THE TAX INSTITUTE
AT H&R BLOCK

THE EARNED INCOME TAX CREDIT:

Illustrations of Complexity

August 2014

ABOUT THE TAX INSTITUTE at H&R BLOCK

The Tax Institute at H&R Block is the go-to source for objective insights on federal and state tax laws affecting the individual. It provides nonpartisan information and analysis on the real-world implications of tax policies and proposals to policymakers, journalists, experts and tax preparers. The Institute's experts include CPAs, Enrolled Agents, tax attorneys and former IRS agents. Building off more than 10 years of research and analysis from a specialized tax research group at H&R Block, the company launched The Tax Institute in 2007.

STAFF ACKNOWLEDGEMENTS

Jackie Perlman, MSA, CPA, the primary author of this paper, is a Principal Tax Research Analyst for The Tax Institute at H&R Block. She has been with the company for 16 years in positions of increasing responsibility researching, as well as explaining the impacts of legislation, regulations, and judicial decisions on the business and on taxpayers. Her tenure also includes three years in RSM McGladrey's small business division. Prior to joining H&R Block, Jackie held various positions at the Social Security Administration and also worked as an assistant controller at two different firms

She is a member of the Missouri Society of CPAs, the National Association of Enrolled Agents, the AICPA, and Beta Gamma Sigma, the honor society for collegiate schools of business. In her current position at The Tax Institute, Jackie is always involved in her favorite assignment—writing, speaking, and teaching about taxes.

Special thanks to Jayme White and Betsy Keane for their review and comments.

CONTACT INFORMATION

mediadesk@hrblock.com
(816) 854-4287
@HRBlockNews
www.newsroom.hrblock.com

Table of Contents

I. Introduction

According to the U.S. Treasury Department Agency Financial Report for Fiscal Year 2013, released on December 16, 2013, (Treasury Financial Report)[1], the Earned Income Tax Credit (EITC) improper payment rate, reported annually as part of the IRS National Research Program, has remained consistently above 20% for more than 10 years.

According to the Treasury Financial Report, two types of errors cause improper EITC payments:

1. Authentication errors (70 percent) result when taxpayers cannot prove qualifying child eligibility, mainly because of relationship and residency requirements, filing status, and nontraditional or complex living situations.[2]
2. Verification errors (30 percent) result when taxpayers improperly report their income, allowing them to fall within EITC income limitations and qualify for the credit. These errors include underreporting and overreporting of income by wage earners and self-employed taxpayers.[3]

National Taxpayer Advocate Nina Olson, in recent Congressional testimony, uses data from an unpublished Internal Revenue Service (IRS) study to explain the sources of the EITC improper payment rate.[4]

This paper, by using specific scenarios and applying the relevant law, illustrates how some portion of the EITC improper payment rate may be the result of the complex eligibility and qualification rules.

II. Applicable Law & Discussion

The Working Families Tax Relief Act (PL 108-311) was enacted on October 4, 2004, and established the Uniform Definition of Child (UDC). As its name implies, the UDC established a standard definition for a qualifying child for five child-related tax benefits: the dependency exemption (section 152(c)), head of household filing status (section 2(b)), the Child Tax Credit (section 24(c)), the Dependent Care Credit (section 21(b)), and the EITC (section 32(c)). However, eligibility rules are not identical for the five tax benefits.

Navigation of the UDC rules can be confusing and burdensome for taxpayers and may lead some to incorrectly conclude that they are eligible for the EITC and other tax benefits when they are not. One or more broad issues are frequently involved:

1. Differences in eligibility rules for the dependency exemption and the EITC
2. The special rule for divorced or separated parents
3. The tie-breaker rule
4. Dependency exemptions for qualifying relatives
5. Head of household requirements and complications

---

[1] Department of the Treasury, Agency Financial Report: Fiscal Year 2013 at 210, available at http://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/2013%20Department%20of%20the%20Treasury%20AFR%20Report%20v2.pdf (Dec. 2013).
[2] *Id.* at 207.
[3] *Id.* at 207.
[4] See http://docs.house.gov/meetings/AP/AP23/20140226/101771/HHRG-113-AP23-Wstate-OlsonN-20140226.pdf pages 32-39.

Issue 1: Differences in Eligibility Rules for the Dependency Exemption and the EITC

See Appendix A for qualifying child eligibility rules for all five child-related benefits. Despite the uniform definition, the qualifying child tests for the dependency exemption and the EITC are different. In addition to the qualifying child tests, the EITC has other requirements that may not pertain to the dependency exemption, or vice versa. As a result, a taxpayer claiming the dependency exemption may erroneously assume that he or she is eligible for the EITC, as well.

Test	Differences between Dependency Exemption and EITC Requirements	
	Dependency Exemption	**EITC**
RESIDENCY	The taxpayer and qualifying child must have the same principal place of abode for more than half of the year.	The taxpayer and qualifying child must have the same principal place of abode for more than half of the year. For the EITC, the residence must be in the 50 states of the U.S.
SUPPORT	The child must not provide more than half of his or her own support.	No test for support
CITIZENSHIP	The child must be a U.S. citizen, national, or resident; or a resident of Canada or Mexico.	The child may be a U.S. citizen, national, or resident.
SOCIAL SECURITY NUMBER	Any lawfully obtained tax identification (SSN, ITIN, ATIN, etc.) is acceptable.	The taxpayer, qualifying child, and all individuals listed on the tax return must have valid SSNs.
DEPENDENTS CLAIMING DEPENDENTS	A taxpayer who is a dependent of another taxpayer may not claim his or her own child for the exemption.	A dependent taxpayer may claim a child for the EITC. However, a taxpayer who is a qualifying child of another taxpayer for EITC purposes (regardless of whether the taxpayer is also a dependent), may not claim the EITC for his or her own child.
FILING STATUS LIMITATION	No filing status restrictions	A taxpayer using the married filing separately (MFS) status may not claim the EITC.

Issue 2: Special Rule for Divorced or Separated Parents

A custodial parent may release a child's exemption to the noncustodial parent if the parents meet all of the following requirements under section 152(e):

- The parents are divorced or legally separated, or they were never married.
- Separately or together, the parents provide more than half of the child's support.
- The child was in the custody of one or both parents for more than half the year.
- The custodial parent completes Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, for one or more years, and the noncustodial parent submits it with his or her tax return.

If a child's exemption is released under this special rule, the noncustodial parent may claim the child's dependency exemption and, if applicable, the Child Tax Credit. However, the noncustodial parent may not claim the EITC. If eligible, the custodial parent or another taxpayer for whom the child is a qualifying child may claim the EITC or other child-related tax benefits. This is the only instance in which child-related benefits may be split for one child.

Issue 3: The Tie-breaker Rule

When a child meets the eligibility requirements to be a qualifying child of more than one person, the UDC in section 152(c)(4) includes a set of "tie-breaker rules" (see Appendix B). Under the rules, parents who do not file a joint return may decide and cooperate on who will claim the child; the tie-breaker rules are invoked only if the parents cannot agree and both try to claim the child. The rules become more complicated if other taxpayers are involved. For instance, even if the parent is willing to let another taxpayer (a grandparent, for example) claim the child, the other taxpayer may do so only if his or her adjusted gross income (AGI) is higher than the parent's.

Perhaps the most vexing and poorly understood ramification of the tie-breaker rules is that child-related tax benefits cannot be split among taxpayers. The taxpayer who "wins" the tie-breaker rule claims the benefits for which he or she is eligible. Using the parent/grandparent example, if the grandparent wins the tie-breaker rule and files using the head of household filing status, but has AGI that is out of the EITC range, then nobody can claim the EITC for that child.

The special rule for divorced parents (Issue 2) is the only exception to the "no-split" rule.

Issue 4: Qualifying Relatives

A child who does not meet the eligibility rules to be a qualifying child may instead meet the eligibility rules under section 152(d) to be a "qualifying relative." See Appendix C for these rules and a comparison to the qualifying child rules. A child who is a qualifying relative of the taxpayer may be claimed for the dependency exemption and, in some circumstances, head of household filing status and the Dependent Care Credit. However, a qualifying relative is never a qualifying person for the Child Tax Credit or for the EITC. In particular, two of the qualifying relative rules may cause some confusion with taxpayers, especially if EITC is involved:

- *Not of qualifying child test (section 152(d)(1)(D))*. If a child meets the eligibility rules to be a qualifying child of any taxpayer, the child may not be claimed as a qualifying relative by another taxpayer, even if that taxpayer fully supports the child.
    - The IRS provides in Notice 2008-5 that an individual is not a taxpayer if he or she has no tax return filing requirement and does not file a tax return for any reason other than to get a refund of all withheld taxes.
- *Unrelated child in the home (section 152(d)(2)(H))*. An individual may claim the dependency exemption for an unrelated individual in the home if all other eligibility rules are met and the individual lives in the taxpayer's household the entire tax year. However, a child or other dependent claimed under these circumstances is not a qualifying individual for any other tax benefit, including head of household status (see Issue 5), the Child Tax Credit, or EITC.

Issue 5: Head of Household Status

A taxpayer who is not married, or who can be treated as not married, may be eligible to file using the head of household filing status. In general, this status is usually more favorable (i.e., results in a better tax outcome) than either the single or married filing separately status. Also, keep in mind that the EITC and many other tax benefits are not available for taxpayers who file as married filing separately.

- *Maintaining a home*. The support test for head of household filing status is more stringent than that for a qualifying child. The taxpayer must pay more than half the cost of maintaining a home that is the main home of the qualifying child or other qualifying dependent. If the test is not met, the taxpayer may still be able to claim the dependent, but must file as single or married filing separately and, if the latter, would be ineligible to claim the EITC.
- *Considered unmarried*. A taxpayer who is still married may be treated as not married under section 7703(b) if the taxpayer's spouse did not live in the taxpayer's household for the past six months of the year, and the home the taxpayer maintains (see above rule) is for the taxpayer's child, as defined in section 152(f)(1) (that is, the taxpayer's son or daughter, including natural children, adopted children, and stepchildren). Thus, to be considered unmarried, a much narrower relationship test applies.

III. Scenarios

Consider the following stories and accompanying analysis on EITC eligibility. In each scenario, assume:

- There is no intent on the part of the taxpayer to commit fraud; the taxpayer who claims the EITC believes he or she is entitled to it.
- Unless a parent is specifically discussed in a scenario, the parent does not live in the home and is not involved with the child.
- Any qualifying child or qualifying relative eligibility test (such as the joint return test) not specifically discussed in a particular scenario is not at issue (i.e., assume the eligibility test is met).

Scenario 1: My Girlfriend's Son

Andy lives with and fully supports his girlfriend, Barbara, who has no income. Andy also supports Barbara's 2-year-old son, Ben. Andy is not Ben's father and is not related to him in any way. Andy files his return using the head of household filing status, claims dependency exemptions for Barbara and Ben, and claims the Child Tax Credit and EITC for Ben. Barbara does not file a tax return.

Analysis: Andy may not claim Ben for the EITC. Ben is Andy's qualifying relative under the rules of section 152(d)(2)(H) and IRS Notice 2008-5 that apply to a taxpayer living with an unrelated child and the child's parent. These rules allow Andy to claim the dependency exemption for Ben, but do not allow him to claim any other child-related tax benefits with respect to Ben (see Issue 4, qualifying relatives). In this scenario, nobody can claim the EITC.

Scenario 2: My Canadian Family

Carla, a U.S. citizen, moves to Canada in March and marries her fiancé, David. David's 14-year-old daughter, Danielle (Carla's stepdaughter), also lives with the couple in Quebec City. David and Danielle are Canadian citizens and residents and have not lived in the U.S. for any part of the year. They both have ITINs. The appropriate election has been made to treat David as a U.S. resident for tax purposes. Carla and David file a joint return and claim Danielle as their dependent. They also claim Danielle for the Child Tax Credit and EITC.

Analysis: Carla and David may not claim Danielle for the EITC. Danielle is Carla and David's qualifying child, and they may claim her for the dependency exemption. They may not claim the EITC because Danielle is not a U.S. citizen or resident, because the family did not live in the U.S. for more than half of the tax year, and because Danielle and David have ITINs (see Issue 1, differences in eligibility rules for the dependency exemption and the EITC). *Note:* They cannot claim the Child Tax Credit either, because Danielle is not a U.S. citizen or resident. In this scenario, nobody can claim the EITC.

Scenario 3: My Husband Moved Out (and My Grandchildren Stayed)

Elaine's husband, Earl, moved out of their home in May and has not returned. The couple will likely get divorced, but have not yet taken any legal action. They have raised their twin grandchildren, Frank and Fred (now age 10), who continue to live with Elaine. The boys' parents do not live in the home. Elaine files her return using the head of household filing status and claims dependency exemptions, the Child Tax Credit, and EITC for Frank and Fred.

Analysis: Elaine may not claim Frank and Fred for the EITC. Frank and Fred are Elaine's qualifying children, and she may claim dependency exemptions and Child Tax Credits. However, she may not claim the EITC because her proper filing status is married filing separately rather than head of household (see Issue 5, head of household status). Although they have been living apart for the past six months of the year, Elaine and Earl are still legally married. To be treated as not married, the rules of section 7703(b) require Elaine to maintain a home for her son or daughter. Elaine may be paying more than half the cost of maintaining her home; however, the home is for her grandchildren rather than her children, so she cannot be "considered unmarried" under the head of household rules. In this scenario, Elaine may claim the EITC only if she and Earl are willing to file a joint return and they have income within the EITC range.

Scenario 4: My Brother's House

Gina (age 28) and her daughter, Gaby (age 4), live with Gina's brother, Hank. Gina's earnings and AGI are $7,000. Hank's earnings and AGI are $65,000. Hank files his return using the head of household filing status and claims the dependency exemption and Child Tax Credit for Gaby (which Gina has agreed to). Gina files her return using the single filing status and claims the EITC for Gaby.

Analysis: Gina may claim Gaby for the EITC only if Hank does not claim Gaby on his tax return. Gaby may be a qualifying child of her uncle, Hank, or her mother, Gina, but she cannot be both. Gaby meets the eligibility rules to be a qualifying child of both taxpayers. Because of his higher AGI, Gina may allow her brother to claim Gaby as his qualifying child under the tie-breaker rule of section 152(c)(4), but she may not claim her, too (see Issue 3, the tie-breaker rule). The fact that only Gina's income is in the EITC range or that the dependency exemption is more valuable to Hank does not allow them to split child-related benefits. In this scenario, the family must make a choice about how they file.

Scenario 5: My Parents Support Me and My Son

Irwin (age 25) and his son, Ike (age 3), live in the home of Irwin's friend (no relation). Irwin's parents, Joe and Jane, who do not live with him, have agreed to support Irwin and Ike until Irwin finishes college. Irwin earns $1,500. Joe and Jane's combined earnings and AGI are $90,000. Joe and Jane file a joint return and claim dependency exemptions for Irwin and Ike, and the Child Tax Credit for Ike. Irwin files a return using the single filing status and claims the EITC for Ike.

Analysis: Irwin may claim the EITC for Ike only if Joe and Jane do not claim Ike on their tax return. Ike may be a qualifying relative of his grandparents, Joe and Jane, or he may be a qualifying child of his father, Irwin, but he cannot be both. Joe and Jane may claim Ike as their dependent only if Irwin is not a "taxpayer," as defined in IRS Notice 2008-5 (see Issue 4, qualifying relatives). Although Irwin doesn't have a tax filing requirement, if he files a return to get the EITC, he *is* treated as a taxpayer, and, consequently, Ike is his qualifying child and cannot be claimed as a qualifying relative by his grandparents or anyone else. Note that unlike the previous scenario, the tie-breaker rule is not invoked because Ike is a qualifying child of his father only. However, this family, too, must make a choice about how they file.

Scenario 6: My Children and My Ex-wife

Kate and Ken are divorced. Kate is the custodial parent of their two children, Larry (age 12) and Linda (age 9). Kate has given Ken a signed Form 8332 agreeing to relinquish the children's exemptions for this year and all future years. Ken pays alimony, child support, and many of the household expenses. He files his return using the head of household filing status and claims dependency exemptions, the Child Tax Credit, and EITC for Larry and Linda.

Analysis: Larry and Linda are treated as the qualifying children of their father, Ken. Under the rules for divorced parents under section 152(e), custodial parent Kate has properly released the children's exemptions to noncustodial parent Ken (see Issue 2, special rule for divorced or separated parents). The release allows Ken to claim the dependency exemptions and Child Tax Credits, but not any of the other child-related tax benefits. If she qualifies, Kate may file as head of household and claim the EITC for the children. This is only instance in which the tax benefits may be split. In this scenario, Linda or another qualifying taxpayer may be able to claim the EITC.

Scenario 7: I Pay My Bills

Maria (age 20) lives with 6-month-old daughter, Millie, and her grandmother, Nora, in Nora's home. Maria is a full-time student and works, earning $20,000 a year. Nora works and earns $16,000 a year. The two adults share most household expenses, including rent, utilities, and food. Because Maria provides more than half of her own support, she is not a dependent of Nora's (qualifying child or qualifying relative) for the dependency exemption or head of household purposes. Maria files her return using the head of household filing status and claims Millie for the dependency exemption, Child Tax Credit, and the EITC.

Analysis: Millie is a qualifying child of her mother, Maria, but cannot be claimed by her mother for the EITC. That is because Maria *is* a qualifying child of her mother, Nora, but only for EITC purposes. Because of Maria's income and support, she is not a dependent of Nora's. However, there is no support test for the EITC (see Issue 1, differences in eligibility rules for the dependency exemption and the EITC), and Maria meets all of the other qualifying child tests and requirements with respect to Nora. Maria may use the head of household filing status and claim the dependency exemption and Child Tax Credit, but she is precluded from claiming the EITC. Note that if Nora had no income and no tax filing requirement, she would not be treated as a taxpayer, and Maria could claim the EITC. In this scenario, nobody can claim the EITC for Millie.

IV. Conclusion

Taxpayers may reasonably conclude that they are eligible to claim the EITC when in fact they are not. It may be that the taxpayer is legitimately able to claim the child's dependency exemption, or supports the child financially, or is the only family member with income in the EITC range. Based on family dynamics, it could be that a different taxpayer is eligible for the EITC or that nobody may claim the credit. These scenarios illustrate that taxpayers may not understand the intricacies of the EITC both in and of itself and as part of the Uniform Definition of Child.

Appendix A: Qualifying Child Tests

Qualifying Child Tests	Dependency Exemption	Head of Household Filing Status	Child Tax Credit	Earned Income Tax Credit	Child and Dependent Care Credit
AGE 1) younger than taxpayer and under 19 or under 24 and full-time student, or 2) Any age and totally/permanently disabled	✓	✓	Under age 17	✓	Under age 13 or disabled
RELATIONSHIP Taxpayer's son, daughter, stepson, stepdaughter, eligible foster child, brother, sister, half-sibling, stepsibling, or descendant of any of these individuals	✓	✓	✓	✓	✓
RESIDENCY Child must have the same principal residence as taxpayer for more than half the year	✓	✓	✓	✓	✓
SUPPORT Child must not provide more than one-half of own support	✓	✓	✓	No support requirement	✓
CITIZENSHIP Child must be U.S. citizen or resident of Canada or Mexico	✓	✓	U.S. citizen or resident only	U.S. citizen or resident only; valid SSN needed	✓
MARRIED CHILD May not file a joint return with spouse other than a claim for refund	✓	✓	✓	✓	✓
ADDITIONAL REQUIREMENTS FOR TAXPAYER	Must not be claimed (or allowed to be claimed) as a dependent of another taxpayer	Must pay more than half the cost of maintaining home	Must meet AGI limitations; must have over $3,000 in earned income to qualify for refundable portion of credit	Must meet earned income, investment income, AGI limitations; SSN; U.S. residency; and other tests	Must pay for child/dependent care so taxpayer (and spouse) can work
THIS TAX BENEFIT MAY BE CLAIMED FOR A QUALIFYING RELATIVE	Yes	Yes	No	No	Yes

Appendix B: The "Tie-breaker" Rules

IRC section 152(c)(4) Special rule relating to two or more who can claim the same qualifying child.

(A) In general. Except as provided in subparagraphs (B) and (C) , if (but for this paragraph) an individual may be claimed as a qualifying child by 2 or more taxpayers for a taxable year beginning in the same calendar year, such individual shall be treated as the qualifying child of the taxpayer who is—

(i) parent of the individual, or

(ii) if clause (i) does not apply, the taxpayer with the highest adjusted gross income for such taxable year.

(B) More than 1 parent claiming qualifying child. If the parents claiming any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of—

(i) the parent with whom the child resided for the longest period of time during the tax- able year, or

(ii) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.

(C) No parent claiming qualifying child. If the parents of an individual may claim such individual as a qualifying child but no parent so claims the individual, such individual may be claimed as the qualifying child of another taxpayer but only if the adjusted gross income of such taxpayer is higher than the highest adjusted gross income of any parent of the individual.

Appendix C: Qualifying Relative and Qualifying Child Comparison

Test	Qualifying Relative Section 152(d)	Qualifying Child Section 152(c)
AGE	N/A	1) Younger than taxpayer and under 19 or under 24 and a full-time student, or 2) Any age and totally/permanently disabled
RELATIONSHIP	Taxpayer's: • Child or descendant of the child, • Sibling, or son/daughter of the sibling, • Father/mother, or ancestor or sibling of either, • Stepsibling or stepparent, • Son/daughter-in-law, father/mother-in-law, brother/sister-in-law, or • An individual (other than a spouse) who is a member of the taxpayer's household the entire tax year	Taxpayer's: • Son, • Daughter, • Stepson, • Stepdaughter, • Eligible foster child, • Brother, • Sister, • Half-sibling, • Stepsibling, or • Descendant of any of these individuals
RESIDENCY	The related individuals on the above list do not have to live with the taxpayer. An unrelated individual (the last item on the above list) must live with the taxpayer all year.	The child must have lived with the taxpayer for more than one-half of the year.
GROSS INCOME	The individual's gross income subject to tax must be less than the exemption amount for the year.	N/A
SUPPORT	The taxpayer must provide more than one-half of the individual's support (multiple support agreements okay).	The child must not provide more than one-half of his or her own support (multiple support agreements are N/A).
CITIZENSHIP	The individual must be a U.S. citizen or resident of Canada or Mexico (same test as for qualifying child).	The child must be U.S. citizen or resident of Canada or Mexico.
MARRIED DEPENDENTS	The individual may not file a joint return with spouse, other than a claim for refund (same test as for qualifying child).	The child may not file a joint refund with spouse, other than a claim for refund.
NOT A QUALIFYING CHILD	The individual may not be a qualifying child of the taxpayer or of any other taxpayer.	N/A (but tie-breaker rules apply if the child is a qualifying child of more than one taxpayer)
POTENTIAL TAX BENEFITS	Dependency exemption, Child/Dependent Care Credit, head of household filing status	Dependency exemption, Child Tax Credit, EITC, Child/Dependent Care Credit, head of household filing status