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HOW THE NEW TAX LAW ALTERS THE CHILD TAX CREDIT AND HOW LOW-INCOME FAMILIES ARE AFFECTED

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Overview

Because the Child Tax Credit is aimed in part at low- and middle-income working families, the expansion of the credit contained in the new tax law has been seen as having significant benefits for these families. This perception is based on a misreading of the changes the new tax law makes in the credit. In fact, millions of low-income working families with children would receive no benefit from this provision of the new law.

The final bill dropped a child tax credit provision included in the Senate version of the tax bill that would have assisted close to 12 million children in low-income working families, many of which receive no benefit from the final bill. This provision would have cost $3.5 billion, or one percent of the official $350 billion cost of the legislation and 2.3 percent of the bill's capital gains/dividends provision.

The final legislation accelerates the child tax credit provision of the 2001 tax cut that is targeted on middle- and upper-income families but not the comparable provision of the 2001 law that is targeted on low- and moderate-income families. (Similarly, the final legislation accelerates the marriage penalty relief provisions in the 2001 law for middle- and upper-income families but not the marriage penalty relief provision of that law targeted on low-income working families.) As a result, while some low-income families will benefit from the Child Tax Credit provisions of the new tax law, those provisions — like the new law as a whole — largely ignore low-income working families.

What the New Law Does to the Child Tax Credit

The Child Tax Credit provisions of the new tax law are based on changes made in the credit by the 2001 tax cut. That earlier tax cut expanded the child tax credit in two ways. First, it increased the size of the credit from $500 per child to $600 in 2001 through 2004, $700 in 2005 through 2008, $800 in 2009, and $1,000 in 2010. Second, it expanded the refundability of the credit — or the amount in excess of a household's tax liability that can be received as a refund from the Treasury. The credit was made refundable in an amount equal to 10 percent of earnings in excess of $10,000 (indexed for inflation), up to the maximum credit per child, with the refundability percentage scheduled to rise from 10 percent to 15 percent in 2005. (Since the refundability threshold level is indexed, it stands at $10,500 in 2003 and will rise further in coming years.)

The new law accelerates the increase in the size of the credit from $600 to $1,000 per child for 2003 and 2004. If not extended at this level, the credit would fall back to $700 per child in 2005 and gradually increase to $1,000 in 2010 as prescribed in the 2001 tax law.

This provision of the new law provides a $400 child tax credit increase per child for many middle-income families. For example, a married couple with two children and income of $50,000 would receive an $800 tax cut in 2003 from the increase in the size of the child tax credit.

What the New Law Does *Not* Do to the Child Tax Credit

The conference agreement does not accelerate the increase in the credit's refundability percentage from 10 percent of earnings above $10,500 to 15 percent of earnings above this level. Such an acceleration was part of the Senate-passed bill but was dropped in conference.

For low-income families, the amount of the child tax credit often is limited by the amount of the credit that is refundable. Simply increasing the size of the credit to $1,000 does not increase the amount of the benefit for most of these families.

For example, consider a married couple with two children and $20,000 in income in 2003. Due to the standard deduction and personal exemptions, this family owes no income tax. Its credit is limited to the amount that can be received in refundable form. And that amount is limited to 10 percent of earned income above $10,500. Since the family has $9,500 in income above the $10,500 threshold, it is limited to a refundable child tax credit of $950 in 2003, which works out to $475 per child. In other words, this family is already unable to use the full $600 per child. Increasing the maximum credit amount to $1,000 does nothing for this family; its credit still cannot exceed $950 (10 percent of earnings above $10,500), or $475 per child.

What would have happened to this family if the child tax credit had been increased to $1,000 per child *and* the increase in the refundability percentage to 15 percent scheduled for 2005 had been accelerated, as would have occurred under the Senate bill? The family's credit amount would be 15 percent of earned income above $10,500, or $1,425. This family would have received a tax cut of $475, rather than getting nothing.

Families in the following income ranges will receive no benefit from the increase to $1,000 in the size of the child tax credit. These families would have benefited if the scheduled increase in the refundability percentage had been accelerated.

No Benefit from the Child Tax Credit Increase in the Conference Tax-Cut Package

Children	Married filers		Heads of households	
	From	To	From	to
1	$10,500	$16,500	$10,500	$14,800
2	$10,500	$22,100	$10,500	$19,325
3	$10,500	$26,625	$10,500	$23,850

There are 11.9 million children nationwide — or one of every six children under age 17 — who would have benefited from accelerating the increase in the refundability of the child tax credit.[1] About eight million of these children will receive no benefit from the child tax credit provisions of the new legislation.

The $9.5 Billion in Increased Outlays for Refundable Tax Credits

According to the Joint Committee on Taxation, the conference agreement will increase outlays (or expenditures) for refundable tax credits by $9.5 billion through 2013. This increase does not, however, represent a direct expansion in the refundable earned income tax credit or in the refundability rules for the child tax credit. Instead, these outlay increases occur indirectly because of other changes in the new tax law.

Income tax cuts that reduce tax liability can increase the refundable portion of the earned income tax credit without changing the size of the credit. Consider a family that owes $500 in income tax before its EITC is calculated and qualifies for an EITC of $1,500. Some $500 of the family's EITC is used to eliminate its income tax liability, and the family receives the remaining $1,000 of its EITC in the form of a refund. If this family receives tax cuts that lower its tax liability (before the EITC is figured) to $200, the portion of the family's EITC that is provided as a refund will rise to $1,300. This increase in the refund amount occurs even though the family's total EITC remains unchanged at $1,500.

Thus, the impact of other, *non*-refundable tax cuts can increase the amount of outlays for refundable EITC payments without changing the EITC's overall size or cost. This occurs under the new tax law for some families in the upper part of the EITC eligibility range. This shift of more EITC benefits into the refundable component of the EITC as a result of other tax-cut provisions accounts for a portion of the new law's $9.5 billion increase in outlays for refundable tax credits. (Note: while EITC refund payments are counted as outlays, the non-refundable component of the EITC, under which the EITC reduces the income taxes that some families must pay, are appropriately treated as lowering tax receipts. The total cost of the EITC is the *sum* of the cost of the reduction in tax receipts that it generates and the cost of the refund payments it provides. Shifting more of the EITC from tax reduction to refund payments, which occurs here because some EITC families will have fewer income taxes left for the EITC to offset, does not affect overall EITC costs or benefit levels.)

Similarly, some increases in refundable *child credit* outlays occur under the new law, for two reasons. First, in the same way that EITC outlays will rise due to the enactment of other tax-cut provisions, the reductions in income tax liability that result from other tax cuts also will lower the portion of the child tax credit needed to offset some families' income tax liability, and will thereby increase the amount of child tax credit benefits provided as refunds. Second, some low-to-moderate income families with incomes modestly above the income ranges shown in the

[1] These figures are Center on Budget and Policy Priorities calculations based on Citizens for Tax Justice data. According to calculations from the Children's Defense Fund, under the new bill about two-thirds of the 11.9 million children would receive no increase in their child tax credit.

table on page 2 *are* affected by the current $600-per-child ceiling on the child tax credit and will see an increase in their refundable child credit as a result of the increase in the child credit to $1,000 per child.

Consider, for example, a married couple with one child and income of $18,000 in 2003. Prior to enactment of the new legislation, this couple would have owed $90 in taxes in 2003 before its child tax credit was figured. The family would have received a child tax credit of $600, with $90 of it going to eliminate the family's tax liability and the remaining $510 provided in refundable form. Under the new law, this family's pre-child credit tax liability is reduced to zero because of the increase in the standard deduction for married couples. The family now qualifies for a refundable child tax credit of $750 (10 percent of the amount by which its $18,000 income exceeds the $10,500 refundability threshold), and all $750 will be provided in refundable form. The family's *total* child credit will rise from $600 to $750, while the amount of its credit that is provided *in refundable form* will rise by a somewhat larger amount, from $510 to $750.

These factors explain why the new law results in an increase of $9.5 billion in outlays for refundable tax credits even though the EITC and the refundability provisions of the child tax credit are not accelerated or changed.