

**INFORMATION BRIEF**  
**Research Department**  
**Minnesota House of Representatives**  
600 State Office Building  
St. Paul, MN 55155

Nina Manzi, Legislative Analyst, 651-296-5204  
Joel Michael, Legislative Analyst, 651-296-5057

Updated: December 2016

---

# **The Federal Earned Income Tax Credit and The Minnesota Working Family Credit**

The federal earned income tax credit (EITC) provides a wage supplement equal to a percentage of the earnings of low-income individuals. The credit is fully refundable; if the credit exceeds a filer's tax liability, the rest is paid as a refund.

The Minnesota working family credit (WFC) is also a tax credit that is a percentage of earnings. Before 1998, the WFC was set as a percentage of the federal EITC. Legislation enacted in 1998 restructured the WFC as a percentage of earnings. Like the EITC, the WFC is refundable. This information brief describes the credits.

---

## **Contents**

<a href="#">Executive Summary</a> .....	3
<a href="#">The Federal Earned Income Tax Credit</a> .....	5
<a href="#">The Minnesota Working Family Credit</a> .....	9
<a href="#">The Tax Credits and Poverty</a> .....	17
<a href="#">The Tax Credits and Work Effort</a> .....	20
<a href="#">The Tax Credits and Compliance</a> .....	24
<a href="#">Appendix: Earned Income Tax Credits in Other States, 2015</a> .....	28

## **List of Tables and Figures**

Copies of this publication may be obtained by calling 651-296-6753. This document can be made available in alternative formats for people with disabilities by calling 651-296-6753 or the Minnesota State Relay Service at 711 or 1-800-627-3529 (TTY). Many House Research Department publications are also available on the Internet at: [www.house.mn/hrd/](http://www.house.mn/hrd/).

## Tables

Table 1: Maximum Federal Earned Income Tax Credit, 2016.....	5
Table 2: Federal Earned Income Tax Credit Phaseout, 2016 .....	6
Table 3: Minnesota Working Family Credit Calculation, 2016 .....	11
Table 4: Minnesota Working Family Credit, 1991 to 2019 .....	13

## Graphics and Maps

Figure 1: Minnesota Working Family Credit Recipients, 2014.....	11
Figure 2: Percentage of Returns Claiming Minnesota Working Family Credit, 2014 .....	12
Figure 3: Refundability of Working Family Credit, 2014 .....	15
Figure 4: WFC Recipients by Number of Qualifying Children and Marital Status, 2014 .....	16
Figure 5: Effect of EITC and WFC on Income: Single Parent and Married Couple Families, One Full-Time Minimum Wage Worker, 2016.....	19
Figure 6: EITC and WFC Ranges, Filers with One Qualifying Child, 2016.....	21

## **Executive Summary**

The federal earned income tax credit (EITC) and Minnesota working family credit (WFC) equal a percentage of the earnings of low-income individuals, up to a maximum amount. The credits are phased out for filers with incomes above dollar limits. Different maximum amounts, credit percentages, and phaseout rates apply for people with zero, one, two, or three or more dependents. The credits are refundable; if the credit exceeds a filer's tax liability, the rest is paid as a refund. Eligible individuals claim the credits when they file their federal and state income tax returns.

In 2014, about 360,000 Minnesota filers claimed federal EITCs totaling \$761 million, and about 345,000 filers claimed state WFCs totaling \$256.1 million. About 13 percent of Minnesota filers claimed the federal credit and about 12 percent claimed the state credit.<sup>1</sup> The average EITC was \$2,130; the average WFC was \$741. Most credit recipients had one or more qualifying children.

Twenty-six other states offer earned income tax credits. Most of these equal a percentage of the federal credit and are refundable, but a handful of states provide nonrefundable credits. These programs are listed in the appendix.

### **The Tax Credits and Poverty**

The EITC was designed to provide financial assistance to families who would otherwise be living in poverty. Since the EITC took effect in 1975, the federal government has expanded the program significantly, and the current credit parameters are indexed annually to keep pace with inflation.

Nationwide, the EITC has an estimated participation rate of 80 percent, a higher rate than many means-tested, direct spending programs, such as the Supplemental Nutrition Assistance Program (formerly food stamps) and Medical Assistance.

The Census Bureau reports that the federal and state refundable tax credits reduce the poverty rate by about three percentage points and by twice that for children under 18. Combined with the recent increase in the minimum wage for large employers, in 2016 the EITC and WFC together will be large enough to lift single parents and married couples with one or two children above the poverty level.

### **The Tax Credits and Work Effort**

Because the credits phase out when income increases, their effect on work incentive varies depending on where an individual is on the income scale. If an individual is in the phase-in range, the credits reward individuals with a higher return on work; if an individual is on the

---

<sup>1</sup> In 2013 the federal credit extended to higher income levels for families with three or more children than did the state credit, making more filers eligible for the federal credit than for the state credit.

phaseout range, the credits reduce the return on work. This provides a work incentive for those in the phase-in range, and a work disincentive for those in the phaseout range; such a disincentive is inevitable for a credit that phases out as income increases. Most research suggests that the EITC increases total work effort by a small amount.

## **The Tax Credits and Compliance**

The growth of the EITC program has led to concerns about compliance and payments to ineligible recipients. The IRS estimates that taxpayers overclaimed the amount of EITCs by between 29 percent and 39 percent for tax years 2006 to 2008, although IRS compliance efforts reduce the actual amounts overpaid. The IRS has conducted three pilot compliance tests or studies to better understand how to reduce overclaims for the EITC:

- The Qualifying Child Residency Study had the objective of reducing erroneous claims for children who don't meet the definition of a qualifying child by requiring precertification of children
- The Filing Status Study had the goal of reducing the number of taxpayers filing as head of household in order to claim larger credits than they would be eligible for as married joint filers
- The Automated Underreporter Study (AUR) sought to reduce income underreporting that results in larger credit claims

The IRS determined that neither precertifying qualifying children nor requiring documentation of filing status were cost-effective; while both reduced the number of erroneous claims, the administrative costs exceeded the savings realized by reducing erroneous claims. Third-party income matching developed in AUR proved to be cost-effective and has been incorporated into IRS methodology used in annually reviewing a subset of all EITC claims.

## The Federal Earned Income Tax Credit

The federal earned income tax credit (EITC) equals a percentage of earned income, up to a maximum amount. The credit increases as earnings increase, up to the maximum amount. The credit then remains constant until earnings reach the phaseout threshold. It phases out as income increases above the threshold.

This section describes how the credit is calculated. Filers do not have to perform these calculations to obtain the credit; instead they enter relevant information in a worksheet or into tax calculation software. Filers submitting paper returns then look up their credit in a table keyed to income and number of qualifying children, while those using software have the credit calculated for them based on the information supplied.

**Earned income, up to a maximum amount, is multiplied by a credit percentage to calculate the credit.**

Earned income generally consists of income from wages, salary, and self-employment. Different maximum amounts and credit percentages apply for individuals with zero, one, two, and three or more dependents. The maximum amount of earned income that qualifies for the credit is indexed each year for inflation. Table 1 shows the credit percentages, maximum amounts, and maximum credits for tax year 2016.

Table 1:  
**Maximum Federal Earned Income Tax Credit, 2016**

	<b>Maximum Earned Income</b>	<b>x</b>	<b>Credit Percentage</b>	<b>=</b>	<b>Maximum Credit</b>
No Qualifying Children	\$6,610	x	7.65%	=	\$506
1 Qualifying Child	9,920	x	34.00	=	3,373
2 Qualifying Children	13,930	x	40.00	=	5,572
3 or More Qualifying Children	13,930	x	45.00	=	6,269

House Research Department

**The EITC is phased out for filers with incomes above set dollar thresholds.**

The credit provides separate phaseout thresholds and phaseout rates for filers with zero, one, and two or more qualifying children. The thresholds are indexed annually for inflation. Although the credit is a percentage of earned income, the phaseout is based on the greater of earned income or adjusted gross income. Use of adjusted gross income as an alternative limit is intended to adjust the amount of credit for other sources of income (such as investment income, unemployment compensation, and so forth). Married couples filing joint returns use higher phaseout thresholds, which reduces marriage penalties under the credit. For tax year 2016, the phaseout threshold for married couples filing jointly is \$5,550 higher than the threshold used by other filers. Table 2 shows the phaseout thresholds, rates, and income at which the credit is fully phased out in 2016, for married couples and for all other filers.

Table 2:  
**Federal Earned Income Tax Credit Phaseout, 2016**

	Phaseout Rate		Phaseout Threshold	Income at which credit is fully phased out
<b>Married couples</b>				
No Qualifying Children	7.65%	of income over	\$13,820	\$20,430
1 Qualifying Child	15.98	of income over	23,740	44,846
2 Qualifying Children	21.06	of income over	23,740	50,198
3 or More Qualifying Children	21.06	of income over	23,740	53,505
<b>All other filers</b>				
No Qualifying Children	7.65%	of income over	\$8,270	\$14,880
1 Qualifying Child	15.98	of income over	18,190	39,296
2 Qualifying Children	21.06	of income over	18,190	44,648
3 or More Qualifying Children	21.06	of income over	18,190	47,955

House Research Department

A marriage penalty may occur under the earned income credit when a single parent eligible for the credit marries.<sup>2</sup> The couple's combined income is likely to be higher than the single parent's income was, resulting in a reduction or complete loss of the credit due to more income being in the phaseout range. For example, a single parent with one qualifying child and earned income of \$12,000 qualifies for the maximum credit of \$3,373. If this individual marries a single filer who also has \$12,000 of earned income, the couple has a combined earned income of \$24,000. Before the phaseout was extended for married couples, this couple would have qualified for a credit of \$2,445 (the \$3,373 maximum credit, minus 15.98 percent of income over the phaseout threshold of \$18,190). The couple would have experienced a marriage penalty of \$928, since the credit is \$928 smaller than what the single parent qualified for before marriage. Increasing the phaseout threshold by \$5,550 for married couples increases this couple's credit to \$3,331 and reduces the marriage penalty.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided for higher phaseout thresholds for married couples filing joint returns than for other taxpayers. This change was intended to reduce the marriage penalty imposed under the earned income tax credit. The American Recovery and Reinvestment Act (ARRA) of 2009 further increased the threshold for married joint filers. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRCA) of 2010 extended the increased threshold for two years, through tax year 2012. The American Taxpayer Relief Act (ATRA) of 2012 extended the higher thresholds put in place under ARRA through 2017, and made the EGTRRA thresholds permanent in

<sup>2</sup> Conversely, some couples receive a marriage bonus. This generally occurs for lower income couples, where an individual with modest earnings marries an individual who has one or more dependents and low or no earnings. In such a case, marriage results in more earnings qualifying for the credit and a marriage bonus. Marriage penalties tend to occur among couples with higher incomes, while couples with lower incomes tend to have bonuses. One study has estimated that the EITC causes about 10 percent of federal income tax marriage penalties. Janet Holtzblatt and Robert Rebelein, "Measuring the Effect of the EITC on Marriage Penalties and Bonuses," *National Tax Journal* 52 (2000): 1107, 1131 (assumption that couples continue to live together). This study does not reflect the EGTRRA changes.

following years.<sup>3</sup> The Protecting Americans from Tax Hikes Act (PATH) of 2015 made the increased thresholds initially put in place under ARRA permanent.

**Filers with more than \$3,400 in disqualified income are not eligible for the EITC in tax year 2016.**

“Disqualified income” consists of the following:

- taxable and nontaxable interest
- dividends
- rent and royalty income if greater than zero
- capital gain income if greater than zero
- net passive income that is not self-employment income, if greater than zero

In 1995, Congress limited claimants to \$2,350 in disqualified income, effective in tax year 1996. In 1996, Congress lowered the \$2,350 limit to \$2,200 before the original limit took effect and indexed the \$2,200 annually for inflation. The implementation of a disqualified income limit, along with using adjusted gross income for the phaseout, is intended to stop individuals with significant assets but low income in a particular year from claiming the EITC.

**The credit is fully refundable.**

If a filer is eligible for a credit that exceeds his or her tax liability, that filer receives the amount of credit that exceeds liability as a refund. Many credit recipients have little or no tax liability. In 2016, the standard deduction and exemption amounts ensure that a married couple with two dependents will owe no federal income tax until gross income exceeds \$28,800; the federal child credit of \$1,000 per child further increases the income level at which a married couple with two children first owes tax to \$48,317. A head of household filer with one dependent will owe no tax until gross income exceeds \$17,400; with the child credit this increases to \$27,400. Many EITC recipients have gross incomes below these levels; they receive the full credit amount for which they qualify as a refund.

**In 2014, 357,410 Minnesotans claimed \$761 million in earned income tax credits.**

Of this amount, \$94 million offset liability, and the remaining \$667 million was paid as refunds. The 357,410 claims represented 13.3 percent of all federal returns filed by Minnesotans. The average EITC claimed by Minnesotans was \$2,130. Nationwide, 19.1 percent of all returns claimed an average EITC of \$2,399. The percent of returns claiming the credit ranged from 11.9

---

<sup>3</sup> Under the provisions of EGTRRA 2001, the income level at which the credit begins to phase out was increased for married couples filing joint returns by \$1,000 in tax years 2002-2004, \$2,000 in tax years 2005-2007, and by \$3,000 in tax year 2008 and indexed for inflation in following years. ARRA 2009 further increased the threshold to \$5,000 in 2009 and provided for it to be indexed for inflation in 2010. Like most provisions of EGTRRA 2001, the increased phaseout threshold for married filers was scheduled to expire after tax year 2010, but was extended through tax year 2012 under TRUIRCA 2010. ATRA extended the \$5,000 increased threshold, indexed from 2009, through 2017 and made the \$3,000 increased threshold, indexed from 2008, permanent beginning in 2018. PATH made the \$5,000 increased threshold, indexed from 2009, permanent.

percent in New Hampshire to 32.1 percent in Mississippi, and the average credit claimed ranged from \$1,893 in Vermont to \$2,823 in Mississippi.

**Filers claim the credit when they file their income tax returns.**

Filers eligible for the EITC must file either form 1040 or 1040A. Taxpayers who want to have the IRS calculate the credit amount for them do so by writing “EIC” on the line for the credit on the tax return; taxpayers who want to calculate the credit themselves complete a worksheet included in the instructions for form 1040, which is included in tax preparation software.

Prior to tax year 2011, taxpayers had the option of claiming all or part of the credit as an advance payment from their employer.<sup>4</sup> Very few people used the advance payment options. It imposed an administrative burden on employers, who had to adjust their payrolls and forward a supplement to the taxpayer’s W-4 to the IRS. It also posed compliance issues and presented opportunities for abuse, since individuals could potentially receive a larger credit during the year than they were ultimately entitled to. A 2007 Government Accountability Office report<sup>5</sup> recommended that the IRS consider options to reduce noncompliance among the small number of claimants who received advance payments. If those options were found to be impractical, the GAO recommended that the U.S. Treasury secretary make a recommendation to Congress on retention or repeal of the advance payment option.

The President’s Budget for Fiscal Year 2010 proposed eliminating the advanced payment option. The press briefing materials indicated that the elimination was based on the high error rates associated with the option. Office of Management and Budget Director Peter Orszag said the program “does not work well.”<sup>6</sup> The budget for fiscal year 2011 contained a similar provision,<sup>7</sup> and elimination of the option was enacted and signed into law in August 2010.

---

<sup>4</sup> Public Law Number 111-226 repealed the advance payment option, effective in tax year 2011.

<sup>5</sup> U.S. Government Accountability Office, *Advance Earned Income Credit* (August 2007).

<sup>6</sup> White House, Press Briefing by OMB Director Peter Orszag and CEA Chair Christina Romer, February 26, 2009, [http://www.whitehouse.gov/the\\_press\\_office/Press-Briefing-by-OMB-Director-Peter-Orszag-and-CEA-Chair-Christina-Romer/](http://www.whitehouse.gov/the_press_office/Press-Briefing-by-OMB-Director-Peter-Orszag-and-CEA-Chair-Christina-Romer/) (accessed May 26, 2010).

<sup>7</sup> U.S. Department of the Treasury, “General Explanation of the Administration’s Fiscal Year 2011 Revenue Provisions,” February 2010, 94, <http://www.wipfli.com/resources/images/11984.pdf> (accessed May 26, 2010).



## The Minnesota Working Family Credit

Minnesota, as well as 26 other states, offers a state version of the EITC.<sup>8</sup> Like the federal credit, it is fully refundable. Most state credits simply equal a percentage of the federal credit.

Minnesota’s credit initially followed that pattern. In 1998 the legislature restructured Minnesota’s credit so that it equaled a percentage of earned income under a two-tiered calculation, rather than a percentage of the federal credit. The 2014 Legislature eliminated the second tier, and increased the first tier credit percentage. Claimants must continue to meet federal eligibility requirements.

The WFC equaled 10 percent of the federal credit when it was first implemented in 1991. The legislature increased it to 15 percent of the federal EITC for tax years 1993 to 1997. In tax year 1998 the WFC was scheduled to increase to 25 percent of the federal credit. However, the 1998 Legislature restructured the state credit into a two-tiered calculation, effective in tax year 1998, in order to reduce high marginal rates faced by low-income taxpayers.

### History of the EITC and WFC

1975	Federal Earned Income Tax Credit (EITC) enacted
1979	EITC increased; advance payments made available
1985	EITC increased
1987	EITC increased and indexed for inflation
1988	EITC phaseout floor increased
1991	EITC increased; filers with two or more children receive larger credit than those with one; supplemental credits for health insurance and young children added
	Minnesota implements the refundable Working Family Credit (WFC), equal to 10 percent of the EITC
1993	WFC increased to 15 percent of the EITC
1994	EITC increased; supplemental credits eliminated; EITC extended to claimants without dependents
1995	EITC increased; qualifying income decreased for filers with one child
1996	EITC rate increased for filers with two or more children; claimants limited to \$2,200 in “disqualified investment income”
1997	WFC increased to 25 percent of the EITC for filers with dependents, effective tax year 1998
1998	WFC restructured as a percentage of earnings rather than a percentage of EITC
1999	WFC percentage increased for first tier of earned income
2001	EITC and WFC phaseout thresholds increased for married joint filers to reduce marriage penalties, effective tax year 2002
2009	EITC rate increased for claimants with three or more children, phaseout threshold further increased for married joint filers
2011	WFC phaseout threshold for married claimants increased for tax year 2011 only
2013	WFC phaseout threshold for married claimants increased to match federal threshold through 2017
2014	WFC second tier eliminated, first-tier credit rate increased
2015	EITC increased rate for three or more children and increased phaseout threshold for married joint filers made permanent; nonresidents prohibited from claiming WFC

<sup>8</sup> The appendix provides a table listing state earned income tax credits.

The 1998 restructuring did not change the maximum credit for filers with no qualifying children and those with one qualifying child, but increased the maximum credit for tax year 1998 from \$939 to \$1,127 for those with two or more qualifying children. The 1999 Legislature increased the maximum credit for all filers, and the 2000 Legislature increased the credit rates to ensure that all claimants received at least 25 percent of the federal credit.

In 2001, Congress enacted marriage penalty relief in the EITC that provided for the phaseout threshold to be \$1,000 higher for married couples than for single and head of household filers, with the additional amount scheduled to increase over time and be indexed for inflation. The additional amount was subsequently increased to \$5,000 indexed for inflation, and became a permanent feature of the credit in the Protecting Americans from Tax Hikes (PATH) Act of 2015. Minnesota conformed to the increased phaseout threshold for 2002 through 2011, did not conform to the additional increase to \$5,000 in 2012, and in 2013 conformed to the additional increase through 2017.<sup>9</sup> Minnesota has not yet acted to conform to the federal change that made the \$5,000 increase in the threshold permanent; absent state action, the increase in the phaseout threshold for married joint filers at the state level will revert to \$3,000 indexed from 2008.

Effective in 2009, Congress increased the EITC rate for claimants with three or more children to 45 percent. PATH made the higher rate permanent. Minnesota has not provided a higher WFC rate for claimants with three or more children.

In 2014 Minnesota eliminated the second tier of the WFC calculation while increasing the credit rate and, for claimants with children, the maximum earnings eligible for the credit, so that all eligible claimants qualified for higher credits than under prior law.

In 2015, Minnesota disallowed the WFC for nonresidents. This followed the termination of the state's income tax reciprocity agreement with Wisconsin. Under reciprocity, Minnesota and Wisconsin residents with earnings in the other state were able to just file income tax returns in their state of residence, rather than filing returns in both states. With the end of reciprocity in 2010, Wisconsin residents with earned income in Minnesota had to file Minnesota returns and pay tax on their Minnesota earnings, and began claiming Minnesota's working family credit on their Minnesota returns, while also claiming Wisconsin's state credit on their Wisconsin returns. Wisconsin limits its state earned income credit to full-year residents.<sup>10</sup>

Table 3 shows the credit calculation for tax year 2016 for single and head of household filers, and for married couples filing joint returns.

---

<sup>9</sup> The income level at which the EITC phaseout begins and ends was increased for married filers by \$1,000 in 2002-2004, \$2,000 in 2005-2007, and \$3,000 in 2008. It was adjusted in following years for inflation and further increased to \$5,000 for tax year 2009. In 2009 Minnesota did not conform to the increase to \$5,000 and instead provided an increase in the phaseout of \$3,130, the "old" federal law adjusted for inflation. Minnesota conformed to extension of the \$5,000 with indexing through tax year 2010; when Congress extended it through tax year 2012, Minnesota conformed for tax year 2011 only, so that in tax year 2012 there was no increase in the phaseout threshold for married joint filers under the WFC. Minnesota conformed to the extension of the indexed \$5,000 through 2017, but has not yet conformed to the federal law change that made the indexed \$5,000 permanent.

<sup>10</sup> As a result, a Minnesota resident working in Wisconsin could not qualify for the Wisconsin credit.

Table 3:  
**Minnesota Working Family Credit Calculation, 2016**

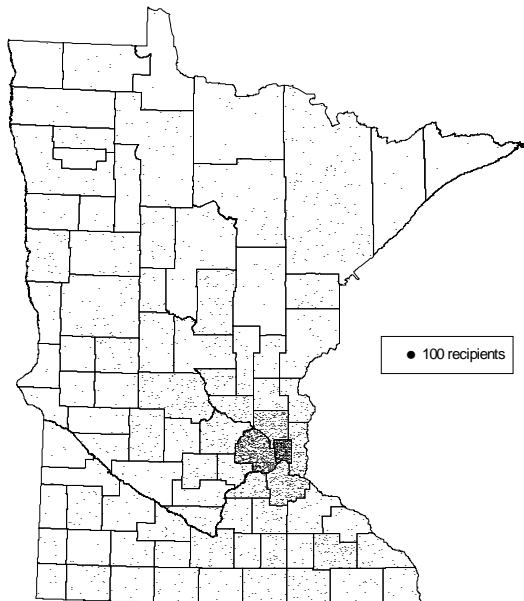
	<b>No qualifying children</b>	<b>One qualifying child</b>	<b>Two or more qualifying children</b>
<b>Credit calculation</b>	2.1% of first \$6,310 of earnings	9.35% of first \$11,350 of earnings	11% of first \$18,610 of earnings
<b>Maximum credit</b>	\$133	\$1,061	\$2,047
<b>Credit phaseout</b>	2.01% of income over \$8,300	6.02% of income over \$21,620	10.82% of income over \$25,640
<b>Maximum income eligible</b>	\$14,893	\$39,248	\$44,560

House Research Department

**In 2014, 345,858 filers claimed the WFC for a total of \$256.1 million.**

Figure 1 shows the distribution of returns by county for 2014.

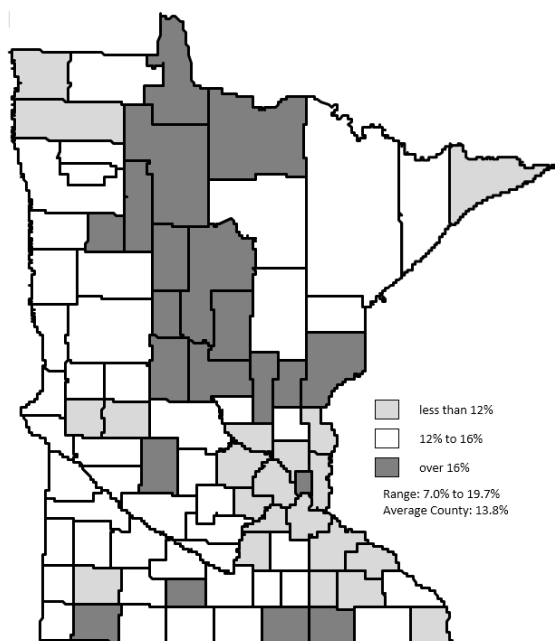
Figure 1:  
**Minnesota Working Family Credit Recipients, 2014**



While over 51 percent of the returns claiming credits came from the Twin Cities metropolitan area, these seven counties generated about 55 percent of all returns filed. Put another way, in 2014 metro filers were slightly less likely to claim the credit than were nonmetro area filers

Figure 2 shows the percent of returns on which the credit was claimed by county; this ranged from 7.0 percent of all returns in Carver County in the metropolitan area, to 19.7 percent of all returns in Wadena County in north central Minnesota.

Figure 2:  
**Percentage of Returns Claiming Minnesota Working Family Credit, 2014**



Over 16 percent of all tax returns filed in many north central Minnesota counties claimed the WFC, while fewer than 12 percent of returns filed in most Twin Cities metropolitan counties claimed the credit. Ramsey County, with over 16 percent of returns claiming the credit, was the exception in the metro area. Generally higher incomes in the metro area make it less likely for filers to qualify for the credit.

**Statewide, about 13.5 percent of all tax returns claimed the EITC and WFC in 2014.**

The number of returns claiming the credit increased by about 39 percent over the last ten years, from about 249,800 in 2004 to about 346,000 in 2014. The number of returns filed

increased just over 1 percent over the same time period. The credit has changed in two ways in that time period, both of which contributed to the increase in the number of claimants. Congress and the legislature have increased the credit rate and have increased the income phaseout of the credit for married joint filers, in order to reduce marriage penalties in the credits.

**Both the average working family credit and the total credit amount per year have increased dramatically since the credit took effect in 1991.**

The average WFC was \$78 in 1991, when the credit rate was 10 percent, and \$142 in 1993, when the rate increased to 15 percent. The increases since 1993 resulted from significant expansion of the federal credit, which took effect in 1994, the increases in the state credit rates in 1998 to 2001 and in 2014, the extended phaseout range for married joint filers, beginning in 2002, and the increased federal credit rate for filers with three or more qualifying children, beginning in 2009. Table 4 shows the total amount of credit claimed, number of claimants, average amount claimed from 1991 through 2014, and projected amounts for 2015 to 2019.

Table 4:  
**Minnesota Working Family Credit, 1991 to 2019**

Tax year	\$ claimed (millions)	Number of claimants	Average credit
1991	\$9.7	123,774	\$78
1992	\$11.5	134,746	\$86
1993	\$20.5	145,161	\$142
1994	\$29.6	187,155	\$158
1995	\$36.9	206,387	\$179
1996	\$42.5	214,581	\$198
1997	\$43.5	212,658	\$205
1998	\$79.6	204,675	\$389
1999	\$88.6	203,032	\$437
2000	\$100.7	203,500	\$495
2001	\$102.7	202,266	\$508
2002	\$128.3	245,967	\$522
2003	\$127.4	247,068	\$516
2004	\$130.3	249,841	\$522
2005	\$138.8	258,672	\$537
2006	\$147.2	267,603	\$550
2007	\$163.3	289,293	\$565
2008	\$172.6	297,107	\$581
2009	\$193.8	325,673	\$595
2010	\$193.6	330,040	\$586
2011	\$208.7	344,367	\$606
2012	\$196.3	324,686	\$605
2013	\$211.7	339,901	\$623
2014	\$256.1	345,858	\$741
2015 (projected)	\$253.7	330,100	\$769
2016 (projected)	\$259.5	333,700	\$778
2017 (projected)	\$265.5	337,400	\$787
2018 (projected)	\$263.7	335,900	\$785
2019 (projected)	\$269.8	339,600	\$794

Source: Minnesota Department of Revenue

**The Minnesota working family credit totaled \$256.1 million in tax year 2014, with the amount projected to increase to over \$265 million in tax year 2017.**

The total for 2011 is over five times the \$43.5 million paid in 1997, with the increase due to the 1998 restructuring of the credit, the rate increases in 1998 and 2000, and changes to the phaseout for married joint filers in 2002 and 2009. The decrease in the overall credit amount from 2011 to 2012 reflects the one-year suspension at the state level of the extended phaseout range for

married joint filers. The increase in credit claims after 2010 may reflect claims by Wisconsin residents with Minnesota earnings following the termination of income tax reciprocity with Wisconsin, while the decrease in claims from 2014 to 2015 may reflect in part Minnesota's disallowance of the credit to nonresidents, including Wisconsin residents with Minnesota earned income.

**About 55 percent of WFC recipients have no tax liability, but file a tax return to receive the credit as a refund.**

As Figure 3 shows, another 27 percent of the 2014 recipients owe some tax but receive a credit that exceeds their liability, so a total of 82 percent of claimants receive at least part of their WFC as a refund. The remaining recipients—18 percent—have tax liability that equals or exceeds their credit. This means that a total of 45 percent of claimants use at least part of their WFC to offset tax liability.

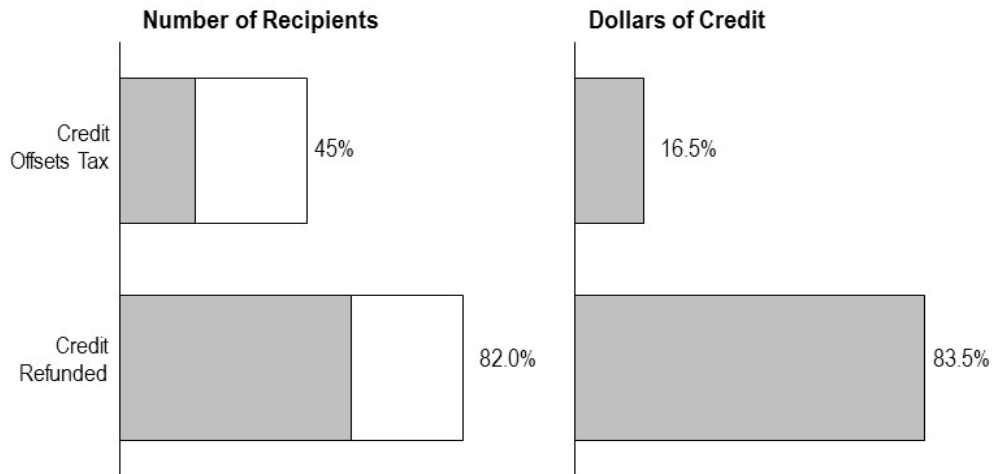
Nationwide, 86 percent of all EITC recipients receive at least part of their credit as a refund. In Minnesota, 84.6 percent of recipients received a full or partial refund of their EITC compared with a low of 80.0 percent in Vermont and a high of 91.0 percent in Mississippi.<sup>11</sup>

In 1997, the Department of Revenue calculated the WFC for filers who had claimed the federal credit but not the state credit in tax years 1995 and 1996. It issued over \$750,000 in refund checks to 8,380 eligible filers. The restructuring of the credit in 1998 prevents the department from repeating this project. Prior to 1998, the state credit was a percentage of the federal credit, and the federal credit was available electronically to the department, as coded from Form 1040. The earned income figures needed to calculate the restructured state credit are on a federal worksheet, not the 1040, and are not available electronically. Data from the 2014 income tax sample indicates that about 99 percent of Minnesota EITC recipients also claimed the WFC. This figure is higher in 2014 than in previous years, perhaps because in 2014 the extended phaseout for married filers was the same for the WFC as for the EITC.

---

<sup>11</sup> U.S. Department of the Treasury, Internal Revenue Service; Statistics of Income Division.

Figure 3:  
**Refundability of Working Family Credit, 2014**



Note: 27% of claimants qualify for a credit that exceeds their tax liability. For this 27%, part of the credit offsets liability, and the rest is paid as a refund. This 27% is shown in white in both bars on the left.

House Research Graphics

**Under one-fifth—16.5 percent—of the total amount paid in WFC offsets tax liability, while the rest—83.5 percent—of the total is distributed as refunds.**

In 2014, \$213.6 million of the WFC offset tax liability and the remaining \$42.5 million was paid as refunds. At the national level, just under 87 percent of EITC dollars were distributed as refunds in 2014, with only 13 percent offsetting the federal income tax. In Minnesota, 87.6 percent of the EITC was refunded compared to a high of 90.6 percent in West Virginia, and a low of 83.2 percent in California.<sup>12</sup>

While nationwide the percent of claimants receiving at least part of the credit as a refund (87 percent) happens to equal the percent of the total amount paid in credits, in Minnesota 84.6 percent of EITC recipients receive a full or partial refund, and 87.6 percent of the total paid in EITCs is paid as a refund.

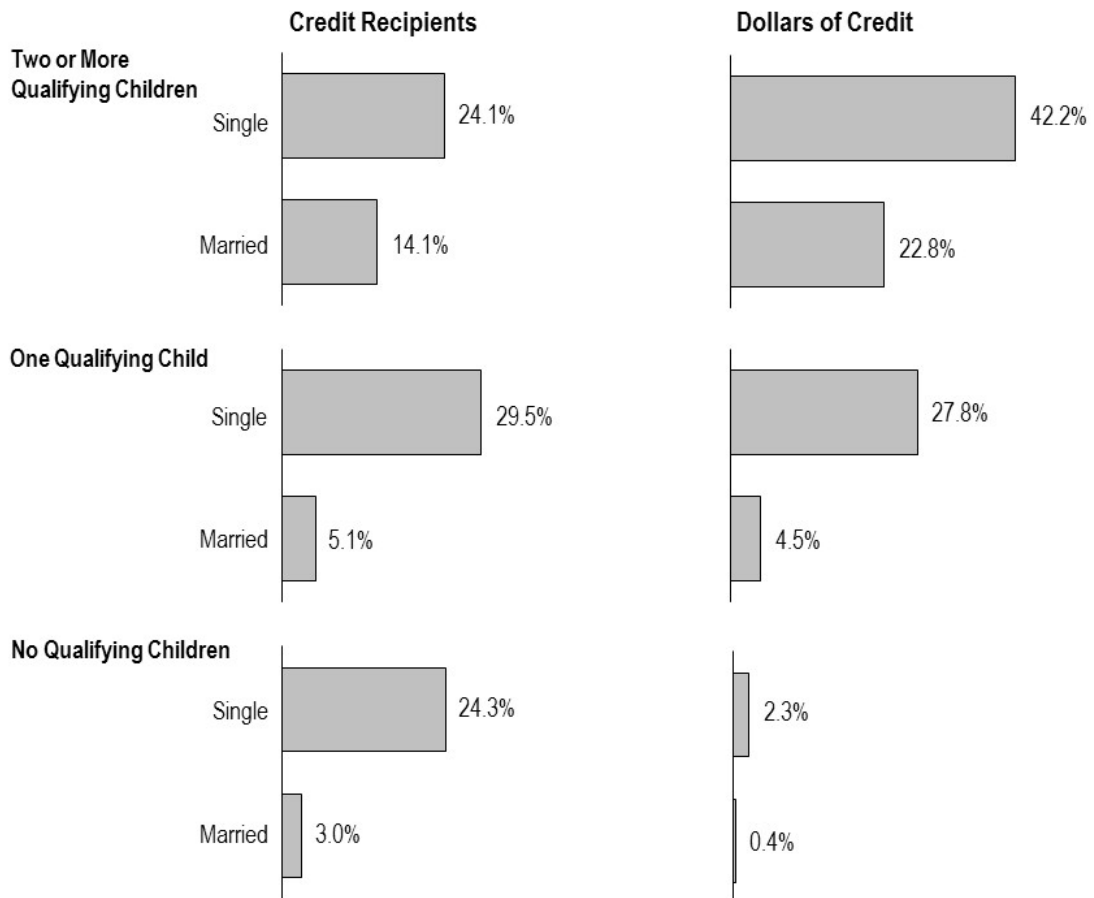
---

<sup>12</sup> Ibid.

**Most WFC recipients have one or more qualifying children.**

Figure 4 shows that in 2014,<sup>13</sup> 38.2 percent of recipients had two or more qualifying children and 34.5 percent had one qualifying child. About 65 percent of the dollars paid in credits went to the 38.2 percent of claimants who had two or more qualifying children. This group received a disproportionate share of credit dollars because of higher credit rates and a higher income at which the credit phases out for parents with two or more qualifying children than for those with one or no qualifying children.

Figure 4:  
**WFC Recipients by Number of Qualifying Children and Marital Status, 2014**



House Research Graphics

<sup>13</sup> Data on the total amount and refundability of the credit is from the Department of Revenue’s 2014 processing report, and data on the number of qualifying children claimed by recipients is from the 2014 income tax sample, also prepared by the Department of Revenue.



Single parents who received the credit were slightly more likely to have only one child than to have two or more; 29.5 percent of all recipients were single parents with one child, while 24.1 percent were single parents with two or more qualifying children. Married parents, however, were more likely to have at least two children; 14.1 percent of recipients were married with two or more qualifying children, and only 5.1 percent were married with one qualifying child.

Over 27 percent of all recipients had no qualifying children. This group, however, received less than 3 percent of credit dollars. In 2014, claimants without children received credits equal to 2.1 percent of their first \$6,280 of earnings. The credit is fully phased out at a relatively low income for filers without qualifying children—\$14,820 in 2014, compared to a maximum income of \$39,071 for parents of one qualifying child, and \$44,368 for those with two or more qualifying children.<sup>14</sup>

## The Tax Credits and Poverty

The EITC has long been viewed as a way to provide financial assistance to families who would otherwise be living in poverty. In 1975, when the EITC took effect, the federal poverty guideline for a family of four was around \$4,000, the income amount at which the EITC phaseout began. Since then, the poverty guidelines have risen with inflation to reach \$26,339 for a family of four in 2016. Many view the EITC as a way to raise working families above the poverty level; to this end the federal government has expanded and revised the EITC to keep pace with inflation.

**The IRS and Census Bureau estimate that about 80 percent of those eligible for the EITC claim it, both nationwide and in Minnesota.<sup>15</sup>**

The earned income and working family tax credits are relatively effective at reaching the low-income population. These participation rates compare favorably with participation rates for direct spending programs, such as the Supplemental Nutrition Assistance Program (SNAP, formerly called food stamps), which targets a similar population.<sup>16</sup> Some speculated in the early

---

<sup>14</sup> The maximum incomes shown are for single and head of household filers. In 2014, the maximum income eligible for the working family credit was \$5,430 higher for married couples filing joint returns.

<sup>15</sup> For tax years 2008 through 2013, Minnesota's estimated participation rates ranged from a low of 78 percent (tax years 2008 and 2010) to a high of 81 percent (tax year 2013). Internal Revenue Service, *EITC Participation Rate by States*, [www.eitc.irs.gov/EITC-Central/Participation-Rate](http://www.eitc.irs.gov/EITC-Central/Participation-Rate) (accessed July 28, 2016). These estimates are based on linking data from tax returns and the American Community Survey (ACS) conducted by the Census Bureau. The ACS data allow making state-by-state estimates. Earlier estimates prepared using somewhat more detailed national survey data, which allows better estimating of EITC eligibility for nonclaimants, suggest lower participation rates (75 percent or less). Dean Plueger, *Earned Income Tax Credit Participation Rate for Tax Year 2005* (2009), <https://www.irs.gov/pub/irs-soi/09resconeitcpart.pdf> (accessed July 28, 2016).

<sup>16</sup> See Table 1 in Janet Currie, *The Take up of Social Benefits*, NBER Working Paper (May 2004), <http://escholarship.org/uc/item/0r38h5d4> (accessed July 28, 2016), for estimated take-up rates for various social benefit programs from published studies. For example, estimates of the overall take-up rates for SNAP range from 54 percent to 69 percent of eligibles. By comparison, more universal programs have higher take-up rates, such as Medicare with an estimated rate of 96 percent.

years of the EITC that the higher take-up rates for the EITC were attributable to the lower “stigma,” because accessing a tax credit is relatively invisible, as compared with using food stamps or similar.<sup>17</sup> However, recent research suggests that stigma may not be as important as typically was thought. Lack of information and the cost of accessing benefits may be larger factors.<sup>18</sup> The EITC and WFC have built-in participation advantages in that the cost of accessing the benefits is lower (it’s less burdensome to file income tax returns than to apply for most means-tested direct spending benefits, such as SNAP or Medical Assistance) and that outside entities (e.g., commercial tax preparers and Volunteer Income Tax Assistance (VITA) volunteers) encourage participation and provide or solicit the information necessary to do so.

EITC participation rates are typically quite a bit higher for individuals with dependents than those without.<sup>19</sup> In part, this reflects the much more generous benefits for those claimants; the economic incentive to file is higher, although the rules for claiming the credit (e.g., determining if the qualified child rules are met) are more complex. Similarly, eligible individuals who already file tax returns (e.g., because they owe tax or have withholding) have higher rates than individuals who are not required to file.<sup>20</sup> The IRS mails a notice and worksheet to filers whom it believes are eligible and fail to claim the credit. This increases claiming rates by 41 percent to 52 percent.<sup>21</sup>

### **Census Bureau research suggests that refundable tax credits lift a substantial number of households above the poverty level.**

The official federal poverty thresholds have been criticized on a number of grounds, including that they do not take into account the effect of taxes (both taxes paid and refundable credits, such as the EITC).<sup>22</sup> The Census Bureau, in response, has developed and regularly publishes a Supplemental Poverty Measure (SPM) to address these criticisms, although the SPM has not replaced the official poverty thresholds, which are used in various laws and programs. The SPM does include the effect of refundable tax credits, such as the EITC, on poverty thresholds.

---

<sup>17</sup> Analysts have identified two different types of stigma: (1) *social* stigma that reflects concerns about what others may think about one’s accessing the benefits, and (2) *personal* stigma where one considers accessing benefits to be contrary to his or her principles. The relatively anonymity of tax credits addresses only the first type or social stigma.

<sup>18</sup> See note 16, Currie, for a survey of the research.

<sup>19</sup> Note 15, Plueger, 179 (56 percent rate for claimants without a qualified child and 86 percent for those with two or more qualified children).

<sup>20</sup> *Ibid.* Plueger data implies 90 percent of those who have filing obligations claim the credit. This is consistent with earlier estimates. Marsha Blumenthal, Brian Erard, and Chih-Chin Ho, “Participation and Compliance with the Earned Income Tax Credit,” *National Tax Journal*, 53, no. 2 (2005): 189-213 (89 percent estimate). Much lower percentages of individuals without filing obligations claim the credit (31 percent to 39 percent).

<sup>21</sup> Saurabh Bhargava and Dayanand Manoli, “Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment,” *American Economic Review*, 105, no. 11 (2015).

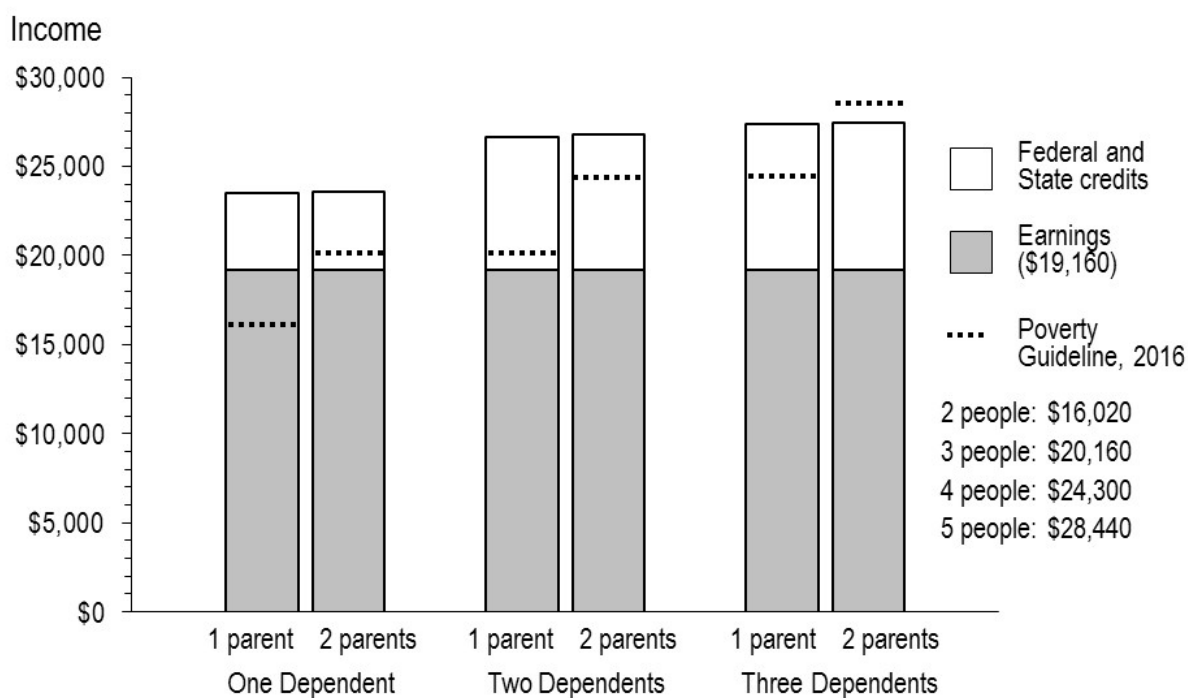
<sup>22</sup> That is one of several criticisms of the official thresholds. Some of the others include the failure to take into account in-kind benefits (such as SNAP and Medicaid) and geographic variations in price levels. For a summary of the criticisms and how SPM addresses them, see Kathleen Short, *Supplemental Poverty Measure: 2010*, United States Census Bureau Current Population Report, (Nov. 2011): 1-3.

A 2015 Census Bureau Current Population Report estimated the effect of the EITC on the number of households under the SPM for 2014. This research showed that federal and state refundable tax credits (principally the EITC) reduced the number of people in poverty by about three percentage points.<sup>23</sup> For children under 18, the effect was larger, more than a seven percentage point drop.

**The 2016 EITC and WFC will be large enough to lift single parents and married couples with one or two children above the poverty level.**

Figure 5 compares the earnings of single parent and married couple families with one full-time minimum wage worker plus the EITC and WFC to the federal poverty level for families with one, two, or three dependents. The figure uses 2016 poverty guidelines and Minnesota minimum wage for large employers<sup>24</sup> and assumes that all income is from earnings.

Figure 5:  
**Effect of EITC and WFC on Income: Single Parent and Married Couple Families, One Full-Time Minimum Wage Worker, 2016**



House Research Graphics

<sup>23</sup> Kathleen Short, *Supplemental Poverty Measure: 2014*, United States Census Bureau Current Population Report, Table 4a, (Sept. 2015): 9. Only the Social Security program, which is not means-tested, had a larger effect on the poverty rate.

<sup>24</sup> The Minnesota minimum wage for employees of establishments that have at least \$500,000 of gross receipts per year increased to \$9.00 on August 1, 2015, and to \$9.50 on August 1, 2016. The figure assumes the \$9.00 minimum wage for the first 30 weeks of the year, and the \$9.50 minimum wage for the remaining 22 weeks.

**The federal EITC, combined with Minnesota’s WFC and the increased state minimum wage, is enough to raise the income of full-time working single and married parents of two dependents above the federal poverty guidelines.**

The increased minimum wage and the credits also raise the income of single parents of three children over the poverty guideline, but leave married one-earner families with three children slightly below the poverty guideline.<sup>25</sup> Larger families with only one worker would remain below the poverty guideline. The poverty level increases as family size increases, while the EITC reaches its maximum amount for families with three dependents, and the WFC for families with two dependents. The 2016 poverty guideline is \$16,020 for a two-person family, and \$20,160 for a three-person family. The poverty guideline then increases by \$4,140 for each additional family member. A single parent with four dependents faces a poverty guideline of \$28,440 but receives the same EITC and WFC as a single parent with three dependents. As family size increases, the gap between earnings from a full-time, minimum wage job plus the EITC and WFC and the poverty guideline also increases. The EITC and WFC move larger families closer to the poverty guideline, but does not lift them above it.

## **The Tax Credits and Work Effort**

**The work incentive effects of the credits depend upon which part of the credits affects the individual: in the phase-in range, the credits reward individuals with a higher return on work, while the credits’ phaseout provisions actually reduce the return on work for those affected.**

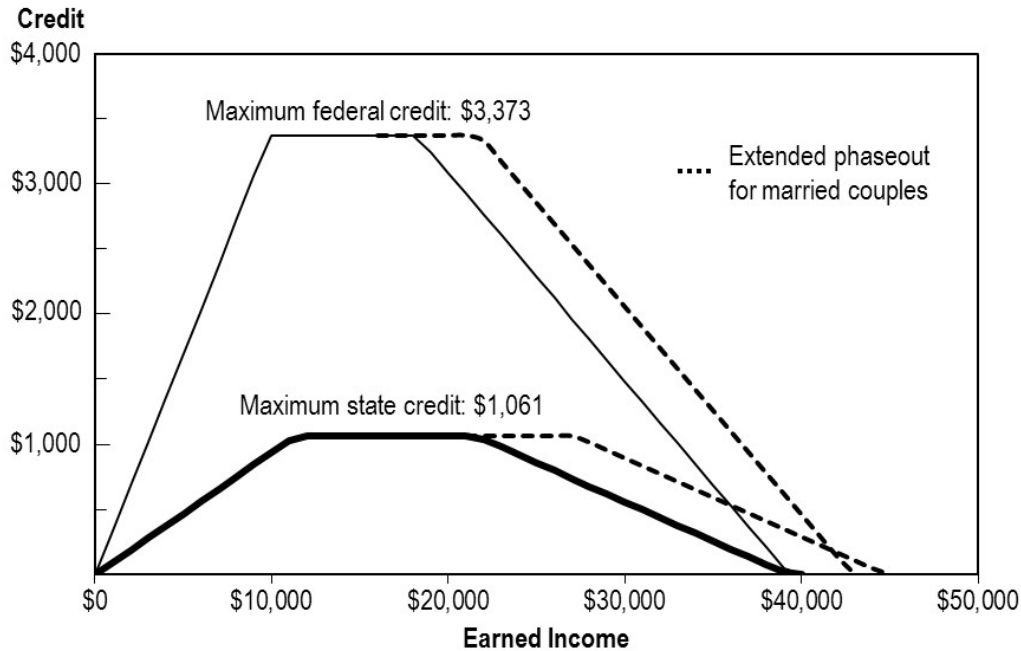
Economic theory suggests that the EITC and WFC have two contradictory effects on individual work effort: the substitution effect and the income effect.

The **substitution effect** suggests that by increasing or decreasing the return on work, the credits cause individuals to work more or less (to “substitute” work for leisure or vice versa). To understand the potential substitution effects of the credits, it is necessary to look at what happens to the credit if a filer’s wages increase. Filers can be affected in three ways, depending upon whether they are in the phase-in, flat, or phaseout range of the credits. Figure 6 graphically shows these ranges of the EITC and WFC for filers with one dependent in tax year 2016. The figure assumes that all income is from earnings.

---

<sup>25</sup> Note that married couples with three dependents and two full-time minimum wage workers would have income above the poverty guidelines based on wage income alone (\$38,320).

Figure 6:  
**EITC and WFC Ranges, Filers with One Qualifying Child, 2016**



House Research Graphics

**For an individual in the phase-in range, a greater work effort results not only in greater earnings but in larger credits as well.**

As long as the individual's income is less than the maximum qualifying amount, the credits increase the wage rate. The return for working is higher (in 2016, by as much as 43.35 percent for individuals with one qualifying child, 51 percent for those with two qualifying children, and 56 percent for those with three or more qualifying children). Because individuals can earn more, the credits encourage recipients to work more—that is, to substitute work for leisure. The credits have a positive substitution effect on individuals in the phase-in range. In tax year 2014, an estimated 22.7 percent of Minnesota credit recipients will have income in the EITC phase-in range.<sup>26</sup>

**For filers with incomes above the maximum qualifying amount but below the phaseout threshold, no substitution effect occurs; working more neither increases nor decreases the credits.**

In tax year 2014, an estimated 21.0 percent of credit recipients will have income in the EITC “flat” range.

<sup>26</sup> Estimates were made using the House Income Tax Simulation (HITS) Model, and the Minnesota Department of Revenue 2014 sample of income tax returns.

**Finally, the substitution effect is negative, creating a work disincentive, for filers in the phaseout range; working more reduces their credits.**

For example, a 2016 filer with two dependents and income in the phaseout range who received a \$1,000 increase in wages would also experience a \$211 reduction in the EITC and a \$108 reduction in the WFC.<sup>27</sup> This can be viewed as a 32 percent implicit tax on the additional \$1,000 of wages. To put this in a broader context, these same filers are likely to pay a 10 percent, or at most a 15 percent, federal income tax and a 5.35 percent state income tax. Well over half—56.3 percent—of credit recipients were in the EITC phaseout range in 2014.

The earned income and working family tax credits also have an **income effect**. The credits effectively increase the income of low-income workers; they receive both their wages and the credits. Economic theory suggests that this income effect will cause some individuals to work less. With the credit, they can maintain the same standard of living while working fewer hours. The common sense of the income effect can be seen from an extreme example—it is the reason one expects lottery winners to quit working or work less. While the magnitude of the earned income tax credit or other wage supplements is much smaller, the effect is similar. The work disincentive of the income effect affects all individuals who qualify for the credit, regardless of which range of the credit they are in.

**The work disincentive effect is inevitable in a credit that includes a phaseout.**

In designing the credit, Congress and the legislature are faced with these trade-offs:

- Targeting or limiting the credit to lower income workers
- Minimizing the work disincentive that results from “taking away” the credit as income rises
- Limiting the cost of the credit

The credit can have a high phaseout rate, which means that it will go primarily to filers with incomes below the phaseout threshold. The downside of this approach is that there will be a high effective tax rate and large work disincentive for filers in the phaseout range. Or, the credit can have a low phaseout rate, with filers in the phaseout range facing a smaller effective tax rate and a smaller work disincentive. But this approach means that the credit will be available to filers with higher incomes and will cost more. Policymakers must choose between imposing a steep phaseout rate to target the credit to low-income families and to keep the overall cost of the credit low, or using a lower phaseout rate that makes the credit available at higher incomes and costs more to fund.

---

<sup>27</sup> This calculation of the change in “take-home” pay does not take into account the effect of Social Security or Medicare tax, or the phaseout of other credits that the filer receives, such as the federal and state dependent care credits.

**Most available research suggests that the EITC causes more single parents to work and increases the total hours worked by those already in the labor force by a small amount.**

Academic researchers have extensively studied the effects of the EITC, including in some instances state earned income credits, on work—that is, the extent to which the credit leads more people to enter the workforce and/or to work more hours. The results of this research can be summarized as reaching two main conclusions.<sup>28</sup>

- A strong consensus is that the credits increase employment by single mothers, particularly low-skill workers with more than one qualifying child. The effects on other groups are less clear (e.g., on males and married women) and may be negative.
- The credits likely have small, but positive, effects on number of hours worked.

Other interesting results of these academic, empirical studies of the economic effects of the credits on the labor market include the following:

- Studies also have found that the EITC induces low-income single women to report self-employment income and for those in the phase-in range to report more self-employment income (thereby maximizing their credits).<sup>29</sup> It is unclear the extent to which this effect represents increasing work effort (e.g., undertaking new entrepreneurial efforts or increasing those efforts) or simply reflects reporting previously unreported income to claim larger credits.
- One study using an experiment with users of H&R Block tax preparation services, found that tax preparers educating credit recipients about where they lay on the credit's curve (i.e., in the phase-in, flat, or phaseout ranges) was much more effective in increasing work effort than was making the credit parameters more generous.<sup>30</sup> These effects applied to both self-employed individuals (who may simply have been reporting more income) and wage earners.

---

<sup>28</sup> The summary of the research is based on two recent reviews of the literature. Hilary Hoynes and Jesse Rothstein, *Tax Policy Toward Low-Income Families*, NBER Working Paper No 22080, (March 2016): 16-30, <https://www.semanticscholar.org/paper/Tax-Policy-toward-Low-income-Families-Hoynes-Rothstein/2e8c815ee346ec9792acae964c3683d40c928215/pdf> (accessed August 11, 2016); Austin Nichols and Jesse Rothstein, "The Earned Income Tax Credit," chapter in *Economics of Means Tested Transfer Programs in the United States* (forthcoming), (Sept. 2015): 38-47, available <http://www.nber.org/chapters/c13484.pdf> (accessed August 11, 2016).

<sup>29</sup> Sara LaLumia, "The Earned Income Tax Credit and Reported Self-Employment Income," *National Tax Journal* 52, no. 2 (June 2009): 191-217; Emmanuel Saez, "Do Taxpayers Bunch at Kink Points?" *American Economic Journal* 2, no. 3 (2010): 180-212 (finding clear evidence that credit recipients who report self-employment income bunch at the first "kink" in the EITC schedule where the credit is maximized relative to the amount of wages or self-employment income).

<sup>30</sup> Raj Chetty and Emmanuel Saez, "Information and Behavioral Responses to the Taxation: Evidence from an Experiment with EITC Clients at H&R Block," National Bureau of Economic Research, working paper (September 7, 2008). This suggests that lack of understanding of the complicated credit structure is a barrier to its effectiveness and that investing more on education efforts would be more cost-effective than making the credit formula more generous. The authors' estimates suggest these efforts could be more than ten times as cost-effective.

- Some of the credit may be captured by employers. By expanding the supply of low-skill workers, it may enable these employers to pay lower wages than otherwise would be the case. The extent to which this occurs depends upon the tightness of the labor market for low-skill workers, minimum wage laws and other factors, but employers may capture up to a third of the value of the credits.<sup>31</sup>

## The Tax Credits and Compliance

The EITC has grown to be among the largest cash or near-cash income transfer-type federal programs, somewhat lower than outlays under the Supplemental Nutrition Assistance Program or SNAP (formerly the food stamp program) and well above the Temporary Assistance to Needy Families (TANF) program, the more traditionally thought of “welfare” programs.<sup>32</sup> This growth has led to concerns about compliance and payments to recipients who are not eligible for the credit. The Internal Revenue Service estimates that about \$15.6 billion in erroneous EITC payments were made in fiscal year 2015.<sup>33</sup> Some of these overpayments likely result from unintentional mistakes by claimants and preparers, given the complexity of the credit.<sup>34</sup> Because of budget effects, most of the focus has been on overpayments and payments to those who are not eligible for the credit at all.

**For tax years 2006 to 2008, the IRS estimates 28.5 percent to 39.1 percent of the dollar amount of EITCs claimed exceeded the legal amount allowed.<sup>35</sup>**

The IRS periodically conducts National Research Program (NRP) audits to assess tax compliance. These detailed research audits include a special subsample for EITC claimants. NRP results are then used to project compliance for the population of filers to determine the source and amounts of errors and similar information of interest to the IRS. The last published EITC NRP estimates were done for tax years 2006 to 2008.

---

<sup>31</sup> See note 28 discussion in Nichols and Rothstein, pp. 44-47 (one study suggesting that 36 percent of the credit may be captured by employers).

<sup>32</sup> Outlays under TANF in fiscal year 2015 were \$20.0 billion and for SNAP (formerly the food stamp program) \$76.1 billion, while the tax expenditure for the EITC was \$60.1 billion (refundable or “outlay” portion of the credit). Office of Management and Budget, *Budget of the United States Government: Fiscal Year 2017*, Historical Tables 268, <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/hist.pdf> (accessed July 5, 2016).

<sup>33</sup> GAO, *Refundable Tax Credits* (May 2016): 7, <http://www.gao.gov/assets/680/677548.pdf> (accessed July 5, 2016).

<sup>34</sup> In addition to some individuals claiming credits for which they are not eligible or larger credits than they are eligible for, many other individuals who are eligible for the credit fail to claim it and others fail to claim the full amount of the credit to which they are entitled. See pages 17 and 18 for a discussion of participation in the credit.

<sup>35</sup> Internal Revenue Service, *Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns* Table 2b, (August 2014): 13.



These estimates show a range of EITC overclaimed dollar amounts from \$14 billion to \$19.3 billion in 2008 dollars.<sup>36</sup> Note that these overclaims are gross amounts (i.e., they are the amounts claimed by taxpayers on their tax returns before IRS's collection of overclaimed amounts). The \$15.6 billion amount of overpayments listed above differs in that it is net of the amount collected by the IRS. The two largest sources of overclaims are misreporting of income and qualifying child errors. Misreporting of income is the most common error (67 percent of known errors and 25 percent of the dollar amount), while qualifying child errors account for the largest dollar amount (38 percent).<sup>37</sup>

The NRP estimates indicate that a significantly larger percentage of EITC claimants use paid preparers (68 percent) compared to other filers (55 percent).<sup>38</sup> These preparers are also more likely to be unenrolled preparers or preparers from national firms.<sup>39</sup> This suggests a portion of the benefit of the credit is captured by tax preparation firms. Returns prepared by these firms are the most prone to error (compared with returns prepared under volunteer programs,<sup>40</sup> which are the least likely to contain errors or self-prepared returns).<sup>41</sup>

**In an attempt to reduce overclaims for the EITC, the IRS has conducted three pilot compliance tests—the EITC Qualifying Child Residency Study, the EITC Filing Status Study, and the EITC Automated Underreporter (AUR) Study.**

Studies showing a high rate of overclaims for the EITC led the IRS to conduct the three pilot studies. The Qualifying Child Residency Study had the goal of reducing erroneous claims for children who do not meet the definition of “qualifying child” for purposes of claiming the credit; the Filing Status Study, the goal of reducing taxpayers filing as head of household in order to claim larger credits than they would qualify for as married joint filers; and the AUR Study, the goal of reducing income underreporting in order to qualify for a larger credit. In 2008 the IRS issued a report on the three initiatives,<sup>42</sup> and subsequently issued an addendum addressing the cost-effectiveness of implementing new compliance measures suggested by the studies.<sup>43</sup>

**The Qualifying Child Residency Study** focused on determining the effect of requiring claimants to certify that qualifying children had lived with the claimant for more than half the tax year, which is a precondition to claiming the EITC. In each of three years the IRS required a

---

<sup>36</sup> Ibid., 10.

<sup>37</sup> Ibid., 17.

<sup>38</sup> Ibid., Table 8, page 25.

<sup>39</sup> Ibid., 24.

<sup>40</sup> Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) volunteers receive training focused on preparing low-income returns and are certified by the IRS.

<sup>41</sup> Ibid., Table 9, page 26.

<sup>42</sup> U.S. Department of the Treasury, Internal Revenue Service, IRS Earned Income Tax Credit (EITC) Initiatives, *Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests* (2008).

<sup>43</sup> U.S. Department of the Treasury, Internal Revenue Service, IRS Earned Income Tax Credit (EITC) Initiatives, *Addendum to the Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests* (2008).

sample of taxpayers to certify residency of qualifying children. Each year the IRS improved its sampling methodology to focus on claims that, based on other data, were more likely to report qualifying children who did not meet the residency requirement.

The IRS reports that the certification requirement deterred ineligible taxpayers from claiming the EITC, and reduced the number of erroneous claims. However, the IRS continued to track taxpayers who were required to certify in subsequent tax years and found that the deterrent effect tended to decay over time. This suggests that an ongoing, rather than a onetime, certification requirement would be necessary to reduce erroneous claims and overpayments. However, the addendum to the full report analyzed the return on investment from implementing a certification requirement and found it to be substantially lower than the return on pre-existing correspondence audits of EITC claims; in addition, the certification requirement had the effect of deterring a small percentage of eligible parents from claiming the credit. As a result, the IRS has not required certification of qualifying child residency.

A related study by university researchers found that child support registry information data could provide an independent method of verifying qualifying child residency of credit claimants.<sup>44</sup> This study matched Wisconsin child support registry information for EITC claimants with court records and found a high correlation between the two (estimated 96 percent accuracy). Subject to some significant caveats, the federal registry information could be used to preverify whether a claimed child meets the residency requirement for individuals who are in the registry under the IRS's math correction authority.<sup>45</sup>

**The Filing Status Study** was developed in response to a finding in the tax year 1999 compliance study that a significant share of improper EITC claims were from individuals who filed as single or head of household, when they should have filed as either married filing jointly or married filing separately. Using the correct filing status would either decrease the credit allowed or make them ineligible to claim the credit.

The Filing Status Study focused primarily on individuals who claimed the EITC as single or head of household, but who had filed as married filing jointly or separately in one of the three previous years. Taxpayers in the sample group were asked to provide documentation of their marital status before the IRS released their EITC. In the tax year 2003 trial, 22 percent of returns in the sample group were unable or unwilling to document their filing status, and EITC amounts paid to the group were reduced by 20 percent. For 2004 the IRS revised the sampling methodology to better target individuals more likely to be filing erroneously, and this resulted in a higher rate of claim adjustments and credit reductions.

---

<sup>44</sup> V. Joseph Hotz and John Karl Scholz, "Can Administrative Data on Child Support be Used to Improve the EITC? Evidence from Wisconsin," *National Tax Journal* 51, no. 2 (June 2008): 189-203. In 1999, Congress directed the IRS to study the possibility of using federal child support registry data for EITC compliance purposes.

<sup>45</sup> The authors note that this could result in a fair number of "false positives" and the initial denial of refunds to eligible claimants. *Ibid.* This could be a serious problem, since a fair number of recipients are unlikely to meet the 60-day requirement to appeal the denial. Thus, the cost of reducing erroneous payments may be to deny a smaller number of legitimate claims that never get paid or (at best) force eligible claimants to go through more difficult administrative processes to receive the credit.

The IRS also verified filing status with a smaller sample of claimants filing as head of household who had not filed as married in a previous year. This study resulted in some head of household filers changing to single status. Since heads of household and single filers use the same parameters for determining the credit amount, the adjustments did not result in a reduction in the amount of credit paid.

While the Filing Status Study did identify some claimants who should have used a different filing status and received a smaller credit (or no credit), the IRS concluded that it did not detect a high enough percentage of ineligible claims to make it worth continuing. In addition, verification of filing status was found to impose a substantial burden on taxpayers, with a relatively small savings in terms of reduced credit payments.

**The Automated Underreporter (AUR) Study** focused on improving the selection of EITC returns for review to better identify returns that may have misreported income. It did this by matching third-party income information (such as W-2s received from employers) to return data, and including returns that appeared to under- or overreport income in the population to be sampled. Including the third-party income data in the sample selection process increased the percentage of returns in the sample that had assessments for tax from about 72 percent to 82 percent. The IRS has since incorporated the third-party income matching developed in AUR in its annual review of EITC claims. GAO reports that the AUR system was used in 2014 to audit about 1 million EITC returns and recommended \$1.5 billion in additional tax.<sup>46</sup>

---

<sup>46</sup> GAO, *Refundable Tax Credits* (May 2016): 18, <http://www.gao.gov/assets/680/677548.pdf> (accessed July 5, 2016).

## Appendix: Earned Income Tax Credits in Other States, 2015

State (year adopted)	Percentage of federal credit	Notes
<b>Refundable Credits</b>		
California (2015)	85%	California's credit begins to phase out at income levels equal to half the amount at which the federal credit is fully phased-in, and is fully phased out for all family sizes when income reaches \$14,000
Colorado (1999)	10%	Colorado's credit was initially only in effect in years in which the state has a budget surplus; it became a permanent feature of the income tax in 2013, effective the next time the state had a budget surplus, which occurred in 2015
Connecticut	27.5%	
District of Columbia (2000)	40%	Delaware's credit for adults without dependents equals 100% of the federal credit, for incomes up to 200% of the federal poverty guideline for one person
Illinois (2000)	10%	Illinois' credit was made permanent in 2002
Indiana (2002)	9%	Indiana's credit does not match the increased federal 45% rate for families with three or more children, or the extended phaseout for married couples
Iowa (1990)	15%	Iowa's credit became refundable in 2007
Kansas (1998)	17%	
Louisiana (2007, effective 2008)	3.5%	
Maryland (1987)	25.5% (refundable) or 50% (nonrefundable)	A Maryland taxpayer may claim the refundable credit or the nonrefundable credit, but not both; Maryland's credit is scheduled to increase annually until it reaches 28% in 2018
Massachusetts (1997)	23%	Massachusetts increased its credit from 15% to 23% in 2015
Michigan (2006, effective 2008)	6%	
Nebraska (2006)	10%	
New Jersey (2000)	30%	New Jersey increased its credit from 20% to 30% in 2015
New Mexico (2007)	10%	
New York (1994)	30%	New York's credit decreases to 20% if the federal government reduces the state's TANF grant
Oklahoma (2002)	5%	Oklahoma's credit will become nonrefundable in 2016
Oregon (1997)	8%	Oregon made its credit refundable in 2006; the credit expires after tax year 2019
Rhode Island (1975)	12.5%	Rhode Island made its credit refundable in 2014 and increased it from 10% to 12.5% in 2015
Vermont (1988)	32%	

State (year adopted)	Percentage of federal credit	Notes
Washington (2008)	10%	Washington's credit equals the greater of \$50 or 10% of the federal credit and has not yet been funded
Wisconsin (1989)	4% one child 11% two children 34% three children	Wisconsin does not allow the credit for workers without dependents
<b>Nonrefundable Credits</b>		
Delaware (2005)	20%	
Maine (2000)	5%	Maine made its credit refundable in 2015, effective for 2016
Ohio (2013)	10%	Ohio's credit is limited to half of income taxes owed on taxable income over \$20,000
Virginia (2004, effective 2006)	20%	
Sources: Shen Stesel and Qiana Flores, Earned Income Tax Credit 2009-2012 Enactments, National Conference of State Legislatures (updated July 2012); Ifie Okwuje and Nicholas Johnson, <i>A Rising Number of State Earned Income Tax Credits Are Helping Working Families Escape Poverty</i> , Center on Budget and Policy Priorities (October 20, 2006); Jason Levitas and Jeremy Koulisch, <i>A Majority of States with Income Taxes Have Enacted State Earned Income Tax Credits</i> , Center on Budget and Policy Priorities (October 5, 2007); "Maryland Enacts Tax Package," <i>State Tax Notes</i> 46 (November 26, 2007): 592; same adoption years also from Dickert-Conlin and Houser (2002), which in turn are from Nicholas Johnson, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001: An Overview," particularly Table 4 (December 2001; summary updated in May 2004); Ed Hatcher and Amy Beall, "Education Leadership and Persistence Pay Off in Delaware: New State EITC Will Benefit 28,000 Low-Income Workers," <i>The EITC Policy Update</i> (September 2005); Jason Levitis and Jeremy Koulisch, <i>State Earned Income Tax Credits: 2008 Legislative Update</i> , Center on Budget and Policy Priorities (October 8, 2008); Erica Williams, "States Can Adopt or Expand Earned Income Tax Credits to Build a Stronger Future Economy", Center on Budget and Policy Priorities (Updated January 19, 2016); "State and Local Governments with Earned Income Tax Credit," <a href="http://www.irs.gov">www.irs.gov</a> .		

In addition to the information shown in the table, New York City, San Francisco,<sup>47</sup> and counties in Maryland that impose local income taxes, have enacted local earned income tax credits.<sup>48</sup>

For more information about tax credits, visit the income tax area of our website, [www.house.mn/hrd/](http://www.house.mn/hrd/).

<sup>47</sup> In 2015 San Francisco's credit was only available to families that had never before claimed it (<http://www.workingfamiliescredit.org/>; city and county of San Francisco).

<sup>48</sup> Nicholas Johnson and Erica Williams, *A Hand Up: How State Earned Income Tax Credits Are Helping Working Families Escape Poverty*, Center on Budget and Policy Priorities (April 2011).