Tax Alliance for ECONOMIC MOBILITY

January 2019

PRINCIPLES FOR REFORM: TAX CREDITS FOR LOW-INCOME WORKERS

About the Tax Alliance for Economic Mobility

The Tax Alliance for Economic Mobility, chaired by Prosperity Now, convenes racial justice advocates, asset-building advocates, tax reform experts and researchers to identify near- and long-term policy priorities to expand savings and investment opportunities for lower-income households by reforming the U.S. tax code.

As a coalition of national organizations, the Tax Alliance has agreed on shared principles and is working to educate and engage its networks about why equitable, inclusive and progressive tax reform is crucial to building the long-term security of families, communities and the national economy.

The Tax Alliance convenes a working group that focuses specifically on tax credits for low-income workers and their families, including the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), the Child and Dependent Care Tax Credit (CDCTC) and the Retirement Savings Contributions Credit (Saver's Credit).

The working group has analyzed these tax benefits to determine each credit's significance in promoting economic mobility among low-income workers. This document reviews these tax provisions and proposes a set of policy ideas to strengthen them.

The principles outlined in this document were developed by the Tax Credits for Low-Income Workers Working Group and may not reflect the views of individual members of the Tax Alliance for Economic Mobility.

Policy Principles Snapshot

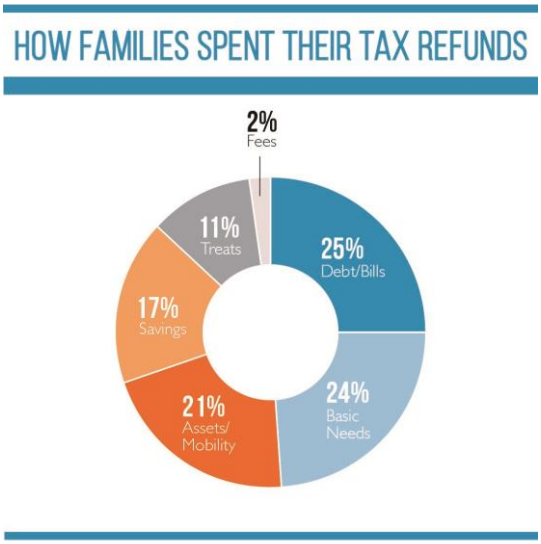
1. Build on the opportunity-boosting successes of the Earned Income Tax Credit and Child Tax Credit by strengthening these programs through actions that expand eligibility, refundability and inclusivity.
2. Protect honest, working-class families when strengthening program integrity.
3. Increase take-up and improve accessibility of the federal EITC.
4. Build on the success of the federal EITC by expanding it at the state level.
5. Strengthen the Saver's Credit, so that it fully delivers on its promise of helping low- and moderate-income workers save for retirement.
6. Improve the Child and Dependent Care Tax Credit to help working families with the high cost of child care.

The Importance of Tax Credits to Create Financial Security and Opportunity for Working Families and Children

Unlike many other poorly-designed tax exemptions and deductions that deliver the bulk of their benefits to the highest-income filers, the EITC and CTC can be accessed by low-income working families.

The EITC is a federal tax credit for low- and moderate-income workers that rewards work and offsets federal payroll and income taxes. The credit is "refundable," meaning that if the value of the credit exceeds a worker's federal income tax liability, the IRS will refund the balance. To date, twenty-nine states, plus the District of Columbia, have established their own EITCs to supplement the federal credit.[1]

The CTC is a federal tax credit designed to help working families offset the cost of raising children. Unlike the EITC, the CTC is only partially refundable, meaning that it is partly, but not entirely, available to low- and moderate-income families with low levels of federal income tax liability.



Source: Sarah Halpern-Meekin et al., *It's Not Like I'm Poor*, 2015.

Together, both the EITC[2] and CTC[3] are powerful tools for building financial security and boosting opportunity for working families and their children. The EITC and CTC are also especially important for women of color, who make up a disproportionately large share of the low-wage workforce.[4]

In 2017, these credits collectively lifted more than nine million people out of poverty, including more than five million children.[5] Research shows families use the EITC and CTC not only to pay routine bills and afford basic needs, but also to pay down debt, including avoiding evictions, which are lowest in February[6] (soon after the tax filing season has begun). Families also use these credits to save, build assets and make other investments that help build mobility, such as spending on training or education, or homeownership and home repairs.[7]

In addition to encouraging work and improving financial security, a substantial body of research suggests the income from the EITC and CTC helps build opportunity for children in families that receive the credits at virtually every stage of life. Research indicates that these children perform better in school, are likelier to attend college and have increased earnings and work effort in adulthood. The EITC is also linked to improvements in the health of infants and mothers.[8]

The Child and Dependent Care Tax Credit (CDCTC) is a federal tax credit designed to help families meet the cost of the child and dependent care that allows them to work and their loved ones to thrive. With average annual costs ranging between $3,000 and $23,000,[9] many families struggle with the high cost of child care. And in 2017, the median annual cost for full-day, adult dependent care services totaled almost $19,000.[10] Unfortunately, fewer than one in six eligible children receives direct assistance through the Child Care and Development Block Grant.[11] The CDCTC provides tax assistance to families with child and dependent care expenses by allowing them to claim a percentage of eligible expenses as a "non-refundable" tax credit, meaning that the credit is designed to lower a family's federal income tax liability up to a zero balance. While the CDCTC is structured to be more valuable for lower-income families, the fact that the CDCTC—unlike the EITC and CTC—is non-refundable limits how much low- and moderate-income families can benefit from the credit. Because many low- and moderate-income families have little or no tax liability (especially if they claim the CTC), they may be unable to fully benefit from the CDCTC.

Similarly, while the Saver's Credit is also unique in that it targets and helps low- and moderate-income workers contribute to their retirement accounts and build longer-term financial security, it is also a non-refundable tax credit. As a result, it leaves low- and moderate-income workers who have little or no federal income tax liability unable to receive the full benefit from this program. For example, while the maximum Saver's Credit is $1,000 per saver, the actual average credit claimed by workers was worth just $177 in 2014.[12] At the same time, although workers can claim the credit through private Individual Retirement Accounts (IRAs), uptake of the Saver's Credit is further limited by uneven access to workplace retirement plans, which are the primary way most Americans save for the long-term. According to recent research, half of private sector workers are not offered a retirement account at work, and the proportion is even higher among lower-income workers and workers of color.[13]

Ultimately, the EITC, CTC, CDCTC and the Saver's Credit work together with other aspects of the tax code that improve opportunity for working families and their children, including tax incentives that make higher education more affordable, such as the American Opportunity Tax Credit.[14]

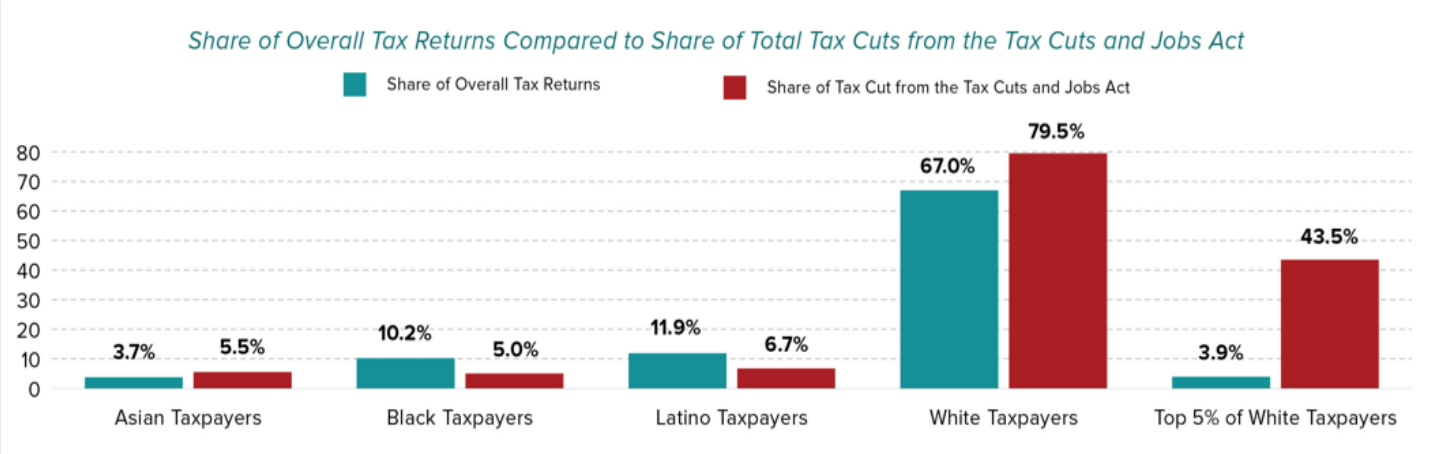
Despite Changes to the Tax Code, Strengthening Tax Credits for Workers Remains a Priority

The federal tax code spends hundreds of billions of dollars each year through tax subsidies and tax breaks to help families purchase a home, attend college, and save and invest for the future.

Unfortunately, the tax code overwhelmingly benefits wealthy households, while providing very little, if any, support for working families. To put this dynamic into greater perspective, consider that in 2017, prior to the passage of the Tax Cuts and Jobs Act (TCJA), a millionaire received an average tax benefit of $160,000, while a working family earning about $50,000 received just $226.[15] At the same time, while the IRS does not collect data by race (or gender), research published by PolicyLink[16] and Prosperity Now,[17] (both members of the Tax Alliance) has found that tax benefits skew heavily towards White households, meaning that low- and moderate-income households of color are doubly disadvantaged under the tax code.

Despite substantial changes to the federal tax code, the TCJA did little, if anything, to make it more equitable, inclusive and progressive for households of color and working families. In fact, because the TCJA favors income earned through passive means—such as investment—rather than wages, it mostly benefits wealthy White households. As a result, the TCJA leaves very little for working households, especially those of color, to build financial security and wealth.

Recent research from Prosperity Now and the Institute on Taxation and Economic Policy (ITEP) found that of the nearly $275 billion in tax cuts within the TCJA, $218 billion (80%) go to White households, and more than 40% go to White households in the top 5% of earners (with incomes of $243,000 or more). As a direct result of this skew, White households will receive an average of $2,020 in cuts from the TCJA while Latino and Black households will receive $970 and $840, respectively.



SOURCE I *Race, Wealth and Taxes: How the Tax Cuts and Jobs Act Supercharges the Racial Wealth Divide*, Prosperity Now, ITEP

Beyond the racial inequities in the distribution of benefits from the TCJA, the law also failed to strengthen tax credits for low- and moderate-income workers and their families. In some instances, despite any improvements made within the TCJA to expand the reach and impact of these tax credits, the 2017 law either erodes their value and/or leaves many low-income families unable to fully reap their benefits or access them at all.

For example, the TCJA failed to not only expand the EITC's ability to help more families, it also failed to address the glaring gap facing "childless workers" (including non-custodial parents) not raising dependent children in the home. It also failed to address the fact that the EITC continues to completely exclude young childless workers—including youth formally in foster care—below the age of 25 who are trying to get a toehold in the economy, as well as individuals over the age of 65. For low-income childless workers who are either completely ineligible for the EITC or receive only a small EITC, this unaddressed gap means that they remain the sole group that is either taxed or pushed deeper into poverty by the federal tax code.[18] At the same time, the implementation of a less generous inflation adjustment measure within the TCJA—intended to hold down the overall cost of the new law—also means that the EITC will lose its value over time.[19]

The TCJA took a step in the right direction by increasing the maximum CTC available per-child from $1,000 to $2,000. But this is limited by the fact that the credit is still not accessible to many low- and moderate-income families due to its partial refundability. As a result, children in these families qualify for only a very small CTC or no tax credit increase at all, even though they are the children who need it most and for whom it would have the largest beneficial impact.

This is particularly true for the youngest children, who have higher poverty rates than older children and for whom research finds even modest improvements in family income can have big developmental impacts.[20] Eleven million children, for example, are in low-income families that only receive a token CTC increase of $75 or less. That is because, under prior law, the refundable portion of the CTC was limited to 15% of earnings above $3,000 a year and the TCJA only reduced that threshold to $2,500.[21] A single parent with two children earning $14,500, therefore, only gets a $75 CTC increase because she does not have enough earnings to benefit from the rest of the increase in the maximum credit.[22] An additional 15 million children in moderate-income families also don't receive the full CTC increase because the refundable portion is limited to $1,400 per child (adjusted for inflation moving forward) instead of $2,000.[23] This cap on refundability is new: before the 2017 tax law, if a child's parents had enough earnings, they could qualify for the $1,000-per-child CTC.[24] Even more unfortunate, the TCJA's new requirement that a social security number be provided for each child claimed for the CTC will deny the credit to an estimated one million children in immigrant families that pay taxes.

The TCJA also failed to improve the CDCTC, despite bipartisan support for improving this credit.[25] In fact, the TCJA actually *reduced* the value of the CDCTC for many low- and moderate-income families, likely because of the law's limitation on the amount of refund received from the CTC.[26] As a result, families receive even less assistance in meeting their child care expenses, despite the rising cost of child care across the country.

Ultimately, any benefits low- and moderate-income households would enjoy from changes to credits focused on low-income workers and families could be offset when cuts are made by Congress to critical programs that support health, housing and food assistance, due to the law's $1.9 trillion-dollar cost.[27]

Principles for Reform

As we have highlighted throughout this brief, the EITC, CTC, CDCTC and the Saver's Credit provide crucial support to millions of families and their children each year. They are well-targeted to reduce poverty and are proven to support and encourage work, support children's development throughout life and boost retirement savings. Unlike many other tax incentives that primarily benefit higher-income taxpayers, these credits are progressive. As a result, these credits do not need broad restructuring. Rather, reforms are necessary to ensure that these credits can achieve their full potential towards helping low- and moderate-income working families. To accomplish these goals, policymakers should build on each credit's strengths and successes, while also closing gaps in access to the credits and improving their effectiveness. More specifically, policymakers should:

1. **Build on the opportunity-boosting successes of the EITC and CTC by strengthening these programs through actions that expand eligibility, refundability and inclusivity.** As a first step, the EITC and CTC should be expanded to workers who are currently excluded or receive disproportionately small benefits and are thus largely locked out of the tax credits' proven successes. A key priority in this area is fully extending the EITC's pro-work success to childless adults, including non-custodial parents, as well as workers and qualified foster youth under 25 and workers over 65. The CTC should also be made fully refundable to further help low-income families or, at the very least, policymakers should let the credit begin to phase in at the first dollar of earnings, increase the phase-in rate and eliminate the $1,400 refundability cap. After helping the workers and families that the current structure of the credits mostly leaves out, policymakers should also consider expanding these credits.

   In that spirit, policymakers should also oppose proposals that deny tax credits to hard-working low- and moderate-income families and their children. For example, proposals to deny the CTC to immigrant parents who pay their taxes using an IRS Individual Taxpayer Identification Number (ITIN) should be rejected. Many of these families are of mixed immigration status, and several million children in these families who are U.S. citizens would be affected.[28] In addition to increasing hardship, such proposals would likely have long-lasting harmful effects on the affected children, given the research linking workers' tax credits with positive impacts on children's development.

2. **Protect honest working families when strengthening program integrity.** The EITC and CTC are among the most complex elements of the tax code. This means that working families can make honest mistakes while filing taxes. Untrained or unscrupulous commercial tax preparers who lack credentials are also a leading source of error. Commercial preparers file a majority of EITC returns, and a majority of EITC overpayments occur on commercially prepared returns.[29]

   In seeking to reduce errors, policymakers should avoid dubious proposals purporting to address errors or fraud. For example, lawmakers should reject measures that are primarily eligibility or cost restrictions masquerading as error-reduction proposals. These measures cut or greatly delay the receipt of tax credits for large numbers of working families who are honestly and accurately claiming them. Lawmakers should also reject proposals for onerous new paperwork and filing requirements that would deter or prevent working families from claiming the credits for which they qualify.

   Policymakers should, however, take other responsible measures to reduce error and overpayments that do not reduce accessibility or cut tax credits for honest working families—and would in fact better protect these families. For example, in addition to providing the IRS with adequate resources to administer current program integrity measures effectively, including those enacted at the end of 2015, policymakers should provide the IRS the authority to ensure commercial tax preparers meet minimum competency standards. This would meaningfully reduce errors without placing undue hardship on tax filers. Several EITC and CTC rules can also be simplified in ways that might reduce errors and improve accessibility.

3. **Increase take-up and improve accessibility of the federal EITC.** About four out of five eligible workers claim the EITC nationwide,[30] but more can be done to ensure that all workers claim the tax credits they have earned. Federal support for the Volunteer Income Tax Assistance (VITA) program, which helps low-income taxpayers file their returns, should be strengthened. Researchers and policymakers should also explore options for allowing filers more delivery channels to receive the EITC (such as periodic payment options), while ensuring that filers can continue to choose how they receive tax credits in a way that suits them. Policymakers should also continue to improve coordination of the credits with initiatives to improve emergency and long-term savings (such as split refund) and other financial security and opportunity-building initiatives that can be accessed at tax time.

   Proposals that reduce the accessibility of the credits should be rejected. This includes proposals that significantly increase the paperwork burden on honest low-income families seeking to file for tax credits that they have earned. Such barriers do not exist for tax credits and subsidies that go to high-income families and businesses.

4. **Build on the success of the federal EITC by introducing or expanding state EITCs.** More states should join the twenty-nine states, plus the District of Columbia, that currently boost incomes for working families by supplementing the federal EITC with a state credit. States that already have an EITC should consider making it more generous by increasing the share of the federal credit that it matches or increasing its refundability.[31]

5. **Strengthen the Saver's Credit so that it fully delivers on its promise of helping low-income workers save for retirement**. Each year, the federal government spends billions on tax incentives for retirement, but little help goes to most working families. In 2017, approximately $112 billion was spent through tax incentives to support retirement savings.[32] Overall, the average tax benefit from these programs for households in the top 20% of the income distribution that year was more than $4,700, while for the bottom 40% of income earners it was an average of $80.[33] Distributional inequities like these are partially to blame for low retirement savings among most working families.

   As we noted earlier, the Saver's Credit is a bright spot for working families, but it needs reform. The Saver's Credit should be made fully refundable, so that all working families—whether they owe income tax or not—can receive support for retirement savings. The credit should also be restructured to more effectively incentivize low- and moderate-income workers to save for retirement. This can be achieved by providing the credit as a savings match directly into the filer's retirement savings account.[34] The credit should also be made easier to claim to increase its uptake. Currently, because of the complexity involved in filing for the Saver's Credit, only 5.3% of income eligible taxpayers filed for the credit in 2014.[35] To address problems stemming from filing complexities, lawmakers should

emulate the filing process of less complicated tax credits designed to benefit low- and moderate-income taxpayers, such as the EITC. [36]

Finally, policymakers at the state level should expand access to the Saver's Credit through the use and/or expansion of state-sponsored retirement plans (e.g. California's CalSavers program, the Illinois Secure Choice Savings Program, etc.), as well as through tax-time outreach efforts to educate the public about the Saver's Credit.

6. **Improve the CDCTC to help working families with the high cost of child care.** Lower-income families spend a substantially larger share of their income on child care than higher-income families,[37] and the CDCTC is designed to be more valuable for these families (by providing a higher percentage of expenses for lower-income families). However, the credit's lack of refundability limits its utility for lower-earning families. Indeed, in 2018, families with incomes under $30,000 are estimated to receive only about 1% of the overall benefits from the CDCTC, and the average tax credit for families in this income range is negligible.[38]

   To provide meaningful help to low- and moderate-income families, policymakers should make the CDCTC refundable. In 2006, it was estimated that making the credit refundable would allow over a million families to benefit from it for the first time.[39] In addition, the credit should be expanded by increasing the percentage of expenses that are used to calculate the credit. Currently, families with adjusted gross income of over $43,000 only receive 20% of their eligible child care expenses, even though families at this income level still struggle with child care costs. The credit should also be improved by raising limits on the child and dependent care expenses that can be claimed. Under current law, the amount of expenses that can be claimed for the CDCTC is $3,000 per child or dependent, and $6,000 for two or more children or dependents, despite the fact that average child care costs far exceed those amounts in almost every state. Finally, indexing the expense limits and income levels for inflation would ensure that the CDCTC does not decrease in value over time.

   Improving the federal CDCTC would also increase the value of state child and dependent care tax provisions that are based on the federal credit.[40]

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[12] Jennifer Erin Brown and David C. John, *Issue Brief: Improving the Saver's Credit for Low-and Moderate-Income Workers* (Washington, DC: National Institute on Retirement Security, 2017), 5.

[13] David John and Gary Koenig, *Fact Sheet: Workplace Retirement Plans Will Help Workers Build Economic Security* (Washington, DC: David John and Gary Koenig, 2014), 2.
[14] For more information about all of our principles for reforms, including on the issue of higher education, visit the "Policy Reforms" section of our website.
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[35] Ibid, 9.
[36] Ibid, 9.
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