TJAGSA Practice Notes

Faculty, The Judge Advocate General's School

Tax Law Note

Earned Income Credit: New Rules Could Ease Qualification

Lieutenant Colonel Curtis A. Parker
Chief, Legal Assistance Branch
Professor, Administrative and Civil Law Department
The Judge Advocate General's School, U.S. Army

Several changes to the Earned Income Credit (EIC) rules should reduce the confusion surrounding the EIC as well as increase the number of service members eligible for this valuable credit. The Economic Growth and Tax Reconciliation Act of 2001 (2001 Act)[1] changes the definition of earned income,[2] eliminates the use of modified adjusted gross income to measure eligibility for the EIC,[3] relaxes the definition of qualifying child,[4] and creates new rules for credit eligibility for persons with the same qualifying child.[5]

EIC: An Overview

In the case of an eligible individual, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the credit percentage of so much of the taxpayer's earned income for the taxable year as does not exceed the earned income amount.[6]

The EIC is a refundable credit for working taxpayers whose income is below a certain dollar amount.[7] As a refundable credit, it not only reduces the amount of tax the taxpayer may owe, but also may provide a refund to the taxpayer in excess of his withholdings.

An eligible individual[8] is allowed a credit equal to the credit percentage times the amount of the individual's earned income for the tax year that does not exceed the statutory earned income amount.[9] For 2001, the EIC for a tax year could not be more than the excess of (1) the *earned* percentage of the earned

1. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38 (codified in scattered sections of I.R.C. (LEXIS 2002)) [hereinafter 2001 Act].

2. I.R.C. § 32(c)(2)(A)(i) (codifying 2001 Act § 303(b)).

3. *Id.* §§ 32(a)(2)(B), (c)(5) (codifying 2001 Act §§ 303(d)(1), (2)(A)).

4. *Id.* §§ 32(c)(3)(A)(ii), (B)(i), (iii) (codifying 2001 Act § 303(e)(1), (2)(A)-(B)).

5. *Id.* § 32(c)(1)(C) (codifying 2001 Act § 303(f)).

6. *Id.* § 32(A)(1).

7. Generally, for tax year 2001, individuals with two or more qualifying children, and earned and modified adjusted gross income below $32,121, qualify for the EIC. For tax year 2002, individuals with two or more qualifying children, and earned and *adjusted gross income* below $33,178 ($34,178 if filing jointly), qualify for the EIC. I.R.S. Form W-5 (2002).

8. An "eligible individual" is any individual who "has a qualifying child for the taxable year." I.R.C. § 32(c)(1)(A)(i)). Qualifying children must live with the taxpayer for more than one-half of the year, and must be the taxpayer's (1) children or stepchildren (or their descendants); (2) brothers, sisters, step-brothers, step-sisters (or their descendants) whom the taxpayer cares for as his own children; or (3) eligible foster children. Eligible foster children are children "placed with the taxpayer by an authorized placement agency [that] the taxpayer cares for as [his] own child[ren]." *Id.* § 32(c)(3)).

An individual who does not have a qualifying child for the tax year is also an eligible individual if:

> (1) "[the] individual's principal place of abode is in the United States for more than one-half of the taxable year," *id.* § 32(c)(1)(A)(ii)(I) (Armed Forces personnel are considered to have their personal abode in the United States for the time they are stationed outside the United States on extended active duty, *id.* § 32(c)(4));
>
> (2) either the individual or the individual's spouse (if any) is older than twenty-four but younger than sixty-five before the end of the tax year, *id.* § 32(c)(1)(A)(ii)(II);
>
> (3) the individual cannot be claimed as the dependent of another taxpayer for any tax year beginning in the same calendar year as the individual's tax year, *id.* § 32(c)(1)(A)(ii); and
>
> (4) the individual is not a nonresident alien for any part of the tax year, or has elected under I.R.C. § 6013(g) or § 6013(h) to be treated as a U.S. resident, *id.* § 32(c)(1)(E).

9. *Id.* § 32(a)(1).

income amount, over (2) the phase-out percentage of so much of the modified adjusted gross income (or if greater, earned income) of the individual for the tax year as exceeds the phase-out amount.[10]

Huh? If you are wondering what that last paragraph means, then you understand the need for simplification. The instructions for IRS Form 1040, the *U.S. Individual Income Tax Return*, contain ten pages of worksheets and tables necessary for determining eligibility and amount of the EIC. The Form 1040 instructions, a booklet only sixty-one pages long, dedicates thirteen percent of its material for calculating the entry for one line on Form 1040.[11] The time obviously was, and remains, ripe for simplification.

In general terms, the EIC is available to single or married people who work, either full- or part-time at some point during the year, depending on their income. Workers raising one child in their home and with family incomes of less than $28,281 in 2001 could get an EIC of up to $2428. Workers raising more than one child in their home and with family incomes of less than $32,121 in 2001 could get an EIC of up to $4008. Workers not raising children in their home who were between ages twenty-five and sixty-four on 31 December 2001, and had income below $10,710, could get an EIC of up to $364.[12]

To understand the EIC better, one must understand that it phases-in as well as phases-out. That is, to a point, the amount of credit for which the taxpayer qualifies increases as his income increases—phases in. The credit then levels out and remains level over a set income range.[13] Once the taxpayer's income exceeds this range, the amount of credit reduces as income increases, until the entitlement ceases—phases-out.[14]

The following examples illustrate calculation of the EIC under the pre-2001 Act rules:

> ***Example 1.*** Corporal John Andrews and his wife Doris will file a joint return for 2001. They have two children—Mark who is age three and Connie who was born in May of 2001. Their total earned income is $23,650 (basic pay $16,104, basic allowance for housing (BAH) $4896, basic allowance for subsistence (BAS) $2650). John and Doris qualify for an EIC of $1779 in 2001.[15]
>
> ***Example 2.*** Staff Sergeant Brad Wilson and his wife Judy will file a joint return for 2001. They have two children —Angela who is six years old and Eric who is four years old. Their total earned income is $34,054 (basic pay $25,140, which includes $7780 nontaxable pay for service in a combat zone, plus BAH $6264 and BAS $2650). Even though the Wilsons' modified adjusted gross income is $17,360, they do not qualify for the earned income credit because their total earned income is not less than $32,121.[16]

In 2002, however, there will be some changes.

Earned Income

Old Law. Before the 2001 Act, the Internal Revenue Code defined earned income as wages, salaries, tips, and other employee compensation,[17] and it included both compensation

---

10. *Id*. § 32(a)(2).

11. I.R.S. Form 1040, Instructions, 41-50 (2000) (line sixty-one of a seventy-line form).

12. I.R.S. Pub. No. 596, Earned Income Credit (EIC) tbls. 46-48 (2000) [hereinafter IRS EIC Guidance] (for use in preparing 2001 tax returns).

13. *See id*. For 2001, workers attained maximum EIC benefits at the following income ranges:

workers with one child:	$7100 – 13,099	(EIC = $2428);
workers with more than one child:	$10,000 – 13,099	(EIC = $4008); and
workers with no children:	$4750 – 5949	(EIC = $364).

Id.

14. For 2001, maximum EIC benefits began to decrease at the following income levels:

workers with one child:	$13,100, terminating once income exceeded $28,299;
workers with more than one child:	$13,100, terminating once income exceeded $32,121; and
workers with no children:	$5950, terminating once income exceeded $10,750.

Id.

15. I.R.S. Pub. No. 3, Armed Forces' Tax Guide 17 (2000) (for use in preparing 2001 tax returns).

16. *Id.*

17. I.R.C. § 32(c)(2)(A)(i) (LEXIS 2001) (Code as it existed before the 2001 Act).

and self-employment income.[18] Such compensation included "anything of value received by the taxpayer from the employer in return for services of the employee."[19] The definition of earned income included compensation excluded from gross income as well as taxable compensation.[20] Nontaxable forms of compensation treated as earned income for EIC purposes included the following: (1) elective deferrals under a cash or deferred arrangement or annuity;[21] (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance,[22] dependent care,[23] adoption assistance,[24] educational assistance,[25] and miscellaneous fringe benefits;[26] (3) salary reduction contributions under a cafeteria plan;[27] (4) meals and lodging provided for the convenience of the employer;[28] and (5) housing allowance or rental value of a parsonage for the clergy.[29] For the military, it also included nontaxable combat zone pay and nontaxable housing and subsistence allowances received by military members.[30] Such amounts were included even if received in kind, for example, government quarters or furnished meals.[31]

The inclusion of nontaxable forms of employee compensation complicated the process of determining earned income. Both the IRS and taxpayers were required to keep track of nontaxable amounts for determining EIC eligibility, even though such amounts were generally not necessary for other tax purposes. Some of these items are not required to be reported on the Wage and Tax Statement (Form W-2), making it difficult for taxpayers to ascertain their correct amount of nontaxable earned income. The IRS also cannot easily determine these amounts. Congress believes that redefining earned income to exclude amounts not includable in gross income will simplify the calculation.[32]

New Law. The 2001 Act defines earned income, beginning in 2002,[33] as wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the tax year.[34] Thus, the definition of earned income will be: wages, salaries, tips, and other employee compensation, *if includible in gross income* for the tax year, plus net earnings from self-employment.[35] Military taxpayers will no longer be required to include nontaxable combat zone pay, nontaxable housing allowance, and nontaxable subsistence allowance as earned income. These changes should increase the number of service members qualifying for the credit because the number of soldiers whose earned income exceeds the phase-out amount will decrease.

Revisiting the examples above best illustrates this change in the law. In Example 1, the Andrews' EIC under the old rules was $1779. Under the new rules for 2002, under which the Andrews no longer include any nontaxable compensation—BAH and BAS—when calculating income for determining

18. IRS EIC Guidance, *supra* note 12, at 20.

19. Research Institute of America (RIA) Checkpoint, Congressional Committee Reports Accompanying the Economic Growth and Tax Relief Reconciliation Act of 2001 (2002) [hereinafter Committee Reports] (generally summarizing the relevant congressional committee reports).

20. Treas. Reg. § 1.32-2(c)(2) (LEXIS 2002). The Treasury Regulations do not reflect the changes of the 2001 Act. *See id.*

21. I.R.C. §§ 403(b), 402(g), 7701(j) (LEXIS 2001) (Code as it existed before the 2001 Act).

22. *Id.* § 106.

23. *Id.* § 129.

24. *Id* § 137.

25. *Id*. § 127.

26. *Id.* § 132.

27. *Id.* § 125.

28. *Id.* § 119.

29. *Id*. § 107.

30. *Id.* §§ 112, 134.

31. Armed Forces' Tax Guide, *supra* note 15, at 17.

32. *See* Committee Reports, *supra* note 19.

33. The 2001 Act applies to tax years beginning after 31 December 2001. 2001 Act, *supra* note 1, § 303(i)(1)).

34. I.R.C. § 32(c)(2)(A)(i) (LEXIS 2002) (codifying 2001 Act § 303(b)).

35. *See* Committee Reports, *supra* note 19.

their EIC, the Andrews' EIC is $3369. In Example 2, the Wilsons did not qualify for the EIC under the old rules. Under the news rules, the Wilsons can exclude BAH, BAS, and pay for service in a combat zone when calculating income for purposes of the EIC. The Wilsons now qualify for an EIC of $3106.

Not everyone may benefit; the change apparently affects only a minority of military taxpayers, and only those at very low-income levels.[36] Recall that the EIC phases-in as well as phases-out. For taxpayers whose earned income, including only taxable compensation, is below the maximum amount of earned income used to calculate the EIC, excluding the nontaxable amounts from earned income will cause the taxpayer to qualify for a smaller EIC.[37] Those most at risk for a decrease in EIC are single soldiers without children and single soldiers with only one child. In each case, before the soldier realizes any decrease in EIC, his income would need to decrease below $4750 and $7100, respectively.[38]

Modified Adjusted Gross Income

Old Law. Pre-2001 Act law defined modified adjusted gross income (MAGI) as adjusted gross income (AGI) determined without regard to certain losses and increased by certain amounts not includible in gross income.[39] The disregarded losses were: (1) net capital losses (up to $3000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) seventy-five percent of net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses.[40] The amounts added to AGI to calculate MAGI included tax-exempt interest and nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).[41]

New Law. Beginning in 2002, the phase-out of the credit will apply to taxpayers whose AGI (rather than MAGI), or earned income, whichever is greater, exceeds a phase-out amount.[42] The maximum credit amount will be reduced by the phase-out percentage multiplied by the AGI (or earned income) in excess of the phase-out amount (as adjusted for inflation).[43] The 2001 Act accordingly deletes the definition of MAGI.[44]

By replacing MAGI with AGI, Congress reduced the number of steps necessary for a taxpayer to determine his EIC.[45] While this may not have a significant impact on the number of service members qualifying for the credit, it will simplify the calculation.

Qualifying Child

Old Law. The amount of EIC that an eligible taxpayer may claim depends upon the number of "qualifying children" a taxpayer has. To be a qualifying child, a child must bear a specified relationship to the taxpayer and meet a residency requirement.[46] To fulfill the residency test, a child has to have the same principal place of abode as the taxpayer for *more than one-half* of the taxpayer's tax year.[47] For an otherwise eligible foster child to be a qualifying child, however, the pre-2001 Act required that child to have the same principal abode as the taxpayer for the taxpayer's entire tax year.[48]

New Law. "The distinctions among familial relationships drawn by [pre-2001 Act] law in defining a qualifying child add[ed] to the complexity of the earned income credit."[49]

---

36. To illustrate, if the base pay of Corporal Andrews and Staff Sergeant Smith was reduced by half because of combat zone duty, their EIC actually increases.

37. Assume the taxpayer had one child and earned income of $8000, including $1000 of nontaxable income. Applying the 2001 rules, that taxpayer qualifies for a credit of $2428. Applying the 2002 rules, however, this taxpayer would calculate his EIC based on his taxable income of $7000, and his credit would be $2389.

38. IRS EIC Guidance, *supra* note 12, tbls. 46-48.

39. I.R.C. § 32(c)(5)(A) (LEXIS 2001) (Code as it existed before the 2001 Act).

40. *Id*. § 32(c)(5)(B).

41. *Id.* § 32(c)(5)(C).

42. I.R.C. § 32(b)(2)(A) (LEXIS 2002).

43. *Id.* § 32(a)(2)(B) (codifying 2001 Act § 303(d)(1)).

44. *Id*. § 32(b)(2) (codifying 2001 Act § 303(d)(1)).

45. Committee Reports, *supra* note 19.

46. *Id.* § 32(3) (unchanged by the 2001 Act).

47. *Id.* § 32(3)(A)(ii) (unchanged by the 2001 Act).

48. I.R.C. § 32(3)(B)(iii)(III) (LEXIS 2001) (Code as it existed before the 2001 Act).

Beginning in 2002, the 2001 Act removes "foster child" as an exception to the greater than six-month residency requirement to be an eligible child.[50] The 2001 Act also removes from the definition of "eligible foster child" the requirement that the child have the same principal place of abode as the taxpayer for the taxpayer's entire tax year.[51] The removal of the entire-year residency requirement for eligible foster children extends the more than six-month residency requirement to all children, including foster children, after 2001.[52]

The 2001 Act adds the descendant of any stepson or stepdaughter to the eligible child category.[53] It also removes brothers, sisters, stepbrothers, or stepsisters of the taxpayer (or a descendant of any such relative) from the definition of eligible foster child,[54] and it reclassifies them under the general eligible child category, but only if the taxpayer cares for them as the taxpayer's own.[55]

> **Example 3.** You and your sister live together. You are 30. Your sister is 15. When your parents died 2 years ago, you took over the care of your sister, but you did not adopt her. She is considered your eligible foster child because she lived with you all year and because you cared for her as you would your own child.[56]

In the above example, under the new rules, it is no longer necessary that the sister live with the taxpayer all year. Service members caring for foster children and siblings, whom they care for as they would their own child, will qualify for the EIC, even though the qualifying child does not live with the service member all year.[57] These changes will both simplify the calculation and expand the class of service members eligible for the EIC.

Tie-Breaker Rule

Old Law. Under pre-2001 Act tax rules, if a child was otherwise qualified for more than one taxpayer, the tie-breaker rules for calculating EIC treated the child as a qualifying child for only the person with the highest MAGI.[58]

New Law. Beginning in 2002, if an individual is a qualifying child for more than one taxpayer, and more than one taxpayer claims the EIC for that child, then the following tie-breaking rules apply: First, if one of the individuals claiming the child is the child's parent (or parents filing jointly), then the child is considered the qualifying child of the parent (or parents).[59] Second, if both parents claim the child and the parents do not file jointly, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year,[60] and second of the parent with the highest AGI.[61] Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child for the taxpayer with the highest AGI.[62]

---

49. *See* Committee Reports, *supra* note 19.

50. I.R.C. § 32(c)(3)(A)(ii) (LEXIS 2002) (codifying 2001 Act § 303(e)(2)(B)).

51. *Id.* § 32(c)(3)(B)(iii) (codifying 2001 Act § 303(e)(2)(A)).

52. *See* Committee Reports, *supra* note 19.

53. I.R.C. § 32(c)(3)(B)(i)(I) (codifying 2001 Act § 303(e)(1)).

54. *Id.* § 32(c)(3)(B)(iii) (codifying 2001 Act § 303(e)(2)(A)).

55. *Id.* § 32(c)(3)(B)(i)(II) (codifying 2001 Act § 303(e)(1)).

56. IRS EIC Guidance, *supra* note 12, at 12.

57. *See* I.R.C. § 32(c)(3).

58. I.R.C. § 32(c)(1)(C) (LEXIS 2001) (Code as it existed before 2001 Act).

59. I.R.C. § 32(c)(1)(C)(i)(I) (LEXIS 2002) (codifying 2001 Act § 303(f)).

60. *Id.* § 32(c)(1)(C)(ii)(I).

61. *Id.* § 32(c)(1)(C)(ii)(II).

62. *Id.* § 32(c)(1)(C)(i)(II).

Conclusion

These changes in the rules will expand the number of service members who qualify for the EIC. Additionally, the new rules will simplify the calculation for service members and the tax assistance centers that support them. Judge advocates must get this information out to their clients *now*. Counsel should encourage their clients to determine their eligibility for the EIC and, if appropriate, apply for the Advanced Earned Income Credit by completing IRS Form W-5.[63]

63. If the taxpayer expects to eligible for the earned income credit in 2002 and has a qualifying child, the taxpayer can receive EIC payments in his paycheck, rather than as part of his tax refund, by submitting an IRS Form W-5 to his employer. IRS EIC Guidance, *supra* note 12, at 34-36