

Low-Income Tax Policy: Increases in Tax Credits for Tax Year 2003 are Good News for Working Families

Introduction

When many low- and moderate-income taxpayers file their 2003 tax returns in 2004, they are likely to receive additional money due to increases in two tax credits for working families at both the federal and state level. Both the Earned Income Tax Credit (EITC), available to many working families with modest incomes, and the Child and Dependent Credit (CDCC), available to families with allowable child or dependent care expenses, will increase in value in Tax Year 2003. In addition, New York State continues to be a leader in exempting low- and modest-income families from paying any state taxes, having the seventh highest tax threshold nationwide (ie., the income level which families must reach before they begin to pay any state taxes). These issues are discussed in depth in this issue of *SCAA on-line Reports*.

Federal and New York State Earned Income Tax Credit (EITC) Both Increase for Tax Year 2003

Background: EITC Increases Annually

Each year the federal EITC is indexed for inflation. This leads to a higher income eligibility ceiling for the credit and growth in the size of the credit itself. Eligibility levels for the federal EITC are slightly higher for married couples with children than for non-married filers, as a way to partially address a marriage penalty in the EITC.

New York's EITC, because it is tied on a percentage basis to the federal EITC, increases in the same fashion. In addition, New York's EITC will grow from 27.5% to 30% of the federal EITC in Tax Year 2003, as the final year of a four-year expansion becomes effective. It will remain at 30% of the federal EITC for tax years after 2003.

Tax Year 2003 Specifics: Who is Eligible and How Large is the Maximum Credit

When taxpayers begin to file their Tax Year 2003 tax returns in early 2004, maximum EITC eligibility levels and maximum credits will be as follows:

<u>Family Type</u>	<u>Eligibility Ceiling</u>	<u>Maximum Federal EITC</u>	<u>Maximum State EITC</u>
With one child	\$29,666	\$2,547	\$ 764
Married w/ one child	\$30,666	\$2,547	\$ 764
With 2 or more children	\$33,692	\$4,204	\$1,261
Married w/ 2 or more children	\$34,692	\$4,204	\$1,261
No children	\$11,230	\$ 382	\$ 115
Married no children	\$12,230	\$ 382	\$ 115

Claiming Rates: Too Many Eligible Taxpayers Still Don't Claim the EITC

Over 1.2 million taxpayers in New York claimed nearly \$2.6 billion in federal EITC credits in the last year for which data is available. When it is fully phased-in in Tax Year 2003, the state EITC will provide over 1.1 million taxpayers with nearly \$700 million in tax credits. These EITC benefits tend to be re-spent in communities and therefore have a large positive domino effect on local economies.

Estimates are that approximately 75-80% of those eligible for the federal and state EITC actually claim benefits. While this is a high participation rate compared to many direct benefit programs like food stamps, it still leaves 20-25% of eligible taxpayers without the EITC benefits to which they are entitled. As a result, a sizable amount of federal and state EITC benefits may go unclaimed in New York. The IRS currently estimates that this loss could be as large as \$650 million in federal EITC benefits and nearly \$200 million in state EITC benefits for eligible New York taxpayers.

File for Your EITC in Tax Year 2003 and For Up to Three Previous Tax Years

As previously, you must file both a federal and state tax return to claim the EITC for Tax Year 2003. To file for the federal EITC, taxpayers raising children must complete either federal Form 1040 or 1040A as well as fill out and attach Schedule EIC. Workers not raising children can file any federal tax form including Form 1040 EZ. They do not fill out Schedule EIC. Instead they simply write EIC on the appropriate line on the federal return.

To file for the state EITC you must have filed for the federal EITC and you must fill out a state income tax return as well as attach a completed Schedule IT-215, *Claim for Earned Income Credit*.

You may also "backclaim" the EITC for the three previous tax years. If you believe you were eligible in Tax Year 2000, 2001 and/or 2002, but did not claim the benefit, you may simply file amended federal and state tax returns for any or all of those years to "backclaim" the EITC.

Federal Tax Changes Greatly Increase Value of Federal and State Child and Dependent Care Credit (CDCC)

Background: Increases Take Effect for Tax Year 2003

The federal Economic Growth and Tax Relief and Reconciliation Act of 2001 made changes to the federal Dependent Care Credit that take effect in Tax Year 2003. These changes include increasing:

- the maximum amount of eligible employment-related expenses from \$2,400 annually to \$3,000 annually for one qualifying child or dependent in care and from \$4,800 to \$6,000 annually for two or more qualifying children or dependents in care.
- the maximum allowable credit from 30% to 35% of qualifying expenses allowing for a maximum credit of \$1,050 for one child or dependent and \$2,100 for two or more children or dependents. Before Tax Year 2003, these maximum credits were \$720 for one qualifying child and \$1,440 for two or more.
- the income level for receipt of the maximum credit from the pre- TY 2003 level of \$10,000 annually to \$15,000 annually and then phases the maximum percentage down from 35% to 20% as income goes up.

While these changes increase the value of the federal dependent care credit, the federal credit remains non-refundable. This means that lower income families with out-of-pocket child care expenses cannot take the full value of the federal credit for which they qualify, because its value cannot exceed their actual tax liability. Since lower income families often have little or no federal tax liability the federal dependent care credit, while important, is limited in value for these families. These increases will, however, provide larger benefits in the form of reduced tax liability for middle-income families with child care expenses. The largest increases in the federal credit (by at least 60%) will go to families with incomes between \$18,000 and \$33,000 annually and maximum allowable child care costs.

However, the increases to the federal Dependent Care Credit will have a significant impact on the New York State Child and Dependent Care Credit (CDCC), which is linked on a percentage basis to the federal credit and is refundable. This means that to the degree the state CDCC exceeds an eligible taxpayer's actual state tax liability, the remainder will come to them in the form of a tax refund.

How Do These Federal Changes Increase New York's CDCC?

New York's CDCC was already the most generous in the nation and it gets even more generous starting in Tax Year 2003 as a result of the federal changes. As an example, a family in New York with two qualifying children under age 13 in child care that allows them to work or look for employment (assuming the provider of that care has a tax ID# or social security number) and with income of \$15,000 annually as well as maximum allowable out-of-pocket costs for child care of \$6,000 annually, can receive a credit of \$2,310 in New York.

This calculation begins with a calculation of the federal Dependent Care Credit. The federal credit allows \$6,000 in qualified expenses for two or more children in care and allows families at this income level to claim a credit of up to 35% of qualifying expenses or \$2,100 (\$6,000 times 35%). The maximum NYS CDCC for this family is equal to 110% of the federal credit or \$2,310 (\$2,100 times 110%).

If a family receives a direct subsidy for any portion of their child care in New York, only their actual out-of-pocket expenses that exceed the value of their subsidy will count as qualifying expenses for the federal or state CDCC. So, if the same family were having 60% of their \$6,000, or \$3,600 in child care costs subsidized, only the remaining \$2,400 in out-of-pocket expenses would count towards determining the NYS CDCC, which in this instance would be \$924 (\$2,400 times 35% times 110%).

All eligible New York taxpayers can receive a state CDCC on a sliding scale according to their income. The state CDCC is equal to 110% of the federal credit if income is below \$25,000 annually. Families with incomes between \$25,000 and \$50,000 can claim from 110% to 100% of the federal credit for which they are eligible. Families with incomes between \$50,000 and \$65,000 can claim between 100% and 20% of the federal credit for which they are eligible. Families with incomes above \$65,000 can claim 20% of the federal credit for which they are eligible. In total, the State CDCC is expected to provide eligible taxpayers with over \$230 million in credits in Tax Year 2003.

Again, taxpayers must file both federal and state tax returns in 2003 as well as the appropriate forms to claim the CDCC.

New York Continues to Have One of the Nation's Highest Tax Thresholds for Low-Income Families

The point at which a family begins to have any state tax obligation is called a state's tax threshold. In New York in Tax Year 2002, a two-parent family of four had no state tax obligation if their Adjusted Gross Income (AGI) was \$26,838 or below. This is the seventh highest tax threshold nationwide and the third highest among the 10 most populous states nationwide. Only California and Pennsylvania are more generous among populous states, while Maryland, Rhode Island, Vermont and Minnesota are smaller states with more generous tax thresholds. New York's tax threshold also increases annually due to indexing of the state's standard deduction and the EITC. The chart below outlines how New York's Tax Threshold or Point of Zero Tax Liability is determined.

Point of Zero Tax Liability is Calculated as:

AGI	\$26,838
Standard Deduction	\$14,200
<u>Exemptions</u>	<u>\$ 2,000</u>
Taxable Income	\$10,638
Tax Owed Before Credits:	\$426
Household Credit	– \$ 55
<u>EITC</u>	<u>– \$371</u>
Tax Liability	\$ 0

Another measure of the generosity of a state's tax system towards low-income workers is how it taxes income for families at the poverty level. **In New York in 2002 a single parent family of three (adult and two children) with a poverty level income of \$14,351** had a negative tax liability of (\$1,015). This generous treatment is predominantly due to the state's sizable EITC. In contrast, 15 states actually impose some level of income taxes on the same families at poverty. The calculation of this tax treatment of families with a poverty level income is shown below.

NYS Tax Liability at Poverty Line is Calculated as:

AGI	\$14,531
Standard Deduction	\$10,500
<u>Exemptions</u>	<u>\$ 2,000</u>
Taxable Income	\$ 1,851
Tax Owed Before Credits:	\$ 74
Household Credit	– \$ 90
<u>EITC</u>	<u>– \$ 999</u>
Tax Liability	– \$ 1,015

These tax thresholds will increase again for Tax Year 2003 due to indexing of both the standard deduction and the state EITC.

Internal Revenue Service (IRS) Scales Back Proposed EITC Pre-Certification Proposal

The IRS proposed last summer to implement a broad new pre-certification procedure (in reality a pre-audit) for what they termed “error prone filers” for the Earned Income Tax Credit (EITC). The proposal, in response to reports of high error rates in the EITC from the 1990’s (much of which has already been corrected through new legislation tightening rules, and application procedures), would have affected 45,000 EITC recipient households with children, predominantly comprised of grandparent, aunt, and uncle headed households, single father and foster parent households.

These households would have had to file an IRS form prior to being allowed to file an actual claim for EITC benefits as part of their tax return. This proof of child residency form (Form 8836), which is complicated and often required third-part verification, would have had to be submitted by these families by December 31, 2003 to demonstrate, as a condition of eligibility, that the child(ren) they claimed for EITC purposes:

- currently lived with them
- were in their care for more than six months in the Tax Year.

The IRS intended to rapidly expand this EITC pre-certification over the next several tax years to several million EITC recipients.

A main concern with requiring that Form 8836 be submitted before the actual tax return was that taxpayers would be left to their own devices in trying to complete this complicated form at a time when neither free nor commercial tax preparation sites are operating. Many who commented also felt the pre-certification proposal singled out low-income taxpayers for a higher standard of proof than high-income taxpayers, with no evidence that poor families cheat on their taxes more often. This “guilty before proven innocent” approach to the EITC pre-certification proposal was roundly criticized by many, including the US Conference of Mayors.

The IRS received voluminous critical comments from advocates, tax professionals, city and state officials, and other civic and charitable organizations that these procedures would have an enormous chilling effect on participation by EITC eligible households. As a result, the IRS greatly scaled back the pre-certification program to a much narrower pilot. Now only 25,000 EITC recipients will be affected in Tax Year 2003. Also, rather than being required to file Form 8836 prior to filing an actual Schedule EIC with their tax return, filers will only have to attach the form to their actual return. The IRS also announced that it will carefully assess the results of the initial pilot project before proceeding with any major expansion. For detail about the original IRS proposal, review SCAA’s comments on the pre-certification proposals through the following link: www.scaany.org/docs/july_irs_comments.pdf.

For further information about any of the tax issues addressed in this issue of *SCAA on-line Reports*, please contact Russell Sykes by e-mail at rsykes@scaany.org. SCAA will also be pursuing further low- and moderate-income state tax relief in years to come including additional reforms to the EITC, further expansion of the CDCC, enactment of a state child tax credit, expansion of the college tuition tax credit, adoption of a child care worker tax credit and others. These tax policy issues are addressed in more detail in SCAA’s December 2002 Policy Brief, *Utilizing the Tax System to Help Low and Moderate Income Working Families in New York*, which can be found at the following link www.scaany.org/docs/utilizing_taxsystem.pdf. Finally, SCAA will release the 2004 edition of its annual *Helping Hands for Working Families Outreach Tool Kit* in January of 2004 and will post it on our website at that time. The annual *Helping Hands Tool Kit* contains the latest eligibility and application information for numerous tax credits and direct benefit programs that help working families.