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# The Child Tax Credit and the President's Tax Cut Plan

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## Summary

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997. The current credit is $500 per qualifying child. President Bush has proposed increasing the child tax credit to $1,000 per qualifying child. The President has also proposed making permanent the temporary rule in current law that allows the child tax credit to offset a taxpayer's alternative minimum tax.

Economic theory does not provide a definitive answer to the question of how the costs of child rearing should be accounted for under an income tax. The empirical evidence suggests, however, that over the past 15 years the average federal tax rate on families in the low- and middle-income ranges has fallen and has remained relatively constant for upper-income families.

## Current Law

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997. Congress passed the bill because it believed that the tax structure did not adequately reflect a family's reduced ability to pay taxes as family size increased. The decline in the real value of the personal exemption over time was cited as evidence of the tax system's failure to reflect a family's ability to pay. Congress believed that the child tax credit would reduce families' tax liabilities, would better recognize the financial responsibilities of child rearing, and promote family values.

Initially, for tax year 1998, families with qualifying children were allowed a credit against their federal income tax of $400 for each qualifying child. For tax years after 1998, the credit increased to $500 per qualifying child.

To qualify for the credit the child must be an individual for whom the taxpayer can claim a dependency exemption. That means the child must be the son, daughter, grandson, granddaughter, stepson, stepdaughter or an eligible foster child of the taxpayer. The child must be under the age of 17 at the close of the calender year in which the taxable year of the taxpayer begins.

For families with one or two qualifying children, the child tax credit is not refundable. However, it is calculated before the taxpayer calculates his earned income tax credit (EITC). For families with three or more qualifying children, the child tax credit is refundable. However, in any given year, the credit cannot exceed: (a) the sum of the taxpayer's regular income tax liability (excluding the EITC) and the taxpayer's share of Social Security taxes, reduced by (b) his EITC.

The child tax credit is phased out for taxpayers whose adjusted gross incomes (AGIs) exceed certain thresholds. For married taxpayers filing joint returns, the phaseout begins at AGI levels in excess of $110,000, for married couples filing separately the phaseout begins at AGI levels in excess of $55,000, and for single individuals filing as either heads of households or as singles the phaseout begins at AGI levels in excess of $75,000. The child tax credit is phased out by $50 for each $1,000 (or fraction thereof) by which the taxpayer's AGI exceeds the threshold amounts. Neither the child tax credit amount nor the phaseout thresholds are indexed for inflation.

## President Bush's Proposal

President Bush has proposed expanding the child tax credit from its current law level of $500 per child to $1,000 per child. The increase in the child tax credit would be phased in with the credit rising to $600 in 2002, $700 in 2003, $800 in 2004, $900 in 2005, and $1,000 in 2006 and thereafter.

In addition, the President would increase to $200,000 the point at which the child tax credit is phased out. The new $200,000 threshold would be the same for joint, head of household, and single returns. This new threshold would also be phased in between 2002 and 2006. After 2006, the $200,000 threshold would not be indexed for inflation. Finally, the President would make permanent the current law provision that allows the child tax credit to offset an individual's alternative minimum tax (AMT) liability.

Preliminary estimates by the Joint Committee on Taxation (JCT) indicate that these proposed changes in the child tax credit would reduce federal income tax revenues by $162 billion over the fiscal year period 2002 to 2010.

One of the most important elements of the President's proposal is the fact that he would permanently allow the child tax credit to offset a taxpayer's alternative minimum tax liability. The interaction of the child tax credit and the individual alternative minimum tax is an area of growing concern.[1]

Usually, personal tax credits are limited in that they cannot be used to reduce regular income tax liability below an individual's alternative minimum tax liability. For example,

[1] For more information on the AMT see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein. Also see CRS Report RL30485, *The Individual Alternative Minimum Tax: Interaction with Marriage Penalty Tax Relief and Other Tax Cuts*, by Jane G. Gravelle.

consider the case where a taxpayer has a regular income tax liability before credits of $600, is eligible for a $500 child tax credit, and has an alternative minimum tax liability of $350. Under regular federal income tax rules, the taxpayer would only be allowed to use $250 of the child tax credit to reduce his regular income tax to $350 ( the same but no lower than the alternative minimum tax).

Congress became aware that the interaction of the child tax credit and the alternative minimum tax could reduce the value of the child tax credit. Thus, in the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, Congress allowed personal tax credits (including the child tax credit) to offset an individual's regular income tax in full for tax year 1998 even though the personal tax credits might be larger than the amount by which the taxpayer's regular income tax exceeded his alternative minimum tax.

Subsequently, the Ticket to Work and Work Incentives Improvement Act of 1999 extended, through December 31, 2001, the provision allowing individuals to offset their regular income tax by the full amount of their personal tax credits regardless of their alternative minimum tax liability.

However, starting in tax year 2002 when these provisions expire, the interaction of the alternative minimum tax with the personal tax credits could result in some families not receiving the full benefits of the child tax credit. If the child tax credit was doubled without taking account of the interaction with the AMT, many households would not be able to take full advantage of the increase in the credit. Hence, the President’s proposal to permanently allow the child tax credit to offset AMT liability is a critical component of the overall change.

## Legislative Activity in the 107th Congress

In late March 2001, the House passed H.R. 6, a bill that, among other things, would make changes to the child tax credit. Under this bill the child tax credit would be increased to $1,000 with the increase phased in between 2001 and 2006. It would also make the child tax credit refundable for families with one or two children. Finally, it would make permanent the temporary rule in current law that allows the child tax credit to offset a taxpayer’s AMT. The first two of these provisions are estimated to cost $175 billion over the fiscal year period 2001 to 2011.

## Assessment

Economic theory does not provide an answer to the question of how the costs of child rearing should be accounted for under an income tax. Proponents of an increased child tax credit argue that the current credit is not large enough to offset the costs of raising a child. Critics argue, however, that it was never intended that the federal income tax provide offsets for the full financial responsibility of raising children. Indeed, some even argue that the decision to have children represents a choice of how to consume one’s income and therefore the costs of raising children should not be a consideration when assessing income taxes.

Historically, the federal income tax has differentiated among families of different size through the combined use of personal exemptions, dependent care credits, standard deductions, and the earned income tax credit. These provisions were modified over time so that families of differing size would not be subject to federal income tax if their incomes fell below the poverty level.[2]

The child tax credit represents a departure from past policy practices because it is not designed primarily as a means of differentiating between low-income families of different size, but rather is designed to provide general tax reductions to middle income families. The empirical evidence, however, suggests that for families at the low end of the income spectrum the federal tax burden has declined over the past 15 years. For families in the middle and higher income ranges, the federal tax burden has either declined or remained constant over the same time period.[3]

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[2] For more information on the tax treatment of different family types see CRS Report 98-653E, *The Marriage Penalty and Other Family Tax Issues*, by Jane G. Gravelle.

[3] U.S. Department of Treasury. Office of Tax Analysis. *Average and Marginal Federal Income, Social Security and Medicare, and Combined Tax Rates for Four-Person Families at the Same Relative Positions in the Income Distribution, 1955-1999.* Jan. 15, 1998.