

**EARNED INCOME TAX CREDIT PORTABILITY:
RESPECTING THE AUTONOMY OF AMERICAN FAMILIES**

*Mary Leto Pareja**

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* Assistant Professor of Law, University of New Mexico School of Law; Smith College, B.A., 1991; Georgetown University Law Center, J.D., 1996. The Author wishes to thank Professor Robert Nassau of the Syracuse University College of Law and Professors Max Minzner, Sergio Pareja, and Nathalie Martin of the University of New Mexico School of Law for helpful comments on earlier drafts and Ernesto Longa for research assistance. Opinions expressed in this Article are solely those of the Author, as are any omissions or errors.

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[The Earned Income Tax Credit is] the best anti-poverty bill, the best pro-family measure, and the best job creation program ever to come out of the Congress of the United States.

– Ronald Reagan¹

[W]e will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty.

– William Jefferson Clinton²

I. INTRODUCTION

The earned income tax credit (“EITC”) is the largest federal cash assistance poverty relief program in the United States today.³ It is a powerful

¹ Ronald Reagan, upon signing the 1986 Tax Reform Act which made the EITC a permanent feature of the Code. Ronald Reagan, U.S. President, Remarks on Signing the Tax Reform Act of 1986 (Oct. 22, 1986), available at <http://www.reagan.utexas.edu/archives/speeches/1986/102286a.htm>; see also, Lea Donosky, *Sweeping Tax Overhaul Now the Law*, CHI. TRIB., Oct. 23, 1986, available at http://articles.chicagotribune.com/1986-10-23/news/8603190647_1_tax-code-tax-reform-tax-bills-next-year.

² William Jefferson Clinton, U.S. President, Address Before a Joint Session of Congress on Administration Goals, 139 CONG. REC. 2871, 2873 (Feb. 17, 1993), available at <http://www.presidency.ucsb.edu/ws/?pid=47232>.

³ In 2010, the federal government spent \$54.7 billion on the EITC, almost 30% of the entire outlay for all public assistance and related programs combined (\$183.1 billion including the EITC). The second-largest needs-based cash assistance program in 2010 was the supplemental

tool for reducing poverty among the lowest-level earners in American society. President Obama, in his 2014 State of the Union Address, explained that “few [measures] are more effective at reducing inequality and helping families pull themselves up through hard work than the Earned Income Tax Credit. Right now, it helps about half of all parents at some point.”⁴ There have been regular proposals for reform and improvement,⁵ but the EITC is a successful and popular program.⁶ It is easy to understand why the EITC enjoys bipartisan support;⁷ the left appreciates the social welfare aspect of the credit, while the

security income program at \$43.9 billion. In comparison, TANF (welfare) payments were only \$21.9 billion in 2010. The federal government spent \$95 billion in 2010 on food and nutrition assistance programs, including food stamps. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2012, Sec. 9, 313, tbl. 474, available at <http://www.census.gov/prod/2011pubs/12statab/fedgov.pdf>.

⁴ Barack Obama, U.S. President, President Barack Obama’s State of the Union Address (Jan. 28, 2014), available at <http://www.whitehouse.gov/the-press-office/2014/01/28/president-barack-obamas-state-union-address>.

⁵ See, e.g., Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, 88 N.Y.U. L. REV. 515, 520 (2013); Kerry A. Ryan, *EITC as Income (In)Stability?*, 15 FLA. TAX REV. 583 (2014); George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL’Y 225 (1994).

⁶ Politicians are becoming increasingly concerned with the “welfare” aspect of the credit. See STEVE HOLT, BROOKINGS INST., *THE EARNED INCOME TAX CREDIT AT AGE 30: WHAT WE KNOW* 3 (2006), available at <http://www.brookings.edu/research/reports/2006/02/children-families-holt>. In the 2012 Presidential election, candidate Mitt Romney was secretly taped at a fundraising event bemoaning that 47% of Americans pay no federal income taxes and are dependent on the government. Candidate Romney noted that he would “never convince them they should take personal responsibility and care for their lives.” *Romney’s Speech from Mother Jones Video*, N.Y. TIMES, (Sept. 19, 2012), <http://www.nytimes.com/2012/09/19/us/politics/mitt-romneys-speech-from-mother-jones-video.html?pagewanted=all&r=0>. The 47% statistic was accurate. For tax year 2013, the number has decreased to about 43%. Importantly, about two-thirds of the 43% pay payroll taxes, which means they are workers taken off the tax rolls by policies like the EITC. Slightly less than one-fourth of the 43% are non-working elderly. Only about 5% of all households fall outside these categories. TAX POL’Y CTR., URBAN INST. & BROOKINGS INST., *Who Doesn’t Pay Federal Tax*, <http://www.taxpolicycenter.org/taxtopics/federal-taxes-households.cfm> (last visited Sept. 7, 2014). Mr. Romney’s interpretation of the statistics reveals that the EITC is still viewed with some suspicion.

⁷ Republican support seems to be fading. See note 6 for a discussion of political concern about the social welfare aspects of the EITC. Additional concern has focused on fraudulent EITC claims. See Leslie Book, *EITC Noncompliance: What We Don’t Know Can Hurt Them*, 99 TAX NOTES 1821 (2003). The IRS estimated that in fiscal year 2012, between 21–25% of EITC claims were paid in error, with a dollar value between \$11.6 and \$13.6 billion. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REPORT NO. 2013-40-024, *THE INTERNAL REVENUE SERVICE WAS NOT IN COMPLIANCE WITH ALL REQUIREMENTS OF THE IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT FOR FISCAL YEAR 2012* (2013), available at <http://www.treasury.gov/tigta/auditreports/2013reports/201340024fr.pdf>. Commentators were quick to report a 25% “fraud” rate for the EITC. See, e.g., Paul L. Caron, *TIGTA: IRS Fails to Comply Mandated Reduction in Improper Payments—25% Fraud Rate Costs \$14 Billion/Year*, TAXPROF BLOG (Apr. 22, 2013), http://taxprof.typepad.com/taxprof_blog/2013/04/tigta-irs-.html. However, even

right can stand behind the credit's encouragement to work.⁸ The EITC is "welfare"⁹ but only for "deserving poor" people; it is both qualities joined together that have generated bipartisan support.¹⁰ However, the system leaves many low level earners behind. Specifically, this Article examines how the system cheats parents who do not live together.

Imagine two people who are unmarried and have two children together. The couple used to live together, but now they live apart. They live in a rural area. Dad commutes 30 miles each way to the nearest urban center to work two part-time minimum-wage jobs to make ends meet. He is lucky to have the work as he does not even have a high school diploma. Mom does not work outside the home. There is little job opportunity in their rural area, and she lacks access to reliable child care. Both are caring and responsible parents. The family court placed both of the children with Mom, largely because of their work situations. Dad's schedule is erratic. He is often gone from home for work. Mom, being unemployed, can devote more time to parenting. Dad pays child support and has unsupervised visitation when his schedule permits. He almost always sees the children on weekends, even when they cannot spend the night with him.

This is exactly the type of family that Congress intended to help with the EITC. The family works; the family is low income; the family has children. The EITC is intended to help lift this family (in particular the children) out of poverty while simultaneously encouraging them to continue working. However, currently, this family would receive \$0 in EITC. That's right—\$0! This family

if the figure were accurate, the evidence is far from clear what percentage of the erroneous payments stems from fraud perpetrated by taxpayers, what percentage stems from fraud perpetrated by unscrupulous tax preparers, and what percentage stems from innocent errors in filing, primarily due to the complexity of the law. See ROBERT GREENSTEIN ET AL., CTR. ON THE BUDGET & POLICY PRIORITIES, REDUCING OVERPAYMENTS IN THE EARNED INCOME TAX CREDIT (2013), available at <http://www.cbpp.org/files/4-30-13tax.pdf>.

⁸ See, e.g., Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Size Adjustment to the Minimum Wage*, 57 TAX L. REV. 301 (2004) [hereinafter Zelenak, *Family-Size Adjustment to the Minimum Wage*].

⁹ The Author hesitates to label the EITC welfare in any sense because welfare is a very loaded term. Professor Brown has very eloquently argued that calling a program welfare amounts to playing a race card. Programs perceived as welfare face far greater scrutiny; Professor Brown argues this is so because most Americans associate welfare with black people. Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790 (2007). Despite this, it is clear, as discussed *infra*, that the EITC is, at least in part, an anti-poverty social welfare program. In other words, it is true that the EITC is, in part, "welfare." The Author sincerely hopes that one day we can call a spade a spade without fear of losing the farm.

¹⁰ There is a debate about whether the EITC is a tax benefit or a welfare program. The EITC is best understood as both. The reason the EITC has been politically successful is due in large part to its appeal to both sides of the political aisle. Those on the left can embrace the EITC's redistributive effect (its "welfare-ness") while those on the right can embrace the EITC's work incentives (its "for the deserving poor only-ness"). See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1873 (2005) [hereinafter Zelenak, *Tax or Welfare?*] (describing the EITC as a "hybrid tax-transfer program").

completely forfeits the most important federal anti-poverty benefit. Why? Because Mom does not work but devotes herself to the children, relying on Dad's work for support. The exact same family would generate a large EITC (up to \$5,460 in 2014) if they lived together. However, because this family has made a personal decision to live in separate homes, they lose an important federal benefit.

This example is not fiction. It is based on actual clients that the Author worked with at a low-income taxpayer clinic. Situations like this play out repeatedly in law clinics across the country. Since the Great Recession, more and more families living apart are finding themselves in this situation because one of the parents has lost a job.

What causes families like this to lose the EITC and what can be done about it? Children can save taxpayers a lot of money on taxes.¹¹ However, children cannot be claimed by more than one taxpayer. Detailed, and often convoluted, eligibility rules determine who can claim children for various tax purposes.¹² When a child can legitimately be claimed by more than one taxpayer, tie-breaker rules determine the taxpayer allowed to claim the child.¹³ Although the eligibility and tie-breaker rules could be improved in many ways, this Article examines one rule in particular. When a child's parents live apart, the custodial parent is allowed to claim the child. The custodial parent, however, can waive his or her right to claim the child and allow the noncustodial parent to claim the child. However, this waiver can only shift the child for purposes of the dependent exemption amount and the child tax credit; the waiver cannot shift the child for purposes of head of household filing status or the EITC. This seriously limits the family's ability to enhance the EITC through tax planning. Upper-income families commonly use tax arbitrage to increase the family's wealth; there is no legitimate reason why lower-income families should be prohibited from doing the same.

This Article proposes that Congress amend the Internal Revenue Code ("Code")¹⁴ to allow custodial parents to sign a waiver granting the noncustodial parent the right to claim a child not only for the child tax credit and dependent exemption amount but also for the EITC. This Article does not propose other changes in the eligibility rules. Although problems exist with the requirements

¹¹ As discussed in *infra* Part III, in 2014 a qualifying child can potentially generate for a taxpayer a \$3,950 deduction for the dependent exemption amount, a \$1,000 child tax credit, and an EITC of up to \$3,305, as well as potentially entitle the taxpayer to the larger standard deduction and more favorable tax rates available to heads of households.

¹² See *infra* Part III for a discussion of when a dependent qualifies a taxpayer for a dependent exemption amount, the child tax credit, the EITC, and head of household status.

¹³ See *infra* Parts III.A.4 and III.A.5 for a discussion of what happens when more than one taxpayer is entitled to claim a child.

¹⁴ In this Article, the word "Code" refers to the Internal Revenue Code of 1986, as amended.

for custodial parent waivers,¹⁵ this Article does not propose changes to those rules. This Article also does not systematically address possible reforms that would address marriage penalties and bonuses in the EITC system, although this Article discusses marriage penalties and bonuses in order to place the proposal in context.

The first part of this Article discusses the EITC's history and policy objectives. The second part examines the mechanics of the current rule and examines current opportunities for tax arbitrage. The third part analyzes the current rule under traditional measures of tax policy analysis: horizontal and vertical equity, efficiency, and neutrality. It also looks at the current rule's effectiveness at advancing the EITC's policy goals. The Article ends with a detailed analysis of the Author's proposal and demonstrates why it is a superior approach to the current system.

II. HISTORICAL FRAMEWORK

In order to truly understand the EITC's policy goals, one must understand the political history of its enactment and subsequent expansions. The EITC, brainchild of Senator Russell Long,¹⁶ was born as a compromise measure in response to President Nixon's proposed "negative income tax."¹⁷ Nixon's 1969 proposal, the "Family Assistance Plan," was intended to replace the Great Depression-era "Aid to Families with Dependent Children" program (commonly known as "welfare").¹⁸ The family assistance plan borrowed heavily from negative income tax concepts first proposed by Milton Friedman in 1962.¹⁹ Under a negative income tax, a person receives a payment equal to some percentage of the amount by which their income is lower than a particular threshold.²⁰ For example, if (1) the percentage is 50%, (2) the threshold is

¹⁵ See, e.g., Robert G. Nassau, *How to Split the Tax Baby: What Would Solomon Do?*, 61 SYRACUSE L. REV. 83 (2010).

¹⁶ Long was a Democratic Senator for Louisiana from December 31, 1948, until January 3, 1987. Long, Russell Billiu — *Biographical Information*, CONG. BIOGRAPHICAL DIRECTORY, <http://bioguide.congress.gov/scripts/biodisplay.pl?index=l000428> (last visited Sept. 5, 2014).

¹⁷ Jane Gravelle & Jennifer Gravelle, *Taxing Poor Families: The Evolution of Treatment Under the Federal Income Tax*, 7 CONN. PUB. INT. L.J. 35, 38 (2008); Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 NAT'L TAX J. 983, 992 (2000) [hereinafter Ventry, *Political History of the Earned Income Tax Credit*]; Jodie T. Allen, *Present at the Creation*, SLATE MAG. (Dec. 13, 1999, 9:56 AM), http://www.slate.com/articles/news_and_politics/chatterbox/1999/12/present_at_the_creation.html.

¹⁸ Ventry, *Political History of the Earned Income Tax Credit*, *supra* note 17, at 987-88.

¹⁹ Zelenak, *Family-Size Adjustment to the Minimum Wage*, *supra* note 8.

²⁰ Jodie T. Allen, *Negative Income Tax*, in THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 1st ed. 1993), available at <http://www.econlib.org/library/Enc1/NegativeIncomeTax.html>.

\$10,000, and (3) a person has no income, then he or she would receive a payment of \$5,000 [50% of (\$10,000 minus \$0)].²¹ In effect, the negative income tax gives each person a guaranteed income.²² Although Nixon's proposal contained some work incentives, conservatives deemed them insufficient, and liberals were wary of the meager nature of the cash support provided.²³

The family assistance plan came very close to passing Congress;²⁴ however, it was defeated in 1972.²⁵ That same year, Senator Long proposed the EITC as an alternative,²⁶ but it too was rejected.²⁷ The EITC continued to be debated in Congress and ultimately was adopted in 1975.²⁸ The legislative history indicates the EITC was intended as an offset for payroll taxes paid by low-income workers.²⁹ However, it also was a compromise measure born in response to obvious interest in the negative income tax as an anti-poverty tool.³⁰ In addition, the EITC responded to concerns about anti-work incentives

²¹ *Id.*; Leland G. Neuberg, Emergence and Defeat of Nixon's Family Assistance Plan (FAP) (Jan. 2004) (unpublished manuscript), available at <http://www.usbig.net/papers/066-Neuberg-FAP2.doc>.

²² Allen, *supra* note 20; Neuberg, *supra* note 21.

²³ Zelenak, *Family-Size Adjustment to the Minimum Wage*, *supra* note 8; see also Ventry, *Political History of the Earned Income Tax Credit*, *supra* note 17.

²⁴ Zelenak, *Family-Size Adjustment to the Minimum Wage*, *supra* note 8.

²⁵ *Id.* Intriguingly, there has been at least one recent call to resurrect the negative income tax idea. Chris Farrell, *It's Time for a Negative Income Tax*, BLOOMBERG BUSINESSWEEK (Aug. 8, 2013), <http://www.businessweek.com/articles/2013-08-08/its-time-for-a-negative-income-tax>.

²⁶ Gravelle, *supra* note 17; V. Joseph Hotz & John Karl Scholz, *The Earned Income Tax Credit*, in MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES (Robert Moffitt ed., Univ. of Chic. Press 2003), available at <http://www.nber.org/chapters/c10256.pdf>; Zelenak, *Family-Size Adjustment to the Minimum Wage*, *supra* note 8, at 304 ("Long's proposal was for a 'work bonus,' a credit equal to 10% of the first \$4,000 of earned income, with the credit phased out at the rate of 25% as earned income rose above \$4,000.").

²⁷ Ventry, *Political History of the Earned Income Tax Credit*, *supra* note 17, at 992.

²⁸ Tax Reduction Act of 1975, Pub. L. No. 94-12, tit. II, § 204(a), 89 Stat. 30, 30-31 (1975) (codified in scattered sections of 26 U.S.C.).

²⁹ The House of Representatives included an EITC in the Tax Reduction Act of 1975. *Id.* The Senate Finance Committee indicated the purpose of the credit was to provide relief to earners with little or no tax liability by providing a refundable tax credit based on earned income noting that the credit amount was designed to "closely match [] the employee and employer social security tax on the first \$4,000 of income . . ." S. REP. NO. 94-19, at 36 (1975). The committee also found that it was "appropriate to use the income tax system to offset the impact of the social security taxes on low-income persons . . ." *Id.* at 29. The Senate Finance Committee agreed with the House that it was appropriate to offset social security taxes through an income tax system. *Id.* at 33.

³⁰ While fully agreeing with the goal of offsetting payroll taxes for low wage workers, the Senate Finance Committee had a narrower view of the scope of the new EITC. It explained that "the most significant objective of the provision should be to assist in encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls." S. REP. NO.

of traditional welfare³¹ and the reduced, but still present, anti-work incentives of negative income tax proposals.³² Thus, the original EITC had several different apparent purposes: (1) incentivize work, (2) reduce welfare rolls, and (3) offset the burden of payroll taxes on those least able to afford them.³³

Every single U.S. President since 1975 has expanded the EITC. President Ford signed the EITC into law in 1975.³⁴ The credit was made permanent in 1978 under President Carter³⁵ and was expanded and indexed for inflation under President Reagan's 1986 Tax Reform Act.³⁶ The credit was

9436, at 33 (1975). Thus, the Senate proposed an amendment increasing the amount of the credit and restricting the credit to "individuals who maintain a household." *Id.* at 34. The Senate wanted to offset payroll taxes, but only for those individuals likely to be eligible for welfare payments if they were not working. It was a strategy for moving families from welfare to work by making work more attractive than welfare (or at least not more unattractive). The Conference Committee adopted the Senate's version of the EITC. H.R. REP. NO. 94-120, at 58-59 (1975). It passed Congress and was signed by President Nixon.

³¹ The Aid to Families with Dependent Children (AFDC) program of the 1960s did not condition benefits on a mother working. Susan W. Blank & Barbara B. Blum, *A Brief History of Work Expectation for Welfare Mothers*, 7 WELFARE TO WORK 28, 29-30 (1997), available at http://www.princeton.edu/futureofchildren/publications/docs/07_01_02.pdf. Also, the family's income offset their benefits, an obvious disincentive to work. Stephen B. Page & Mary B. Larner, *Introduction to the AFDC Program*, 7 WELFARE TO WORK 20, 21 (1997), available at http://futureofchildren.org/futureofchildren/publications/docs/07_01_01.pdf; see also Peter Passell & Leonard Ross, *Daniel Moynihan and President-Elect Nixon: How Charity Didn't Begin at Home*, N.Y. TIMES, Jan. 14, 1973, <http://www.nytimes.com/books/98/10/04/specials/moynihan-income.html>.

³² This legislation was, in part, a welfare-to-work initiative. The Senate report to the original EITC legislation called the EITC a "work bonus" and noted that "[f]ederal welfare costs will be reduced by an estimated \$0.1 billion." S. REP. NO. 94-36, at 3 (1975).

³³ Payroll taxes are a flat percentage of covered income. Currently, employees pay payroll taxes through wage withholding of 7.65% of covered wages. I.R.C. § 3101(a)-(b) (2014). A worker making \$10,000 in wages each year pays 7.65% of those wages as payroll taxes, and a worker making \$70,000 of wages each year also pays 7.65% of those wages as payroll taxes. There is no effort to adjust the rates to reflect relative ability to pay. This flat tax system stands in sharp contrast with the progressive rates of the federal income tax, where lower levels of income are taxed at one percentage but higher levels of income are taxed at a higher percentage. The Code is codified at Title 26 of the United States Code. Tax lawyers commonly cite directly to the Code rather than to the United State Code, and this Article follows that convention. For example, I.R.C. § 3101 is a reference to 26 U.S.C. § 3101.

³⁴ Tax Reduction Act of 1975, Pub. L. No. 94-12, tit. II, § 204(a), 89 Stat. 30, 30-31 (1975) (codified in scattered sections of 26 U.S.C.).

³⁵ Revenue Act of 1978, Pub. L. No. 95-600, tit. I, §§ 104(a)-(e), 105(a), 92 Stat. 2763, 2772-73 (1978) (codified in scattered sections of 26 U.S.C.).

³⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, tit. I, §§ 104(b)(1)(B), 111(a)-(d)(1), tit. XII, §§ 1272(d)(4), tit. XIII, § 1301(j)(8), 100 Stat. 2085, 2104, 2107-08, 2594, 2658 (1986).

expanded again in 1990 under President George H. W. Bush, introducing a slightly higher credit for families with more than one child.³⁷

Nineteen ninety-three was a significant year in the EITC's history. In 1993, the credit was expanded under President Clinton, establishing a small credit for childless workers and increasing the credit for workers with children.³⁸ In 1993, the EITC's two primary policy reasons became clearer.³⁹ The rate of the credit for childless workers was (and remains) 7.65%, equal to the employee portion of federal payroll taxes,⁴⁰ thus underscoring the EITC's stated purpose of functioning as a payroll tax offset.⁴¹ Simultaneously, having substantially larger credit amounts for workers with children was motivated by the anti-poverty intent of the EITC.⁴²

The EITC continued to expand and develop in the 2000s. In 2001, President George W. Bush signed legislation designed to alleviate marriage penalties inherent in the EITC design.⁴³ Under President Obama, in 2008 the EITC was temporarily expanded for tax years 2009 and 2010 to provide for the first time a higher credit for families with three or more children.⁴⁴ In 2010, this

³⁷ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, tit. XI, §§ 11101(d)(1)(B), 11111(a)–(b), 11111(e), 104 Stat. 1388-405, 1388-408, 1388-412, 1388-413 (1990) (codified as amended in 26 U.S.C. § 32).

³⁸ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, tit. XIII, ch. 1, pt. 3, § 13131, 107 Stat. 312, 433–35 (1993) (codified as amended at 26 U.S.C. § 32).

³⁹ Arguably, there now are more than two policy objectives for the EITC. *See* Yin et al., *supra* note 5, at 260 (identifying as objectives of the EITC “a Social Security tax rebate, a work incentive, an income supplement, a benefit for children of low-income families, and an offset generally to regressive federal taxes”).

⁴⁰ I.R.C. §§ 32(b)(1)(C), 3101(a)–(b) (2014).

⁴¹ According to the House Budget Committee's report on the Omnibus Budget Reconciliation Act of 1993, “[T]he committee believes that extending the EITC to low-income working taxpayers without qualifying children will provide these taxpayers with an additional benefit for entering the labor force and reduce the burden of the individual income and payroll taxes on those with a lower ability to pay taxes.” H.R. Rep. No. 103-111, at 609 (1993).

⁴² The House Budget Committee's report explained that “[p]roviding a larger basic EITC to larger families recognizes the role the EITC can play in alleviating poverty. Moreover, this larger credit may provide work incentives and increase equity by reducing the tax burden for those workers with a lower ability to pay taxes.” H.R. Rep. No. 103-111, at 609 (1993); *see also supra* note 2 and accompanying text.

⁴³ Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, tit. III, §§ 303(a)–(f), (h), 115 Stat. 38, 55–57 (2001) (codified as amended at 26 U.S.C. § 32).

⁴⁴ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, div. B., tit. I, § 1002, 123 Stat. 115, 312 (2009) (codified as amended at 26 U.S.C. § 32).

temporary expansion was extended through 2012.⁴⁵ In 2013, it was extended again through 2017.⁴⁶

Twenty-seven states have enacted state versions of the EITC.⁴⁷ Twenty-two of them are refundable, like the federal credit.⁴⁸ Five of them are nonrefundable.⁴⁹ Most piggyback off of the federal eligibility rules; if a taxpayer is eligible for the federal credit, he or she is also eligible for the state credit.⁵⁰ Even some localities have enacted small local credits.⁵¹

Understanding the political history of the EITC helps in analyzing the structure and impact of the rules. The EITC often is described as a payroll offset measure, and indeed that has been a purpose since the beginning.⁵² However, the EITC also was part of the welfare reform and welfare-to-work movements.⁵³ The EITC cannot legitimately be called a general anti-poverty measure. Despite the small EITC for childless workers, the primary focus of the EITC has been on alleviating poverty for families with children.⁵⁴ Its main concern is not with lifting people out of poverty, but with lifting children out of poverty.⁵⁵

⁴⁵ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, tit. I, § 103(c), 124 Stat. 3296, 3299 (2010) (codified as amended in 26 U.S.C. § 32).

⁴⁶ American Taxpayer Relief Act of 2012, Pub. L. No. 112240 § 103(c), 126 Stat. 2323, 2319–20 (2013) (codified as amended in 26 U.S.C. § 32).

⁴⁷ See *States and Local Governments with Earned Income Tax Credit*, IRS, <http://www.irs.gov/Individuals/States-and-Local-Governments-with-Earned-Income-Tax-Credit> (last visited Sept. 6, 2014); see also *States with EITCs*, TAX CREDITS FOR WORKING FAMILIES, <http://www.taxcreditsforworkingfamilies.org/earned-income-tax-credit/states-with-eitcs/> (last visited Sept. 6, 2014).

⁴⁸ See IRS, *States and Local Governments with Earned Income Tax Credit*, *supra* note 47; see also *Tax Credits for Working Families*, *supra* note 47.

⁴⁹ See IRS, *States and Local Governments with Earned Income Tax Credit*, *supra* note 47; see also *Tax Credits for Working Families*, *supra* note 47.

⁵⁰ See IRS, *States and Local Governments with Earned Income Tax Credit*, *supra* note 47; see also *Tax Credits for Working Families*, *supra* note 47.

⁵¹ See IRS, *States and Local Governments with Earned Income Tax Credit*, *supra* note 47; see also *Tax Credits for Working Families*, *supra* note 47.

⁵² See *supra* note 29 and accompanying text.

⁵³ See *supra* note 30 and accompanying text.

⁵⁴ See *supra* note 41 and accompanying text.

⁵⁵ However, in his 2014 State of the Union Address, President Obama indicated a desire to bolster the credit for childless workers, saying, “I agree with Republicans like Senator Rubio that it doesn’t do enough for single workers who don’t have kids. So let’s work together to strengthen the credit, reward work, and help more Americans get ahead.” Obama, *supra* note 4. The President’s proposal does not obviate the need for this Article’s proposal, however. Indeed, they would work well in tandem.

III. MECHANICS OF THE CURRENT RULE

In order to understand how current law impacts taxpayers and why this Article's proposal is a superior approach, it is necessary to understand how current law functions. There are four primary child-based tax benefits: (1) the dependent exemption, (2) the EITC, (3) the child tax credit, and (4) head of household filing status.⁵⁶ Prior to 2005, the eligibility requirements for each were distinctly different. In 2005, Congress attempted to adopt "uniform" definitions of dependent and qualifying child.⁵⁷ While the rules are more uniform now, important (and confusing) differences remain.⁵⁸ All of these rules are interrelated, however. To understand one, a person must understand the others. This part examines the rules for each of these four benefits in subsequent subparts. This part also analyzes the tax arbitrage opportunities presented by the current rules. In other words, it looks at the extent to which cooperative parents can generate tax savings under the current rules.

A. *The Dependent Exemption Amount*

Section 151 of the Code allows taxpayers to deduct from income a "personal exemption" amount⁵⁹ for themselves, their spouse if filing jointly,⁶⁰ and for eligible dependents claimed on the return.⁶¹ For tax year 2014,⁶² the

⁵⁶ See Nassau, *supra* note 15.

⁵⁷ Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, tit. II, 118 Stat. 1166, 1169-78, (2004) (codified as amended in scattered sections of 26 U.S.C.); see also Danshera Cords, *Paid Tax Preparers, Used Car Dealers, Refund Anticipation Loans, and the Earned Income Tax Credit: The Need to Regulate Tax Return Preparers and Provide More Free Alternatives*, 59 CASE W. RES. L. REV. 351, 360 (2009).

⁵⁸ See Jonathan P. Schneller et al., *The Earned Income Tax Credit, Low-Income Workers, and the Legal Aid Community*, 3 COLUM. J. TAX L. 176, 189 (2012) ("[T]he qualifying child issue illustrates this complexity: a taxpayer's child can be qualifying under the dependency exemption but not for the EITC, or vice versa. The lack of a uniform definition of qualifying child confuses claimants unfamiliar with the tax system . . .").

⁵⁹ The term "exemption" is a confusing misnomer, given that the amount of the "personal exemption" is actually a below-the-line deduction from adjusted gross income.

⁶⁰ This is a simplification of the spousal exemption rules. If the taxpayers are filing jointly, each gets a personal exemption as taxpayers. If they are not filing jointly, the taxpayer may claim a personal exemption for his or her spouse if the spouse had no gross income and was not the dependent of another taxpayer. I.R.C. § 151(b) (2014).

⁶¹ I.R.C. § 151.

⁶² Taxpayers must report their taxes on a fiscal year basis. Most individuals are required to use the calendar year as their fiscal year. I.R.C. § 441. Therefore, "tax year 2014" for an individual is the same as calendar year 2014. One potential source of confusion is the difference between the tax year and the tax filing season. The return for tax year 2014 for an individual will be due on April 15, 2015, without extensions. The filing season for tax year 2014 occurs in 2015. Another potential source of confusion is the difference between a tax year and a fiscal year. Tax

personal exemption amount is \$3,950.⁶³ Beginning in 2013, personal exemption amounts are phased out for higher-income taxpayers.⁶⁴ This subpart examines the rules for claiming a personal exemption amount for a dependent. First, there are general rules that all taxpayers must meet. Second, certain dependents may be considered “qualifying children,” which is a status that unlocks eligibility for the other child-based tax benefits. Third, certain dependents may be considered “qualifying relatives.” Fourth, there are tie-breaker rules that apply when more than one taxpayer is eligible to claim a dependent. Finally, there are exceptions to the normal rules that could allow a noncustodial parent to claim a dependent with the consent of the custodial parent. Each of these groups of rules is discussed in turn.

1. General Rules for Claiming Dependents

Three initial qualifying rules must be met before a taxpayer can claim a dependent. The tests are as follows:

(1) *Taxpayer Cannot Be a Dependent*: The taxpayer must not be the dependent of another taxpayer.⁶⁵ In other words, dependents cannot have dependents.

(2) *Potential Dependent Has Not Filed a Joint Return*: If a person files a joint return, that person cannot be the dependent of another taxpayer.⁶⁶ However, if the return is only a claim for a refund (i.e., of income taxes withheld) and neither spouse⁶⁷ would owe taxes had they filed separately, then the joint return will not bar a dependency claim.⁶⁸

year 2014 for taxpayers using a non-calendar year fiscal year refers to the fiscal year that ends in 2014. Because this Article is discussing tax attributes that apply only to individuals, and because almost all individuals report taxes on a calendar year basis, the term “tax year 2014” and similar terms in this Article refer to calendar year 2014.

⁶³ Rev. Proc. 2013-35, 2013-47 I.R.B. 537. There is a base exemption amount of \$2,000 which is indexed annually for cost of living increases. I.R.C. §§ 151(d)(1), 151(d)(4)(A).

⁶⁴ I.R.C. § 151(d)(3). In 2014, the exemption is subject to a phase-out that begins with adjusted gross income of \$254,200 (\$305,050 for married couples filing jointly) and that phases out completely at adjusted gross income of \$376,700 (\$427,550 for married couples filing jointly). Rev. Proc. 13-35, 2013-47 I.R.B. 537.

⁶⁵ I.R.C. § 152(b)(1). For example, if a grandparent lives with his or her child and grandchild, and if the grandparent is eligible to claim the child as a dependent, the child may not claim the grandchild as a dependent on a tax return.

⁶⁶ I.R.C. § 152(b)(2).

⁶⁷ This Article considers persons married if they are considered married under the Code. If Code section 7703 allows a married couple to be considered unmarried, this Article also considers them unmarried. See I.R.C. § 7703.

⁶⁸ See *Martino v. Comm’r*, 71 T.C. 456 (1978); see also Rev. Rul. 54-567, 1954-2 C.B. 108, *aff’d* Rev. Rul. 65-34, 1965-1 C.B. 86.

(3) *Citizenship Test*: The potential dependent must be a citizen or national⁶⁹ of the United States or a resident of the United States,⁷⁰ Canada, or Mexico.⁷¹

If these threshold tests are met, a dependent exemption is allowed if the dependent is either a “qualifying child” or a “qualifying relative.”⁷²

2. Qualifying Child

The definition of qualifying child is critical to all of the child-based tax benefits. The qualifying child rules are incorporated into all of the child-based tax benefits,⁷³ with important exceptions that are discussed as they arise. The following tests apply for “qualifying child” status:

(1) *Relationship Test*: The dependent must be (a) the taxpayer’s child, stepchild, or eligible foster child⁷⁴ or the descendent of such person or (b) the taxpayer’s brother, sister, stepbrother, stepsister, half-brother, or half-sister or the descendant of such person.⁷⁵ One does not need to be the taxpayer’s child to be a “qualifying child.”

(2) *Residence Test*: The dependent must have the same “principal place of abode” as the taxpayer for more than one-half of the tax year.⁷⁶ There

⁶⁹ U.S. nationals are people who are not citizens of the United States but who are born in or have ties to a possession of the United States. The term “national” was added alongside the term “citizen” starting in tax year 1972 in order to give American Samoans the right to personal exemption amounts. Act of Oct. 27, 1972, Pub. L. No. 92-580, 86 Stat. 1276 (1972).

⁷⁰ A resident of the United States for tax purposes is not defined solely by immigration laws. A person can be a U.S. resident for tax purposes (1) if he or she is a lawful permanent resident under the U.S. immigration laws or (2) if he or she meets a substantial presence test designed to determine whether the person was physically present in the United States (authorized or not) for a substantial amount of time during the tax year. I.R.C. § 7701(b). *See also* Blankson v. Comm’r, No. 10845-00S, 2003 WL 356118 (U.S. Tax Ct.) (2003) (non-reviewable case, persuasive value only).

⁷¹ I.R.C. § 152(b)(3). There is an exception for children adopted by or placed for adoption with a taxpayer who is a citizen or national of the United States if the child lives with the taxpayer as a member of the taxpayer’s household. I.R.C. § 152(b)(3)(B).

⁷² I.R.C. § 152(a).

⁷³ For example, if a taxpayer has a qualifying child, that potentially allows the taxpayer to claim a dependent exemption amount, a child tax credit, an EITC, and head of household status. These rules are discussed in detail in this Part III.

⁷⁴ The term “eligible foster child” means “an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.” I.R.C. § 152(f)(1)(C).

⁷⁵ I.R.C. §§ 152(c)(1)(A), 152(c)(2), 152(f)(1)(A). Adopted children are treated as children by blood. I.R.C. § 152(f)(1)(B).

⁷⁶ I.R.C. § 152(c)(1)(B). It is this residence test that prevents noncustodial parents from claiming the EITC. In general, the residence test, while simple enough on its face, presents major hurdles for many low-income taxpayers. When the IRS audits a return and requests proof that a

is an exception for noncustodial parents, but the exception does not apply for purposes of the EITC or head of household filing status. This exception is discussed further *infra* in Part III.A.5.

(3) *Age Test*: The dependent must be younger than the taxpayer (and the taxpayer's spouse if filing jointly) and be under age 19 at the close of the year or under age 24 and a full-time student during at least five calendar months of the year.⁷⁷ There is no age limit if the dependent is permanently and totally disabled at any time during the year.⁷⁸

(4) *Support Test*: The dependent cannot have provided over one-half of his or her own support during the year.⁷⁹

(5) *Joint Return Test*: The dependent cannot have filed a joint return for the year, except if the return was filed solely to claim a refund.⁸⁰

3. Qualifying Relative

A taxpayer may take a dependent exemption for a "qualifying relative" who is not a "qualifying child."⁸¹ Having a qualifying relative also may qualify

dependent meets the residence test, the taxpayer must be able to obtain reliable, documentary evidence from the year of the return that proves residence that spans at least a six-month period. This documentary hurdle often proves insurmountable for families that move frequently or do not use traditional child care. See Nat'l Taxpayer Advocate, IRS, *Volume Two: TAS Research & Related Studies*, 2012 ANN. REP. TO CONGRESS 71, 79–81 [hereinafter 2012 NTA, *Study of Tax Court Cases*], available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Volume-2.pdf>.

⁷⁷ I.R.C. §§ 152(c)(1)(C), 152(3)(A). The age requirement must be met as of the "close of the calendar year in which the taxable year of the taxpayer begins." *Id.* As discussed in *supra* note 59, this Article assumes that the tax year is the same as a calendar year. However, if the taxpayer's tax year is not a calendar year, taxpayers must read the requirements very carefully.

⁷⁸ I.R.C. § 152(c)(3)(B). Permanently and totally disabled is defined in Code section 22(e)(3).

⁷⁹ I.R.C. § 152(c)(1)(D). This is a different standard than a requirement that the taxpayer provide most of the dependent's support. That was the rule prior to 2005. Measuring support can be very tricky and proof issues loom large. Earned income and investment income earned by a potential dependent count as the dependent providing their own support, but only if the money is actually spent on support items. If the dependent put the money in a savings account, it would not count toward support. See *Dick v. United States*, 218 F. Supp. 839 (E.D. Wis. 1963); see also IRS, PUBLICATION 17: YOUR FEDERAL INCOME TAX FOR INDIVIDUALS 34 (2013) [hereinafter IRS, PUBLICATION 17], available at <http://www.irs.gov/pub/irs-pdf/p17.pdf>. Similarly, non-needs-based Social Security benefits paid on behalf of the potential dependent (such as survivor's benefits) count as the dependent providing their own support if the money is actually spent on support items. See *id.*; see also Rev. Rul. 57-344, 1957-2 C.B. 112. However, needs-based support payments provided by a state, such as SNAP (food stamps), TANF (welfare), or housing subsidies are considered support provided by the state, not the potential dependent, unless the payments are not used for support. See IRS, PUBLICATION 17, *supra*, at 34; see also *Lutter v. Comm'r*, 514 F.2d 1095 (7th Cir. 1975); Rev. Rul. 71-468, 1971-2 C.B. 115. Similarly, foster care payments by a placement agency are support provided by the agency, not the potential dependent. *Id.*

⁸⁰ I.R.C. § 152(c)(1)(E).

a taxpayer for head of household filing status. However, neither the EITC nor the child tax credit extends to taxpayers with qualifying relatives.⁸² The eligibility rules to be a qualifying relative are not directly relevant to this Article because a qualifying relative does not support an EITC claim. Thus, they are not explained in depth. The rules are discussed in IRS Publications 17 and 501.

4. Tie-Breaker Rules

All the child-based tax benefits must be claimed as a group; they cannot be split among various otherwise-eligible taxpayers.⁸³ However, separated parents may split some tax benefits between them.⁸⁴ For example, a mother cannot use a child for the EITC while the father uses the same child for the child tax credit (unless they are separated and comply with special rules).

Even if more than one taxpayer is eligible to claim a dependent, only one may do so.⁸⁵ In these cases, special tie-breaker rules apply. When a

⁸¹ I.R.C. § 152(d)(1)(D). This is really a tie-breaker rule. If a person is a qualifying child of one taxpayer but the qualifying relative of another taxpayer, the taxpayer with the qualifying child relationship wins. There is an important exception to this general rule. The taxpayer with the qualifying relative relationship to the dependent can claim the dependent if the person who has the qualifying child relationship is not required to file an income tax return (for example, because he or she makes too little income to have a filing obligation) and if the person with the qualifying child relationship either (1) does not actually file a return, or (2) files a return solely to obtain a refund of withheld income taxes. IRS Notice 08-5, 2008-2 I.R.B. 256. If the person with a qualifying child relationship files a tax return to obtain a refund of withheld income taxes and also claims the EITC, then this rule is not triggered and the qualifying child relationship has precedence over the qualifying relative relationship. *Id.*

⁸² There is a special rule that permits a noncustodial parent to claim a child as a qualifying relative even if the noncustodial parent does not provide more than one-half of the potential dependent's support for the year. Then the qualifying relative support test is ignored if the custodial parent has shifted the right to claim the child to the noncustodial parent, as discussed in *infra* Part III.A.5. However, this rule would operate to treat a child as the qualifying relative of a noncustodial parent, rather than as his or her qualifying child, only in unusual circumstances. For example, it could apply when the child is too old to be a qualifying child. It also could apply when the child provides over half of his or her own support, disqualifying him or her from being a qualifying child. If this rule is triggered, it does not entitle the noncustodial parent to claim an EITC based on that child.

⁸³ IRS Notice 06-86, 2006-2 C.B. 680; IRS, PUBLICATION 501: EXEMPTIONS, STANDARD DEDUCTION, AND FILING INFORMATION 17 (2013) [hereinafter IRS, PUBLICATION 501], available at <http://www.irs.gov/pub/irs-pdf/p501.pdf>. There is a list of tax benefits that must be grouped together by child. All of the tax benefits discussed in this Article fall within that list.

⁸⁴ See *infra* Part III.A.5.

⁸⁵ See IRS, PUBLICATION 501, *supra* note 83, at 17. When a dependent is claimed on more than one tax return, both taxpayers are commonly audited. For example, if mom claims her child on her tax return and so does dad, the IRS's computers will flag the dual use of the child's taxpayer identification number, and both will be audited. In addition, any refund claimed by the second-to-be-filed return typically is frozen until the audit is completed. See IRS, INTERNAL

dependent is the qualifying child (or qualifying relative) of more than one taxpayer, special rules decide which taxpayer may claim the dependent for various tax purposes.⁸⁶ As discussed above, if a person is the qualifying relative of one taxpayer and the qualifying child of another taxpayer, the taxpayer with the qualifying-child relationship may claim the dependent.⁸⁷ Sometimes the tie-breaker is needed between a parent and a non-parent. If the dependent is the qualifying child of two or more taxpayers, one of whom is the parent, the child's⁸⁸ parent is allowed to claim the child.⁸⁹ Effectively, an eligible parent has a right-of-first refusal against any non-parent to claim his or her child. For example, if a child lives with the child's mother and grandmother, the mother is entitled to claim the child.⁹⁰ However, if an eligible parent does not claim the child, another taxpayer may do so as long as that other taxpayer has an adjusted gross income ("AGI") greater than the otherwise-eligible parent.⁹¹ AGI is a tax term of art. It is the taxpayer's gross income as reported on his or her return less certain "above-the-line" deductions, such as the deduction for alimony paid, the deduction for certain tuition payments, and the deduction for one-half of self-employment taxes.⁹² Thus, in the above example where the child is living with his or her mother and grandmother, the grandmother can claim the child as long as (1) the mother does not do so and (2) the grandmother's AGI is greater than the mother's AGI.⁹³

Sometimes the tie-breaker is needed between more than one eligible non-parent. If more than one non-parent can claim the dependent as a qualifying child, the one with the highest AGI is allowed to claim the dependent.⁹⁴ This is true provided that either (1) the parents are not eligible to claim the child or (2) the parents do not actually claim the child and any

REVENUE MANUAL 4.19.15.13 (2014), available at http://www.irs.gov/irm/part4/irm_04-019-015r.html#d0e2544.

⁸⁶ For a description of some pre-2001 tie-breaker rules, see JANET HOLTZBLATT & ROBERT REBELEIN, *Measuring the Effect of the Earned Income Tax Credit on Marriage Penalties and Bonuses*, in MAKING WORK PAY: THE EARNED INCOME TAX CREDIT AND ITS IMPACT ON AMERICA'S FAMILIES 166, 193 n.4-5 (Bruce D. Meyer & Douglas Holtz-Eakin eds., Russell Sage Found. 2001).

⁸⁷ I.R.C. § 152(d)(1)(D) (2014).

⁸⁸ This Article's examples refer to the potential dependent as the "child" because that is the most common context in which these issues arise. Recall, however, that adults and those in a relationship other than parent-child can be considered a "qualifying child." See *supra* Part III.A.2.

⁸⁹ I.R.C. § 152(e)(4).

⁹⁰ See IRS, PUBLICATION 501, *supra* note 83, at 17 ex. 3.

⁹¹ I.R.C. § 152(e)(4)(A).

⁹² I.R.C. § 62.

⁹³ See IRS, PUBLICATION 501, *supra* note 83, at 17 exs. 1 & 2.

⁹⁴ I.R.C. § 152(e)(4)(A).

otherwise-eligible parent has a lower AGI than the non-parent allowed to claim the child.⁹⁵

Sometimes the tie-breaker is needed between two parents. If more than one parent actually claims the child as a qualifying child, then the parent with whom the child lived longer during the year is granted the dependent.⁹⁶ For example, if a child lives with his mother and mid-year both move into the father's home, the mother may claim the child because the child lived with her longer. If the child lived with the parents an equal amount of time, then the parent with the higher AGI is allowed to claim the child.⁹⁷

Notice that the tie-breaker rule between parents is fundamentally different than the tie-breaker rule between non-parents. The tie-breaker rule between non-parents compares two (or more) taxpayers who are otherwise eligible to claim a child and determines which of them is allowed to claim the child. They cannot agree amongst themselves who will claim the child.⁹⁸ The rule works differently between parents. The tie-breaker rule between parents compares two taxpayers each of whom actually attempts to claim the child.⁹⁹ In other words, parents can agree who will claim the child; as long as only one parent actually does claim the child, then the tax claim is valid.¹⁰⁰

5. Exceptions for Noncustodial Parents

An exception allows a parent who could not claim a child under the normal rules to do so.¹⁰¹ Normally, a qualifying child must live with the taxpayer more than half of the year.¹⁰² That means that the custodial parent normally is allowed to claim the child, assuming that the parents live apart for most of the year. The custodial parent is the parent who actually has custody for the greater portion of the year.¹⁰³ However, special rules allow the custodial

⁹⁵ *Id.* There are excellent examples of this surprisingly complex rule in IRS Publication 501.

⁹⁶ I.R.C. § 152(c)(4)(B).

⁹⁷ *Id.*

⁹⁸ See IRS, PUBLICATION 501, *supra* note 83, at 18 ex. 11. Of course, speaking practically, if they make such an agreement and if only one of them actually claims the child, it would be highly unlikely that the IRS would detect the error.

⁹⁹ The wording is significant. The rule applies to “parents *claiming* any qualifying child” whereas the non-parent tie-breaker rule applies where a child “*may be claimed* as the qualifying child of another taxpayer.” I.R.C. §§ 152(c)(4)(B), 152(c)(4)(A) (emphasis added).

¹⁰⁰ See IRS, PUBLICATION 501, *supra* note 83, at 18 exs. 9 & 10.

¹⁰¹ This rule applies to shift either qualifying child status or qualifying relative status. However, cases where the noncustodial parent would be claiming a child as a qualifying relative instead of as a qualifying child are rare. See *supra* note 82. This Article assumes the status being shifted is that of qualifying child.

¹⁰² See *infra* Part III.A.2.

¹⁰³ A court order usually suffices to demonstrate which parent has custody for more nights during the year. However, if the parents do not follow the parenting plan, the parent who actually

parent to shift the dependent exemption (and the child tax credit) to the noncustodial parent. This is allowed when all of the following are true:

(1) the child receives over one-half of his or her support from the child's parents;¹⁰⁴

(2) the child is in the custody of one or both of the parents for more than one-half of the year; and

(3) the child's parents (a) are divorced or legally separated under a decree of divorce or separate maintenance,¹⁰⁵ (b) are separated under a written separation agreement, or (c) live apart at all times during the last six months of the year.¹⁰⁶

If these threshold criteria are satisfied, then the custodial parent can shift the dependent exemption (and the child tax credit) to the noncustodial parent.¹⁰⁷ This must be done in a very particular fashion, however. The custodial parent must execute IRS Form 8332 and the noncustodial parent must include the Form 8332 with his or her return.¹⁰⁸

has custody of the child for more nights during the year is considered the custodial parent. *See* IRS, PUBLICATION 504: DIVORCED OR SEPARATED INDIVIDUALS, at 8 (2013) [hereinafter IRS, PUBLICATION 504], available at <http://www.irs.gov/pub/irs-pdf/p504.pdf>.

¹⁰⁴ The support rules discussed in *supra* note 79 apply here. Caution is needed when people or entities other than the parents are contributing to the child's support. Common issues arise when grandparents or other relatives are providing cash or in-kind support or when the child is receiving social security or needs-based benefits (which may be considered support they provide for themselves or support provided by the state).

¹⁰⁵ This is determined by reference to state law. Not all state court orders constitute a decree of divorce or a decree of separate maintenance. *See* *Frazier v. Comm'r*, 638 F.2d 63 (8th Cir. 1981) (an order of support and protection issued by a state court was not a legal separation under Code section 152).

¹⁰⁶ I.R.C. § 152(e)(1) (2014). The requirement here is that the parents live apart for the last six months of the year, not simply for any six months or six months cumulatively.

¹⁰⁷ Although beyond the scope of this Article and an uncommon situation, if a multiple support agreement is required for the custodial parent to claim the child as a qualifying relative, then the dependent exemption amount cannot be shifted to the noncustodial parent under the special rule for "divorced" parents. I.R.C. § 152(e)(5).

¹⁰⁸ Regulations permit a taxpayer to not use IRS Form 8332, but the substitute "must conform to the substance of [Form 8332] and must be a document executed for the sole purpose of serving as a written declaration under [Section 152(e)]." Special Rule for a Child of Divorced or Separated Parents or Parents Who Live Apart, 26 C.F.R. § 1.152-4(e)(ii) (2014). Common family court documents fail this test because they serve functions in addition to waiving the right to claim a dependent. Thus, for all practical purposes, taxpayers are required to use IRS Form 8332. Other scholars have noted the practical problems this presents for parents living apart. *See* Nassau, *supra* note 14. If a court orders that the deduction be shifted to the noncustodial parent, it is best practice to have the custodial parent execute Form 8332 before the court closes the case. If the custodial parent refuses to execute Form 8332, the court can order him or her to do so. *See generally* IRS, FORM 8332: RELEASE/REVOCATION OF RELEASE OF CLAIM TO EXEMPTION FOR CHILD BY CUSTODIAL PARENT (2010) [hereinafter FORM 8332], available at <http://www.irs.gov/pub/irs-pdf/f8332.pdf>.

B. Head of Household Filing Status

The Code provides more favorable tax attributes for head of household taxpayers.¹⁰⁹ The head of household standard deduction is higher than the single or married filing separately standard deduction.¹¹⁰ The standard deduction is used only if the taxpayer does not elect to itemize his or her deductions (i.e., if the standard deduction is higher than the taxpayer's itemized deductions). The standard deduction reduces a taxpayer's income, regardless of the amount of the taxpayer's actual expenses. Head of household filers also enjoy more favorable tax rate brackets.¹¹¹ A taxpayer is eligible for head of household status if the following tests are met:

(1) *Considered Unmarried*: The taxpayer was considered unmarried as of the last day of the year.¹¹² A taxpayer is considered unmarried if (1) the taxpayer actually is unmarried, (2) the taxpayer is separated from his or her spouse under a decree of divorce or of separate maintenance,¹¹³ (3) the taxpayer is married to a nonresident alien,¹¹⁴ (4) the taxpayer's spouse (other than a

¹⁰⁹ See Francine J. Lipman, *Taxing Undocumented Immigrants: Separate, Unequal, and Without Representation*, 59 TAX LAW. 813, 842 (2006).

¹¹⁰ I.R.C. § 63(c)(2). For 2014, the standard deduction amounts are \$12,400 for married filing jointly, \$9,100 for head of household, \$6,200 for single, and \$6,200 for married filing separate. Rev. Proc. 2013-35, 2013-47 I.R.B. 537. There are higher amounts for taxpayers who are blind or aged and lower amounts for taxpayers who can be claimed by someone else as a dependent. I.R.C. §§ 63(c)(3), 63(c)(5).

¹¹¹ I.R.C. § 1. In 2014, the tax brackets are as follows for single and head of household:

Bracket	Single	Head of household
10%	\$0 to \$9,075	\$0 to \$12,950
15%	\$9,076 to \$36,900	\$12,951 to \$49,400
25%	\$36,901 to \$89,350	\$49,401 to \$127,550
28%	\$89,351 to \$186,350	\$127,551 to \$206,600
33%	\$186,351 to \$405,100	\$206,601 to \$405,100
35%	\$405,101 to \$406,750	\$405,101 to \$432,200
39.6%	\$406,751 and up	\$432,201 and up

Rev. Proc. 2013-35, 2013-47 I.R.B. 537. This means that a head of household has his or her income taxed at lower rates as compared with the single filer. For example, in 2014, a head of household taxpayer who makes \$20,000 will pay \$2,352.50 in taxes, ignoring deductions, credits, etc. $[(12,950 * 10\%) + ((20,000 - 12,950) * 15\%)]$ whereas the same person filing as single would pay \$2,546.25 $[(9,075 * 10\%) + ((20,000 - 9,075) * 15\%)]$.

¹¹² I.R.C. § 2(b)(1).

¹¹³ This is determined by reference to state law. See *supra* note 105.

¹¹⁴ This is a tax concept largely unrelated to the immigration laws. An undocumented person can be considered a resident alien for tax purposes. See *supra* note 70.

nonresident alien) died during the year, or (5) the taxpayer lived apart from his or her spouse for the last six months of the year.¹¹⁵

(2) *Maintains a Household*: The taxpayer paid over one-half of the cost of maintaining the household that year.¹¹⁶

(3) *Residence Test*: A qualifying dependent lived with the taxpayer as a member of the household for more than one-half of the year.¹¹⁷ Generally speaking, a qualifying child of the taxpayer satisfies this test.¹¹⁸ However, if the custodial parent signed IRS Form 8332 to shift the child to the noncustodial parent, that shift does not allow the noncustodial parent to file as head of household.¹¹⁹ The same is true for the EITC. Qualifying relatives also may qualify a taxpayer for head of household filing status.¹²⁰

C. *Child Tax Credit and Additional Child Tax Credit*

The Code provides a nonrefundable child tax credit of up to \$1,000 per child, available for low- to middle-income taxpayers, and phasing out for

¹¹⁵ I.R.C. §§ 2(b)(1), 2(b)(2), 2(c), 7703(b).

¹¹⁶ I.R.C. § 2(b)(1). The regulations explain that “[t]he cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants” and instructs taxpayers to “include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises” but to exclude “the cost of clothing, education, medical treatment, vacations, life insurance, and transportation.” 26 C.F.R. §1.2-2(d) (2014). It is useful to think of the distinction between expenses for maintaining a household (such as rent) and expenses for maintaining a person (such as clothing). IRS Publication 17 and IRS Publication 501 each provides a worksheet for determining whether or not this test is satisfied. In addition to distinguishing between household and personal expenses, the taxpayer must identify the source of the money used to pay the household expenses. The taxpayer must be the source of the funds used to pay more than half of the expenses of maintaining the household. The concepts discussed in *supra* note 79 regarding who is considered the source of different types of support also apply here. For example, a taxpayer who uses TANF payments to pay the rent is not considered to have paid that portion of the cost of maintaining the home (the state paid that portion). IRS, PUBLICATION 501, *supra* note 83, at 9. By extension, a taxpayer who uses his or her own Social Security disability payments to pay the rent is considered to have paid that portion of the cost of maintaining the home. Few households keep their household accounts with the level of detail that these rules seem to contemplate. Low-income taxpayers who have their head of household filing status challenged on audit often find that providing sufficient supporting documentation is nearly impossible due to the complexity of the rules, the passage of time, the cash nature of many of the transactions, and the often mobile living situations of the taxpayers.

¹¹⁷ I.R.C. § 2(b)(1)(A). There is an exception to the residence test for a taxpayer entitled to a dependent exemption for his or her parent if the taxpayer is maintaining the parent’s household. I.R.C. § 2(b)(1)(B).

¹¹⁸ I.R.C. § 2(b)(1)(A)(i); *see supra* Part III.A.2.

¹¹⁹ I.R.C. § 2(b)(1)(A)(i).

¹²⁰ I.R.C. § 2(b)(1)(A)(ii).

higher-income taxpayers.¹²¹ The child must be under age 17 by the end of the year.¹²² In addition, the child must be a qualifying child of the taxpayer, as discussed in *supra* Part III.A.2.¹²³ Finally, the taxpayer must include on the return the name and taxpayer identification number of the child.¹²⁴

If the taxpayer does not owe enough in taxes to fully utilize the child tax credit, the unused portion may be refunded to the taxpayer if the taxpayer's income falls within a certain range.¹²⁵ This is called the additional child tax credit. There are no additional qualifying tests, other than the income range, for the additional child tax credit.

D. Earned Income Tax Credit

The EITC is a potentially very valuable refundable tax credit.¹²⁶ If the taxpayer owes \$0 in federal income taxes,¹²⁷ but has a \$1,000 EITC, the IRS will pay \$1,000 to the taxpayer. In the Author's experience, the EITC is almost always the most important issue in an audit regarding child tax benefits of a low-income taxpayer. If the IRS denies the other child-based tax benefits, the taxpayer may owe money back to the IRS, but the amount is often not

¹²¹ The credit begins phasing out at \$55,000 for married couples filing separately, \$75,000 for single, head of household, and qualifying widow(er) filers, and \$110,000 for married couples filing jointly. The credit is reduced by \$50 for each \$1,000 of income above these threshold amounts. The point at which the credit is fully phased out depends on the number of children claimed. I.R.C. § 24(b).

¹²² I.R.C. § 24(c).

¹²³ I.R.C. § 24(a). A noncitizen who is a qualifying child by virtue of being a resident of a country contiguous to the United States does not qualify for the child tax credit. I.R.C. §§ 24(c)(2), 152(b)(3).

¹²⁴ I.R.C. § 24(e). This is the social security number or, for persons not eligible for a social security number, the individual taxpayer identification number (ITIN) issued by the IRS. ITINs can be difficult to obtain for a variety of reasons, such as a lack of documentation from the home country or the requirement to submit original documentation (such as an original passport) to the IRS coupled with the long processing times taxpayers frequently experience. See Nat'l Taxpayer Advocate, IRS, *Volume One: Most Serious Problems*, 2012 ANN. REP. TO CONGRESS 154, available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Volume-1.pdf>.

¹²⁵ I.R.C. § 24(d). The refundable credit is 15% of the amount by which the taxpayer's earned income exceeds \$3,000. Thus, the taxpayer must have at least \$3,000 of earned income to qualify for the additional child tax credit. However, if the taxpayer has three or more qualifying children, the credit is calculated differently; in that case, the credit is the social security taxes paid by the taxpayer less any EITC received by the taxpayer. The same income phase-out rules apply to the additional child tax credit.

¹²⁶ See Jennifer McGroarty, Note, *Time for the Child Tax Credit to Grow Up: Preserving the Credit's Availability and Enhancing Benefits for Families*, 2 COLUM. J. TAX L. 302, 314 (2011).

¹²⁷ Just because someone owes \$0 in federal income taxes does not mean that he or she has not paid any federal taxes. Indeed, by definition, all persons entitled to the EITC are workers and have income subject to payroll taxes.

significant.¹²⁸ However, if the IRS denies a taxpayer's EITC, it can create a devastating tax debt or a crippling financial crisis. The following subparts discuss how the EITC is calculated and the eligibility requirements to claim an EITC.

1. The Amount of the EITC and Phase-Out Rules

The amount of the EITC is a percentage of a taxpayer's earned income, up to a certain dollar amount.¹²⁹ The EITC starts to phase out at certain income levels and becomes fully unavailable once a taxpayer has more than a certain amount of AGI.¹³⁰ The interplay of these two rules means that even the smallest amount of earned income can generate an EITC; however, there is a "sweet spot" range of income which generates the highest credit possible without being subject to the phase-out rules. For taxpayers in the phase-out range, the maximum EITC is reduced by the applicable phase-out percentage multiplied by the amount by which his or her earned income exceeds the beginning of the phase-out range.¹³¹

There are two versions of the EITC: one without children and one with children. In 2014, the following applies to a taxpayer¹³² without a qualifying child:¹³³ The EITC for workers without qualifying children is 7.65% of the taxpayer's earned income, up to the maximum credit (in 2014, \$496).¹³⁴ The minimum earned income a taxpayer without qualifying children needs to

¹²⁸ The child tax credit typically is the second most significant tax benefit discussed in this Article.

¹²⁹ I.R.C. § 32(a). The percentage and dollar limits vary and many of the figures are indexed annually for inflation. In 2014, the percentage and dollar limits range from 7.65% with no qualifying children up to \$6,480 of earned income, to 34% with one qualifying child up to \$9,720 of earned income, to 40% with two qualifying children up to \$13,650 of earned income, to 45% with three or more qualifying children up to \$13,650 of earned income. I.R.C. §§ 32(b)(1)–(3). Rev. Proc. 13-35, 2013-47 I.R.B. 537.

¹³⁰ I.R.C. §§ 32(a)(2), (b).

¹³¹ I.R.C. § 32(a)(2).

¹³² A couple filing jointly would count as one "taxpayer" here.

¹³³ The percentages used in calculating the EITC are located at Code section 32(b)(1)(A) and are static, not changing absent legislative action. I.R.C. § 32(b)(1)(A). The dollar figures, located throughout Code section 32(b), are updated annually to account for changes in the cost of living, pursuant to Code section 32(j). I.R.C. § 32(j). The updated dollar figures are released by the IRS in a Revenue Procedure near the start of each year. *See, e.g.*, Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (releasing inflation-adjusted figures for 2014). For historical figures, see TAX POL'Y CTR., EARNED INCOME TAX CREDIT PARAMETERS, 1975–2014 (2014) [hereinafter EITC PARAMETERS], available at http://www.taxpolicycenter.org/taxfacts/Content/PDF/historical_eitc_parameters.pdf.

¹³⁴ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

receive the maximum credit is \$6,480.¹³⁵ This “individual-only” EITC starts to phase out at \$8,110 of AGI (\$13,540 if filing jointly), phases out at 7.65%, and becomes unavailable at \$14,590 (\$20,020 if filing jointly).¹³⁶ Therefore, the “sweet spot” range of income (where the taxpayer receives the maximum credit without being subject to a phase-out) is between \$6,480 and \$8,110 (for taxpayers filing jointly between \$6,480 and \$14,590). Other than the phase-out ranges, the rules are the same for single, head of household, or joint filers.¹³⁷

An enhanced version of the EITC is available to taxpayers with qualifying children. The credit gets more valuable as more children are claimed, up to three.¹³⁸ The phase-out ranges and the minimum incomes required to get the maximum credit also go up with each child, but only up to two. The sweet spot range, the beginning of the phase-out range, and the phase-out percentage is the same for families with two children and families with three children; the phase-out range extends longer for families with three children because the phase-out percentage takes longer to completely eliminate the maximum credit. As with the individual-only EITC, other than the phase-out ranges, the rules are the same for single, head of household, or joint filers.¹³⁹

In 2014, the following applies to a taxpayer with one qualifying child: The maximum credit is \$3,305.¹⁴⁰ The credit is 34% of the taxpayer’s earned income, up to the maximum credit. The minimum earned income the taxpayer needs to receive the maximum credit is \$9,720.¹⁴¹ The credit starts to phase out at \$17,830 of AGI (\$23,260 if filing jointly), phases out at 15.98%, and becomes unavailable at \$38,511 (\$43,941 if filing jointly).¹⁴²

In 2014, the following applies to a taxpayer with two qualifying children: The maximum credit is \$5,460.¹⁴³ The credit is 40% of the taxpayer’s earned income, up to the maximum credit. The minimum earned income the

¹³⁵ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹³⁶ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹³⁷ The EITC is not available to married filing separately taxpayers.

¹³⁸ The American Taxpayer Relief Act of 2012 extended the provisions for families with three or more children through tax year 2017. Pub. L. 112-240, 126 Stat. 2313 (2012).

¹³⁹ The EITC is not available for married filing separately taxpayers.

¹⁴⁰ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴¹ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴² I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴³ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

taxpayer needs to receive the maximum credit is \$13,650.¹⁴⁴ The credit starts to phase out at \$17,830 of AGI (\$23,260, if filing jointly), phases out at 21.06%, and becomes unavailable at \$43,756 (\$49,186, if filing jointly).¹⁴⁵

In 2014, the following applies to a taxpayer with three or more qualifying children: The maximum credit is \$6,143.¹⁴⁶ The credit is 45% of the taxpayer's earned income, up to the maximum credit. The minimum earned income the taxpayer needs to receive the maximum credit is \$13,650.¹⁴⁷ The credit starts to phase out at \$17,830 of AGI (\$23,260, if filing jointly), phases out at 21.06%, and becomes unavailable at \$46,997 (\$52,427, if filing jointly).¹⁴⁸

These 2014 rules can be summarized as follows:

¹⁴⁴ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴⁵ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴⁶ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴⁷ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

¹⁴⁸ I.R.C. § 32(b); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. For historical figures, see EITC PARAMETERS, *supra* note 134.

Qualifying Children	Credit Percentage	Maximum Credit	Sweet Spot Range	Phase-Out Range	Phase-Out Percentage
0	7.65%	\$496	\$6,480– \$8,110	\$8,110–\$14,590	7.65%
			\$6,480– \$13,540 (MFJ) ¹⁴⁹	\$13,540– \$20,020 (MFJ)	
1	34%	\$3,305	\$9,720– \$17,830	\$17,830– \$38,511	15.98%
			\$9,720– \$23,260 (MFJ)	\$23,260– \$43,941 (MFJ)	
2	40%	\$5,460	\$13,650– \$17,830	\$17,830– \$43,756	21.06%
			\$13,650– \$23,260 (MFJ)	\$23,260– \$49,186 (MFJ)	
3 +	45%	\$6,143	\$13,650– \$17,830	\$17,830– \$46,997	21.06%
			\$13,650– \$23,260 (MFJ)	\$23,260– \$52,427 (MFJ)	

2. Definition of Earned Income

The EITC was designed to encourage low-income individuals to work.¹⁵⁰ It is a support for low-income working people and families.¹⁵¹ To accomplish this, the credit is calculated as a percentage of “earned income.”¹⁵² “Earned income” is wages, salaries, tips, and other employee compensation that the taxpayer must include in income, plus the taxpayer’s net earnings from self-employment.¹⁵³ Earned income for the EITC is determined without regard to community property laws.¹⁵⁴ Pensions or annuities are not earned income,

¹⁴⁹ MFJ is an abbreviation for married filing jointly.

¹⁵⁰ See *supra* Part II.

¹⁵¹ See *supra* Part II.

¹⁵² I.R.C. § 32(a)(1) (2014).

¹⁵³ I.R.C. § 32(c)(2)(A). Net earnings from self-employment are determined under Code section 1402(a), but with regard to the deduction allowed to the taxpayer by Code section 164(f) for one-half of the self-employment taxes paid. I.R.C. § 32(c)(2)(A)(ii).

¹⁵⁴ I.R.C. § 32(c)(2)(B)(i). In community property states, earned income generally is considered community property and is considered to be owned equally by the spouses. Even if only one of the spouses actually did the work to generate the earned income, the non-earning spouse is entitled (and required) to report one-half of the earned income as his or her own. 26 C.F.R. § 1.66-1 (2003). The EITC rules ignore state community property rules when allocating

although certain disability benefits received before the taxpayer reaches minimum retirement age are earned income.¹⁵⁵ Amounts received by prison inmates for work are not earned income.¹⁵⁶ Nontaxable combat pay may be taxable earned income at the taxpayer's election.¹⁵⁷ IRS publications provide many more specific examples of what qualifies as earned income for the EITC.¹⁵⁸

3. EITC Requirements That All Taxpayers Must Meet

There are some general requirements that anyone must meet to claim an EITC, with or without qualifying children, as follows:

(1) *Citizenship*: The taxpayer must be a United States citizen or resident alien¹⁵⁹ during the entire tax year.¹⁶⁰

(2) *Social Security Numbers Valid for Employment*: The taxpayer, the taxpayer's spouse, and any claimed qualifying children¹⁶¹ must have a social security number that is valid for employment in the United States.¹⁶²

(3) *Taxpayer Not a Qualifying Child*: The taxpayer must not be the qualifying child of another taxpayer.¹⁶³

(4) *Limit on Investment Income*: The taxpayer cannot have investment income over a certain amount, which is indexed for inflation.¹⁶⁴ For 2014, the limit is \$3,350.¹⁶⁵

earned income between spouses. I.R.C. § 32(c)(2)(B)(i). Thus, only the spouse that actually earned the income is entitled to use the earned income to claim an EITC. This can become significant where married couples still in a valid community for community property purposes live apart.

¹⁵⁵ I.R.C. § 32(c)(2)(B)(ii); *EITC, Earned Income Tax Credit, Questions and Answers*, IRS, <http://www.irs.gov/Individuals/EITC,-Earned-Income-Tax-Credit,-Questions-and-Answers> (last updated Jan. 6, 2014).

¹⁵⁶ I.R.C. § 32(c)(2)(B)(iv).

¹⁵⁷ *Id.*

¹⁵⁸ See, e.g., *Earned Income*, IRS, http://apps.irs.gov/app/eitc2012/html/en/earned_income.jsp (last visited Sept. 5, 2014); IRS, PUBLICATION 596, EARNED INCOME CREDIT (EIC) FOR USE IN PREPARING 2013 RETURNS (2013) [hereinafter IRS, PUBLICATION 596], available at <http://www.irs.gov/pub/irs-pdf/p596.pdf>.

¹⁵⁹ The term "resident alien" differs here from its usage in the context of U.S. immigration laws. See *supra* note 70.

¹⁶⁰ I.R.C. § 32(c)(1)(D).

¹⁶¹ I.R.C. § 32(c)(3)(D).

¹⁶² I.R.C. §§ 32(c)(1)(E)–(m).

¹⁶³ I.R.C. § 32(c)(1)(B).

¹⁶⁴ I.R.C. § 32(i). Investment income limited under this provision is taxable interest and dividends, non-exempt interest, net non-business income from rents or royalties, capital gain net income, and net passive activity income. I.R.C. § 32(i)(2).

¹⁶⁵ Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

(5) *No Foreign Earned Income Exclusion*: The taxpayer cannot have claimed a foreign earned income exclusion under Code section 911.¹⁶⁶

(6) *Not Filing as Married Filing Separate*: The taxpayer cannot file as married filing separate.¹⁶⁷ All other filings statuses are allowed.¹⁶⁸

(7) *Earned Income*: The taxpayer must have earned income that falls within the ranges discussed above.

4. Additional EITC Requirements

To claim an EITC without children, the taxpayer must (1) live in the United States for more than one-half of the year, (2) be between ages 25 and 65 by the last day of the tax year (if the taxpayer is considered married, the taxpayer's spouse can satisfy the age requirement if the taxpayer does not), and (3) not be a dependent of another taxpayer.¹⁶⁹

To claim an enhanced EITC with qualifying children, different rules apply.¹⁷⁰ The basic qualifying child requirements discussed in *supra* Part III.A.2 apply to the EITC, but are modified. A qualifying child must meet the same relationship and age tests that apply for the dependent exemption.¹⁷¹ In addition, just as with the dependent exemption, a qualifying child cannot have filed a joint return (except for returns simply requesting a refund of withheld income taxes).¹⁷² The EITC adds a requirement that the qualifying child not be married as of the end of the year, unless the taxpayer is entitled to a dependent exemption for the married child.¹⁷³ The support test does not apply at all for the

¹⁶⁶ I.R.C. § 32(c)(1)(C).

¹⁶⁷ I.R.C. § 32(d).

¹⁶⁸ *Id.* This restriction is especially troublesome for low-income married people. The economic benefit from income splitting is not very great in many low-income households, either because both partners must work to make ends meet or because the couple already is in the lowest tax brackets (potential marriage penalties due to tax brackets are not a concern until the couple reaches the 28% tax bracket which in 2014 applies to joint income over \$148,850). Married couples with children face a very large incentive to file as married filing jointly in order to claim the EITC. However, it is not uncommon for one of the spouses to be concerned about the risk of joint and several liability; filing jointly creates joint and several liability. See Michelle Lyon Drumbl, *Decoupling Taxes and Marriage: Beyond Innocence and Income Splitting*, 4 COLUM. J. TAX L. 94, 102 (2012) ("Married taxpayers must accept the risks of joint and several liability or else sacrifice eligibility for the refundable earned income credit; choosing the latter may mean the taxpayers forsake thousands of dollars to help support their household.").

¹⁶⁹ I.R.C. § 32(c)(1)(B).

¹⁷⁰ I.R.C. § 32(c)(1)(A)(i).

¹⁷¹ I.R.C. § 32(c)(3)(A).

¹⁷² *Id.*

¹⁷³ I.R.C. § 32(c)(3)(B).

EITC;¹⁷⁴ there is no requirement that a taxpayer support a qualifying child being claimed for the EITC, and there is no requirement that the child not support himself or herself. Said differently, support is irrelevant to the EITC. A qualifying child must meet the residence test. Significantly, the residence test is applied without regard to the exception for noncustodial parents.¹⁷⁵ This means that the child must actually live with the taxpayer for more than half of the year to claim the EITC. Finally, the taxpayer and qualifying child(ren) must live in the United States.¹⁷⁶

E. Tax Arbitrage Opportunities in the Current System

The current rules enable cooperative parents to generate tax savings by engaging in some limited tax planning. There are opportunities for tax arbitrage because the current rules allow a custodial parent to waive the right to claim a dependent, effectively shifting a dependent to the noncustodial parent. Tax arbitrage means “[b]uying in one market and selling at a higher price in another market . . . where such activity is a result of differences in taxation.”¹⁷⁷ In the family context, tax arbitrage occurs when parents negotiate over who will utilize child-based tax benefits; such benefits are almost always more valuable to one parent than to the other.¹⁷⁸

Consider the example discussed in the introduction. Mom has primary custody of two children and is not working. Dad works two part-time jobs and visits his children as often as his schedule permits. Under the current rules, Mom has the absolute right to claim the two children for the dependent exemption, the child tax credit, the EITC, and as the basis for head of household filing status. She can shift to Dad the right to claim the children for the dependent exemption and the child tax credit. These tax benefits are more valuable to Dad than to Mom. In fact, these tax benefits are useless to Mom, except to the extent they represent a possible tool to negotiate concessions from Dad, such as higher child support payments. In 2014, the difference between

¹⁷⁴ I.R.C. § 32(c)(3)(A) (“The term ‘qualifying child’ means a qualifying child of the taxpayer (as defined in section 152(c), *determined without regard to paragraph (1)(D) thereof* and section 152(e)).” (emphasis added)).

¹⁷⁵ I.R.C. § 32(c)(3)(A) (“The term ‘qualifying child’ means a qualifying child of the taxpayer (as defined in section 152(c), *determined without regard to paragraph (1)(D) thereof* and *section 152(e)*.” (emphasis added)).

¹⁷⁶ I.R.C. § 32(c)(3)(C).

¹⁷⁷ Simon James, *Tax Arbitrage*, in *DICTIONARY OF TAXATION* 249, 249 (2d ed. 2012).

¹⁷⁸ See generally Reginald Mombrun, *Shifting the Paradigm by Bringing Tax Arbitrage to the Lower Income Separated Family: Why Should the Middle to Upper Class Family Have All the Fun?*, 26 *AKRON TAX J.* 107 (2011).

Mom claiming the children versus allowing Dad to claim the children can be summarized as follows:¹⁷⁹

	CUSTODIAL MOM	NONCUSTODIAL DAD
IF MOM USES CHILD-BASED TAX BENEFITS:		
Income	\$0	\$20,000
Less standard deduction	(\$9,100) (HOH) ¹⁸⁰	(\$6,200) (single)
Less exemptions	(\$11,850) (3 persons)	(\$3,950) (1 person)
Taxable income	\$0	\$9,850
Tentative tax	\$0	\$1,023.75 ¹⁸¹
Less child tax credit	(\$0)	(\$0)
Tax	\$0	(\$0)
Less additional child tax credit	(\$0)	(\$0)
Less EITC	(\$0)	(\$0) ¹⁸²
Tax owed	\$0	\$1,023.75
IF DAD USES CHILD-BASED TAX BENEFITS:		
Income	\$0	\$20,000
Less standard deduction	(\$9,100) (HOH)	(\$6,200) (single)
Less exemptions	(\$3,950) (1 person)	(\$11,850) (3 persons)
Taxable income	\$0	\$1,950
Tentative tax	\$0	\$195
Less child tax credit	(\$0)	(\$195)
Tax	\$0	\$0
Less additional child tax credit	(\$0)	(\$1,805)
Less EITC	(\$0)	(\$0)
Tax owed	\$0	(\$1,805) [refund]
Change in Tax Liability	\$0	\$2,828.75

¹⁷⁹ This chart is adapted from a similar chart used in Walter Adams Looney III, Trading Tax Benefits for Child Support, Essays on Tax and Social Policy, (May 25, 2004) (unpublished Ph.D. dissertation, Harvard University) (on file with author). The facts and calculations are the work of the Author, however, and are based on 2014 figures.

¹⁸⁰ HOH is an abbreviation for head of household filing status.

¹⁸¹ This tax is calculated using the applicable tax bracket: $(\$9,075 * 10\%) + ((\$9,850 - \$9,075) * 15\%)$. The actual tax would be calculated using tax tables published by the IRS, which were not available as this Article went to press. The amounts may vary slightly due to rounding in the tax tables.

¹⁸² Dad would be eligible for the EITC for a childless worker except that he makes too much earned income. In 2014, this EITC is fully phased out for incomes above \$14,590. Rev. Proc. 13-35, 2013-47 I.R.B. 537.

If Mom shifts the child-based tax benefits to Dad, her tax situation does not change, but his improves. Not only does he avoid a \$1,023.75 tax bill, but he generates a refund of \$1,805. Dad gets a total tax benefit of \$2,828.75. Mom can negotiate with Dad and require him to share some or all of the “savings” with her. This example is a very clear demonstration of how tax arbitrage benefits Mom. If she had some income, however, her taxes would go up if she shifts the children to Dad. This would need to be considered as part of the negotiation.¹⁸³

IV. ANALYZING THE CURRENT RULES

Given our understanding of the policy goals of the EITC and how the Code currently functions, the next step is to determine how well the rules function. This part looks at the EITC rules through the lens of some traditional measures of tax policy. First, this part looks at horizontal equity and vertical equity, asking whether similarly situated taxpayers are treated similarly and whether the burdens of taxation rest more greatly with those possessing a greater ability to pay. Next, this part looks at how efficient the current EITC rules are, both in terms of cost to the government and cost to the taxpayer. Then, the Article critically analyzes whether the current rules actually advance the policy goals of the EITC. Finally, this part looks at neutrality issues, or whether the EITC rules cause people to alter their behavior in an unintended manner.

A. Equity

1. Horizontal Equity

Horizontal equity is one of the main tools economists use to analyze the fairness of a tax. Horizontal equity requires that similarly situated taxpayers bear similar tax burdens.¹⁸⁴ The EITC, because it is administered as part of the income tax system, should satisfy principles of horizontal equity. Notice that the EITC itself violates horizontal equity. A single taxpayer with \$10,000 of wages will generate an EITC, while the exact same taxpayer with \$10,000 of capital gain, or pension, or unemployment income does not generate an EITC. Congress has determined that this non-uniform system of taxation is justified by policy considerations. For example, the EITC is touted for its ability to

¹⁸³ For a more thorough discussion of the different ways to divide the net gain from the trade, see Mombrun, *supra* note 178, at 141–42.

¹⁸⁴ See John E. Donaldson, *The Future of Transfer Taxation, Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 545 (1993).

incentivize work among the lowest paid,¹⁸⁵ and this policy benefit arguably offsets the violations of horizontal equity.¹⁸⁶ In addition, the EITC was designed to offset payroll taxes for low-wage workers;¹⁸⁷ thus, the non-uniform distinction between earned income (which is subject to payroll taxes) and non-earned income (which is not subject to payroll taxes) is justified by the policy objectives of the EITC.

However, horizontal equity principles should apply to treat equally those who are in equal positions and who could be eligible for the credit. Among those toward whom the credit is targeted (low-wage workers with families),¹⁸⁸ are equals treated equally? When the horizontal equity question is posed this way, the answer is a vigorous no. To illustrate why, it is useful to consider a series of scenarios that involve different types of families. For the sake of brevity and clarity, this Article assigns a name to each type of family compared. The Article looks at different scenarios for each family, but compares these same three types of families with respect to each scenario.

The “Married Couple”: A married couple who lives together and has children who live with them.

The “Cohabiting Couple”: A couple who is not married but who lives together. They have children who live with them.

The “One Home Family”: A “Married Couple” or a “Cohabiting Couple.” In both cases, the couple lives together.

The “Two Home Family”: A couple who has children together. They are not married (whether divorced or never married)¹⁸⁹ and do not live together. Their children live with one of them.

¹⁸⁵ See *supra* Part II for a discussion of work incentives as an important legislative purpose of the EITC.

¹⁸⁶ See Eric M. Zolt, *The Uneasy Case For Uniform Taxation*, 16 VA. TAX REV. 39, 105 (1996) (“For example, under current law, the earned income tax credit provides non-uniform tax treatment for labor and capital income of working parents. The incentive effects of this provision on encouraging work are complex and must be considered in conjunction with other taxes and welfare programs. It would be a mistake, however, to reject a proposal like the earned income tax credit because it may violate some concepts of horizontal equity.”); see also Dennis J. Ventry, Jr., *Welfare by Any Other Name: Tax Transfers and the EITC*, 56 AM. U. L. REV. 1261, 1270 (2007).

¹⁸⁷ See *supra* Part II for a discussion of payroll offsets as an important legislative purpose for the EITC.

¹⁸⁸ Recall that it was not until 1993 that a small credit was added for low-wage workers without qualifying children. See *supra* note 38. The EITC is clearly targeted to this population as well as to low-wage workers with children, although to a much lesser extent. However, this Article is mainly concerned with inequities in the system as between different types of EITC-eligible families with children. Therefore, this Article does not include EITC workers without children in its equity analysis.

¹⁸⁹ Or considered unmarried in accordance with Code section 7703. I.R.C. § 7703 (2014).

i. Two-Earner Families

Many scholars have written about the anti-marriage incentives of the EITC,¹⁹⁰ and these incentives seem to be creeping into the general public consciousness as well.¹⁹¹ To illustrate the potential anti-marriage effect of the EITC, consider two hypothetical families. Assume each family has two children and that each parent earns \$10,000 (a two-children, two-earner family). A two-children, two-earner “Cohabiting Couple” can each file as single and claim one child each on their returns. This is because both children are “qualifying children” with respect to each parent, primarily because there is no separate support test for the EITC and each child meets the residence test with respect to each parent. Furthermore, the tie-breaker rules allow parents to agree who will claim the children for the EITC.¹⁹² Using 2014 figures, each parent in the “Cohabiting Couple” will generate a \$3,305 EITC, \$6,610 for the family unit. A two-children, two-earner “Married Couple” would generate only a single \$5,460 EITC. This is because it is impossible to divide the children between two tax returns that include the EITC when the parents are married. Married Couples may file a joint return that would include both children. The only other filing option for married couples is married filing separately. However, married filing separately taxpayers are not eligible for the EITC.¹⁹³ This \$1,150 inequity between Married Couples and Cohabiting Couples violates horizontal equity.

Horizontal equity also is violated when comparing parents who live together (One Home Families) and parents who do not live together (Two

¹⁹⁰ See Frederick J. Bradshaw, IV, *The Earned Income Tax Credit and the Marriage Penalty: New Proposals in Light of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 54 TAX LAW. 701, 701 (2001) (“Although the marriage penalty affects taxpayers across the economic spectrum, it most severely affects low-income couples. Congress designed the Earned Income Tax Credit (EITC) to benefit the working poor, but both the EITC phase-out ranges and certain qualification rules generate a most egregious marriage penalty that still plagues low-income families today.”); Dorothy A. Brown, *The Tax Treatment of Children: Separate But Unequal*, 54 EMORY L.J. 755, 806 (2005) (“The EITC is granted to individual taxpayers, but there is a requirement that married individuals file joint returns. The effect of these rules is an enormous marriage penalty on the working poor because the phase-out often eliminates the EITC when both spouses’ incomes are included on their joint return.”); Ann F. Thomas, *Marriage and the Income Tax Yesterday, Today, and Tomorrow: A Primer and Legislative Scorecard*, 16 N.Y.L. SCH. J. HUM. RTS. 1, 25 (1999) (“Unusually severe marriage penalties can occur in connection with the earned income tax credit.”).

¹⁹¹ See, e.g., David John Marotta, *Earned Income Tax Credit (EITC) Punishes Marriage*, FORBES.COM (Jan. 20, 2013), <http://www.forbes.com/sites/davidmarotta/2013/01/20/earned-income-tax-credit-eitc-punishes-marriage/>.

¹⁹² See *supra* Part III.A.4.

¹⁹³ See *supra* Part III.D.3. In certain situations, the Code treats married couples as not married. See *supra* note 67. This Article analyzes these families as either Cohabiting Couple or Two Home Families, depending on their living situation.

Home Families). Continue with the same facts as above (two-children, two-earner families making \$10,000 each). In a Two Home Family, only the custodial parent¹⁹⁴ can claim the EITC because of the residence test.¹⁹⁵ The Two Home Family generates \$20,000 of family-unit income; however, because only the custodial parent can claim the EITC, the credit is based on only \$10,000 of income. Using 2014 figures, the custodial parent would generate a \$4,000 EITC.¹⁹⁶ On an individual basis, this is higher than the amount any single taxpayer can generate in the One Home Families (\$3,305 for each individual in the Cohabiting Couple and \$2,730 for each individual in the Married Couple). However, on a family-unit basis, the Two Home Family generates a lower EITC (\$4,000) than either of the One Home Families (\$5,460 for the Married Couple and \$6,610 for the Cohabiting Couple). This is despite the fact that each of the families has the exact same amount of income. This is a dramatic violation of horizontal equity principles.

Change the numbers slightly and a different horizontal equity problem emerges. Assume that each parent has \$15,000 of earned income; that is \$30,000 per family. The Two Home Family will have \$30,000 of family income, but only \$15,000 will count toward the EITC. The Two Home Family will generate the maximum EITC for two qualifying children, \$5,460, without being subject to a phase-out. The Married Couple, on the other hand, is subject to a phase-out because the full \$30,000 of their family income is counted toward the EITC. Therefore, what would normally be the Married Couple's EITC of \$5,460 is reduced by \$1,419.44 to \$4,040.56.¹⁹⁷

Mathematically speaking, this effect will always be true because of the EITC's structure. If a Two Home Family with two earners and two children generates the maximum credit of \$5,460, a similar Married Couple will experience a partial phase-out of their maximum credit of \$5,460¹⁹⁸ and a

¹⁹⁴ This example assumes that the same custody arrangement applies to all of the couple's children. Therefore, only one of the two parents will be considered the custodial parent for all of the couple's children. The results would be different if one parent is the custodial parent of some of the children and the other parent is the custodial parent of the other children.

¹⁹⁵ See *supra* Part III.D.4.

¹⁹⁶ A taxpayer with two qualifying children receives a credit of 40% of their earned income (here \$10,000), up to \$5,460. A taxpayer with \$10,000 of earned income is not affected by the phase-outs. Our taxpayer could generate up to \$1,460 of additional credit by having up to \$7,830 of additional earned income.

¹⁹⁷ The phase-out amount is 21.06% of the amount by which earned income exceeds the start of the phase-out range. The calculation is $[21.06\% * (\$30,000 - \$23,260) = \$1,419.44]$.

¹⁹⁸ This is because, to generate the maximum credit, a Two Home Family with two equal earners must have family-unit income of between \$27,300 and \$35,660, putting the custodial parent with an EITC-eligible income of between \$13,650 and \$17,830 (the sweet spot range). If the Married Couple has the same family-unit income, also divided evenly between two earners, all of that family-unit income is used in calculating the EITC. This range of income (between \$27,300 and \$35,660) puts the Married Couple in the phase-out range. See *supra* Part III.D.1 for the chart summarizing the sweet spot and phase-out ranges.

similar Cohabiting Couple will generate their maximum credit of \$6,610.¹⁹⁹ If a Married Couple with two earners and two children generates the maximum credit of \$5,460, a similar Two Home Family will fall short of their maximum credit of \$5,460²⁰⁰ and a similar Cohabiting Couple will generate an EITC of between \$4,641 and \$6,610.²⁰¹

ii. One-Earner Families

When only one spouse works, the Code often provides a marriage bonus or incentive. A Married Couple with two children making \$20,000, but with only one wage earner, generates a single \$5,460 EITC (the same as a Married Couple with two children and two earners).²⁰² However, a Cohabiting Couple with two children and one earner sees a partial phase-out of the maximum credit and will receive only a \$5,003 EITC²⁰³ (compared with \$6,610

¹⁹⁹ This is because if a Two Home Family has custodial-parent income that puts them in the sweet spot range (between \$13,650 and \$17,830), that means the family-unit income is double. The Cohabiting Couple, like the Two Home Family, has the same level of individual and family-unit income and is also filing separate returns; however, the Cohabiting Couple can split the children between returns. Therefore, they each claim an EITC based on one qualifying child. An individual level of income of between \$13,650 and \$17,830 means that each parent of a Cohabiting Couple generates a maximum one-qualifying child credit of \$3,305, or \$6,610 for the family unit.

²⁰⁰ This is because, to generate the maximum credit, a Married Couple must have between \$13,650 and \$23,260 in income (in 2014). If the Two Home Family has the same family income, also divided evenly between two earners, the EITC rules dictate that only half of that family-unit income will be used to calculate the EITC (the income earned by the custodial parent). That level of EITC-eligible income (between \$6,825 and \$11,630) puts the Two Home Family below the sweet spot range. See *supra* Part III.D.1 for the chart summarizing the sweet spot and phase-out ranges.

²⁰¹ For tax year 2014 and assuming two children, if the Married Couple has family-unit income that puts them in the sweet spot range (between \$13,650 and \$23,260), then each taxpayer in a Cohabiting Couple will have between \$6,825 and \$11,630 of income. Each taxpayer in a Cohabiting Couple can claim one of the couple's two children so they will calculate the EITC based on one qualifying child. That level of income, even with the ability to split the children, can put the Cohabiting Couple short of generating a maximum EITC, although at the higher end of the range, the Cohabiting Couple is in their sweet spot. Each will generate an EITC equal to 34% of his or her earned income up to the maximum credit, or between \$2,320.50 ($\$6,825 * 34\%$) and \$3,305. That means a total family-unit EITC of between \$4,641 and \$6,610. The Cohabiting Couple comes out worse than the Married Couple at the lower end of the income range, but comes out better at the higher end of the income range.

²⁰² This Married Couple is in the sweet spot for an EITC based on two qualifying children if they file jointly. See *supra* Part III.D.1.

²⁰³ A Cohabiting Couple typically files two tax returns. In unusual cases, one may be able to claim the other as a dependent. In our example, there is only one taxpayer with earned income. To obtain the maximum EITC, the partner with the earned income will claim both children on either a single or head of household return. The maximum credit (here \$5,460) is reduced by the phase-out. The phase-out amount is the phase-out percentage (here 21.06%) multiplied by the

for a Cohabiting Couple with two children and two earners). At this income level and with only one earner, couples are incentivized to marry. This problem of marriage bonuses and penalties is not only a problem with the EITC's structure but also a side effect of allowing married couples to file jointly.²⁰⁴

The most egregious penalty of all is experienced by the Two Home Family with only one wage earner. If the custodial parent is the wage earner, the Two Home Family will replicate the EITC of a one-earner Cohabiting Couple.²⁰⁵ However, if the custodial parent is not the wage earner, the Two Home Family is not eligible for an EITC at all. This happens because (1) the custodial parent is the taxpayer normally eligible for an EITC because of the residence test,²⁰⁶ (2) the custodial parent's EITC is \$0 because he or she has no earned income,²⁰⁷ (3) the noncustodial parent has earned income but is not eligible to claim the child-based EITC because he or she does not meet the residence test,²⁰⁸ and (4) current law does not allow the custodial parent to shift the child-based EITC to the noncustodial parent in the same manner as he or she could shift the dependent exemption or the child tax credit.²⁰⁹ The Two Home Family with one wage earner that is the noncustodial parent experiences a complete forfeiture of the EITC. This happens solely because of the personal decisions they have made about custody of their children and living arrangements. This is an egregious violation of horizontal equity.

2. Vertical Equity

“Vertical equity” requires that taxpayers who are not similarly situated bear tax burdens relative to their respective abilities to pay.²¹⁰ Is it possible that the differences in horizontal equity noted above are justified based on differences in the families' ability to pay (i.e., are justified under vertical equity

amount by which the taxpayer's earned income (here \$20,000) exceeds the start of the phase-out range (here \$17,830). So the phase-out is \$457 [(\$20,000 - \$17,830) * 21.06%].

²⁰⁴ For an excellent exposition of marriage penalty and bonus issues, see Bradshaw, *supra* note 185 (proposing two alternatives to fixing the marriage penalties of the EITC: (1) eliminating joint returns coupled with a federal legislation addressing the different impacts community and common law property schemes have on federal income taxation or (2) eliminating the ability to divide qualifying children in a single household between returns coupled with a doubling of the EITC phase-out ranges for couples filing jointly).

²⁰⁵ Just as with a one-earner Cohabiting Couple, the custodial parent will claim both children on a single or head of household return. The noncustodial parent will file a single return. The custodial parent's return looks just like the return of the earner in the Cohabiting Couple: \$20,000 of earned income, subject to a partial phase-out, with a resulting EITC of \$5,003.

²⁰⁶ See *supra* Part III.D.4.

²⁰⁷ See *supra* Part III.D.2.

²⁰⁸ See *supra* Part III.D.4.

²⁰⁹ See *supra* Part III.D.4.

²¹⁰ See Donaldson, *supra* note 184, at 545.

principles)? Each family is generating the same income in our examples. However, a One Home Family should have a higher ability to pay taxes (or to forego a refundable credit) than a Two Home Family because of the economies of scale inherent in maintaining a single household versus maintaining two separate households. In our examples, however, a Cohabiting Couple almost always generates a higher credit than the other families. This violates vertical equity with respect to a Two Home Family; the Cohabiting Couple has a greater ability to pay and should, under vertical equity, generate a lower credit. It also violates vertical equity with respect to a Married Couple because, in theory, both a Married Couple and a Cohabiting Couple have the same ability to pay and should generate equal credits.

The vertical equity equation is murkier when comparing Two Home Families and Married Couples. The Married Couple has a greater ability to pay and sometimes the Married Couple does generate a lower credit (like in our \$15,000 example). However, in other scenarios, the Two Home Family generates a lower credit (like in our \$10,000 example). These differences cannot be explained by vertical equity principles; the families' respective abilities to pay do not change so dramatically just by adding \$5,000 of additional income per parent. Thus, the current system violates vertical equity.

3. Actual Impact on Marriage Decisions

Somewhat surprisingly, studies show the Code's marriage incentives and disincentives have little actual impact on taxpayers' decisions regarding living arrangements, measured on a macro level.²¹¹ Social scientists have had great difficulty coming to a consensus on this issue, however, in large part because it is difficult to estimate and control for other lifestyle changes that often accompany decisions to change living arrangements.²¹² For example, the decision to marry, divorce, or live apart can influence decisions regarding whether to work, not work, work less, or to have children, and those decisions have a corresponding impact on taxes owed. Intriguingly, the EITC as a subset of all tax effects has been estimated to have a greater impact on marriage decisions than non-EITC tax effects or effects in other social welfare

²¹¹ Bruce D. Meyer, *The Effects of the Earned Income Tax Credit and Recent Reforms*, in 24 TAX POLICY AND THE ECONOMY 153, 170 (Jeffrey R. Brown ed., 2010), available at <http://www.nber.org/chapters/c11973.pdf>.

²¹² David T. Ellwood, *The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements*, 53 NAT'L TAX J. 1063, 1090 (2000), available at [http://ntj.tax.org/wwtax/ntjrec.nsf/53542C9468D27BA085256AFC007F39D9/\\$FILE/v53n4p21063.pdf](http://ntj.tax.org/wwtax/ntjrec.nsf/53542C9468D27BA085256AFC007F39D9/$FILE/v53n4p21063.pdf).

programs.²¹³ As a group, however, it appears that taxpayers seem to base their decisions to marry, divorce, or cohabit primarily on factors other than tax costs.

On a macro level, this makes some sense because the EITC has both incentives and disincentives to marriage and divorce which can change as the circumstances of taxpayers' lives change. On average, the effect on marriage may well be neutral. On a micro level, however, these effects can loom large in the lives of taxpayers. At least anecdotally, the Author can attest through her work in a law school clinic that individuals often do take the EITC into account, along with many other factors, when making important life decisions regarding marriage and divorce. Admittedly, it is highly likely that unrepresented and less-informed taxpayers do this with less frequency.

At any rate, the mere existence of the structural inequities is a problem from a tax policy perspective.²¹⁴ Politicians and pundits use marriage penalties to argue for a reduction in EITC benefits, and such arguments are emotionally persuasive to many.²¹⁵ Even if the incentives do not greatly impact taxpayers' actual marriage decisions prospectively, taxpayers experience and take notice of changes in their EITC outcomes retrospectively, following changes in their living situations. A couple who decides to marry in spite of a disincentive to marry will notice the decrease in their EITC when they file their next tax return. A couple who divorces in spite of an incentive to stay married will also notice their sometimes precipitous EITC decrease. These actual results lead to a perception that the rules are unfair, because indeed they are.

B. Efficiency

Efficiency traditionally is judged by analyzing a rule's indirect and direct costs. Indirect costs are costs to taxpayers for attempting to comply with the law, and direct costs are costs to the government for administering the law.²¹⁶ This subpart examines these costs with respect to the EITC in general and the custodial-parents-only rule in particular.

1. The EITC in General

Indirect costs to taxpayers for complying with the current EITC rules are high. Despite a plethora of educational material regarding eligibility requirements for the various dependent tax benefits, the rules remain difficult to

²¹³ Nada Eissa & Hilary Hoynes, Tax and Transfer Policy, and Family Formation: Marriage and Cohabitation (Dec. 2000) (unpublished manuscript), available at http://faculty.georgetown.edu/noe/cohabitation_paper.pdf.

²¹⁴ See Ellwood, *supra* note 212, at 1100–01.

²¹⁵ See, e.g., Marotta, *supra* note 191.

²¹⁶ See Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 *FORDHAM L. REV.* 395, 409–29 (1987).

navigate,²¹⁷ especially for taxpayers in non-traditional relationships.²¹⁸ Most taxpayers find they need professional assistance to correctly file their taxes, especially if they fall outside the “normal” situation.²¹⁹ In addition, taxpayers claiming an EITC face higher audit rates²²⁰ and often are uniquely poorly suited to participate meaningfully in the IRS’s audit and appeal process.²²¹

The cost to the government in administering the current rule (the direct costs) also is very high. The more complex and counterintuitive a tax rule is, the higher the cost will be to administer it. The government bears the cost of educating taxpayers regarding these complex rules, developing forms and instructions that accommodate the rules, and programming its computers and training its employees to handle the rules accurately. The government also must expend resources to audit taxpayers and defend the results in court.

²¹⁷ Francine J. Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Antipoverty Purse*, 2003 WIS. L. REV. 461, 464 (2003) (“Even experienced certified public accountants have stated that preparing a tax return claiming the EITC is more challenging than completing a Form 1040 with itemized deductions.”).

²¹⁸ Just as one example, while IRS Publication 596 (regarding the EITC) makes it relatively clear that noncustodial parents cannot claim the EITC (if a taxpayer is diligent enough to read through to page 20 and can parse the language which scores a grade 11 on the Flesch-Kincaid readability index), neither IRS Form 8332 nor its instructions (the form that custodial parents use to transfer the right to claim children to noncustodial parents) contains an explanation that the transfer is not valid for the EITC. See IRS, PUBLICATION 596, *supra* note 158; FORM 8332, *supra* note 108. Based on the Author’s experience in an EITC program, the average taxpayer is unlikely to get the right result without an unusual display of diligence. Given the dollar amounts involved in an erroneous EITC claim, it seems that the IRS should specifically address the EITC in very clear language in all its publications and forms.

²¹⁹ About 70% of all tax returns with an EITC are filed by commercial tax preparers. PRESIDENT’S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 3 (2010), available at http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf. Disturbingly, in 1999 approximately 70% of EITC overclaims were attributable to returns prepared by paid preparers. Nat’l Taxpayer Advocate, IRS, *Volume Two: Research and Related Studies*, 2009 ANN. REP. TO CONGRESS 96, available at http://www.irs.gov/pub/tas/09_tas_arc_vol_2.pdf. This statistic demonstrates how complex the EITC is.

²²⁰ See Zelenak, *Tax or Welfare?*, *supra* note 10, at 1875 (noting that EITC enforcement efforts are stricter than enforcement of other tax provisions, but far less strict than enforcement of non-tax cash transfer programs, and concluding that perhaps this is a “price worth paying” for the survival of the EITC).

²²¹ See Leslie Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 OR. L. REV. 351 (2002) (discussing the unique barriers that low-income taxpayers face when dealing with the IRS audit and appeal process).

2. Indirect Costs of the Custodial-Parent-Only Rule

There understandably is far less empirical research about the rule that limits the EITC to custodial parents (“Custodial-Parent-Only Rule”) than exists for the EITC generally. The indirect costs to the noncustodial parent in complying with the rule are higher than the indirect costs generally for taxpayers to comply with the EITC rules. The government has even recognized the high compliance burden on divorced and separated parents.²²²

The high compliance burden results primarily because the rules are not consistent regarding when a noncustodial parent may use his or her child to claim tax benefits. With a valid Form 8332 signed by a custodial parent, a noncustodial parent may claim the dependent exemption and the child tax credit, but not the EITC or head of household status. This is not stated at all on the face of Form 8332. Form 8332 speaks only in terms of “release of claim to exemption.”²²³ The form’s instructions (which are part of the form itself and not a separate document) do explain that signing the “release of the exemption will also allow the noncustodial parent to claim the child tax credit and the additional child tax credit (if either applies).”²²⁴ However, neither the form nor its instructions contain any warning or guidance regarding the effect of signing the form on the ability to claim the EITC.²²⁵ The noncustodial parent could (and often does) mistakenly believe that he or she is entitled to claim the child for all purposes under the Code.²²⁶

This mistaken belief is probably bolstered because it comports with the general rule. Normally, if the person entitled to claim the child does not claim a particular tax benefit, that does not allow another person to use the child for

²²² See PRESIDENT’S ECON. RECOVERY ADVISORY BOARD, *supra* note 219, at 22 (“The rules pertaining to divorced and separated parents are particularly complex and dissimilar to the rules that apply to other parents.”).

²²³ FORM 8332, *supra* note 108.

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ See Nassau, *supra* note 15, at 85–86 n.13 (“In the author’s experience, having represented dozens of taxpayers with tax controversies relating to eligibility for child-based tax benefits, it is apparent that many taxpayers and even some family law attorneys, are unaware: (a) that only two—and which two—of the four child-based tax benefits are transferable from the Custodial Parent to the Noncustodial Parent; and (b) that the Internal Revenue Service has very specific rules—and what those rules are—that must be followed if such intended transfer is to be respected.”); see also PRESIDENT’S ECON. RECOVERY ADVISORY BOARD, *supra* note 219, at 22 (“The rule also reduces EITC compliance because noncustodial parents who claim the child tax credit and other benefits may also intentionally or erroneously claim the EITC as well.”). Professor Book has suggested that the EITC has a structural incentive for noncustodial parents (and others significantly involved in children’s lives, but not in a traditional relationship to children) to intentionally misstate their eligibility for an EITC as a way to redress perceived inequities in the system. Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 AM. U. L. REV. 1163, 1177–78 (2007).

that unclaimed tax benefit.²²⁷ In other words, taxpayers cannot agree to split the tax benefits related to a single child between them—except in the case of divorced or separated parents.²²⁸ It seems clear that, especially in the case of divorced or separated parents, professional assistance will be necessary to accurately file tax returns. This is an especially unfortunate feature for a credit targeted to low-income taxpayers.²²⁹

When the IRS suspects that a taxpayer is not entitled to a claimed EITC, it frequently will freeze the EITC portion of the taxpayer's refund while it audits the return.²³⁰ The process can take months (sometimes years if Tax Court litigation is involved).²³¹ Meanwhile, the taxpayer is denied a critical component of annual household income.²³²

Apart from possibly doing without much-needed money as a result of a frozen EITC, there is a high cost to taxpayers from defending themselves in an

²²⁷ IRS, PUBLICATION 501, *supra* note 83, at 17.

²²⁸ In the Author's experience, this aspect of the current rules is quite widely misunderstood, not only among taxpayers, but among lawyers. Anecdotally, it appears that the common understanding is that the tax benefits for a child are non-divisible and that those tax benefits accrue to the person providing the most support for the child. Indeed, pre-2005 law was closer to this common understanding. *See Nassau, supra* note 15, at 99–100. This is an area ripe for an empirical study.

²²⁹ The IRS has long supported access to free tax preparation services for low-income taxpayers through its Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. For the 2012 filing season, the IRS awarded \$12 million in grants to 213 VITA organizations in all 50 states. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REP. NO. 2012-40-049, ADDITIONAL STEPS ARE NEEDED TO ENSURE THE VOLUNTEER INCOME TAX ASSISTANCE GRANT PROGRAM REACHES MORE UNDERSERVED TAXPAYERS (2012), *available at* <http://www.treasury.gov/tigta/auditreports/2012reports/201240049fr.html>. In 2011, VITA sites prepared over one million returns. *Id.* In addition, the IRS has partnered with tax software companies to provide free access to tax preparation software to low-income taxpayers. *See Free File*, IRS, <http://www.freefile.irs.gov/> (last visited Sept. 5, 2014). Despite these efforts, which should be applauded and encouraged, there is no substitute for ensuring that taxpayers can comply without professional assistance, unless there is a policy reason that justifies the complexity.

²³⁰ EITC refunds frequently are frozen when an audit happens as part of the return processing stage. Megan Newman, *The Income-Tax Gap: The Hybrid Nature of the Earned Income Tax Credit Leads to Its Exclusion from Due Process Protection*, 64 TAX LAW. 719 (2011).

²³¹ 2012 NTA, *Study of Tax Court Cases, supra* note 76, at 74 (“The study found that taxpayers often had to wait almost a year and a half to receive the EITC refunds to which they were entitled.”).

²³² If the EITC were typically used to bolster savings or for longer-term financial goals, such a delay would be frustrating, but not especially problematic. However, the lowest-income taxpayers typically use their EITC refunds for everyday necessities, like paying rent and utilities or buying clothes or food. Higher-income taxpayers commonly use their EITC refunds for other urgent needs, like car repairs or replacing broken appliances. *See Newman, supra* note 230; *see also* 2012 NTA, *Study of Tax Court Cases, supra* note 76, at 74 (“For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes.”).

audit process they frequently do not understand and find difficult to navigate.²³³ Apart from the customary monetary “costs,” a taxpayer facing an EITC audit faces an array of other costs. The person may decide to hire professional help, meaning they likely are foregoing other important uses for the money, like a visit to the doctor, fresh produce, or school supplies for their children. The person often must take time off work²³⁴ or find child care in order to visit the attorney’s office or go to the bank to ask for statements or go to a state office to get records regarding assistance payments received. The increased financial stress and uncertainty produced by the audit may actually affect the person’s cognitive abilities, making it even harder to hold down a job, juggle financial priorities, or be successful in school.²³⁵

Even with the burdens that EITC audits impose on families already burdened by poverty, society may deem that an acceptable price to be paid for accuracy. However, there is strong evidence that the IRS’s audit process does not produce more accurate results. While the majority of taxpayers respond to IRS correspondence asking for EITC documentation,²³⁶ approximately 70% of taxpayers do not respond at all or respond “inadequately.”²³⁷ Taxpayers typically want to produce the documentation needed, but have trouble understanding the request.²³⁸ Before her appointment, Nina Olson, the National Taxpayer Advocate, estimated that approximately 25% of credits disallowed by the IRS are disallowed in error because taxpayers are not capable of navigating

²³³ See Schneller et al., *supra* note 58, at 178 (noting that the “system is uniquely challenging to low-income taxpayers who may lack the skills required to navigate the tax return and audit processes”).

²³⁴ Nat’l Taxpayer Advocate, IRS, *Volume Two: Taxpayer Advocate Service Research Studies and Reports*, 2007 ANN. REP. TO CONGRESS 106 [hereinafter 2007 NTA, *EITC Audit Study*], available at http://www.irs.gov/pub/tas/arc_2007_vol_2.pdf (20.9% of survey respondents reported taking time off work to gather requested documentation).

²³⁵ Poverty already causes cognitive ability to decrease, equivalent to 13 IQ points. See Emily Badger, *How Poverty Taxes the Brain*, CITYLAB (Aug. 29, 2013), available at <http://www.citylab.com/work/2013/08/how-poverty-taxes-brain/6716/>.

²³⁶ 2007 NTA, *EITC Audit Study*, *supra* note 234, at 95 (over 90% of taxpayers contacted the IRS about the audit).

²³⁷ Book, *Taxpayers Caught in the Net*, *supra* note 221, at 390–91.

²³⁸ 2007 NTA, *EITC Audit Study*, *supra* note 234, at 103–04. This matches the Author’s experience helping low-income taxpayers defend their EITC claims before the IRS. Taxpayers the Author has worked with commonly misunderstand the purpose for the documentation request. For example, if the IRS questions the residency requirement, the IRS letter suggests that the taxpayer submit school records. Commonly, the taxpayer will submit school records for the current year rather than the relevant tax year, or will submit school records lacking the child’s address. The IRS then sends a generic letter stating that the records were insufficient, but not explaining why. The taxpayer is left highly confused. Some trustingly accept they are not eligible, even though in reality they are. Such taxpayers often forgo future EITC claims. Some enter into installment agreements to repay a debt that they should not owe. Only the most intrepid seek out assistance from the Taxpayer Advocate Service or a Low Income Taxpayer Clinic.

the audit and appeal process.²³⁹ The studies that the National Taxpayer Advocate's Office has performed since then support her assertion that a meaningful percentage of EITC denials are erroneous. The National Taxpayer Advocate reported in her 2004 Annual Report to Congress that EITCs that were initially denied on audit were restored 45% of the time when the taxpayer was assisted by the Taxpayer Advocate Service through the audit reconsideration process.²⁴⁰ In her 2007 Annual Report to Congress, the National Taxpayer Advocate noted that represented taxpayers are almost twice as likely to retain their EITC during the audit process compared to unrepresented taxpayers and that over 40% of all represented taxpayers retained their full EITC after an audit compared with less than one in four unrepresented taxpayers who kept their full EITC.²⁴¹ It seems clear that access to representation dramatically affects the likelihood that a taxpayer's EITC will be fully allowed. In other words, many taxpayers who lose their EITC audits may actually be entitled to the EITC but simply are failing at the audit process.²⁴² This imposes enormous costs on the taxpayers as well as the government and society in general.

3. Direct Costs of the Custodial-Parent-Only Rule

The direct costs to the government in administering the Custodial-Parent-Only Rule are high. This is largely due to the difficulty that divorced and separated parents face in filing accurate returns. In some cases, the problem is easy for the IRS to detect. A taxpayer who filed a Form 8332 and also claimed an EITC likely did so improperly; if the child listed on Form 8332 is the same child listed on Schedule EIC, then the taxpayer clearly did something wrong on the return. In other cases, the problem is harder to detect. For example, a noncustodial parent may fail to file Form 8332 (intentionally, inadvertently, or through misunderstanding) and simply claim the child on the

²³⁹ *Id.*; Sheryl Stratton et al., *EITC Error Rates Up; Review Process Slows Down*, 89 TAX NOTES 28, 30 (2000).

²⁴⁰ Nat'l Taxpayer Advocate, IRS, *Volume Two: Earned Income Tax Credit (EITC) Audit Reconsideration Study*, 2004 ANN. REP. TO CONGRESS 9 [hereinafter 2004 NTA, *Audit Reconsideration Study*], available at <http://www.irs.gov/pub/tas/nta2004arcvol2interactive.pdf>.

²⁴¹ 2007 NTA, *EITC Audit Study*, *supra* note 234, at 96.

²⁴² This dynamic also appears in later stages of EITC controversies. The National Taxpayer Advocate examined the number of EITC claims granted during Tax Court settlements and through audit reconsiderations and determined the numbers are inconsistent with initial audits designed to obtain accurate results. 2004 NTA, *Audit Reconsideration Study*, *supra* note 240, at i ("The study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration. Where the taxpayer received additional EITC, he or she received, on average, 94 percent of the EITC amount claimed on the original return."); *see also* 2012 NTA, *Study of Tax Court Cases*, *supra* note 76 (noting that in cases where the IRS concedes the EITC during Tax Court litigation there was ample opportunity for that result to be settled upon in audit and arguing this indicates the EITC audit process is flawed).

return; if the custodial parent does not also claim the child, then there is little on the face of the returns that would indicate a problem. The IRS would have to rely on additional research or random sample audits to detect the noncompliance.

In either case, the IRS must audit the noncustodial parent, and the case can take a year or more to resolve, using up IRS resources that could be dedicated to other purposes. In the meantime, the IRS may have paid the refund to the taxpayer.²⁴³ The IRS must wait to collect the debt until after the audit is over, plus any administrative or U.S. Tax Court appeals.²⁴⁴ At that point, the taxpayer has almost certainly spent the erroneous refund and cannot pay the liability without serious economic burden. This means the IRS will have to devote additional resources to collecting the tax liability and, in fact, may never fully collect the debt.²⁴⁵

C. Effectiveness in Advancing Policy Goals

1. The EITC in General

Tax policy can be judged using more inclusive measures than equity and efficiency; one can analyze a rule's broader societal costs and whether a rule actually achieves its stated policy objectives. Most scholars agree that the current EITC has been very successful in achieving its policy objectives. The stated purpose of the EITC when it was adopted in 1975 was to offset payroll taxes for low-income workers.²⁴⁶ By its design, it achieves this purpose quite well. The credit rate for the non-child-based EITC is 7.65%, equal to the employee's share of payroll taxes. Many have questioned whether this policy objective would be better served by simply exempting a certain level of wages from payroll taxes.²⁴⁷ Others have argued that the EITC operates as a subsidy

²⁴³ The IRS has authority to freeze refunds it suspects are improper. *See generally* IRS, INTERNAL REVENUE MANUAL 21.5.6.4.7 (2014), available at http://www.irs.gov/irm/part21/irm_21-005-006r.html. However, often the audit occurs after the EITC has already been paid.

²⁴⁴ The IRS has general authority to assess income tax pursuant to Code section 6201, but Code section 6213 restricts the assessment of a deficiency in the reported tax until after Tax Court proceedings have been completed. I.R.C. §§ 6201, 6213 (2014). Code section 6331 permits the IRS to collect tax by levy, but only after notice and demand is made pursuant to Code section 6303, which can only happen after the IRS has made an assessment. I.R.C. §§ 6331, 6303. *See also* 2 KEITH FOGG, EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE IRS, ch. 10 (5th Ed. 2011).

²⁴⁵ The IRS has ten years to collect tax debt using administrative measures such as liens and levies. I.R.C. § 6502. Additionally, the taxpayer may submit a successful offer in compromise, lowering their debt to as low as \$1. I.R.C. § 7122; IRS Form 656 (rev. 1-2014).

²⁴⁶ *See supra* note 29.

²⁴⁷ *See, e.g.*, MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 178–81 (2008); Jonathan Barry Forman, *Making Social Security Work*, 65 OHIO ST. L.J. 145, 172–73 (2004).

for employers that artificially lowers wages, and that rather than offsetting payroll taxes with the EITC, the government should legislate a living minimum wage.²⁴⁸ Despite these and similar calls for reform, it seems clear that the EITC fulfills its goal of offsetting payroll taxes and providing a work incentive for low-wage workers.

Another clear purpose of the EITC was to create a cash assistance program that incentivizes people to work. Studies consistently show that the EITC has resulted in higher participation in the workforce by low-income workers, particularly single mothers.²⁴⁹ Theoretically, there are anti-work incentives at the margins; a worker might reject extra hours to avoid triggering the phase-out; a worker might be better off cutting back on hours to escape the phase-out. While there is a theoretical incentive to reduce work for taxpayers in or near the phase-out range, the studies show that taxpayers do not actually work reduced hours, or that the reduction is very small.²⁵⁰

2. The Custodial-Parent-Only Rule

Does the Custodial-Parent-Only Rule advance the policy goals of the EITC? As discussed above, the stated purpose of the EITC in 1975 was to offset the regressive nature of payroll taxes on low-income workers.²⁵¹ Another clear purpose of the EITC, especially after 1993, is delivering needs-based cash assistance payments to lower-income people.²⁵² Both of these goals can be judged by the amount of EITC that reaches working people; the higher the credit, the greater the payroll tax offset effect and the greater the assistance received.

Although it does not hinder these goals in many cases, the Custodial-Parent-Only Rule never advances these goals. In situations where both parents in a Two Home Family are making relatively equal earned income, these goals arguably are not hindered. When both parents in a Two Home Family are making relatively equal income, a rule that limits the EITC to only the custodial parent does not result in a lower credit, as opposed to a rule that allows either

²⁴⁸ See, e.g., Zelenak, *Family-Size Adjustment to the Minimum Wage*, *supra* note 8.

²⁴⁹ See, e.g., Stephanie Hoffer, *Adopting the Family Taxable Unit*, 76 U. CIN. L. REV. 55, 69 (“[I]t is ‘widely accepted’ that the Earned Income Tax Credit increased labor force participation by single mothers.”); see also Bradley T. Heim, *The Impact of the Earned Income Tax Credit on the Labor Supply of Married Couples: A Structural Estimation* (Jan. 2010) (unpublished manuscript), available at http://www.indiana.edu/~spea/faculty/pdf/heim_EITCFamLS.pdf.

²⁵⁰ See Thomas L. Hungerford & Rebecca Thiess, *The Earned Income Tax Credit and the Child Tax Credit: History, Purpose, Goals, and Effectiveness*, 370 ECON. POL’Y INST. 1 (2013), available at <http://www.epi.org/publication/ib370-earned-income-tax-credit-and-the-child-tax-credit-history-purpose-goals-and-effectiveness/>; Meyer, *supra* note 211, at 168; Greene, *supra* note 5; Heim, *supra* note 249.

²⁵¹ See *supra* note 29.

²⁵² See *supra* note 42.

parent (but not both) to claim the credit.²⁵³ Regardless of which parent claims the credit, it will have the same effect on the identified goals because each parent makes the same amount of money.²⁵⁴ However, where the custodial parent makes less earned income than the noncustodial parent, the identified goals are hindered by the Custodial-Parent-Only Rule. Even if the family's combined income does not change, the credit is lowered or eliminated simply because the custodial parent makes a lower share of the family income. The Author can think of no situation where the Custodial-Parent-Only Rule would generate a higher credit than a rule that allows either parent to claim the EITC.

The EITC's goal of encouraging work seems to be advanced by the Custodial-Parent-Only Rule. The custodial parent is encouraged to work because only the custodial parent is permitted to claim the EITC. However, this positive work incentive for the custodial parent is counterbalanced by a disincentive to work for the noncustodial parent. The noncustodial parent cannot claim the EITC (at least not the child-based EITC) and, therefore, has no incentive to work. As public policy, these incentives are skewed. If society must choose which parent to incentivize to work, it seems more logical to incentivize the parent with fewer child care responsibilities.

D. Neutrality

Tax neutrality suggests that the Code, to the extent possible, should not cause people to alter behavior solely for tax reasons unless there is a public policy reason for doing so.²⁵⁵ By design, the EITC is intended to spur low-income people toward work. It does this well, and the United States has a strong public policy in favor of encouraging able-bodied individuals to work. Even though a primary purpose of the EITC is to cause people to alter their behavior, tax neutrality is not violated because there is a public policy reason for this effect. However, there are clear tax neutrality implications to the marriage incentives and disincentives built into the EITC.

Marriage incentives and disincentives are problems within the structure of the tax system in general and the EITC in particular.²⁵⁶ The EITC's structure encourages some taxpayers to cohabit rather than marry. There is an incentive to cohabit rather than marry when either (1) the taxpayers can split children between two EITC-eligible returns or (2) the potential spouse's income would

²⁵³ Naturally, the credit would be maximized if separated parents were allowed to combine their incomes, but that would create large equity concerns.

²⁵⁴ As compared to a Married Couple or Cohabiting Couple with the same family-level earned income, the results would vary. For higher-income non-married families, splitting income means having less EITC income, which can avoid the phase-out rules. However, for lower-income married families, combining income can increase the EITC.

²⁵⁵ See Donaldson, *supra* note 184, at 550–51.

²⁵⁶ See Bradshaw, *supra* note 190.

push the couple into the phase-out range if married.²⁵⁷ Despite the Author's insistence in this Article that the government should respect individuals' autonomy with regard to marriage choices, there clearly is no policy reason for discouraging marriage. The EITC will encourage other taxpayers to marry. For example, a taxpayer with children and little to no earned income is incentivized to marry a taxpayer with enough earned income (but not too much) to obtain the EITC. While an incentive to marry seems like a more reasonable result, it can have pernicious effects, such as encouraging a battered woman to stay with a violent husband. There do not appear to be any sensible policy justifications for these varying incentives.

As noted in *supra* Part IV.A.3, studies suggest that the Code's marriage incentives and disincentives have little impact on taxpayers' actual marriage decisions on a macro level. However, more work needs to be done in this area to reach a firm conclusion. It seems clear that the EITC has some impact on a micro or family level, meaning it must cause some families to alter their behavior. It also seems reasonable to hypothesize that the Custodial-Parent-Only Rule in particular could have a large non-neutral, behavior-altering effect because the potential impact of the Custodial-Parent-Only Rule can be so severe, up to and including a complete forfeiture of the EITC. Even if there is little prospective effect on marriage decisions, there are clear retrospective inequitable results that occur following changes in living situations. Regardless of the actual level of behavior alteration, there is much to be said even for symbolic neutrality. Symbolic neutrality would contribute to a perception that our tax rules are fair and could even encourage better compliance.

V. PROPOSAL

This Article's proposal is powerful largely because it is simple. However, adopting this one simple change would dramatically improve the ability of families to make personal decisions without having those decisions needlessly warped by the fear of losing the EITC. The proposal respects the basic freedom of people to liberty and autonomy. Custodial parents already have the ability to transfer the dependent exemption and child tax credit to noncustodial parents by signing Form 8332. The proposal simply would extend this ability to the EITC. This part outlines the specific change proposed by this Article, illustrates the effect of this Article's proposed change, looks at other proposals for change, and analyzes the proposed change under tax policy measures.

²⁵⁷ See *supra* Part IV.A.1 (analyzing hypothetical situations and noting incentives to cohabit rather than marry).

A. *Specific Proposed Change*

Accomplishing EITC portability is a simple matter. Currently, Code section 32(c)(3) reads “[t]he term ‘qualifying child’ means a qualifying child of the taxpayer (as defined in section 152(c), determined without regard to paragraph (1)(D) thereof and section 152(e)).” The effect of this language is to disregard the normal support test in Code section 152(c)(1)(D) and the special rules in Code section 152(e) which allow a custodial parent to transfer a tax benefit to a noncustodial parent. The Author proposes that Code section 32(c)(3) be changed to read “[t]he term ‘qualifying child’ means a qualifying child of the taxpayer (as defined in section 152(c), determined without regard to paragraph (1)(D) thereof).”

B. *Effect of Making the EITC Available for Tax Arbitrage*

To demonstrate the impact of full EITC portability on a Two Home Family, return to the case study presented in the Introduction and in *supra* Part III.E and add some details. Recall that Mom has primary custody of two children and cannot find work. Dad fell behind on child support when he lost his job. He was finally able to find two low-wage, part-time jobs. Mom and Dad returned to court to revisit Dad’s child support obligations. Dad resumed regular payments, but did not have enough current income to begin paying his past due support. Under current law, as discussed in *supra* Part III.E, Mom can allow Dad to claim certain child-based tax benefits, resulting in a net positive tax situation of \$2,828.75 (i.e., the family is \$2,828.75 richer). Because Dad had child support arrearages, Mom negotiated that Dad would pay her the full \$2,828.75 toward the arrearages.

If the EITC were also portable, the family’s tax situation significantly improves, as follows, using 2014 figures:

	CUSTODIAL MOM	NONCUSTODIAL DAD
IF MOM USES CHILD-BASED TAX BENEFITS:		
Income	\$0	\$20,000
Less standard deduction	(\$9,100) (HOH) ²⁵⁸	(\$6,200) (single)
Less exemptions	(\$11,850) (3 persons)	(\$3,950) (1 person)
Taxable income	\$0	\$9,850
Tentative tax	\$0	\$1,023.75
Less child tax credit	(\$0)	(\$0)
Tax	\$0	\$1,023.75
Less additional child tax credit	(\$0)	(\$0)
Less EITC	(\$0)	(\$0) ²⁵⁹
Tax owed	\$0	\$1,023.75
IF DAD USES CHILD-BASED TAX BENEFITS:		
Income	\$0	\$20,000
Less standard deduction	(\$9,100) (HOH)	(\$6,200) (single)
Less exemptions	(\$3,950) (1 person)	(\$11,850) (3 persons)
Taxable income	\$0	\$1,950
Tentative tax	\$0	\$195
Less child tax credit	(\$0)	(\$195)
Tax	\$0	\$0
Less additional child tax credit	(\$0)	(\$1,805)
Less EITC	(\$0)	(\$5,003) ²⁶⁰
Tax owed	\$0	(\$6,808) [refund]
Change in Tax Liability	\$0	\$7,831.75

Recall that under current rules, there is a net gain of \$2,828.75 when Mom shifts the exemptions and the child tax credit to Dad; \$2,828.75 that would not exist but for the shift in tax benefits and which Mom could negotiate that Dad pay her to lower his arrearages. Here, with EITC portability, there is a net gain of \$7,831.75. That might enable Dad to pay off his support arrearage and increase his future payments to Mom. This is good for Dad and good for Mom, but most importantly, it is good for the kids.

²⁵⁸ HOH is an abbreviation for head of household filing status.

²⁵⁹ Dad would be eligible for the EITC for a childless worker, but makes too much earned income. In 2014, this EITC is fully phased out for incomes above \$14,590.

²⁶⁰ This reflects the credit available to workers with two qualifying children, reduced by the phase-out, as follows: [\$5,460 - ((\$20,000 - \$17,830) * 21.06%)].

C. Other Proposals for Change

The Author found one other proposal that directly addresses the Custodial-Parent-Only Rule. The President's Economic Recovery Advisory Board ("PERAB") prepared a report in 2010 that recognized the desirability of "clarify[ing]" the rules regarding waivers of child tax benefits.²⁶¹ That report concluded that "one option to address the situation is to eliminate the ability of divorced or separated parents to exchange tax benefits." The report noted that such an elimination would have efficiency benefits and improve horizontal equity when comparing individuals in similar custodial and residential situations.²⁶² It also simplistically claimed that taxes for custodial parents would be reduced.²⁶³ As explained in this Article, that is true only assuming the custodial parent has income. This Article's approach is superior because it also would clarify the rules, simplify the EITC, improve horizontal equity on a family-unit basis, and produce efficiency gains by improving EITC compliance. However, this Article's proposal achieves these goals while also preserving access to an important federal tax benefit and respecting families' rights to self-determination by reducing the influence tax rules have on living and custody decisions. The 2010 PERAB report was cited in a 2013 Senate Finance Committee Staff paper as including a proposal to "simplify[] [the] rules governing which parent can claim the EITC when parents are separated."²⁶⁴ It is true that elimination would be simpler and more efficient, but the Author fervently hopes that the government does not "simplify" the rules out of existence.

Other proposals have targeted noncustodial parents not eligible for the EITC. A separate EITC for noncustodial parents was proposed in 2007 by Senator Evan Bayh and then-Senator Barack Obama.²⁶⁵ Senator Bayh reintroduced the idea in 2009.²⁶⁶ New York State²⁶⁷ and Washington, D.C.,²⁶⁸ have state versions of a noncustodial parent EITC. Most of these proposals are

²⁶¹ See PRESIDENT'S ECON. RECOVERY ADVISORY BD., *supra* note 219, at 22.

²⁶² See *id.* Of course, it would be most "efficient" to eliminate the tax benefits entirely. However, assuming the social gains from the benefits offset the losses to efficiency, the question is how to improve efficiency while maintaining access to the benefits.

²⁶³ *Id.* at 23.

²⁶⁴ SENATE FIN. COMM., 113TH CONG., STAFF TAX REFORM OPTIONS FOR DISCUSSION: FAMILIES, EDUCATION AND OPPORTUNITIES 5 (2013), available at <http://www.finance.senate.gov/imo/media/doc/041813%20Family%20Education,%20and%20Opportunities%20Options%20Paper.pdf>.

²⁶⁵ Responsible Fatherhood and Healthy Families Act of 2007, S. 1626, 110th Cong. (2007).

²⁶⁶ Responsible Fatherhood and Healthy Families Act of 2009, S. 1309, 111th Cong. (2009).

²⁶⁷ N.Y. TAX LAW § 606(d-1) (Consol. 2014).

²⁶⁸ D.C. CODE § 47-1806.04(g) (2014).

conditioned on compliance with child support obligations.²⁶⁹ The adoption of a proposal similar to these would be of great value to low-income families, especially where the custodial parent is able to fully utilize the EITC. This Article's proposal, however, targets the situation where the custodial parent cannot take full advantage of the EITC because of unemployment or underemployment.

Like the proposals for a separate EITC for noncustodial parents, should this Article's proposal be conditioned on compliance with child support obligations? This Article explicitly rejects such a requirement being imposed by the Code and enforced by the IRS. While it is an understandable reaction to want to deny tax benefits to a "dead beat parent," this type of requirement is not an efficient mechanism for offering benefits to noncustodial parents. In addition, it would needlessly complicate tax administration.

The noncustodial parents most in need of a boosted EITC are those experiencing underemployment (to supplement wages) or who have experienced periods of prior unemployment (to pay off debts that usually accrue during unemployment). However, these noncustodial parents also are the most likely to have child support arrearages.²⁷⁰ Conditioning an EITC (or other child-based tax benefit) for noncustodial parents on current compliance with child support undercuts the effectiveness of the program in meeting the needs of the targeted population. Allowing EITC tax arbitrage is more likely to boost child support compliance rates.²⁷¹ A study of the incidence of currently allowable tax arbitrage estimated that when noncustodial parents claimed the child tax credit, the custodial parent would see an increase in child support rates of up to 9%.²⁷² Extending permissible tax arbitrage to the EITC, which involves greater amounts of money, should result in even higher increases in child support rates.

Conditioning tax benefits on paying child support makes it difficult for taxpayers to know with certainty at filing time whether or not they are entitled to the tax benefits. What level of child support compliance is sufficient? Who makes that decision? The answers are unlikely to be sufficiently clear at tax time to enable accurate filing. This merely creates needless risk for taxpayers. If both parents claim the children, perhaps with legitimate reason to believe this is accurate, both will likely be audited and one will lose the audit. One of these

²⁶⁹ Ronald B. Mincy et al., *Income Support Policies for Low-Income Men and Noncustodial Fathers: Tax and Transfer Programs*, 635 ANNALS 240 (2011); Mombrun, *supra* note 178, at 133–34.

²⁷⁰ Perhaps unsurprisingly, there is a strong correlation between having low income and having accumulated child support arrearages. See Mincy et al., *supra* note 269, at 249–51.

²⁷¹ Looney, *supra* note 179.

²⁷² *Id.*

low-income people will be in the unenviable position of repaying the EITC,²⁷³ plus penalties and interest, probably after a prolonged audit and appeal process and possibly litigation. In any case, the family's limited income will be used for paying a tax bill rather than supporting the children or paying past due or current child support.²⁷⁴

The custodial parent has the power to consent or not consent to the transfer of the tax benefits to the noncustodial parent. This consent can be given year-by-year or made effective for a range of future years. The waiver can be revoked by the custodial parent any time until the end of the relevant tax year.²⁷⁵ Thus, the custodial parent can self-police compliance with child support obligations before signing the waiver. Alternatively, either party can ask a court to compel the waiver if child support obligations have been met or to bless the withholding of the waiver if they have not.²⁷⁶ While there are some opportunities for unfair or complicated results, this Article's proposal has the distinct benefit of placing the decision in the hands of the parties involved and/or the courts rather than the IRS. The IRS is ill-suited for policing child support agreements.²⁷⁷ Leaving the IRS in charge of this function is inefficient and more likely to lead to erroneous results because of the inherent limits of the investigative function of an audit as opposed to a court proceeding.

Allowing full EITC portability would empower low-income taxpayers to improve their financial condition using tax arbitrage.²⁷⁸ Rather than relying on default provisions in the Code, which simply guess the party to whom the benefit is best directed, the taxpayers themselves can make this determination. If the family's income increases by having the custodial parent claim the EITC, then the parties could agree to that.²⁷⁹ However, if the family's income increases by having the noncustodial parent claim the EITC, then the parties could agree to that, perhaps coupled with an agreement by the noncustodial

²⁷³ The IRS frequently freezes suspicious EITC refunds. However, in many cases, the IRS pays the refund and later audits the taxpayer. *See infra* notes 230, 243.

²⁷⁴ The alternative is the tax debtor parent will negotiate a lower (as low as \$1) repayment amount through an offer in compromise, or the debt will eventually become uncollectable, which means the government spent a lot of resources to achieve no change in the actual result. *See supra* note 245.

²⁷⁵ 26 C.F.R. § 1.152-4(e)(3) (as amended in 2008).

²⁷⁶ Requiring court action necessarily inserts delays and uncertainty into the process, but may be unavoidable when the separated parents cannot self-police.

²⁷⁷ *See* Mincy et al., *supra* note 269, at 252 ("The administrative challenges associated with verifying whether the [noncustodial parent] has a formal child support order, whether that order has been paid in full, and whether the father is income eligible and meets the tax requirements, and then rapidly sharing that information across the two agencies, [the IRS and the State Office of Child Support Enforcement,] cannot be underestimated.").

²⁷⁸ For a detailed discussion of tax arbitrage, see Mombrun, *supra* note 178.

²⁷⁹ Unless a court is involved, the decision lies solely with the custodial parent who can waive or not waive the tax benefits in his or her exclusive discretion.

parent to pay all or a portion of the credit to the custodial parent. For example, if the noncustodial parent has a support arrearage, the parents could agree (or a court could order) that the noncustodial parent will direct 100% of the EITC (or 100% of the tax savings) toward the arrearage. This benefits everyone involved; the child and custodial parent have increased financial stability and the noncustodial parent works towards compliance. If the noncustodial parent is current on child support, different arrangements may be desirable. The noncustodial parent's net tax benefit could be split evenly; more complicated but more equitable, the noncustodial parent could be required to pay the custodial parent an amount equal to the custodial parent's net tax loss plus half of the "tax arbitrage" savings.²⁸⁰

This Article's proposal replaces a rigid rule that attempts to ensure the credit benefits the child with a flexible rule that enables the child's parents to structure an arrangement that is more likely to ensure this result. In addition to being more efficient and more likely to yield the desired results, allowing full EITC portability respects the autonomy of lower-income taxpayers. Rather than imposing a rule to order the affairs of lower-income taxpayers, this Article's approach enables them to order their own affairs.

D. Equity

Recall from the discussion above that "horizontal equity" requires that similarly situated taxpayers bear similar tax burdens. This Article analyzed the horizontal equity of the current rules in terms of comparing similarly situated taxpayers eligible for the EITC and determined that the current rules frequently break the principle of horizontal equity. Among two-earner couples, the Cohabiting Couple almost always has the highest EITC and Married Couples have a higher EITC than Two Home Families at lower-income levels. Importantly, though, when looking at one-earner families where the sole or principal wage earner is not also the custodial parent, the Two Home Family can experience a complete forfeiture of the EITC.

With respect to two-earner families, this Article's proposal to allow custodial parents to shift the EITC to noncustodial parents promotes horizontal equity between One Home Families and Two Home Families, although it does not achieve true parity of result. Recall the comparison of a two-earner couple with two children making \$10,000 each. Under current law, the Two Home Family would generate a \$4,000 EITC (claimed by the custodial parent), the Married Couple would generate a \$5,460 EITC, and the Cohabiting Couple would generate a \$6,610 credit (\$3,305 of which is claimed by each parent). Under this Article's proposal, the Two Home Family could achieve the same result as the Cohabiting Couple. The custodial parent could keep the right to claim one of the children and transfer the right to claim the other to the

²⁸⁰ Mombrun, *supra* note 178, at 141–42.

noncustodial parent. Each parent would generate an EITC of \$3,305, or \$6,610 for the family. However, the Married Couple would generate a lower credit than either the Cohabiting Couple or the Two Home Family—\$5,460 versus \$6,610.

The same is true when comparing families with two children and \$30,000 of family income divided evenly between two wage earners. Under this Article's proposed rule, the Two Home Families could generate a \$6,610 EITC, the same as a Cohabiting Couple. However, the Married Couple would only generate a \$4,040.56 EITC because the Married Couple is subject to the phase-out.²⁸¹

Thus, while this Article's proposal promotes horizontal equity between Two Home Families and Cohabiting Couples, it worsens the inequity between Married Couples and Two Home Families with respect to two-earner families. This inequity is a function of the EITC's structure and the realities of joint filing.²⁸² One source of the inequity is the ability of the Cohabiting Couple (and the Two Home Family under this Article's proposed change) to split two or more children between two EITC-eligible returns.²⁸³ Married couples cannot split children on separate EITC-eligible returns; if they file as married filing separate, they are ineligible for the EITC. This inequity could easily be fixed by allowing married filing separate taxpayers to claim the EITC.²⁸⁴ Another potential fix, but one which would have an impact more far-reaching than the EITC, would be to eliminate joint filing and tax everyone as individuals.²⁸⁵

A thorough analysis of these alternatives to improving equity is outside the scope of this Article. However, it is clear that eliminating joint filing or allowing married filing separate taxpayers to claim the EITC also would eliminate another important source of EITC marriage inequity. Currently, married taxpayers are forced to combine incomes when claiming the EITC. For lower-income taxpayers, this is usually a benefit, allowing the couple to claim a

²⁸¹ See *supra* note 197.

²⁸² For an overview of marriage penalties and bonuses in the Code, including the EITC, and an analysis of proposals to alleviate marriage penalties, see Thomas, *supra* note 190. (After this article, the EITC was amended to adopt limited marriage penalty relief; however, the article remains highly relevant.)

²⁸³ See Bradshaw, *supra* note 190.

²⁸⁴ There are other disadvantages to married filing separately filing status. For example, married filing separately taxpayers are prohibited from claiming an adoption credit and the newly enacted premium tax credit. I.R.C. §§ 23(f)(1), 36B(c)(1)(C) (2014). These inequities between married filing jointly and married filing separately taxpayers must be fixed to make this solution viable for married couples seeking to maximize their EITC as their non-married counterparts can.

²⁸⁵ This has been suggested by several scholars over the years. See, e.g., Drumb, *supra* note 168; Lily Kahng, *One Is the Loneliest Number: The Single Taxpayer in a Joint Return World*, 61 HASTINGS L.J. 651 (2010).

higher EITC than if they were taxed as individuals.²⁸⁶ However, for taxpayers with relatively higher incomes,²⁸⁷ the joint income requirement is a detriment, leading to a lower EITC than if they had been taxed as individuals.²⁸⁸ This causes disparities among married couples and also between married couples and non-married couples. It is not only an incentive or disincentive to marriage, but also an incentive or disincentive for the “second” wage earner spouse (typically the mother, though certainly not always) to work.²⁸⁹

When looking at one-earner families, this Article’s proposal enhances parity between One Home Families and Two Home Families. Under current law, one-earner Married Couples have a slight advantage over one-earner Cohabiting Couples because Married Couples have a more extended phase-out range than non-married couples. This Article’s proposal does not change that. However, it allows the Two Home Family to allocate the EITC to the parent with earned income, something that One Home Families already can do under the current law. This promotes horizontal equity.

This Article does not attempt to address or solve all the EITC parity issues. Solutions for the EITC’s marriages disincentives involve much more extensive legislative changes than appear practicable in the current political climate; also, because the potential solutions usually affect other tax attributes and can create different inequities, they deserve a more thoughtful and thorough analysis than is possible in this Article. The inequity that is the focus of this Article, the one with such a harsh result, is the complete forfeiture of the EITC for Two Home Families where the custodial parent does not work. This Article’s proposal to allow the custodial parent to shift the right to the EITC to the noncustodial parent prevents this harshest of results; it prevents the complete forfeiture of the EITC even if it does not guarantee perfect equity of result among all similarly situated taxpayers.

Recall that “vertical equity” requires that taxpayers who are not similarly situated bear tax burdens relative to their respective abilities to pay. Stated differently, differences in tax burdens should be explained by differences in abilities to pay based on differing circumstances and not by other factors. The current rules violate vertical equity because the differences in the amounts of credit generated by cohabiting, married, and separated families cannot be explained by differences in their respective abilities to pay. On the contrary, because of economies of scale, the intact families should have a

²⁸⁶ This is true provided the “second” income brings total joint income up to the sweet spot range (in 2014, starting at \$9,720 for one child and \$13,650 for two or more children).

²⁸⁷ No one claiming the EITC can legitimately be called a high-income taxpayer.

²⁸⁸ To the extent that the “second” income brings joint income up to or over \$23,260 in 2014 (the start of the phase-out range for joint taxpayers with any number of children), this marriage penalty exists.

²⁸⁹ See Dorothy A. Brown, *Race, Class, and Gender Essentialism in Tax Literature: The Joint Return*, 54 WASH & LEE L. REV. 1469 (1997).

greater ability to pay than the separated families, yet the separated families often generate lower credit amounts than the intact families.

This Article's proposal to allow EITC portability between custodial and noncustodial parents promotes vertical equity because it promotes horizontal equity. The proposal eliminates the difference in tax burdens for families that are making similar amounts of income. Thus vertical equity is satisfied. It is true that the One Home Family likely has a greater ability to pay due to economies of scale, and thus perhaps should bear a greater tax burden under vertical equity principles. However, lowering the EITC simply because a family lives together as opposed to apart would create exactly the sort of perverse incentive this Article is arguing against. The cost in vertical equity is worth the gain in neutrality.

E. Efficiency

Recall that efficiency traditionally is judged by analyzing a rule's indirect and direct costs. Indirect costs are to taxpayers for attempting to comply with the law and direct costs are to the government for administering the tax law.²⁹⁰ The indirect and direct costs of the current rule allowing only custodial parents to claim an EITC are high. Taxpayers have a hard time complying with the law because of its complexity, and the government has a hard time administering the law because of the nature of the examination and collection functions.

It might seem at first blush that it would more efficient for the statute to define a single person eligible to claim the EITC, as is done under current law. Such bright line rules typically are easier for taxpayers to follow and the IRS to administer. This Article's proposal requires taxpayer action to shift the EITC and also requires the IRS to process the Forms 8332 where taxpayers have shifted the EITC. Recall that current law already allows taxpayers to shift dependents for certain tax purposes. Therefore, the system is already tolerant of the relatively minor inefficiencies involved in shifting dependents. Adding the EITC does not add substantially to the existing inefficiencies. Indeed, this Article's proposal should be more efficient than the current rule. This is because it is easier conceptually for taxpayers to shift all tax benefits for a child rather than picking and choosing. Under current law, if a custodial parent signs Form 8332, transferring the dependent exemption to the noncustodial parent, that automatically also transfers the right to claim a child tax credit for the child. However, even if the custodial parent has signed a Form 8332, he or she can still claim an EITC with respect to the child. Therefore, the tax benefits for the child are split, contrary to the normal rule. The normal rule of not being able to "split the baby" is ingrained in our common understanding of how children affect tax obligations. Thus, following the "normal" rule should reduce

²⁹⁰ See Yorio, *supra* note 216, at 409–29.

error by custodial and noncustodial parents alike.²⁹¹ Similarly, it should be much easier for the IRS to police a system where a child can be claimed by only one taxpayer for all tax benefits and where that eligible taxpayer is easily determined by a simple form that is filed with the return.

F. Effectiveness in Advancing Policy Goals

Allowing EITC portability should increase the amount of EITC money available to taxpayers. Taxpayers currently unable to claim the EITC would have access to an important anti-poverty program. Two Home Families underutilizing the EITC because it is allocated to the parent with lower earned income will similarly be able to access funds that could help lift them out of poverty. Thus, the Article's proposal enhances the EITC's policy goal of reducing poverty. Because it could be expected that payments will increase, the EITC's policy goal of offsetting payroll taxes would similarly be enhanced.

Work incentives are probably slightly enhanced by the proposed EITC portability. Currently, the only parent incentivized to work is the custodial parent, arguably the one society should be supporting in balancing work hours and child care responsibilities. With EITC portability, the parents together have an interest in maximizing the EITC. Therefore, assuming a cooperative relationship, the parent best able to find and maintain employment is incentivized to work.

G. Neutrality

Tax neutrality demands that the Code not cause people to alter behavior solely for tax reasons unless there is a public policy reason for doing so. The current rule fails a neutrality standard because it encourages low-income taxpayers to not marry (or to divorce) in order to generate a larger EITC. It also frequently penalizes parents who decide to separate by giving the family unit a lower EITC or eliminating it altogether. While there is some evidence that the EITC's marriage incentives do not alter taxpayer behavior in the aggregate,²⁹² policy makers should be concerned about any potentially perverse incentive on the individual level and should opt for more neutral policies when possible. Neutrality, even symbolic neutrality, is a critical factor in taxpayers' perceptions of the tax system as being fair or not.

This Article's proposal reduces the penalty upon separation, although it does not eliminate the penalty entirely. For the Two Home Family where the parents earn equal amounts of income, this Article's proposal enables the Two Home Family to generate the same amount of EITC as a Cohabiting Couple. This is true because, just as Cohabiting Couples now can, the Two Home

²⁹¹ This unity would be complete by also allowing head of household status to be shifted.

²⁹² See Meyer, *supra* note 211.

Family would be able to agree between themselves who should claim the children and could allocate the children in a manner that maximizes the EITC. For the Two Home Family where only the noncustodial parent has earned income, this Article's proposal can prevent the total forfeiture of that family's EITC.

VI. CONCLUSION

The last 40 years have seen a movement away from direct cash assistance to needy families and an increasing reliance on tax transfer programs, like the EITC, to lift American families and children out of poverty. Given the importance of these programs to the people they are intended to benefit, it is critical that they be structured in ways that are equitable and that are designed to direct the benefits to the intended beneficiaries.

There currently are complex and entrenched inequities in the EITC structure that operate to treat married couples differently (and most often more poorly) than non-married couples. This Article has described some of those inequities and has sketched out some of the possible solutions. The solutions to those problems would require a fair degree of political will to enact.

However, there is a very great inequity in the system that is easy to fix. That is the inequity between One Home Families and Two Home Families where the custodial parent has little to no earned income. Allowing a custodial parent to transfer the right to claim the EITC to the noncustodial parent alleviates this inequity. Allowing EITC portability can increase family-level income, improve child support compliance, and improve overall child welfare.