MEMORANDUM

TO: Senator Michael Sirotkin, Chair, Minimum Wage Study Committee
Representative Helen Head, Vice-Chair, Minimum Wage Study Committee

FROM: Abby Shepard, Tax Policy Analyst, Vermont Department of Taxes

DATE: Friday, September 29, 2017

RE: New Tax Credit for Working Parents with Children Aged 13 and Under

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The Department of Taxes is responding to questions raised by the legislative Minimum Wage Study Committee. The questions were regarding the creation of a new tax credit, and the Department's capacity to administer it. The Department could administer this credit as proposed at a cost, by reprogramming its IT system VTax. One way to reduce costs would be to pay the credit as a one-time lump sum like for the Earned Income Tax Credit (EITC), rather than making monthly payments. Refining certain aspects of the credit, such as the filing requirements, would also facilitate efficiencies in its administration.

The tax credit currently proposed by the Study Committee would have the following features:

1. **Eligibility.** Parents with earned income below certain thresholds, and who have children aged 13 and under.
2. **Refundability.** The credit would be refundable so that an individual may receive payments even though the amount of the credit exceeds their tax liability.
3. **Monthly payments.** The tax credit would be similar to the EITC, in that it is based on income earned in the prior tax year, but the credit would be paid out monthly during the next calendar year. This differs from the EITC that is paid out in one yearly lump sum as part of the tax refund.
4. **Reconciliation.** There would be no need to reconcile at the end of the year, which means that a recipient would not have to pay anything back if their income increased in the current year.
5. **Not counted as income.** The credit would not be counted as either income or an expense reduction in determining other benefits.

Cost Considerations

Creating a complex new tax credit would result in administrative costs. These costs would be highest in the short term, due to the need to reprogram VTax. Reprogramming would be complicated by the monthly payment aspect of the credit, which is not something VTax is set up to do, because none of the taxes that the Department administers have this feature. The novelty of this credit would increase the costs of reprogramming.

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Comments on Proposed Credit Structure

1. Eligibility.

The Department assumes that eligibility for the tax credit would be based on similar factors, such as the income thresholds, that are used for the EITC. Using these factors for a new credit would leverage the Department's experience with the EITC. The age limit for children (13 and under) is the same as that for the Child and Dependent Care Credit, which the Department is also familiar with administering.

2. Refundable credit.

The refundable feature of this proposed credit is key to achieving the Study Committee's goal of targeting payments to working parents with children who need care. The refundable aspect also makes this credit more like a benefit than a tax incentive, because the full amount may be received regardless of tax liability. This has other consequences, as discussed below.

3. Monthly payments.

Some types of payments that the Department issues are: tax refunds, which include one-time EITC payments; renter rebates; and property tax adjustments. However, the Department does not make any disbursements on a monthly basis. Monthly payments would be the most challenging aspect of this credit for the Department to administer, and would generate the highest administrative costs, particularly for the technical implementation of the credit, because it would require reprogramming of VTax.

There are two changes or clarifications to this credit that would facilitate its administration, both of which would also make the credit more like the EITC. The first is clarifying that eligibility will be determined only once per year, at the time of personal income tax filing. Limiting the process to an annual determination would reduce the Department's administrative burden, and make the process more seamless for individuals who would only have to file once. Allowing applications on a rolling basis would add paperwork and complexity for both the Department and taxpayers. The second recommended change is to allow payment in one lump sum. This would eliminate the concern over VTax reprogramming costs. This is also consistent with the credit's backward-looking income eligibility requirements. By tying the amount of the credit to the prior year's income, the credit is already structured the same as the EITC, and will not reflect current need in the way that a benefit program would. If individuals qualify, and the amount cannot be reduced by the current year's income, the full credit can be paid immediately.

4. Reconciliation.

Basing eligibility on the amount of an individual's prior year income eliminates the need for reconciliation at the year's end. Reconciliation means that if an individual's income increases during the year, the credit will be reduced, and they will have to pay back any part of the credit already received above that new amount. This is avoided under this credit structure, because eligibility would be based on income earned in the prior year, not the current year. The drawback to this structure is that the credit amount is not adapted to the current income or need, which means that eligible individuals will still need to wait one year, like with the EITC, before receiving payments.

5. Not counted as income.

The Vermont statute that codifies other state benefit programs may need to be amended to specifically exclude this tax credit from the programs' eligibility calculations. This would not, however, resolve the effect the credit may have on eligibility for federal benefit programs. The Department is not the best placed to determine what these changes would be, as it does not administer these programs.

This refundable credit could impact an individual's income tax liability to the extent that the credit exceeds the individual's tax liability. To ensure that the refundable portion of the credit would not be counted in Vermont taxable income, legislative change would be necessary. This would require either excluding the credit from Vermont income under 32 V.S.A. § 5823, or deducting the credit from taxable income to the extent that it is included in federal taxable income under 32 V.S.A. § 5811(21). The personal income tax return forms IN-111 and IN-112 would also be changed to reflect this calculation.

Changes to state statute, however, would not resolve this refundable credit's potential impact on federal income tax liability. Even if this credit is explicitly excluded under Vermont law from income and is therefore not taxed by the state, it may still be taxed at the federal level. According to IRS advisories, federal law treats the portion of a refundable credit that exceeds state tax liability and is made available to the taxpayer as cash, as a payment from the state. This payment is then included in income unless an exclusion applies. IRS CCA 200842002 (Oct. 17, 2008); Info. Letters, IRS INFO 2013-0009 (Mar. 29, 2013).

Another consideration is how this credit will be treated for the purposes of the property tax adjustment and the renter rebate. To avoid a concurrent reduction in those payments when receiving this new credit, the definition of Household Income under 32 V.S.A. § 6061 would need to be amended to exempt this credit.