CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

Revised June 18, 2001

THE CHANGES THE NEW TAX LAW MAKES IN REFUNDABLE TAX CREDITS FOR LOW-INCOME WORKING FAMILIES

by Robert Greenstein

The large tax-cut bill that President Bush recently signed into law contains several provisions of significant benefit to low-income working families with children. These provisions fall into three categories: a significant expansion of the "refundable" component of the child tax credit; expansion of the Earned Income Tax Credit for married families; and changes in the EITC that are designed both to simplify it and to reduce errors and fraud associated with it. (A fourth provision, a modest expansion of the Dependent Care Tax Credit, is not discussed here; since that credit is not refundable, low-income families cannot use it, although some moderate-income families will benefit from the expansion of that credit.)

As a result of these provisions (and, to a lesser degree, of the interaction between the EITC, the child credit, and other provisions in the legislation), there will be an increase of $88 billion over ten years in the tax "refund checks" that low-income families with children receive. The refundable component of the child credit is complicated, however; low-income families will need to fill out and enclose a separate tax form with their tax returns to receive the child credit refunds for which they qualify. Substantial outreach efforts will be needed to minimize the number of eligible families that miss out on the credit.

Despite its low-income provisions, the tax bill as a whole remains heavily tilted toward those at the top of the income spectrum. Moreover, because the tax bill is so costly that it will sharply reduce or eliminate the potential for improvements in various programs of importance to low-income families and may ultimately lead to cuts in a number of such programs, the overall impact of the legislation on low-income families is likely to be negative.

I. The Child Credit Provision

The legislation raises the child credit, now $500 per child, to $600 in 2001, $700 in 2005, $800 in 2009, and $1,000 in 2010. The legislation also includes a Senate provision that adds a major refundable component to the child credit. This refundable component will benefit working families with children if those families earn more than $10,000 a year. The new refundable component was not part of the Administration's tax proposal. It will assist about 15 million children who would not have benefitted from the child credit expansion in the Administration's plan.

For low-income working families, the child credit will work as follows, starting with tax year 2001.

- The child credit will first be used to eliminate any federal income tax liability that a family has after other tax credits — except for the EITC — are taken into account. Thus, if a family's income tax liability is $300 before taking the child credit and EITC into account, the child credit is used first to eliminate that $300 tax liability. (So far, this is the same as current law.)

- If part of a family's child credit remains after the credit is used to eliminate any income tax liability the family may have, some or all of the remaining portion of the credit may be sent to the family as a "refund" check (just as the EITC is). If the family has no income tax liability for the child credit to offset, the family will receive as a refund check the full amount of the credit for which it qualifies.

The formula used to determine how much is sent to the family as a refund check works as follows. The family receives a refund check in an amount equal to the *lesser* of its unused child credit (i.e., the child credit that remains after the credit first is used to eliminate any income tax liability the family has) and the following amount:

-- in 2001 - 2004, 10 percent of the amount by which the family's earnings for the year exceed $10,000; and

-- in 2005 and subsequent years, 15 percent of the amount by which the family's earnings for the year exceed $10,000.

Note: These amounts — 10 percent (and then 15 percent) of earnings above $10,000 — are *not* multiplied by the number of children in the family.

Two examples, both for tax year 2001, may help illustrate how this will work. Consider first a family with two children that earns $15,000. (In this example, it does not matter whether the family is a single-parent or two-parent family.) The family has no income tax liability for the child credit to offset. As a result, all of its potential child credit of $1,200 ($600 per child, the maximum level of the child credit for 2001) remains unused. This family earns $15,000, which is $5,000 more than the $10,000 threshold. Since 10 percent of $5,000 (the amount by which its earnings exceed $10,000) is $500 — and this amount does not exceed the family's potential child credit of $1,200 — the IRS will send the family a check for $500 (plus the family's EITC).

Our second example is a single parent with *one* child and earnings of $15,000. In 2001, this family will owe $255 in income tax before the child credit is applied. (Income tax liability starts at a lower income level for this family than for the family in the preceding example because this family has only one child and thus gets one fewer personal exemption.) As a result, $255 of the family's child credit is used to eliminate the family's income tax liability. That leaves $345 of the family's child credit ($600 - $255 = $345). Ten percent of the family's earnings above $10,000 equals $500. Since there is only $345 left of the family's child credit, the family receives a check for $345 rather than $500 (plus the family's EITC).

What Happens in Years After 2001?

Under the legislation, three developments will

The Two Examples for Tax Year 2001

Number of children	2	1
Number of parents	1 or 2	1
Income of parent(s)	$15,000	$15,000
Family income in excess of $10,000	$5,000	$5,000
Income tax liability before the EITC and the Child Tax Credit	$0	$255
Potential maximum child credit ($600 per child in 2001)	$1,200	$600
A: Portion of potential child tax credit used to decrease income tax liability	$0	$255
B: Remainder ("unused portion") of potential child tax credit	$1,200	$345
C: 10% of family income in excess of $10,000	$500	$500
D: "Refundable" portion of Child Tax Credit: B or C, whichever is smaller	$500	$345
Total value of the Child Tax Credit to this family: reduction of income liability (A) plus the Refundable portion (D)	$500	$600

occur in subsequent years. First, as noted, the maximum credit level of $600 per child in 2001 rises over the decade until it reaches $1,000 in 2010. Second, the $10,000 threshold is indexed to inflation. This threshold will be $10,000 only for 2001. In 2002, it is likely to be $10,300, reflecting one year of inflation. (This estimate is based on the Congressional Budget Office's inflation forecast.) The threshold will be raised each year by the percentage the Consumer Price Index has increased over the previous year. Finally, the formula of "10 percent of earnings over $10,000, as indexed for inflation" applies through 2004 and becomes "15 percent of earnings over $10,000, as indexed" starting in 2005.

The child credit "refunds" that many low-income families will receive will become much larger when the credit rises in 2005 to 15 percent of earnings above $10,000, as indexed for inflation. For example, were the 15 percent figure in effect for 2001, a married family with two children that has earnings of $18,000 would receive a child credit refund of $1,200. (This family has no income tax liability; hence all of its potential credit of $1,200 remains unused. Fifteen percent of $8,000 — the amount by which the family's earnings exceed $10,000 — is $1,200. So the family would get a check for $1,200.)

A Special Case: Low-income Families with Three or More Children that Do Not Receive the EITC

The child-credit formula, as just described, would result in a very small number of families receiving a smaller child credit than under current law. These are families that have three or more children, have low earnings, and in most cases, do not qualify for the EITC.[1]

To remedy this problem and ensure no one is worse off, the new legislation provides that families with three or more children can receive a child credit refund check equal to the *greater* of 10 percent of earnings over $10,000, as indexed, (15 percent of earnings starting in 2005) or the amount by which the employee share of the payroll tax the family pays exceeds the Earned Income Tax Credit the family receives. (For the families in question, the EITC will be zero.) As with other families, the refund check that a family with three or more children may receive cannot exceed the unused amount of the family's child credit that remains after any income tax liability the family otherwise would incur is offset.

How Will a Family Apply for the Credit?

Each family will need to complete the child credit worksheet, which is found in the 1040 and 1040A tax booklets. To receive the refundable component of the credit, each family also will need to complete and *submit with its tax returns a new tax form* that the IRS will design. Families not enclosing the new tax form will lose the refundable component of the child credit. (The separate form will not be needed by a family whose child credit is used entirely to offset income tax it otherwise owes.) Major outreach efforts will be needed to alert low-income working families to the need to file the new form. (See below.)

For a family with three or more children, a different — and much more complicated — form may need to be attached. This is because of the special provision for families with three or more children, described above. (We and some tax experts are recommending that Congress revisit and simplify the legislation's complicated formula for figuring child credit refunds for families with three or more children.)

Will Low-income Working Families Receive a Separate Child Credit Refund Check?

No. A family will receive one check that combines its child credit refund, its EITC, and any other income tax refund it may be due. There will be neither a separate child credit check nor a designation on the refund check that a family receives of how much of the check is due to the child credit (just as there is no separate check or designation for the EITC).

Will These Child Credit Refunds Affect Eligibility or Benefit Levels in Means-tested Benefit Programs?

Generally not. The new legislation stipulates that child credit refunds do not count as income under means-tested benefit programs that receive federal funds. This includes TANF, food stamps, Medicaid, SSI, low-income housing, child care subsidies, child nutrition programs, and low-income energy assistance, among other programs. The legislation also states that child credit refunds do not count as resources (i.e., as assets) in these programs during the month the child credit is received or the following month. These are similar to the rules that apply to the treatment of the Earned Income Tax Credit.[2]

The Child Credit, the EITC, and Outreach Efforts

The new refundable component of the child credit is, in some respects, akin to a second Earned Income Tax Credit. Like the EITC, the child credit is targeted on working families with children and phases up as earnings increase until the maximum credit level is reached. Most, although not all, families that qualify for the child credit as a refund also will qualify for the EITC. (Some working families, especially those with earnings below $10,000 but also a significant number of families in the $20,000 to $35,000 range, will qualify for the EITC but not for a child credit refund. Some of these families will not qualify for the child credit *in a refundable form* because their child credit will be used entirely to offset income taxes they otherwise would owe. At the same time, some very large families with earnings of more than $35,000 *will* qualify for a refundable child credit but have income too high to qualify for the EITC. These families will qualify for a child credit refund because they have so many personal exemptions — as a result of having a very large number of children — that they do not begin to owe income tax until their income reaches higher levels; as a consequence, not all of their child credit is needed to offset income tax liability.)

There are, however, some significant differences between the refundable component of the child credit and the EITC. One is that for most low-income working families, the EITC will be much larger than the child credit refund. Earlier, we provided two examples of families at $15,000. The family at $15,000 that has two children will qualify for a $3,606 EITC in 2001, more than seven times the size of its child credit refund of $500. The family at $15,000 that has one child will qualify for a $2,123 EITC, about six times its child credit refund of $345.

The child credit amounts will grow larger when the credit formula increases to 15 percent of earnings above $10,000, as indexed, in 2005 but still will remain well below EITC levels for most low-income families. For example, were all of the provisions of the bill in full effect in 2001 — including the "15 percent formula," the increase in the maximum child credit to $1,000 per child, the EITC expansions, and the provision of the new law that raises the standard deduction for married filers — a married family that earns $20,000 and has two children would qualify for a child credit refund of $1,500. Its EITC refund would exceed $3,000. (This includes the effect of the increase in the EITC for married filers, which is discussed below.)

Moreover, once the child credit expansion is phased in fully, the amount by which many families' EITC benefits exceed their child credit benefits will grow over time. This is a result of differences in how each credit is indexed. (EITC benefit levels increase with inflation each year, as a result of indexing. By contrast, the maximum child credit amount is not indexed. In fact, if a family's earnings remain flat from one year to the next rather than rising with inflation, its EITC will increase while its child credit will decline modestly. The family's child credit will decline because of the indexing of the $10,000 child credit threshold.)

One implication of all of this is that outreach for the new refundable component of the child credit will need to be integrated with EITC outreach. It will not make sense to conduct outreach for the child credit separate and apart from EITC outreach. There will now be two refundable credits, largely for the same families. Such a family will have to file two separate tax forms: the Schedule EIC and the new form relating to child credit refunds.

Coordinated outreach for the two credits will require considerable training and some sophistication, in part because there are some differences in the rules for the two credits that may create confusion. The most important such difference is that the rules for determining who may claim a child for the child credit, which are largely the same as the rules for who may claim a child for the personal exemption, differ from the rules for who may claim a child for the EITC.

For most families, this difference in the rules will not matter. Where it can matter is in cases in which a non-custodial parent pays child support and claims the child for the personal exemption and the child credit. In these cases, the *non*-custodial parent may claim the child for the child credit, while the custodial parent claims the child for the EITC. (Parents may not claim a child for the EITC if they do not live with the child for at least half of the year; hence, non-custodial parents cannot claim the EITC.)[3]

One other important difference between the child credit and the EITC is that the child credit applies only to children under 17. The EITC applies to children under 19, or under 24 if a full-time student, or of any age if the child is permanently and totally disabled.

II. EITC Benefits for Married Families

To provide marriage penalty relief, the new legislation increases EITC benefits for those married parents who have incomes above the income level at which the EITC begins to phase down. This level is $13,090 in 2001, and is projected to be $13,460 in 2002. This income level is adjusted each year for inflation.

The legislation increases the income level at which the EITC begins to phase down for married filers by $1,000 in 2002 through 2004, by $2,000 in 2005 through 2007, and by $3,000 starting in 2008. The $3,000 figure will be adjusted for inflation each year, starting in 2009.

This provision will increase EITC benefits for married filers *with two or more children* and incomes above $14,090 (in 2001 dollars) by exactly $211 in 2002 through 2004. (Those with incomes between $13,090 and $14,090 will get a smaller increase.) In 2005 through 2007, married filers with two or more children and incomes above $15,090 (in 2001 dollars) will receive an increase of $421 in their EITC benefits (with those between $13,090 and $15,090 getting a smaller increase). Finally, starting in 2008, married families with two or more children and incomes above $16,090 (in 2001 dollars) will receive an increased EITC benefit of $632, with this $632 amount increasing with inflation each year thereafter. (Those between $13,090 and $16,090 will receive a smaller increase). For married families with *one* child and incomes above these levels, the comparable EITC benefit increases will be $160 in 2002 through 2004, $320 in 2005 through 2007, and $479 in 2008.

The maximum levels of income that married families can have and still receive some EITC benefit also will rise. The EITC income limit for married families will increase by $1,000 in 2002-2004 (above the levels it otherwise would attain), by $2,000 in 2005-2007, and by $3,000 in 2008. After 2008, the increase in the income limit for married filers will be $3,000, as adjusted annually for inflation.

The combined effect of this provision and the child credit refund provision will be substantial for a number of low-income married families. When the provisions are fully in effect, a married family with two children and income of $20,000 (in 2001 dollars) will receive an increase in refundable credits of more than $2,100.

This provision will, however, also make EITC outreach somewhat more challenging, as there will now be differences in EITC benefit levels not only based on the number of children in a family but also based on whether the family is a married family.

III. EITC Simplification and Error Reduction

This part of the legislation includes five changes. The net effect of these provisions will be some increase in EITC benefits (although the benefits of the majority of EITC families will not be affected by any of these changes). These provisions generally take effect starting with tax year 2002 (meaning the provisions will apply to 2002 tax returns, which will be filed in early 2003).

- The EITC will now use the same definition of earned income as the rest of the tax code. Non-taxable earned income (such as 401(k) contributions) will no longer matter for EITC purposes.
- Under another, similar simplification measure, the EITC will use the same definition of adjusted gross income as is reflected on the 1040 and 1040A forms. EITC filers will no longer need to add various items to the figure shown on their 1040 or 1040A forms to determine their "modified" adjusted gross income for EITC purposes.
- Parents living with relatives who have higher incomes than they do will now be able to claim their children for the EITC. The longstanding rule that the potential claimant with the highest income is the only one who can claim a child for the EITC is replaced with a new rule that *either* an eligible parent or another eligible relative who lives in the household may claim a child for the EITC, as long as both individuals do not claim the child. If both submit a claim for the same child, the parent is deemed to be the eligible claimant ahead of the non-parent. This is a significant simplification that also will result in an increase in EITC benefits for some extended families.[4]
- To claim the EITC, foster parents now will need to live with their foster children for six months of the year, rather than 12 months. The six-month rule also will apply to aunts, uncles, and siblings who claim a child for the EITC; currently, they, too, must live with a child for all 12 months of the year to claim the child for the EITC.
- Starting on January 1, 2004, the IRS will have the authority to deny EITC claims submitted by a parent who shows up in the Federal Case Registry as being under a requirement to pay child support for the child he is claiming for the EITC. In most cases, a parent under a child support order is the child's *non*-custodial parent and hence ineligible to claim the child for the EITC (since a claimant must live with the child for at least six months of the year to claim the child). A taxpayer whose EITC claim is initially denied under this authority may still receive the credit if he can show the IRS he did reside with his child for more than half of the year. (This provision also directs the Treasury Department to conduct a study of the accuracy and timeliness of the Federal Case Registry data, as well as of the efficacy of the authority that the law accords the IRS to use these data to deny EITC claims. The Treasury Department is to submit this study to Congress by October, 2002, some 15 months before the provision is scheduled to take effect.) This provision holds promise for reducing error and fraud; a significant proportion of erroneous EITC claims appear to be submitted by non-custodial parents.

---

1. There are few reasons a low-income working family might not qualify for the EITC. If a family has income from interest, dividends, capital gains, rents, and royalties that exceeds $2,400, it is ineligible for the EITC. (This provision of law is intended to disqualify families with significant assets.) In addition, some non-custodial parents who pay child support claim their children for the personal exemption and the child credit, but cannot claim these children for the EITC because the children do not reside with them. The number of low-income working tax filers with three or more children who can claim these children for the child credit but do not qualify for the EITC is small.

2. In TANF and some other programs, states decide whether to count the EITC as income. Most or all states disregard the EITC in these programs. Also, in the food stamp program, the EITC is not counted as an asset for 12 months after a household receives its EITC.

3. There also are some cases in which a single parent who qualifies for the EITC may not be eligible to claim the child for the personal exemption and the child credit because the parent's income from public benefits or foster care payments exceeds the parent's earnings. (This makes the parent ineligible to claim the personal exemption and the child credit for the child.) However, few parents with earnings exceeding $10,000 are likely to fall into this category.

4. In the case of two eligible, unmarried parents living together with their qualifying child, the parents can choose who claims the EITC. If both parents claim the credit, the parent with the higher adjusted gross income is the eligible claimant. In cases where unmarried parents live apart, but both lived with the child for at least six months, the parent who lived with the child longer is the eligible claimant.