



Earned Income Credit (EIC)



Introduction

This lesson covers the earned income credit (EIC). There are several common errors associated with claiming this credit on the return. Publication 4012, Volunteer Resource Guide, and the intake and interview sheet are critical tools in avoiding these mistakes.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer is eligible for the earned income credit
- Calculate the earned income credit

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Form 1040 and Instructions

Optional:

- Publication 596
- Schedule EIC

What is the EIC?

The earned income credit (EIC) is a refundable tax credit for most people who work but do not earn high incomes. The purpose of the EIC is to reduce their tax burden and to supplement the wages of working families whose earnings are less than the maximums for their filing status. Eligible taxpayers can receive a refund with this credit, even if they have no filing requirement, owe no tax, and had no income tax withheld. All taxpayers and dependents must have valid Social Security numbers by the due date of the return (including extensions) to claim the credit. Tax returns filed claiming EIC generally cannot be released before February 15th.

The EIC can be a very valuable credit. The EIC was permanently expanded to allow families to claim credit for three or more children. The EIC amounts are adjusted for inflation every year.

The EIC is reported in the Refundable Credits line of the tax return.

How does a taxpayer qualify for the EIC?

There are general sets of rules for claiming the earned income credit:

- Rules for everyone
- Rules for taxpayers with a qualifying child
- Rules for taxpayers who do not have a qualifying child

What rules apply to everyone?

The taxpayer must meet all the rules to qualify for the earned income credit. Turn to the chart titled Summary of EIC Eligibility Requirements in the Volunteer Resource Guide, Tab I, Earned Income Credit. Review Part A, Rules for Everyone, and Part D, Earned Income and AGI Limitations.



Both earned income and adjusted gross income must be below the income limits in order for the taxpayer to qualify for the EIC. These amounts are adjusted for inflation every year.



Individual Taxpayer Identification Numbers (ITINs) and Adoption Taxpayer Identification Numbers (ATINs) cannot be used when claiming the EIC. If a couple is filing a joint return, both spouses and all qualifying children must have an SSN that is valid for work by the due date of the return. Taxpayers cannot file an amended return retroactively for any year in which they did not have a valid Social Security number by the due date of the return (including extensions).

example

James and Jill are filing a joint return and both have valid SSNs. They have two daughters; Susie has a valid SSN and Sally has an ITIN. Only the daughter with the valid SSN may qualify the tax return for EIC.



There is a limit to the amount of investment income a person can receive and still qualify for the EIC. See Publication 4012, Tab I, Earned Income Credit, Summary of EIC Eligibility Requirements for the investment income limit. Investment income includes such items as taxable interest and dividends, tax-exempt interest, capital gain net income, and income from residential rental property.

What is “earned” income for EIC purposes?

Earned income is wages, salaries, tips, and other taxable employee pay. Turn to the Earned Income Table in the Volunteer Resource Guide, Tab I, Earned Income Credit, for examples of earned income.

One type of payment considered earned income is “taxable long-term disability benefits received prior to minimum retirement age.” Taxpayers with disabilities can sometimes receive a disability pension from their employer even though they are younger than the minimum retirement age. Minimum retirement age is generally the age at which taxpayers can first receive a pension or annuity from their employer if they are not disabled. Taxpayers usually receive Form 1099-R reporting the pension.

Turn to the Volunteer Resource Guide, Tab D, Income, Form 1099-R. Find the page titled Form 1099-R Rollovers and Disability Under Minimum Retirement Age. A distribution code of “3” in box 7 indicates this is a disability pension. If the taxpayer is under the plan’s minimum retirement age, this income is reported as wages on Form 1040. If the taxpayer is at or above the company’s minimum retirement age, this would be reported as a regular pension. Sometimes the employer does not change the code in box 7 to indicate it is now regular pension income. If this is the case, the taxpayer should request a corrected Form 1099-R from the employer.



Tax Software Hint: Volunteers using software must check the box in the Rollover or Disability section of the Form 1099-R input screen to report disability as wages. To review information on reporting disability income for a person under retirement age, go to the Volunteer Resource Guide, Tab D, Income.

What about combat pay?

Combat pay is never taxable to most soldiers. Members of the U.S. Armed Forces who served in a combat zone may elect to include their nontaxable combat pay in their earned income for the purposes of computing this credit. Doing this may increase or decrease the taxpayer’s EIC. Figure the EIC amount with and without the pay before making the election. If the election is made, *all* of the nontaxable combat pay must be included. If both spouses filing a joint return have combat pay, they can individually choose to make the election on the tax return.



Tax Software Hint: If a taxpayer has combat pay listed in box 12 of Form W-2 marked with code Q, the software will determine if the combat pay should or should not be added to the taxpayer’s income.

What about self-employment income?

Net earnings from self-employment are considered earned income. For most taxpayers within the scope of the VITA/TCE programs, “net earnings” for EIC purposes will be the amount reported as business income minus the deductible portion of the self-employment tax that is reported on Form 1040, Schedule 1.

example

Jeff’s self-employment income reported on Form 1040 is \$2,000. The deductible portion of his self-employment tax, which is recorded on Schedule 1 of Form 1040, is \$142.

His income for EIC purposes is $\$2,000 - \$142 = \$1,858$.

Reminder: Nonwage income received for doing work (such as for side jobs or contract labor) is self-employment income, even for taxpayers who do not think of themselves as “self-employed.” **All self-employment income and expenses are required** to be reported on Schedule C, Profit or Loss from Business. Taxpayers not meeting the VITA/TCE programs’ requirements for filing Schedule C will need to seek the assistance of a professional tax preparer.



An IRS certified volunteer tax preparer must exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns. Although a volunteer tax preparer may rely on good faith on information provided by the taxpayer without requiring documentation as verification, the tax preparer must ask questions if the information furnished appears to be incorrect, inconsistent, or incomplete.

What about household employee income?

Domestic employees such as housekeepers are only issued Form W-2 if their earnings are more than a certain amount. Refer to Publication 926, Household Employer’s Guide, for tax year amounts. The income should be added to wages on Form 1040. This income should also be included when calculating the EIC.

Earned income not qualifying for the EIC

One income item that is reported on Form W-2, but does not qualify as earned income for EIC purposes, is income received for work while an inmate is in a penal institution (including work performed while in a work release program or while in a halfway house). Also, Medicaid waiver payments must be excluded if they qualify. Excluded income is not included as earned income for EIC purposes. Refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, to find this listed in the Earned Income Table.



Tax Software Hint: Income received for work while an inmate is in a penal institution must be entered in the Other Income section, Other Compensation, then Prisoner Earned Income line.



EXERCISES

Use the Summary of EIC Eligibility Requirements Chart in the Volunteer Resource Guide, Tab I, Earned Income Credit, to answer the following questions. Answers follow the lesson summary.

Question 1: A taxpayer is filing as Married Filing Separately. Does this taxpayer qualify for the EIC?

Yes No

Question 2: A taxpayer has interest income of \$4,500. His earned income is only \$7,000. He is single, has a valid Social Security number and is not the qualifying child of anyone else. Does he qualify for the EIC? Yes No

What are the rules for taxpayers with qualifying children?

The taxpayer can file Form 1040 to claim the EIC with a qualifying child. The taxpayer has a qualifying child for EIC purposes if the child meets **all** the tests outlined in the Volunteer Resource Guide, Tab I, Earned Income Credit. A short version of the rules is shown in Part B, Rules If You Have a Qualifying Child. A detailed version is on the next page of the Volunteer Resource Guide.

example

Jane, 31, and Todd, 33, have an 8-year-old daughter, Amanda. All are U.S. citizens and have valid SSNs. Jane and Todd have never been married. Jane and Amanda lived together all year in an apartment. Todd lived alone. Jane earned \$15,000 working as a clerk in a clothing store. Todd is an assistant manager of a hardware store and earned \$48,000. He paid over half Jane's rent and utilities, and also gave Jane extra money for groceries.

Todd does not pay any expenses or support for any other family member. Although Todd provided over half the cost of a home for Jane and Amanda, he cannot file Head of Household and he cannot claim the child for EIC, since Amanda did not live with him more than half the year. Jane cannot file as Head of Household either. Review the Filing Status for Head of Household rules in the Volunteer Resource Guide, Filing Status tab.

Jane is the only one who can claim Amanda as a qualifying child for EIC. Review the Earned Income Credit rules in the Volunteer Resource Guide, Tab I, Earned Income Credit.



For EIC purposes, a qualifying child does *not* have to be the taxpayer's dependent (unless the child is married). In the case of divorced or separated parents, the custodial parent (with whom the child lived for more than half the year) can qualify for the EIC regardless of whether or not they claim the child as a dependent. The noncustodial parent cannot qualify for EIC because the child did not live with them for more than half the year.

What are the rules for a qualifying child of more than one person?

A child who meets the conditions to be a qualifying child of more than one person can only be claimed by one taxpayer for the EIC.

Using the EIC With a Qualifying Child Chart from the Volunteer Resource Guide, Tab I, Earned Income Credit, based on what we have learned so far about Robyn and her family:

example

Robyn is 25 years old. She and her 2-year-old son, Aiden, lived with Robyn's mother all year. Aiden has a valid Social Security number.

Step 1 is YES

Step 2 is YES

Step 3 is YES

Step 4 is NO

Step 5 is YES



Taxpayers have the option to choose which taxpayer will claim the child. Tiebreaker rules apply when the child is claimed by multiple taxpayers.

For Step 6, check to see if Aiden can be anyone else's qualifying child, for EIC purposes.

Who else lived in the house that is related to Aiden? Robyn's mother also lives with them. Go through the steps to see if Aiden can be a qualifying child for Robyn's mother.

If the taxpayer can't claim the EIC because the qualifying child is treated under the tiebreaker rules as the qualifying child of another person, the taxpayer may be able to take the EIC using a different qualifying child, or take the EIC if they qualify using the rules for people who don't have a qualifying child. See the Qualifying Child of More than One Person rules in the Volunteer Resource Guide, Tab I, Earned Income Credit.

What are the rules for taxpayers without qualifying children?

Taxpayers can claim the EIC without a qualifying child. Confirm that the taxpayer and spouse cannot be claimed as dependents by their parents or anyone else. Review the rules in the Volunteer Resource Guide, Tab I, Earned Income Credit, under Part C, Rules If You Don't Have a Qualifying Child.



Taxpayers turning 25 on January 1 are considered to be of age as of December 31. Taxpayers reaching the age of 65 on January 1 are still considered 64 as of December 31. Taxpayers in either of these situations whose return is rejected may need to file a paper return.



For a couple filing a joint return, only one taxpayer has to meet the age requirement.

example

Tom and Martha are a married couple. Tom is 66 and Martha is 58 years old. If all other rules are met, they would qualify for the EIC.



EXERCISES (continued)

Using the EIC charts in the Volunteer Resource Guide, determine if each of these taxpayers has a qualifying child or can claim the EIC. Each taxpayer and child has a valid Social Security number.

Question 3: Maureen's 20-year-old daughter, Angie, lived with her for eight months of the year. Angie is not married and is a full-time college student. Is Angie a qualifying child for the EIC? Yes No

Question 4: Starting in February of the tax year, Sam has cared for Lisa, the 10-year-old daughter of his stepson. Does Lisa meet the EIC requirements for a qualifying child? Yes No

Question 5: Three children live with Mira, who cares for them as her own: Twila, the 3-year-old daughter of Mira's cousin; Chez, Mira's newly adopted 2-year-old son from Europe, who has lived with Mira since November of the tax year; and Dwight, Mira's 20-year-old son, who attends community college part time. Which of them are qualifying children? Twila Chez Dwight None

Question 6: Margie's daughter, Aimee, turned 23 early in the tax year while attending college full time. Margie is filing as Head of Household. Margie has an AGI of \$31,000. Assuming that she and her daughter pass all other tests, can Margie claim the EIC? Yes No

Question 7: Rob and Laura are divorced. Laura is the custodial parent for Dawn, who lived with her all year. Laura signed Form 8332, allowing Rob to claim Dawn as a dependent until she turns 18. Can Rob claim Dawn for the EIC? Yes No

Question 8: Jewel and her daughter lived with Jewel's brother, Emmitt all year. Jewel earns \$20,000 and claims her daughter as the qualifying child for the EIC. Emmitt is 25 years old and earned \$8,500. Is Emmitt able to claim the EIC for a taxpayer without a qualifying child? Yes No

How should I handle a taxpayer whose EIC was disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed EIC in a prior year because special rules apply. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Disallowance of Certain Refundable Credits.

How is the correct EIC amount calculated?

The credit is determined using worksheets and the Earned Income Credit tables. The EIC worksheets can be found in Publication 596, Earned Income Credit, or Form 1040 Instructions. The software will determine the amount of EIC.



When reviewing the Form 1040 Instructions, it is common to mistake the Tax Tables for the EIC tables. Double-check that the heading on the page you are using is “Earned Income Credit (EIC) Table.”

Class Exercise

A taxpayer is filing Head of Household and has one qualifying child. The earned income and AGI is \$19,000. How much EIC is the taxpayer entitled to?

Turn to the first page of the EIC tables. Find the amount in the “At least - But less than” column. Find the correct filing status column: Single, head of household and qualifying widow(er), or in a separate column, married filing jointly. There are subcolumns for the number of qualifying children.

The EIC amount is entered on the Refundable Credits line of the return.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status. The software automatically calculates the credit based on the information entered in the Filing Status, Personal Information, Dependent Information, and Income sections.

Summary

The earned income credit computation is based on filing status, number of qualifying children, earned income, and adjusted gross income. Certain individuals with no children may also qualify.

By using the intake and interview sheet, the EIC charts in the Volunteer Resource Guide and correctly filling out the EIC worksheets, most of the errors that result from incorrectly computing the EIC can be avoided.

The EIC is entered on the Refundable Credits line of the return.



TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study on TaxSlayer.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: No. Married Filing Separately does not qualify for the EIC.

Answer 2: No. His investment income exceeds the limit.

Answer 3: Yes. Daughter Angie meets all the eligibility tests to be a qualifying child.

Answer 4: Yes. Lisa is a descendent of Sam's stepson and meets the other eligibility requirements.

Answer 5: None of the children under Mira's care are qualifying children for the EIC. Twila does not meet the relationship test, Chez does not meet the residency test, and Dwight does not meet the age test.

Answer 6: Yes. Margie meets the general eligibility requirements and Aimee meets the Qualifying Child rules.

Answer 7: No. While Rob can claim his daughter as a dependent, the daughter did not live with him for more than half the year, so she fails the residency test. Dawn is the qualifying child of Laura.

Answer 8: Yes. Jewel's daughter is not the qualifying child of Emmitt, but he can claim the EIC for a taxpayer without a qualifying child.

