

TRACKING EITC QUALIFYING CHILDREN OVER TIME*

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This paper tracks EITC qualifying children over time to determine how often they move across different tax units. Using administrative tax data, I find that over 20 and 50 percent of EITC qualifying children experience a tax unit change within two and six years, respectively, demonstrating that tax units are dynamic for a large portion of this population. I find evidence that some taxpayers may be strategically deciding who claims EITC qualifying children by linking these decisions to after-tax income maximization. I also find evidence that children who stay in the same tax units are better off in terms of income.

Keywords: earned income tax credit, dependents, income support

JEL Codes: H53, I38, J18

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I. INTRODUCTION

This paper examines to what extent Earned Income Tax Credit (EITC) qualifying children are claimed by the same taxpayers over time using administrative tax data. The EITC is a refundable tax credit targeted to low-income working families and one of the largest anti-poverty cash assistance programs in the U.S., with over 27 million families claiming the credit in 2011. This study shows that over 20 and 50 percent of EITC qualifying children experience changes in tax unit structures within a two year period and a six year period, respectively, suggesting that tax units are dynamic for a significant share of the EITC population.

Understanding the mobility of EITC qualifying children is important for several reasons. First, if EITC qualifying children move across different tax units over time, then this will have implications on how to interpret results from the existing EITC literature as well as on how to conduct future EITC research. For example, researchers find that the EITC promotes single mother labor supply (Ellwood, 2000; Meyer, 2002; Grogger, 2003; Eissa and Hoynes, 2006) and taxpayers with self-employment income bunch at kink points (LaLumia, 2009; Saez, 2010; Chetty, Friedman, and Saez, 2013; Chetty and Saez, 2013). If the samples used in these studies include observations with dynamic tax units, then it is also important to determine if these results are static versus dynamic and whether changes in tax unit structure impact these results. Second, if different individuals claim an EITC qualifying child over time, then the person or people primarily responsible for the child's well-being also likely changes assuming tax filers are compliant. If tax unit structures accurately represent family structures, then variance in tax unit structure can be used to study how changes in family structure impact child well-being. Specifically, examining long term well-being, such as intergenerational mobility, will depend on who supports the child during his or her youth. Third, this study examines whether the likelihood

that a taxpayer continues to claim an EITC qualifying child is linked to strategic behavior. LaLumia (2009) and Saez (2010) demonstrate that taxpayers report self-employment income in such a way to maximize their EITC. The allocation of dependents is another dimension in which taxpayers may strategize to maximize their EITC. If taxpayers are found to actively decide who claims a dependent, then this suggests that dependents are potentially moving across different tax units and/or taxpayers are misreporting their dependents. In fact, existing research on EITC compliance has determined that the misreporting of children is one of the main contributors to erroneous EITC claims (McCubbin, 2000; Blumenthal, Erard, and Ho, 2005).¹

In this study, I follow EITC qualifying children over time using administrative tax data for tax years 2006 through 2011. I find that over 20 percent of EITC qualifying children who are aged 17 and under are not in the same tax unit within a two-year window, where being in the same tax unit is defined as being claimed by the same primary and secondary filers. I find evidence that taxpayers may be strategically deciding which tax units claim EITC qualifying children. Children who move into tax units that do not contain the base year primary and/or secondary filers appear to be distributed to these tax units in such a way to maximize after-tax income of the base year filer and T+1 filer. Constructing a panel of EITC qualifying children aged 13 and under in 2006, the data show that under half of EITC qualifying children are claimed by the same tax unit across the six-year time period from 2006 through 2011, illustrating that a sizable share of EITC qualifying children moves across tax units over time. To examine how well-being varies between the two groups of children, I compare income distributions and the fraction of children on tax returns claiming the EITC by tax year. Although higher shares of

¹ Furthermore, there is broader evidence that the taxpayer population in general, not just lower-income tax units, may strategize when claiming dependents. In particular, LaLumia and Sallee (2013) find that some taxpayers misreport dependents in order to claim additional tax benefits as evidenced by a one-time reduction in the total number of dependents claimed after requiring dependent Social Security Numbers to be reported on tax returns was imposed in 1987.

qualifying children in the same tax unit are in the upper quintiles of the income distribution than those for children in different tax units in 2006 and 2011, the proportion of children on tax returns claiming the EITC is higher among children who are in the same tax unit. These statistics imply that children in the same tax unit are better off in terms of income and that children in different tax units may be claimed by taxpayers who are ineligible to claim the EITC even though they are also low income.

The paper is organized as follows. Section II provides background on the EITC and discusses previous literature. Section III describes the administrative data used in this study. Section IV provides analysis of how often children are in the same tax unit using a two and six year time horizon. Section V concludes.

II. BACKGROUND

The EITC phases in on earnings up to a maximum credit amount and then phases out on the greater of earnings and adjusted gross income. The EITC is designed to encourage work among low-income families, and studies have found that the credit promotes the likelihood of working among single mothers (Meyer, 2002; Grogger, 2003; Eissa and Hoynes, 2006). Up until 2009, the EITC had separate schedules for families with no children, one child, and two children, with generosity of the credit increasing with the number of children. In 2009, the EITC was expanded by 1) making a more generous schedule for families with three or more children, and 2) lengthening the plateau range for married couples by an additional \$2,000 and indexing the extended range to inflation. In 2011, the maximum EITC ranged from \$464 for childless couples to \$5,751 for couples with three or more qualifying children.

To my knowledge, there are no existing studies that look at the dynamics associated with claiming dependents. However, there is a growing literature examining how frequently taxpayers claim the EITC. Some studies find that taxpayers claim the EITC for short periods of time, generally three years or less, with this result being robust to different data sources and time periods (Horowitz, 2002; Dowd 2005; Dowd and Horowitz, 2011). The likelihood of claiming the EITC has been linked to changes in earnings and state unemployment rates (Horowitz, 2002; Dowd, 2005). Using tax data for single mothers between 1987 and 2006, Heim and Lurie (2013) also find that generosity of the credit itself increases the probability of claiming the EITC. Although most taxpayers claim the EITC for short periods of time, there is also evidence that the probability of claiming the EITC increases when previous claims have been made (Dowd, 2005; Dowd and Horowitz, 2011). In particular, Dowd and Horowitz (2011) find that 20 percent of taxpayers who claim the EITC claim the credit for more than five years. This paper adds to the existing literature by looking at dynamics of tax units structures among EITC children, which may also affect how often taxpayers claim the EITC.

III. DATA

This study uses administrative tax data for tax years 2006 through 2011 from the Internal Revenue Service's Compliance Data Warehouse (CDW), which contains the population of tax returns. To construct the EITC qualifying children sample, a 1 in 1000 random sample of tax returns filed based on the primary filer's social security number that claim the EITC and have EITC qualifying children listed on their Schedule EIC in tax years 2006 through 2010 were extracted from the CDW. Instead of using a random sample of EITC qualifying children, a random of sample of tax returns is used, which allows me to determine whether EITC qualifying

children within the same tax unit are claimed on the same tax return in the following year. By sampling tax returns instead of children, the results, which are generally presented at the child level, will be skewed by tax returns with multiple EITC qualifying children if these children are all more or less likely to be in the same tax unit in subsequent years.

EITC qualifying children are a subset of dependent children claimed on a tax return for the dependent exemption. A child may be claimed as a child dependent if he/she satisfies the age, relationship, and residency tests.² Additional requirements must be met for the child to be claimed as an EITC qualifying child.³ For this paper, the sample is restricted to EITC qualifying children aged 17 and under in base years 2006 through 2010. The age limitation is imposed to eliminate children who are no longer school aged in the following tax year and thus, not as likely to be claimed as a dependent. In addition, EITC qualifying children who are deceased in the following tax year or whose primary tax filer in the base year is deceased in the following tax year are excluded from the sample.

To determine whether an EITC qualifying child's tax unit changes, I extracted tax returns where the sample of EITC qualifying children from 2006-2010 are claimed as a dependent, although not necessarily claimed as an EITC qualifying child, one year later in 2007 through 2011, and then compared tax unit structures between the two years. EITC qualifying children are categorized into the following four groups: (1) Same Tax Unit if the EITC qualifying child is claimed by the same primary and secondary filers in the base year and T+1; (2) Partially Changed Tax Unit if the EITC qualifying child is linked to a T+1 tax return in which the base

² To pass the age test, the child must be under age 19, under age 24 if he/she is a full-time student, or any age if he/she is permanently and totally disabled. To pass the relationship test, the child must be the taxpayer's son, daughter, stepchild, foster child, sibling, niece, nephew, or any descendent of them. To pass the residency test, the child must live with the taxpayer for more than half of the year.

³ First, the primary and secondary filers must have valid social security numbers. Second, the child must reside in the U.S. for more than half the year and have a valid social security number. If more than one taxpayer can claim a child as an EITC qualifying child, then the taxpayer with the greater adjusted gross income may claim the child as an EITC qualifying child.

year taxpayers have a change in couple composition or the base year primary and/or secondary filer are claimed as dependents; (3) Different Tax Unit if the EITC qualifying child is claimed on a T+1 tax return where the base year primary and secondary filers are not present; (4) Not in a Tax Unit if the EITC qualifying child is not claimed as a dependent on a tax return in year T+1; and (5) Independent Filer if the EITC qualifying child becomes a primary filer in year T+1. The sample excludes children who are claimed on more than one tax return in T+1 because it cannot be determined with whom the child actually resided.⁴ All remaining children in the sample are assumed to be claimed correctly. The sample consists of 123,259 EITC qualifying children.

IV. ANALYSIS

a. Two-Year Analysis

Table 1 contains summary statistics by the EITC qualifying child's location in year T+1. Seventy-nine percent of EITC qualifying children are in the same tax unit, 5 percent are in partially changed tax units, 12 percent are in a different tax unit, 4 percent are not in a tax unit, and 1 percent are independent filers. EITC qualifying children who remain in the same tax unit have the largest average base year adjusted gross income at \$21,936 while children who are not in a tax unit have the lowest average base year adjusted gross income at \$16,223. Children in the same tax unit are more likely to be claimed on base year tax returns that have more than one EITC qualifying child than children in other locations. Across the T+1 locations, 12 to 20 percent of EITC qualifying children are claimed by tax returns that have more dependents than EITC qualifying children. The EITC qualifying child's average age is highest among those who

⁴ An average of 6 percent of the EITC qualifying child sample is claimed on more than one tax return in the following tax year.

become independent filers at about 17 years. Independent filers have an average adjusted gross income of over \$20,000, which is comparable to the averages of children who remain in the same tax unit or move to a partially changed tax unit, suggesting that these independent filers are self-supporting teenagers. The average age is lowest among EITC children in partially changed tax units and different tax units at seven years. Average age of the base year primary filer follows the same pattern as the average age of the EITC qualifying child, with the average age being highest among independent filers at 42 and lowest among those in partially changed and different tax units at 34 and 35, respectively. While higher shares of EITC qualifying children in the same and partially changed tax units are on base year tax returns filed as married, smaller shares are on returns filed as single compared to children in different tax units and not in a tax unit. The average share of EITC qualifying children on base year tax returns filed as head of household is highest among those in different tax units at 77 percent and lowest among those in partially changed tax units at 48 percent.

Table 1 also presents statistics comparing marital status between the base year and T+1 tax returns. By construction, the marital status on tax returns claiming EITC qualifying children who are in the same tax unit does not change between the base year and year T+1. Eighty percent of EITC qualifying children in partially changed tax units are claimed by taxpayers who experience a change in marital status, with 51 percent moving from unmarried to married and 29 percent moving from married to unmarried tax units. Seventeen percent of EITC qualifying children who are in different tax units are claimed by tax returns with different marital statuses. While changes in marital status seem to dictate when EITC qualifying children end up in partially changed tax units and entering the workforce appears to explain when children become independent filers, it is less clear why children are claimed in different tax units or not claimed in

a tax unit. Subsequent analysis will examine whether taxpayers are potentially claiming children who end up in different tax units in a strategic way.

Although EITC qualifying children who do not experience a change or only experience a partial change in tax unit may be claimed by taxpayers who are allocating their children in such a way to optimize after-tax income, it is not clear how to determine whether strategic behavior occurred because there is no obvious counterfactual. In contrast, I use the data to provide insight on whether children claimed by different tax units are being claimed in such a way to maximize total T+1 after-tax income of the base year taxpayer and T+1 taxpayer. While there may be other reasons why EITC qualifying children move to different tax units, such as a change in custodial living arrangements or eligibility to claim the child, this exercise is meant to provide some insight on whether there is evidence that tax units were strategically deciding which taxpayers claim a child. Whether evidence of strategic behavior translates to tax compliant or non-compliant behavior depends on if taxpayers correctly claim eligible children as dependents. However, distinguishing between compliant and non-compliant claims of children cannot be determined in the current data because relationship between the taxpayer and child, residency of the child, and the individuals providing financial support to the child are not currently available.

I use Bakija's (2009) calculator to estimate observed after-tax income and counterfactual after-tax income in year T+1, where counterfactual after-tax income is calculated by subtracting one dependent from the T+1 taxpayer and adding one dependent to the base year taxpayer's T+1 tax return. Twenty-nine percent of children in different tax units have base year taxpayers who do not file a tax return in T+1. Limiting the tax calculations to base year taxpayers who file a tax return in T+1 reveals that 56 percent maximize total after-tax income by shifting one qualifying child to a different tax unit. The average gain in total after-tax income is \$260. One could argue

that allowing a different tax unit to claim an EITC qualifying child is optimal if the base year taxpayer is a non-filer in T+1. Including these non-filers in the maximization statistics would raise the maximization rate to 87 percent.

Table 2 also presents the estimated change in after-tax income for children who are not in a tax unit. Primary taxpayers whose children are not in a tax unit are either worse off (85 percent) or have no change in after-tax income (15 percent) as a result of not claiming the child on their T+1 tax return. The average change in after-tax income from the base year taxpayer not claiming the child in T+1 is -\$1,766. Compared to EITC qualifying children in different tax units, children who are not in a tax unit have a higher proportion of base year taxpayers who do not file in T+1 at 59 percent. As a result, one of the main reasons why children are not in a tax unit in T+1 appears to be because the person claiming them in the base year becomes a non-filer.

The last two columns in Table 2 present the total after-tax income maximization rate and estimated change in after-tax income if base year taxpayers were to claim their child who becomes an independent filer in T+1. In the counterfactual state, the child may be required to file a dependent tax return if his earned or unearned incomes are above certain thresholds. Counterfactual after-tax income of the independent filer equals his observed total income if he is not required to file a dependent tax return and equals the amount of after-tax income on the estimated dependent tax return if he is required to file. Fourteen percent of children who become independent filers are maximizing total after-tax income while four percent would have no change in total after-tax income if their base year primary filer were to claim them in T+1. The average loss in after-tax income from the child becoming an independent filer is -\$1,898. Among the three T+1 location categories presented in Table 4, children who become

independent filers have the lowest proportion of base year taxpayers who are non-filers in T+1 at 23 percent.

b. Six-Year Analysis

In this section, I constructed a panel using the set of EITC qualifying children claimed in 2006 to examine whether base year characteristics and financial well-being differ by whether or not a child remains in the same tax unit between 2006 and 2011. For this part of the analysis, being in a different tax unit is more broadly defined and includes children in partially changed tax units, in tax units where the 2006 primary and/or secondary filers are not present on the tax return, not in a tax unit, and those who become independent filers. The sample is restricted to qualifying children aged 13 and under in 2006 and thus, aged 18 and under in 2011. Out of the 17,923 children in the panel sample, less than half are in the same tax unit in all six years.

To provide insight into how well-being varies by whether a child is in the same tax unit versus different tax units, I constructed quintiles of per capita adjusted gross income in 2006 and 2011 using the panel of children and then compared the income distributions across the two groups. In 2006, Table 3 shows that the proportion of children in different tax units is generally decreasing with each subsequent quintile. In 2011, the proportion of children who are in the lowest quintile increases from 24 to 28 percent and the proportion in the highest quintile increases from 18 to 19 percent, demonstrating that while some children who are claimed in different tax units are able to move up the income distribution, a significant share still remain in the bottom. In contrast, the proportion of children in the same tax unit is generally increasing with each subsequent quintile in 2006. In 2011, the proportion of children who are in the lowest quintile decreases from 16 to 11 percent and the proportion of children in the top quintile decreases from 22 to 21 percent. Among children in the same tax unit, the highest share is in the

fourth quintile in 2011 at 26 percent. Relative to children in the same tax unit, a larger proportion of children in different tax units start off and end up in tax units with the lowest income.

Figure 1 presents the fraction of EITC qualifying children who are on tax returns claiming the EITC by year and whether the child is in the same tax unit (dashed line) or in different tax units (solid line). Figure 1 shows that although children in the same tax unit experience similar declines in the fraction claiming the EITC as children in different tax units, the percentage claiming the EITC remains higher among children in the same tax unit in every year. Between 2006 and 2007, the fraction claiming the EITC drops to 88 percent for those in the same tax unit and 82 percent for those in different tax units. These reductions are in line with Dowd's (2005) statistics of second year EITC claim rates among the sample of tax returns initially claiming the credit, which ranged from 78 to 90 percent between 1990 and 2002. Between 2006 and 2011, the percentage of qualifying children claimed on tax returns that receive the EITC reduces to 83 percent among children in the same tax unit and to 66 percent among children in different tax units.

Even though qualifying children in the same tax unit have a more favorable per capita adjusted gross income distribution in 2006 and 2011 compared to those in different tax units, they are still more likely to claim the EITC. This suggests that EITC qualifying children who are in different tax units are in low-income tax units, but are potentially ineligible for the EITC or less likely to claim the EITC even if eligible. Ineligibility may be due to taxpayers not meeting the investment income test and/or not being able to claim a dependent as an EITC qualifying child. While the data do not contain information on whether taxpayers are eligible to claim a dependent as an EITC qualifying child, the difference in the fraction claiming the EITC persists

even when the sample is restricted to children claimed on tax returns that pass the EITC investment income test.

CONCLUSION

Through the use of administrative tax data, I determine that the tax unit structures of EITC qualifying children are dynamic with over 20 and 50 percent of qualifying children experiencing a change in tax unit structure within a two and six year period, respectively. Consequently, these results suggest that the existing EITC literature, which assumes that tax units remain static, presents an incomplete picture. I estimate that 56 percent of EITC qualifying children who are claimed in different tax units within a two year period are being claimed on returns where after-tax income of the base year taxpayer and T+1 taxpayer is maximized. Panel analysis shows that EITC qualifying children who are in the same tax unit from 2006 through 2011 are claimed on tax returns with higher incomes than those claimed by different tax units. However, a higher share of children in the same unit is on tax returns that claim the EITC than that for children in different tax units. This suggests that even though children in different tax units are lower income, they may not qualify for the EITC for other reasons, such as not being able to claim certain dependents as qualifying children.

In this paper, I assume that taxpayers are compliant, meaning that the individuals claimed as dependents and EITC qualifying children pass all the necessary tests to be claimed as such. In the U.S. Department of the Treasury's Annual Financial Report for Fiscal Year 2012, the IRS estimates that anywhere from 21 to 25 percent of EITC payments were issued improperly in fiscal year 2012. The literature shows that taxpayers improperly claiming EITC tend to pass some, but not all the eligibility requirements (Blumenthal, Erard, and Ho, 2005) and that errors associated with misreporting EITC qualifying children is the largest contributor to improper

claims (McCubbin, 2000). While some taxpayers may be actively misreporting children, others may misreport children due to a lack of understanding of who qualifies to be a dependent, particularly given that the definitions of a qualifying dependent varies across different child-related benefits (Holtzblatt and McCubbin, 2003). Although an evaluation of compliance is beyond the scope of this paper, future studies should investigate to what extent EITC qualifying children, particularly those who move across different tax units, are being claimed correctly. Future research should also investigate to what extent children from middle and higher income families experience tax unit structure changes over time.

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TABLES

Table 1
Summary Statistics by T+1 Location

	Same Tax Unit		Partially Changed Tax Unit		Different Tax Unit		Not in a Tax Unit		Independent Filer	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
<i>Base Year Tax Return Characteristics</i>										
Adjusted Gross Income	21,936	(12,737)	21,229	(11,498)	17,362	(9,956)	16,223	(11,493)	20,118	(10,957)
Two or Three EITC Qualifying Children	0.71	(0.45)	0.64	(0.48)	0.60	(0.49)	0.68	(0.47)	0.63	(0.48)
More Dependents Than EITC Qualifying Children	0.18	(0.38)	0.16	(0.37)	0.12	(0.33)	0.19	(0.39)	0.20	(0.40)
Age of EITC Qualifying Child	7.82	(5.11)	6.68	(5.03)	6.96	(5.16)	8.60	(5.39)	16.72	(0.78)
Age of Primary Filer	35.96	(9.08)	33.73	(8.56)	34.96	(10.49)	37.03	(10.15)	41.51	(9.62)
Single	0.07	(0.25)	0.07	(0.26)	0.15	(0.36)	0.14	(0.35)	0.08	(0.27)
Married	0.33	(0.47)	0.45	(0.50)	0.08	(0.27)	0.22	(0.41)	0.29	(0.46)
Head of Household	0.60	(0.49)	0.48	(0.50)	0.77	(0.42)	0.64	(0.48)	0.63	(0.48)
<i>Comparing Base Year and T+1 Tax Return Characteristics</i>										
Unmarried to Married	0.00	(0.00)	0.51	(0.50)	0.12	(0.32)	N/A		N/A	
Married to Unmarried	0.00	(0.00)	0.29	(0.45)	0.05	(0.23)	N/A		N/A	
All EITC Qualifying Children are in Same Location*	0.94	(0.24)	0.91	(0.29)	0.55	(0.50)	0.57	(0.49)	0.03	(0.18)
All EITC Qualifying Children are in Same T+1 Tax Unit*	0.94	(0.24)	0.82	(0.38)	0.36	(0.48)	N/A		N/A	
Observations	97,109		6,307		14,881		4,303		659	
Percentage**	79%		5%		12%		4%		1%	

Notes: Statistics are at the EITC dependent level. Monetary variables are in 2011 dollars. * Limited to children on base year tax returns with more than one EITC qualifying child. ** Percentage may not add up to 100% due to rounding.

Table 2
After-Tax Income Maximization

	Different Tax Unit		Not in a Tax Unit		Independent Filer	
	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
Maximize After Tax Income	56%	(50)	0%	(0)	14%	(35)
No Change in After Tax Income	1%	(11)	15%	(36)	4%	(20)
Change in After Tax Income	\$260	(1761)	-\$1,766	(1393)	-\$1,898	(2171)
Base Year Primary Filer Not a Primary Filer in T+1*	29%	(46)	59%	(49)	23%	(42)
Observations	14,881		4,303		659	

Notes: Statistics are at the EITC dependent level. Monetary variables are in 2011 dollars. * Includes all EITC dependents. All other statistics are restricted to the set of EITC dependents whose base year primary filers are also primary filers in T+1.

Table 3
Distribution of EITC Qualifying Children by Quintiles of Per Capita Adjusted Gross Income in 2006 and 2011

Quintile	2006				2011			
	Different Tax Units	Same Tax Unit	Average Per Capita Adjusted Gross Income		Different Tax Units	Same Tax Unit	Average Per Capita Adjusted Gross Income	
1	24%	16%	\$3,585	(4,972)	28%	11%	\$2,498	(7,460)
2	21%	19%	\$7,973	(916)	21%	19%	\$8,063	(960)
3	19%	21%	\$11,365	(1,041)	18%	23%	\$11,893	(1,260)
4	18%	22%	\$14,995	(1,052)	15%	26%	\$17,011	(1,732)
5	18%	22%	\$19,566	(1,968)	19%	21%	\$32,024	(15,961)

Notes: Per capita adjusted gross income equals adjusted gross income divided by the number of individuals in the tax unit. Percentages may not add up to 100% due to rounding.

Figure 1
Proportion Claiming the EITC by Tax Year

