

A Credit with Too Few Takers

Crenshaw, Albert
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At an income level of less than about \$38,000 a year, many taxpayers aren't really tax payers. To the contrary, there is a special provision of the tax law that is designed not only to wipe out any taxes they might otherwise owe, but to give them cash back even beyond that.

This provision is called the Earned Income Tax Credit, and today it is the government's largest program for aiding low-income working families. The EITC, as it is widely known, shells out about \$40 billion a year to low-income earners and their dependents.

But the EITC is not a simple program. It involves phaseouts and dependency requirements, and other twists and turns that, while typical of today's tax laws, can be intimidating to people not accustomed to filling out forms.

Also, many low-income people are either unaware of the program or they underestimate its benefits, so they don't apply.

"This is a big problem. These households are such low income they don't owe taxes, and they know they don't owe, [so] they are not going to bother with the hassle," said Nicole Simpson, assistant professor of economics at [Colgate University](#) and coordinator of Volunteer Income Tax Assistance, which is based at the school. The nationwide assistance program is sponsored by the Internal Revenue Service and volunteers provide free tax preparation help.

Simpson said "it's very costly" to go to a commercial tax preparer for help. "They report paying over \$150 on average for H&R Block," and they figure "it's risky to pay that much not knowing what they are going to get back."

The EITC is also prone to error because of its complexity, and to fraud because of its generosity, so it is one of the most heavily audited credits in the tax law.

But for many low-income working families -- and even singles, who can also be eligible -- the effort can be well worthwhile.

The average refund turned up by Simpson's volunteers is nearly \$2,500, almost 20 percent of the \$14,000 average annual income her group's clients report. "They have no idea" they could get that much, she said.

One reason the refunds are so large is that the EITC is both a credit and "refundable."

A credit reduces your taxes dollar for dollar. Thus, if you owe \$3,000 in taxes and your situation entitles you to a credit of, say, \$2,000, the credit wipes out \$2,000 of your taxes, leaving you owing \$1,000.

(This is in contrast to a deduction, which reduces your taxable income, and thus reduces your taxes indirectly. Deductions save you the taxes you would have paid on that income, so they are of greater benefit to people in higher brackets. A \$1 deduction saves a taxpayer in the 35 percent bracket 35 cents; it saves a taxpayer in the 10 percent bracket 10 cents.)

If a credit is refundable, it means that when the credit exceeds the tax you owe, you also get whatever amount of the credit is left over. Thus, if you have a \$2,000 refundable credit and you owe \$1,000, it not only wipes out your tax, but you get the leftover \$1,000 back along with any tax you may have paid through withholding.

To qualify for the EITC, you must have "earned income," such as wages from a job; your "investment income," such as interest on savings accounts, cannot exceed \$2,700; and your adjusted gross income cannot exceed certain limits:

- \$11,750 if you're single and have no child, or \$13,750 if you're married and filing jointly with your spouse and do not have a child.
- \$31,030 if you are single and have one child, or \$33,030 if you are married filing jointly and have one child.
- \$35,263 if you are single and have more than one child, or \$37,263 if you are married filing jointly and have more than one child.

That may sound simple enough, but it's not. Any "child" you claim must be a "qualifying child."

To be a qualifying child for purposes of the EITC, your child must pass a three-step test based on relationship, age and residence.

The child must be your child or grandchild, or your brother, sister, half brother or half sister, step-brother or step-sister, or one of their children, such as a niece or nephew. A foster child can qualify, but only if he or she was placed in your home by a court or authorized placement agency.

The child must also be younger than 19 at the end of 2005 for this tax season, or younger than 24 if a full-time student.

And the child must have lived with you, in this country, for more than half the year.

This isn't all, of course.

The child cannot be claimed by another person to qualify for the credit, which often creates problems for divorced couples. The parents are allowed to decide between themselves who can claim a child for tax purposes, but if they don't agree then the IRS has a flow chart to work out who gets priority.

And if you are the qualifying child of another person, you can't claim the EITC, even if the other person doesn't claim the credit. This can be a problem for three-generation families, where, say, the middle generation has income and could benefit from the credit but can't claim it because he or she is the grandparent's qualifying child.

By some estimates 25 percent of the low-income people eligible for the EITC don't claim it, and it's easy to understand why. But for people within the income limits above, the benefit could be worth thousands -- as much as \$4,400 for a family with two children -- so it's worth searching out a free-assistance site or perhaps a commercial preparer. To locate a Volunteer Income Tax Assistance site, call the IRS at 800-829-1040.