

Department of Legislative Services
 Maryland General Assembly
 2005 Session

FISCAL AND POLICY NOTE

House Bill 1038 (Delegates Rosenberg and Healey)
 Ways and Means

Income Tax - Credit for Earned Income - Noncustodial Parents

This bill provides that a qualifying noncustodial parent aged 18 to 30 with a child support order can claim a refundable State earned income credit (EIC) equal to 400% of the federal EIC the individual qualifies for in the tax year. The bill also allows qualifying noncustodial parents, to the extent adopted by county law, to qualify for the refundable county EIC.

The bill takes effect July 1, 2005 and applies to tax years 2005 through 2012.

Fiscal Summary

State Effect: General fund revenues could decrease by approximately \$2.8 million in FY 2006, which reflects credits being claimed by qualifying noncustodial parents and federal EIC eligibility standards. Future year revenues reflect a constant number of individuals eligible to claim the credit. Potential significant special fund revenue increases in FY 2006 and beyond due to the interception of refunds of qualifying noncustodial parents. State expenditures at the Department of Human Resources (DHR) and the Comptroller's Office could increase by \$190,500 in FY 2006 in order to provide refunds and verify the eligibility of taxpayers.

(\$ in millions)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
GF Revenue	(\$2.8)	(\$2.8)	(\$2.8)	(\$2.8)	(\$2.8)
SF Revenue	-	-	-	-	-
GF Expenditure	.1	0	0	0	0
GF/FF Exp.	.1	0	0	0	0
Net Effect	(\$3.0)	(\$2.8)	(\$2.8)	(\$2.8)	(\$2.8)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: No county has adopted a refundable county EIC as provided by law. Montgomery County, however, currently operates a program that matches county residents' State EIC. Expenditures could increase due to increased payments to qualifying noncustodial parents.

Small Business Effect: None.

Analysis

Bill Summary: The credit allowed under the bill for qualifying noncustodial parents equals 400% of the federal EIC that the individual qualifies for in the tax year. The individual claiming the credit must be: (1) a noncustodial parent of a minor child; (2) between 18 and 30 years old; and (3) subject to a court order that has been in effect for at least six months and has paid at least 75% of the required child support obligations during the tax year. The Child Enforcement Administration within DHR is required to certify to the Comptroller that the individual claiming the credit has met the required child support obligations.

On or before December 15 of each year, DHR and the Comptroller's Office are required to estimate the cost of the credit and assess the credit's success in creating incentives for noncustodial parents to fulfill child support obligations.

Current Law: Taxpayers can claim a State EIC equal to 50% of the federal EIC credit allowed. The amount of the credit cannot exceed the taxpayer's tax liability in that tax year. Taxpayers with one or more dependents who may be claimed as exemptions may claim a refundable State EIC if the State EIC exceeds the taxpayer's tax liability. The amount of the refundable credit in tax year 2004 and beyond is equal to 20% of the federal EIC credit allowed.

Taxpayers can also claim a nonrefundable credit against the county income tax. The amount of the credit equals the amount of federal EIC allowed multiplied by 10 times the county income tax rate, not to exceed the county income tax liability.

A county may provide, by law, a refundable EIC for individuals who meet the qualifications of the State refundable EIC. The refundable county EIC equals the federal EIC allowed multiplied by four times the county income tax rate.

Background: To claim the federal EIC in tax year 2003, an individual must have earned income, less than \$2,600 of investment income, and a modified federal adjusted gross income of less than \$11,230 with no qualifying children, \$29,666 with one qualifying

child, or \$33,692 with two or more qualifying children. The phase-out range is currently \$1,000 higher for joint returns. The Economic Growth and Tax Reconciliation Act of 2001 increases the phase-out range for joint returns by \$1,000 for tax years 2005 through 2007; and by \$2,000 for tax years 2008 and later. In order to claim the credit, a taxpayer must be at least 25 years old and less than 65 years old and cannot be claimed as a dependent.

In tax year 2003, the maximum federal EIC was \$382 with no qualifying children, \$2,547 with one qualifying child, and \$4,204 with two or more qualifying children.

In tax year 2003, the maximum State EIC was \$191 with no qualifying children, \$1,274 with one qualifying child, and \$2,102 with two or more qualifying children. For tax year 2003, a taxpayer with a qualifying child can receive a refund of that portion, up to 18% (increased from 16% in tax years 2002 and earlier) of the federal EIC, which exceeds the State tax liability. In tax year 2003 the maximum value of the refundable portion of the credit was \$458 for one child and \$757 for two children or more. The percentage of the federal EIC on which the refundable portion of the State credit is based increases to 20% for tax year 2004 and subsequent years.

Exhibit 1 lists the amounts of federal and State EIC credits claimed in tax year 2002 or 2003. Data are available for 2002 for the federal EIC and 2003 for the State EIC.

Exhibit 1
State and Federal EIC claimed

	<u>Tax Year</u>	<u>Number Taxpayers</u>	<u>Amount Claimed (millions)</u>	<u>Average Claimed</u>
Federal EIC	2002	341,783	565.2	1,654
State EIC	2003	239,410	64.1	268
State Refundable EIC	2003	189,335	67.8	358

Maryland has three tax credits specifically geared towards lower-income individuals – earned income, refundable earned income, and poverty level. EIC was established in 1987 while the refundable EIC and poverty level credit were established in 1998. The federal EIC, established in 1975, is generally considered a successful antipoverty program by researchers. A joint IRS – federal Department of Treasury task force estimated that nationwide the EIC lifted 4.3 million individuals including 2.3 million

children out of poverty in 2000. In recent years, the IRS has paid about \$30 billion annually to about 29 million EIC recipients. The federal tax credit, however, has been consistently plagued by overclaim rates. The IRS estimated that 27 to 32% of EIC credits in 1999 (the latest year data are available) were erroneously or fraudulently claimed, or approximately \$8.5 billion to \$9.9 billion out of a total of approximately \$31 billion claimed. In response, the IRS instituted a certification process and other reforms in an effort to reduce overclaim efforts. The IRS' relative degree of success in reducing overclaims will impact Maryland's EIC, since Maryland eligibility standards are based on whether the taxpayer claimed the federal EIC.

State Revenues: Qualifying noncustodial parents could begin earning credits beginning in tax year 2005. As a result, general fund revenues could decrease by approximately \$2.8 million annually beginning in fiscal 2006.

This estimate is based on the following facts and assumptions:

- According to DHR, there are currently 38,986 noncustodial parents age 18 to 30 who are subject to a child support order in effect for at least six months.
- Approximately 25% of these individuals are estimated to be eligible for the federal EIC.
- Twenty percent of these individuals are estimated to have paid at least 75% of the amount of child support obligation due in the tax year.
- The number of qualifying noncustodial parents is estimated to remain constant.
- The amount of revenue loss per qualifying taxpayer is estimated based on tax year 2002 IRS and Comptroller data.

As mentioned previously, in order to claim the federal EIC a taxpayer must be at least 25 years old. Qualifying noncustodial parents age 18 to 24 do not qualify for the federal EIC and would not receive the refundable State EIC as provided by the bill since the bill bases the State credit on "400% of the of EIC allowable under Section 32 of the Internal Revenue Code." If all noncustodial parents age 18 to 30 would receive a refundable EIC equal to 400% of what could be claimed by the individual if they had qualified, State revenues would decrease by approximately \$6.0 million annually beginning in fiscal 2006.

The State currently operates a tax intercept program whereby if a taxpayer has an unpaid child support liability the Comptroller's Office is authorized to withhold the tax refund of the individual. In tax year 2003, the Comptroller's Office withheld the tax refunds of 12,382 child support debtors totaling approximately \$5.6 million. The bill provides that an individual can qualify for the credit if the individual has paid at least 75% of required

child support obligations. To the extent that individuals claiming the tax credit have unpaid child support obligations in the current year of up to 25% and any unpaid child support obligations from prior years, the Comptroller's Office would intercept the part or all of the refundable EIC claimed by the qualifying noncustodial parent.

If the custodial parent who was owed the child support is not receiving Temporary Cash Assistance (TCA), the intercepted refund is transferred to the custodial parent. If the custodial parent is receiving TCA, 50% of the refund is transferred to the federal government and 50% is transferred to DHR for the TCA program.

State Expenditures: The Comptroller's Office reports that it would incur a one-time general fund expenditure increase of \$75,000 in order to add the credit to the personal income tax credit and calculate the value of the credit. This includes data processing changes to the SMART income tax return processing and imaging system, and systems testing.

DHR reports that it would incur a one-time expenditure of \$115,500 in fiscal 2006 in order to create an automated process that verifies the eligibility of the taxpayer claiming the credit. Of the expenditure required, \$76,230 would be a general fund expenditure and \$39,270 would be federal funds.

Local Revenues: No county has provided by law a refundable EIC that can be claimed with the tax return under the formula provided by State law. Montgomery County, however, operates a county refundable EIC that matches the State EIC claimed by the individual and acts as a grant program. Under the County program, eligible residents receive a check from the Comptroller, but paid for by Montgomery County. In tax year 2003, 22,129 tax returns from the County claimed approximately \$8.1 million of the State EIC. This represented approximately 12% of all the State refundable EIC claimed. In fiscal 2003, there were 13,223 child support cases with established court orders in Montgomery County or approximately 6% of the State total. Based on the estimated cost to the State due to the provisions of the bill, Montgomery County expenditures could increase by approximately \$245,000 in fiscal 2006 and beyond if the County continues to match State refundable EIC claimed for all taxpayers. If all noncustodial parents could earn 400% of the federal EIC, Montgomery County expenditures could increase by approximately \$543,000.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Human Resources, Comptroller's Office, General Accountability Office, Internal Revenue Service, Department of Legislative Services

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