

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. This restructuring reduces work disincentives caused by interactions with income and payroll taxes and the state's welfare program. Like the EITC, the WFC is refundable.

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How the Federal Earned Income Tax Credit Works

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 phase-out 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 and look up their credit in a table keyed to income and number of qualifying children.

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, and two 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 2004.

Table 1:

Maximum Federal Earned Income Tax Credit, 2004

	Maximum Earned Income	x	Credit Percentage	=	Maximum Credit
No Qualifying Children	\$5,100	x	7.65%	=	\$390
1 Qualifying Child	7,660	x	34.00	=	2,604
2 or More Qualifying Children	10,750	x	40.00	=	4,300

Note: Dollar amounts are indexed to projected changes in the consumer price index.

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

The credit provides separate phase-out thresholds and phase-out 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).

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for higher phase-out thresholds for married couples filing joint returns than for other taxpayers. This change is intended to alleviate the marriage penalty imposed under the earned income tax credit.¹ Table 2

¹ Under the provisions of EGTRRA 2001, the income level at which the credit begins to phase out is 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. The increased amount is indexed for inflation beginning in 2009.

shows the phase-out thresholds, rates, and income at which the credit is fully phased out in 2004, for married couples and for all other filers.

Table 2:
Federal Earned Income Tax Credit Phaseout, 2004

	Phase-out Rate		Phase-out Threshold	Income at which credit is fully phased out
Married couples				
No Qualifying Children	7.65%	of income over	\$7,390	\$12,490
1 Qualifying Child	15.98	of income over	15,040	31,338
2 or More Qualifying Children	21.06	of income over	15,040	35,458
All other filers				
No Qualifying Children	7.65%	of income over	\$6,390	\$11,490
1 Qualifying Child	15.98	of income over	14,040	30,338
2 or More Qualifying Children	21.06	of income over	14,040	34,458
Note: Dollar amounts for the phase-out thresholds are estimates. These amounts are indexed to projected changes in the consumer price index.				

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A marriage penalty may occur under the earned income credit when a single parent eligible for the credit gets married.² 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 phase-out range. For example, a single parent with one qualifying child and earned income of \$10,000 qualifies for the maximum credit of \$2,604. If this individual marries a single filer who also has \$10,000 of earned income, the couple has a combined earned income of \$20,000. Before the phaseout was extended for married couples, this couple would have qualified for a credit of \$1,652 (the \$2,604 maximum credit, minus 15.98 percent of income over the phase-out threshold of \$14,040). The couple experiences a marriage penalty of \$953, since the credit is \$953 smaller than what the single parent qualified for before marriage. Increasing the phase-out threshold by \$1,000 for married couples increases this couple's credit to \$1,811 (the \$2,604 maximum credit, minus 15.98 percent of income over the extended phase-out threshold of \$15,040), and reduces the marriage penalty to \$793.

² 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," 53 Nat. Tax J. 1107, 1131 (2000) (assumption that couples continue to live together). This study does not reflect the EGTRRA changes.

Filers with more than \$2,650 in disqualified income are not eligible for the EITC in tax year 2004.

“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 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 2004, the standard deduction and exemption amounts ensure that a married couple with two dependents will owe no federal income tax until gross income exceeds \$21,900. A head of household filer with one dependent will owe no tax until gross income exceeds \$13,350. Many EITC recipients have gross incomes below these levels; they receive the full credit amount for which they qualify as a refund.

How Filers Claim the Credit

Most filers claim the credit when they file their income tax returns. They must file either form 1040 or 1040A and complete schedule EIC. The Internal Revenue Service (IRS) will calculate the credit amount for filers who only wish to complete the front of schedule EIC.

In 2004, the IRS will operate a pilot “precertification” project.

The pilot project is an attempt to reduce what studies have shown to be a high rate of erroneous claims for children who do not meet the definition of “qualifying child” for purposes of claiming the credit. In the precertification pilot, 25,000 taxpayers identified by the IRS as at high risk of filing an erroneous claim will be asked to provide verification that children for whom the credit is claimed resided with them for at least half of the tax year. Precertification for the 2004 EITC will occur during the 2003 filing season. This will allow the 70 percent of EITC filers who use a tax preparer to obtain help in complying with the precertification requirements.

The credit may be claimed as an advance payment from the employer.

Individuals may complete a supplement to form W-4 and receive an estimated credit amount as an offset to FICA (Social Security) tax or an addition to wages throughout the year. The advance payment option provides a way for the credit to offset ongoing household costs.

Very few people use the advance payment option—less than 1 percent in 2001.³

The advance payment option apparently is not widely known or is not attractive to filers. A series of town meetings conducted by the Minnesota Departments of Revenue and Human Services in 1995 indicate that many potential recipients did not know about the advance payment option. Others were concerned about receiving too much in advance payments and having to pay back the excess. Still others had concerns about employers being unwilling to administer the advance credits or finding out they received the EITC.⁴

Advance payments can result in individuals receiving a larger credit during the year than they are ultimately entitled to. If this occurs, the excess must be repaid when filing the tax return for the year, usually in April. Using the advance payment option requires an individual to estimate total earnings and income for the upcoming year. Because the credit is calculated as an advance payment at only one job, this can pose calculation difficulties for individuals with more than one job and for married couples if both spouses work. Individuals who experience a large increase in

³ Approximately 138,000 taxpayers used the advanced earned income payment option in 2001 (down from 169,000 in 1999) out of a total population (in both years) of credit recipients of approximately 19 million. Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division 1 - 2 (June 17, 2003). In 2001, \$67 million was paid out in advance payments out of total earned income tax credits of \$32.5 billion.

⁴ Minnesota Department of Human Services and Minnesota Department of Revenue, “Tax Credit Express Pilot Project – 1997 Update,” Report to the legislature (1997).

earnings midway through the year may not qualify for the amount of credit that they have received in advance payments.⁵

Since overpayment could discourage individuals from using advance payments, the Revenue Reconciliation Act of 1993 limited the maximum amount available to 60 percent of the estimated credit.⁶ In addition, Congress required the IRS to notify families who receive EITC refunds of the availability of advance payments. Following this change, the percentage of credit recipients using the advance payment option increased significantly, but it has been declining recently.⁷ With the maximum EITC over \$4,000, some credit recipients may prefer to receive a single “lump-sum” payment, which may constitute the largest single “check” that a low-income filer receives during the course of the year.⁸

The advance payment option imposes an administrative burden on the employer.

Employers must forward a supplement to the advance payment recipient’s W-4 form to the federal government. They must also adjust their payrolls to take the advance payments into account. This may make some employers reluctant to offer the advance payment option. At least one participant in the Department of Revenue’s 1995 town meetings indicated that his employer did not want to do the necessary paperwork.

⁵ This is apparently a serious possibility. The Treasury Inspector General for Tax Administration reported that 65,000 taxpayers in tax years 2000 and 2001 had advanced payments, but did not qualify for the EITC. This was 22 percent of returns that received advance payments of the credit. These taxpayers had \$15.3 million in unpaid taxes due to the IRS. Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division 8, 17 (June 17, 2003). It is unclear how much of this is due to data entry errors that were not corrected by the IRS. (Some of it obviously is attributable to uncorrected data entry errors, since over one thousand of the accounts also had adjusted gross incomes over \$100,000 and some over \$1 million.)

⁶ “Earned Income Tax Credit Effectiveness of Design and Administration,” Testimony before Subcommittee on Select Revenue Measures and Human Resources, Committee on Ways and Means, U.S. House of Representatives, General Accounting Office (March 30, 1993): 9. This change may also have been motivated by a concern that many individuals who receive advance payments never bother to file tax returns—about 40 percent according to a General Accounting Office study. These individuals may be receiving larger or smaller credits than they are actually entitled to. There is also evidence that a fair number of individuals fail to report receipt of advance payments and may be receiving the credit a second time as a lump sum. See also “Earned Income Tax Credit: Advance Payment Option is Not Widely Understood by the Public,” General Accounting Office (February 1992).

⁷ In 1993, 0.2 percent of recipients used the advance payment option. This increased to 0.4 percent in 1994 after the notification requirement was enacted. By 1998 the percentage had increased to about 1 percent of recipients, but it had dropped to 0.7 percent in 2001. “Few Taxpayers Taking Advantage of Advance Earned Income Tax Credit,” *Tax Notes* (March 20, 1995); Hotz, V. Joseph and John Karl Scholz, *The Earned Income Credit* 58 (August 29, 2002); Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division, 1- 2 (June 17, 2003).

⁸ One study has found that receipt of the EITC affects when eligible families purchase durable goods. Specifically, the credit has led to measurable increases in durable good purchases in February, the most common month in which EITC refunds are received. Lisa Barrow and Leslie McGranahan, “The Effects of the Earned Income Credit on the Seasonality of Household Expenditures,” 53 *Nat. Tax J.* 1211 (2000).

The Minnesota Working Family Credit

Minnesota, as well as 16 other states, offers a state version of the EITC.⁹ Like the federal credit, it is fully refundable. In 1998 the legislature restructured Minnesota's credit so that it equals a percentage of earned income, rather than a percentage of the federal credit. The 1999 Legislature increased the percentage of the first tier of income that qualifies for the credit. 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 earned income tax credit 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, effective in tax year 1998, in order to reduce high marginal rates faced by low-income taxpayers.

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 changes further increased the maximum credit, and the 2000 Legislature increased the credit rates to ensure that all claimants received at least 25 percent of the federal credit. In 2001, the legislature conformed to marriage penalty relief provisions enacted at the federal level, and provided for the phaseout threshold to be higher for married couples than for single and head of household filers.¹⁰ Table 3 shows the credit calculation for tax year 2004 for single and head of household filers, and for married couples filing joint returns.

⁹ Appendix 1 provides a table listing state earned income tax credits.

¹⁰ The income level at which the phaseout begins and ends will be increased for married filers by \$1,000 in 2002-2004, \$2,000 in 2005-2007, and \$3,000 in 2008. It will be adjusted in following years for inflation.

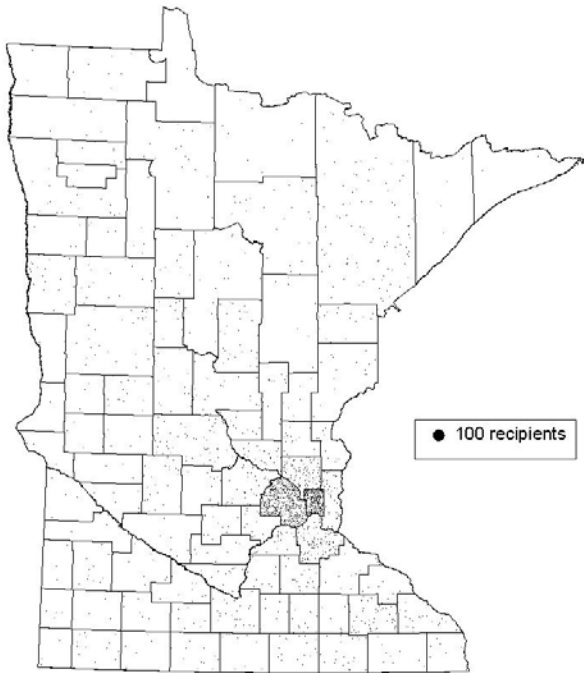
Table 3:
Minnesota Working Family Credit, 2004

	One qualifying child	Two or more qualifying children
Married couple filing jointly		
Credit calculation	8.5% of first \$7,660 of earnings, plus 8.5% of earnings between \$13,370 and \$14,880	10% of first \$10,760 of earnings, plus 20% of earnings between \$16,440 and \$18,590
Maximum credit	\$779	\$1,506
Credit phaseout	5.73% of income over \$17,690	10.3% of income over \$20,800
Maximum income eligible	\$31,293	\$35,421
Single and head of household filers		
Credit calculation	8.5% of first \$7,660 of earnings, plus 8.5% of earnings between \$13,370 and \$14,880	10% of first \$10,760 of earnings, plus 20% of earnings between \$16,440 and \$18,590
Maximum credit	\$779	\$1,506
Credit phaseout	5.73% of income over \$16,690	10.3% of income over \$19,800
Maximum income eligible	\$30,293	\$34,421

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In 2001, 212,709 filers claimed the credit for a total of \$107.5 million. When the credit was restructured in 1997, there was concern that fewer families would claim the credit because the calculation had become more complicated. However, the number of claimants declined by only 4 percent from 1997, the last year before restructuring, to 1998, the first year the restructured credit was implemented. Figure 1 shows the distribution of returns by county for 2001.

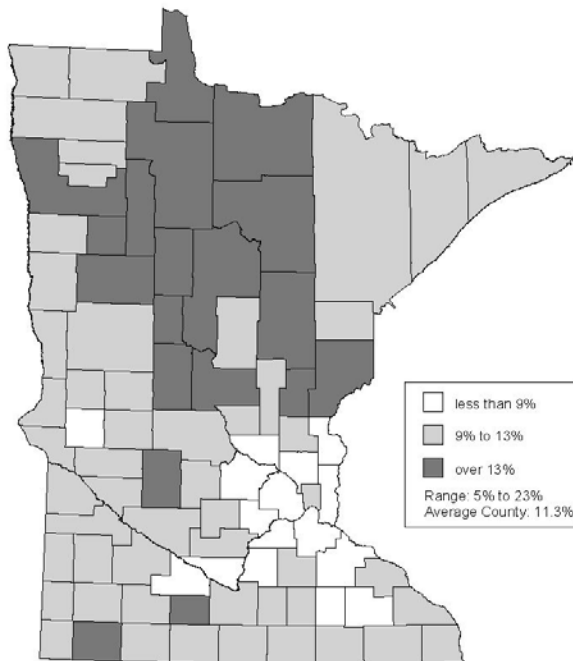
Figure 1:
Minnesota Working Family Credit Recipients, 2001



While over 47 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 2001 nonmetro filers were more likely to claim the credit than were metro area filers.

Figure 2 shows the percent of returns on which the credit was claimed by county; this ranged from 4.9 percent of all returns in Carver County in the metropolitan area, to 22.9 percent of all returns in Mahnommen County in northwestern Minnesota.

Figure 2:
Percentage of Returns Claiming Minnesota Working Family Credit, 2001



Over 13 percent of all tax returns filed in many north central and northwestern Minnesota counties claimed the WFC, while fewer than 9 percent of returns filed in Hennepin County and the suburban Twin Cities metropolitan counties claimed the credit. Generally higher incomes in the metro area make it less likely for filers to qualify for the credit.

Statewide, about 9 percent of all tax returns claimed the EITC and WFC in 2001.

The number of individuals claiming the credit increased by 46 percent from 1993 to 2001, when over 212,000 Minnesotans qualified for the WFC. Over this time period the credit became available to individuals without dependents, and the maximum credits and incomes increased. Nationwide, 15 percent of all returns filed claimed the credit in 2001. A smaller

percentage of Minnesota returns claimed the federal credit—9.1 percent—probably due to Minnesota’s higher than average personal income. The highest percentage of returns claiming the credit was 29.8 percent in Mississippi, and the lowest was 8.3 percent in New Hampshire.¹¹

The average EITC claimed in Minnesota in 2001 was \$1,472;¹² the average WFC was \$508.

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, and the increases in the state credit rates in 1998 and 2000.

¹¹ Internal Revenue Service, Statistics of Income Division, *SOI Bulletin* Spring 2003.

¹² *Ibid.*

In 2001, the average EITC nationwide was worth \$1,691. The state with the highest average was Mississippi at \$1,980, and the lowest was Alaska at \$1,355.¹³

The Minnesota working family credit cost \$107.5 million in tax year 2001, with the cost estimated to remain at about the same level in tax year 2002.

The total for 2001 is more than double the \$43.5 million paid in 1997, with the increase due to the 1998 restructuring of the credit and the rate increases in 1998 and 2000.

About 51.5 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 29 percent of the 2001 recipients owe some tax but receive a credit that exceeds their liability, so a total of 80.5 percent of claimants receive at least part of their WFC as a refund. The remaining recipients—19.5 percent—have tax liability that exceeds their credit. This means that a total of 48.5 percent of claimants use at least part of their WFC to offset tax liability.

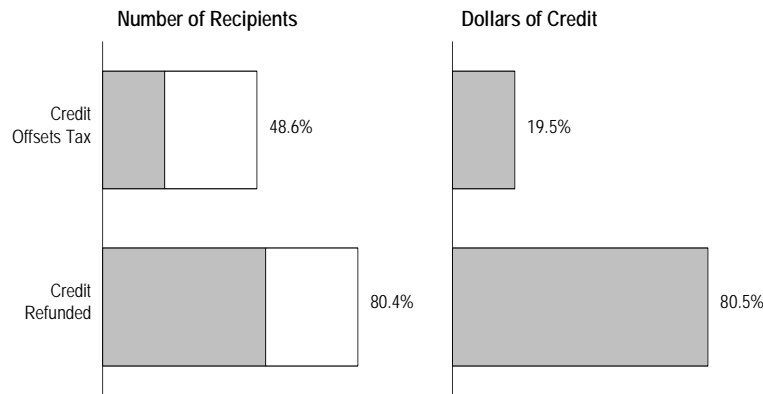
Nationwide, 84.7 percent of all EITC recipients receive at least part of their credit as a refund. In Minnesota, 80.6 percent of recipients received a full or partial refund of their EITC compared with a low of 76.4 percent in Vermont, and a high of 89.7 percent in Louisiana.¹⁴

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. After the restructuring, the earned income figures needed to calculate the state credit are on a federal worksheet, not the 1040, and are not available electronically. Data from the 2000 income tax sample indicates that about 94 percent of Minnesota EITC recipients also claimed the WFC. This figure has remained fairly constant in recent years.

¹³ *Ibid.*

¹⁴ *Ibid.*

Figure 3:
Refundability of Working Family Credit, 2000



Note: 29% of claimants qualify for a credit that exceeds their tax liability. For this 29%, part of the credit offsets liability, and the rest is paid as a refund. This 29% is shown in white in both bars on the left.

About one-fifth—19.5 percent—of the total amount paid in WFC offsets tax liability, while four-fifths—80.5 percent—of the total is distributed as refunds.

In 2001, \$21 million of the WFC offset tax liability and the remaining \$86.5 million was paid as refunds. At the national level, just over 87 percent of EITC dollars were distributed as refunds in 2001, with only 13 percent offsetting the federal income tax. In Minnesota, 84.3 percent of the EITC was refunded compared to a high of 91.1 percent in Mississippi, and a low of 80.4 percent in Vermont.¹⁵

Most WFC recipients have one or more qualifying children.

Figure 4 shows that in 2000,¹⁶ 42 percent of recipients had two or more qualifying children and 37 percent had one qualifying child. About 64 percent of the dollars paid in credits went to the 42 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.

¹⁵ *Ibid.*

¹⁶ Data on the total amount and refundability of the credit is from the Department of Revenue's 2001 processing file, while data on the number of qualifying children claimed by recipients is from the 2000 income tax sample, also prepared by the Department of Revenue.

