit phases out. If an individual's earned income (or adjusted gross income, if higher) exceeds the phase-out limit, no credit is available. These dollar amounts are adjusted annually for the effect of inflation. The credit amounts and phase-out rates and amounts vary depending on whether the claimant has one qualifying child, two or more qualifying children, or no qualifying child. Definitions of earned income and qualifying child are provided for purposes of the credit.

Certain factors will disqualify a low-income individual who otherwise meets the income thresholds from claiming the credit. For example, married taxpayers must generally file a joint return in order to claim the credit. Also, individuals must provide the taxpayer identification numbers of the qualifying children. In addition, individuals with investment income in excess of $2,400 (for the year 2000) are not eligible for the EITC.

The credit percentage and phase-out percentages used to compute the EITC are shown in the following chart.

Eligible individual has …	(a) Credit percentage	(b) Phase-out percentage
1 qualifying child	34	15.98
2 or more qualifying children	40	21.06
No qualifying child	7.65	7.65

[3] Today, individuals with a qualifying child claiming an EITC may not use Form 1040EZ. In addition, individuals may not use the simple Telefile system if they claim dependents or received advance earned income credit payments. The Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206; July 22, 1998; Section 2004) requires the Service to study the feasibility of and to develop procedures for a return-free tax system for "appropriate" individuals for tax years beginning after 2007.

For the year 2000, the following amounts apply in computing the EITC:[4]

Number of Qualifying Children	(c) Maximum EITC	(d) Earned Income Amount	(e) Phase-out Amount	(f) Completed Phase-out Amount (no EITC available if the greater of earned income or modified AGI exceeds these amounts)
1	$2,353	$6,920	$12,690	$27,413
2 or more	$3,888	$9,720	$12,690	$31,152
None	$ 353	$4,610	$5,770	$10,380

Formula: The EITC is calculated using the following formula using the letter references in the above two charts.

Step 1: If an otherwise eligible taxpayer's earned income (or modified AGI, if higher) exceeds the completed phase-out amount (f), the taxpayer is not eligible for the EITC.

Step 2: Determine the lower of the taxpayer's earned income or the earned income amount (d).

Step 3: Multiply the amount from Step 2 by the credit percentage (a). If the taxpayer's earned income (or modified AGI, if higher) does not exceed the phase-out amount (e), then the amount computed at Step 3 is the EITC amount. If the taxpayer's earned income (or modified AGI, if higher) equals or exceeds the phase-out amount (e), then Step 4 is needed because the taxpayer is in the EITC phase-out range.

Step 4: Compute [Earned income (or modified AGI, if higher)] – [Phase-out amount (e)] x Phase-out percentage (b)

Step 5: EITC = [Maximum EITC (c)] – [Step 4 amount]

Example 1: Mr. and Mrs. Smith have earned income of $10,000 in 2000 and no other income. Thus, their AGI is also $10,000. The Smiths have two qualifying children. The Smith's EITC is $3,888 computed as follows.

Step 1: The Smiths are eligible for the EITC because their earned income is less than $31,152.

Step 2: The lower amount is $9,720.

Step 3: $9,720 x 40% = $3,888. Because the Smith's earned income does not exceed $12.690, their EITC is $3,888 (which is the maximum EITC amount).

Example 2: Same as Example 1 except that the earned income amount is $16,000. The Smith's EITC is $3,191 computed as follows.

Step 1: The Smiths are eligible for the EITC because their earned income is less than $31,152.

Step 2: The lower amount is $9,720.

Step 3: $9,720 x 40% = $3,888. Because the Smith's earned income equals or exceeds $12,690, the phase-out must be computed.

Step 4: [$16,000 - $12,690] x 21.06% = $697.

Step 5: $3,888 - $697 = EITC of $3,191.

[4] Rev. Proc. 99-42, 1999-46 I.R.B. 568, 570.

Observations: The effect of the phase-out is to create a range of earned income that produces the maximum EITC. This range is from the earned income amount (d) to the phase-out amount (e). At earned income amounts below (d) and those above (e), the EITC gradually reduces in amount. The effect of this formula is to create an "ideal" income range between (d) and (e) where the maximum credit can be obtained. This feature has led to problems of some individuals reporting higher income than actually earned in order to reach the earned income amount (d) or to report lower earned income to reduce the effect of the phase-out when income exceeds the phase-out amount (e). The phase-out mechanics also causes an individual's marginal tax rate to increase once earned income exceeds the phase-out amount (e).[5]

Rationale for the EITC

The EITC was created to provide relief to families[6] with little or no income tax liability, but who were subject to payroll taxes on their earned income. The credit has been viewed as "an effective way of providing tax relief for low-income families, while at the same time providing work incentives for these individuals."[7] In 1990, the amount of the credit was increased to provide partial relief for the regressive effect of excise tax increases.

History[8]

The EITC was created by the Tax Reduction Act of 1975.[9] The EITC was part of a package of tax reductions intended to address the high unemployment rate and slow economy. The EITC began as a one-time benefit to families with at least one dependent child to provide a refundable credit of 10% on the first $4,000 of earned income, for a maximum credit of $400. The EITC phased out as income rose from $4,000 to $8,000. Congress expected that the EITC would help stimulate the economy because most claimants would spend the credit they received. The credit was intended to provide relief to families with little or no income tax liability, but who were subject to Social Security tax on their earned income. In 1975, the Social Security tax rate was 5.85% on earnings up to $14,000, while self-employed individuals were subject to a rate of 7.9% on self-employment income up to $14,100. For 1975, the EITC was intended to be a simple calculation that merely involved adding up earned income and applying the credit percentage. Also, individuals below the income level requiring for filing a tax return were expected to have a simple form available to them for claiming the credit.[10]

The Revenue Adjustment Act of 1975 extended the EITC to the first six months of 1976.[11] The Tax Reform Act of 1976 extended the EITC through the end of 1977 and made slight

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[5] For a detailed explanation of the marginal tax rate effects of the EITC phase-out, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), Feb. 3, 1998, pages 39-45.

[6] The credit was extended to low-income individuals with no qualifying children in 1993.

[7] *General Explanation of the Revenue Act of 1978*, prepared by the Staff of the Joint Committee on Taxation, March 12, 1979.

[8] For a more detailed history of the EITC, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), Feb. 3, 1998, pages 37 – 39.

[9] P.L. 94-12 (March 29, 1975).

[10] House of Representatives Report No. 94-19 (1st Sess), 1975-1 C.B. 569, 579; Senate Report No. 94-36 (1st Sess.), 1975-1 C.B. 590, 595.

[11] P.L. 94-164 (Dec. 23, 1975).

modifications to the eligibility criteria.[12] The rationale for the extension was explained as follows:[13]

> [The EITC] provides needed tax relief to a hard-pressed group in the population – the lower income worker. It also provides a work incentive, since the credit is based on the amount of earned income. In effect, it offsets the social security payroll taxes payable with respect to those who are working but whose incomes are slightly, if any, above the levels of those on welfare. This is designed to improve the financial position of those who work relative to those remaining on welfare.

The Revenue Act of 1978 made the EITC a permanent provision and increased the credit to 10% of the first $5,000 of earned income for a maximum credit of $500. The income phase-out was changed to begin at $6,000. The eligibility criteria were simplified and a system was created to allow individuals to claim advance earned income tax payments throughout the year.[14]

Small increases to the EITC were made by the Deficit Reduction Act of 1984[15] and the Tax Reform Act of 1986.[16] More substantial increases were made to the EITC by the Omnibus Budget Reconciliation Act of 1990.[17] In addition, the 1990 Act broadened the category of individuals eligible for the EITC, and added the supplemental young child credit and supplemental health insurance credit. With the EITC increase, the advance EITC was changed to be limited to the credit allowable to a taxpayer with only one qualifying child. In addition, Congress called for the Treasury Department to conduct a study on the effectiveness of the advance payment system and how complexity could be alleviated for small businesses. The rationale for the study was the fact that participation in the advance payment program was minimal. Treasury was also directed to create a taxpayer awareness program to inform the public of the EITC.

The Omnibus Budget Reconciliation Act of 1993[18] further raised the EITC rates and expanded eligibility. The 1993 changes allowed individuals without a qualifying child to also claim the credit, but at a much lower rate then for taxpayers with children. Taxpayers with no qualifying children must be at least age 25 and under age 65 to claim the EITC. The 1993 Act also repealed the supplemental young child and supplemental health insurance credits that had been added just three years earlier.

Tax legislation in 1994, 1995 and 1996 made certain individuals, such as prison inmates, ineligible for the EITC. Also, individuals with certain levels of "disqualifying income," such as certain investment income, were made ineligible for the EITC. Finally, the most recent changes of significance were compliance provisions added by the Taxpayer Relief Act of 1997.[19] These changes include a provision that denies the EITC for ten years for taxpayers who fraudulently claimed the EITC, as well as a provision that imposes due diligence requirements on paid preparers of returns on which the EITC is claimed.

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[12] P.L. 94-455 (Oct. 4, 1976).

[13] *General Explanation of the Tax Reform Act of 1976*, prepared by the Staff of the Joint Committee on Taxation, JCS-33-76, Dec. 29, 1976, pages 123-126.

[14] P.L. 95-600 (Nov. 6, 1978).

[15] P.L. 98-369 (July 18, 1984), §§423(c), 471(c) and 1042(a).

[16] P.L. 99-514 (Oct. 22, 1986), §§104(b), 111 and 1272(d)(4).

[17] P.L. 101-508 (Nov. 5, 1990), §§11101(d) and 11111 to 11116.

[18] P.L. 103-66 (Aug. 10, 1993), §§909-910.

[19] P.L. 105-34 (Aug. 5, 1997), §1085.

Who Claims the EITC

In 1998, approximately 19.1 million taxpayers claimed the EITC on their tax returns. Of these taxpayers, 4.4 million (23%) were in the EITC phase-in range, while 11.7 million (61%) were in the EITC phase-out range. The income categories for the 19.1 million claimants was as follows:[20]

Income Category	Number of Taxpayers Claiming the EITC (millions)
Less than $10,000	4.8
$10,000 - $20,000	6.7
$20,000 - $30,000	5.3
$30,000 - $40,000	2.1
$40,000 - $50,000	0.2
$50,000 - $75,000	Under 50,000

Projections for 1997 indicated the following breakdown of the types of individuals claiming the EITC:[21]

Type of Household	Number of returns (000s)	EIC (millions)	Percentage of dollars
No qualifying children	3,639	635	2
One qualifying child	7,949	11,463	43
Two or more qualifying children	7,064	14,821	55
All households	18,652	26,919	100

Average EITC Benefits

In 1975, the average credit for families claiming the credit was $201. This amount gradually increased to reach $601 in 1990 and $1,567 in 1997. The projected benefit is $1,625 per family for 2000 and $1,701 for 2002.[22]

EITC Problem Areas

The EITC began in 1975 as a fairly simple calculation (10% of earned income, not to exceed a credit of $400, with a phase-out on earned income up to $8,000). Today, the maximum credit is much larger ($3,888 in 2000) and the definitions necessary to calculate the credit go beyond just "earned income" and the credit has been expanded to cover more low-income individuals. In addition, the number of individuals claiming the credit has grown in the past 25 years. In 1975, about 6.2 million taxpayers claimed the credit (totaling approximately $1.25 billion of credits), while 19.4 million claimed it in 1998 (about $30 billion of credits).[23] The expansion of the EITC,

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[20] Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), Feb. 3, 1998, page 42.

[21] Joint Committee on Taxation, *Impact on Individuals and Families of Replacing the Federal Income Tax* (JCS-8-97), April 14, 1997, page 40.

[22] House Ways and Means Committee, *2000 Green Book*, WMCP: 106-14, page 813; hereinafter *2000 Green Book.*

[23] Treasury Dept., *Management Advisory Report: Administration of the Earned Income Credit*, September 2000, No. 2000-40-160; available from Tax Analysts: 2000 TNT 217-17; hereinafter *2000 Treasury Report*.

the large dollar amounts involved and the refundable nature of the credit have caused the EITC to be both error prone and fraud prone. In addition, the large phase-out range for the credit can create high marginal tax rates for certain individuals. Finally, the EITC is not tied to providing similar relief in terms of the level above the poverty line at which individuals have federal income and payroll tax liabilities. These problems are further explained below for the purpose of indicating why changes are needed to the EITC.

Taxpayer Costs—Complexity:

- The 1999 IRS Publication 596, *Earned Income Credit (EIC)*, was 54 pages long.
- An IRS study has indicated that about 65% of taxpayers claiming the EITC in 1997 used a paid preparer, compared to 53% of all taxpayers who used a paid preparer.[24]
- Many reports, including ones from the IRS National Taxpayer Advocate, have commented on the complexity of the EITC.[25] The American Institute of Certified Public Accountants (AICPA) has described the EITC as the Number 1 Taxpayer Headache:

  > "Childhood dreams turn into adult nightmares for low-income parents trying to figure out the earned income tax credit. The credit has been changed 13 times since 1976 and now requires taxpayers to wind their way through a maze of eligibility tests and worksheets. This credit is one of the most error prone, complex provisions of the individual income tax."[26]

  The Joint Committee on Taxation notes that the sources of EITC complexity stem from two sources: 1) identifying whether a child is a "qualifying child," and 2) calculation of the credit and what constitutes earned income.[27]

  Simplification proposals from the Service and tax practitioners have often called for conforming the definition of "qualifying child" to that of "dependent child," changing the definition of earned income to wages plus self-employment income, and providing tax relief for children through the dependency exemption rather than the EITC.[28]

Taxpayer Costs—Tax Rate Anomolies:

- Above the phase-out point, a taxpayer's marginal tax rate can be quite high. Arguably, this effect also creates a disincentive to earn more.

  Example: Married taxpayers with two qualifying children have earned income in 2000 of $12,690 which entitles them to the maximum EITC amount of $3,888. If the family earns an additional $1,000 of earned income, their EITC is reduced by $211 ($1,000 x 21.06%). The marginal tax on the $1,000 of earned income is 51% (15% income tax + 21.06% EITC phase-out + 15.3 payroll taxes). Other credits though, such as the child credit, would reduce this amount.

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[24] *2000 Treasury Report, supra.*

[25] IRS, National Taxpayer Advocate's Annual Reports to Congress for FY 1999 and FY 1998. EITC complexity was also noted in the *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity*, June 5, 2000.

[26] AICPA, "10 Big Taxpayer Headaches That Could Be Cured Through A Little Tax Simplification," 4/9/98, http://www.aicpa.org/members/div/tax/headache.htm.

[27] Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Individual Income Taxes* (JCS-18-99), April 14, 1999, page 82.

[28] See AICPA, Individual Tax Simplification, 1997, http://www.aicpa.org/letters/pkgcvr7.htm; Treasury Dept., Treasury News Release LS-904, 9/22/00; and IRS, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity*, June 5, 2000, pages 17 - 18.

It is estimated that over 50% of EITC claimants are in the phase-out range, and thus, subject to the high marginal tax rate explained in the example.[29]

- The EITC can create a significant marriage penalty when both spouses work. This can be seen in the charts provided earlier on how to calculate the EITC. Assume two working individuals each have one qualifying child and earned income of $12,690, which would qualify each for the maximum EITC in 2000 of $2,353 (a total of $4,706). If these two individuals were instead married, their earned income amount would be in the phase-out percentage and their EITC would be less than the maximum of $3,888.[30]

Taxpayer Costs—Problems of Obtaining the Credit:

- The complexity problems noted above can prevent eligible taxpayers from claiming the credit.[31]
- At least one private study has estimated that as few as 65% of eligible taxpayers receive the EITC.[32] As reported by the Joint Committee on Taxation in 1995, other studies have reported higher participation rates, noting that EITC participation is likely higher than for other programs, such as food stamps and SSI. The report also noted that EITC was more prone to improper claims because it was not subject to the same verification process as food stamps and similar welfare programs.[33]
- One expert on low-income taxpayer problems believes that up to 25% of the EITC error rate that the Service may follow up on stems from individuals who are entitled to the credit but don't respond to IRS notices due to time constraints, inability to access a phone, or to take time off from work to obtain requested documentation.[34]
- While some EITC-eligible individuals may receive the EITC in their paychecks, doing so involves filing Form W-5 with the individual's employer every year. An individual may be disinclined to give an employer a W-5 for privacy reasons. Also, the instructions to Form W-5 and the limitations on who may claim the Advance EITC may discourage an eligible individual from applying (and instead waiting to receive the EITC when the Form 1040 is filed in the subsequent year).

IRS Costs and Problems:

- "The IRS uses a complex process to administer the approximately $30 billion in EIC claims received each year. The over 18 functions that process these claims have conflicting goals and different approaches for achieving full participation and compliance, both between and within functions. For example, one function's goal is to process paper tax returns and issue

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[29] Joint Economic Committee, *The EITC and the Taxation of Lower-Income Working Families*, March 2000, page 8; hereinafter, *2000 JEC Report*.

[30] The specifics of the EITC marriage penalty, as well as possible remedies, are explained in Congressional Budget Office, *For Better or Worse: Marriage and the Federal Income Tax*, June 1997.

[31] The complexity of the EITC, along with the fact that it is refundable, has also caused individuals to overclaim the credit.

[32] *2000 Treasury Report*, *supra*; see Executive Summary of Treasury Report, footnotes 6, 7, and 8.

[33] Joint Committee on Taxation, *Description of Present Law and Discussion of Issues Relating to the Earned Income Tax Credit*, JCX-27-95, 6/14/95. See footnotes 12, 13 and 14 of the JCT report which primarily refer to John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, 47, March 1994.

[34] Comment from Nina Olson, Director of the Community Tax Law Project in Virginia, reported in Tax Analyst, "EITC Error Rates Up; Review Process Slows Down," 2000 TNT 191-3, 9/29/00.

refunds within 45 days. Another function's goal is to identify fraudulent returns during processing of the returns and stop payment of the refunds."[35]

- The fraud and error rate for 1997 was about 25.6%, compared to 21% for 1994. This means that about $7.8 billion of credits were erroneously paid out.[36]
- The most common math error on tax forms is incorrectly calculating the EITC. "[EITC] errors accounting for the highest percentage (28 percent) of math errors related to categories of complexity."[37]
- The IRS spends over $140 million annually on EITC compliance.[38]

EITC Benefits and Poverty Levels:

While the relationship between EITC benefits and poverty levels is not a simplification issue, the topic is briefly noted here. A structural change to deliver the EITC benefit via a payroll tax exemption (or similar mechanism) along with an increased dependency exemption or child credit amounts in order to maintain the dollar amount of the EITC, is likely to be more equitable in providing relief to low-income taxpayers in terms of providing similar tax relief for those at similar poverty levels than is the current mechanism. The issues with equity under the current EITC is that it is capped at two or more qualifying children and is much lower for individuals with no qualifying children. Thus, to illustrate that such improved equity should not discredit the proposal, a brief discussion of how the current EITC does not provide similar relief to similarly situated individuals relative to poverty levels is provided.

- The income and payroll taxes imposed at the poverty level as a percentage of the poverty level for selected years and family sizes is illustrated in the following chart.[39] The percentages vary among family sizes, not only due to the EITC, but also due to the bracket structure, standard and personal deductions, and the child credit.

	Family Size					
Year	**1**	**2**	**3**	**4**	**5**	**6**
1993	10.3	7.7	-4.8	-0.2	3.2	5.3
1999	9.1	5.6	-8.1	-9.4	-3.7	-0.2
2002	9.2	5.7	-7.9	-9.2	-3.5	0.0

- From 1993 to 2009 (projected), only individuals with a family size of one have an income tax liability when their income is below the poverty level.[40]
- In 1998, the poverty rate or children in families with three children was 22.4% and for was 33.8% for children in families with four children.[41]

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[35] *2000 Treasury Report, supra.*

[36] Treasury Dept., Treasury News Release LS-904, 9/22/00. In response, Treasury announced new administrative initiatives, legislative proposals, and urged Congress to enact two simplification proposals included in the Administrations FY 2001 budget, including conforming definitions used for the EITC to those used in other parts of the income tax rules. Also see Tax Analysts, "IRS Proposes Solutions to Boost EITC Compliance," 2000 TNT 186-1, 9/22/00.

[37] IRS, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity*, June 5, 2000, pages 12 and 50 - 51.

[38] *2000 JEC Report, supra*, page 11.

[39] *2000 Green Book, supra*, pages 839 to 842.

[40] *2000 Green Book, supra*, pages 841.

III. Proposal for an Alternative EITC Structure

Criteria: An alternative structure for delivering the benefits of the current EITC should satisfy the following criteria:

a. Employ a system that prevents taking money from individuals (payroll tax withholding) and returning all or part of that money later. The system must be more effective than the current advance EITC procedure that is not available to all EITC taxpayers and not required to be used.

b. Be able to provide the same dollar benefit as under the current EITC structure.

c. Be simpler for EITC-eligible taxpayers.

d. Be simpler for the IRS to administer.

The Proposed Alternative Structure: The premise of the alternative structure for the EITC that would satisfy the above criteria is to change the withholding system for payroll taxes. The specifics of this changed withholding structure are listed below.[42] Potential problem areas and potential solutions for them are also covered.

i. Withholding would not apply until a certain threshold of income is earned. To phase-out this benefit at increasing earned income levels, the new withholding system (rate structure) could be progressive with the tax rate increasing as income exceeds the threshold. Statutory changes would be needed to change the rate structure for these payroll taxes.

Observation 1: To be simple, this structure should apply to all individuals with earned income. There should be no exceptions based on age (as there is with today's EITC for individuals with no qualifying child). If the current structure of limiting the EITC benefits to a maximum of two qualifying children is to remain, the rate structure would have to consider the number of qualifying children the worker has (similar to our current withholding table for income taxes). Similarly, if a much lower EITC remains for individuals with no qualifying children, the withholding rate would need to incorporate this.

Observation 2: While the structure could instead just exempt people with an expected annual salary below a certain amount from payroll tax withholding, such a system would likely be more complicated for employers. To maintain revenue neutrality, the new progressive rate structure could be set to, in effect, cause higher income individuals to end up paying payroll taxes on the initial exempted amount (similar to the corporate surtax system that results in corporate taxpayers at certain high levels of income losing the benefit of having some of their initial income taxed at the lower bracket amounts).

Two potential problem areas of the exemption amount for all individuals with earned income is that for individuals beyond the EITC eligibility levels, they would see their paychecks get smaller as the year progresses. This is the opposite effect individuals with

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[41] Center on Budget and Policy Priorities, *Should EITC Benefits Be Enlarged For Families with Three or More Children?*, July 10, 2000, page 3. The report suggests that allowing a larger EITC for families with three or more children would promote work and self-sufficiency. It also notes that approximately 15% of families claiming the EITC have three or more children and therefore, an expanded EITC would have a limited cost.

[42] The proposed alternative structure for the EITC is similar to proposals made by others. See *2000 JEC Report, supra*; Joint Committee on Taxation, *Description of Present Law and Discussion of Issues Relating to the Earned Income Tax Credit*, JCX-27-95, 6/14/95; and Yin, Scholz, Forman, and Mazur, "Improving The Delivery of Benefits To The Working Poor: Proposals To Reform The Earned Income Credit Program," 94 TNT 40-56, 3/3/94.

earnings above the Social Security base experience today. However, this issue could be resolved by incorporating a "leveling" mechanism into the withholding system whereby withholding would be performed on a more equal basis throughout the year (similar to the current withholding system for income taxes).

A similar problem is created for some EITC-eligible individuals in that they would receive the bulk of their EITC benefit in the first part of the year, rather than evenly throughout the year (although today, many receive the entire benefit after they file their Form 1040). This could also be addressed by incorporating a leveling mechanism into the withholding schedule. Under such a system, the gross earnings would be annualized to determine the payroll withholding rate to use. While this could be complicated for employers, payroll software systems used by many employers today could handle the necessary calculations (the payroll tax withholding structure would be similar to the current income tax withholding mechanism). This same leveling mechanism would also address the issue of non-EITC eligible workers having smaller paychecks later in the year.

ii. The employer share of payroll taxes could remain as they are today, or employer payroll taxes could match employee payroll taxes. This is an important issue to resolve both for revenue neutrality purposes and for purposes of determining how much self-employment taxes a self-employed individual should pay.

iii. Replace part of the current EITC benefit with increased dependent deduction and/or child credit. This mechanism will allow a larger EITC benefit tied to family size (although whether the EITC should be provided beyond two qualifying children is a political and social issue for lawmakers to resolve). An advantage of replacing some of the EITC benefit with the dependent deduction or child credit is that it could help alleviate the potential problem a worker having multiple jobs during the year may face. Such an individual may not have paid enough payroll taxes. To reduce or eliminate that person's liability to the U.S. Treasury, he will have a reduced dependent deduction or reduced child credit. In addition, employees could be allowed to indicate on Form W-4 that they want payroll tax withholding for the remainder of the year when they change jobs during the year.

Observation: Today's EITC has both a phase-in and phase-out feature. The withholding system proposed here could be unduly complicated if the phase-in structure were added to it. Alternatively, if the phase-in structure were kept, it could be implemented via the dependency exemption, child credit and/or personal exemption amounts allowed at certain earned income levels.

iv. For further simplicity, the definitions used in the EITC should be changed to better match terms used elsewhere in the Internal Revenue Code. For example, the definition of "qualifying child" could match that of dependent child. This would allow employers to use W-4 information in determining the payroll tax withholding for employees.

Expected Benefits:

- Workers eligible for EITC benefits would be able to receive the benefits throughout the year without the need to file a W-5 with the employer.
- The calculation by individuals of the EITC would be simplified in that the "truing up" of the EITC amount could be done as part of the Form 1040 calculations, particularly if EITC definitions of earned income and "qualifying child" are conformed to other definitions already used in computing taxable income. For example, a person's adjusted gross income (AGI) and number of dependent children would indicate the EITC amount and such amount

should have already been provided to that taxpayer through the new payroll withholding system.

- The reduction in complexity should lower the fraud and error rate that currently exists for the EITC.
- Costs to taxpayers should be reduced in that they would need to perform fewer calculations and could, perhaps, avoid having to hire someone to prepare their return.
- The alternative structure should work better under a return-free filing system because the necessary filing information would be on an employee's W-4 and W-2 and the number of calculations required to compute the credit could be reduced.

IV. Conclusion

No one would likely disagree with the statement that the EITC is too complex. While it began as a fairly simple calculation in 1975, its expansion and increase in benefit amount and desire to place certain limitations on eligibility have made it overly complex. Complexity brings with it results that are counterproductive to the purpose of the benefit. That is, complexity leads some eligible individuals to not claim their full EITC benefit, causes some ineligible individuals to attempt to claim the credit, and increases costs for both taxpayers and the IRS.

The EITC is designed to provide relief to low-income taxpayers who, while exempted from income tax on the first several thousand dollars of their earned income, are still subject to payroll taxes. However, unlike the income tax relief they receive in each paycheck, the payroll tax relief provided through the EITC is really only effectively returned today after the end of the year when the worker files his tax return. A structural change (as well as some changes to simplify EITC definitions and provide some of the benefit through increased dependency deductions and child credits) can turn the EITC benefit into one that is provided through the payroll tax withholding system, just as is done under the income tax system.

While the alternative structure described in Part III above might not be the simplest item in the tax law, it should be simpler than the current overly complex EITC structure. In addition, it would enable eligible taxpayers to obtain the EITC benefit throughout the year, rather than waiting until after year-end when they file their Form 1040.