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The Child Tax Credit

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Summary

The child tax credit was enacted in 1997, as Congress addressed concerns that the income tax structure did not adequately reflect a family's reduced ability to pay taxes as family size increased. Subsequent changes in 2001, 2003, and 2004 increased the child tax credit and made it refundable for most families. These recent changes will sunset (expire) in 2011. The child tax credit is scheduled to decline from $1,000 in 2010 to $500 in 2011.

Multiple bills affecting the child tax credit have been introduced in the 109th Congress. This report will be updated as legislative action warrants.

Current Law

For tax year 2005, families, below certain income levels, with qualifying children are allowed a credit against their federal income tax of $1,000 for each 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 calendar year in which the taxable year of the taxpayer begins. For families with one or two qualifying children, the credit is refundable to the extent of 15% of a taxpayer's earned income in excess of $10,750.[1] (This earned income threshold is indexed annually for inflation.) For families with three or more children, the child tax credit is refundable to the extent that the taxpayer's Social Security taxes exceed the taxpayer's earned income tax credit or to the extent of 15% of their earned income in excess of $10,750, whichever is larger.

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

[1] A refundable tax credit means that you receive the tax credit even if you do not have an income tax liability. For example, a taxpayer with $12,000 of earned income, a zero income tax liability, and one qualifying child would receive a refundable child tax credit of $188 (15% of $12,000 minus $10,750).

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. These phaseout thresholds are not indexed for inflation. The child tax credit is allowed in full against a taxpayer's alternative minimum tax.

Legislative History

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997. Congress established the child tax credit to address concerns that the tax structure did not adequately reflect a family's reduced ability to pay taxes as family size increased. The decline (prior to its indexation) 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 acted so that the child tax credit would reduce families' tax liabilities, would better recognize the financial responsibilities of child rearing, and promote family values.[2]

Initially, for tax year 1998, families with qualifying children under the age of 17 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. For families with three or more children the child tax credit was refundable.

The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 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 (AMT). [3]

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.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made several major changes to the child tax credit. The child tax credit was increased to $1,000, with the increase scheduled to phase in between 2001 and 2010. For calendar years 2001 and 2002 the credit was $600. In calendar years 2003 and 2004 the credit was scheduled to be $600; for calendar years 2005 to 2008 the credit was scheduled to be $700; for calendar year 2009 the credit was scheduled to be $800 and for calendar year 2010 the credit is scheduled to be $1,000.

The 2001 Act also extended the refundability of the child tax credit to families with fewer than three children. For tax years 2001 through 2004, the credit was made

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[2] Joint Committee on Taxation, JCS-23-97, *General Explanation of Tax Legislation Enacted in 1997*, Dec. 1997, p. 6.

[3] For more information on the interaction of personal tax credits and the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein.

refundable to the extent of 10% of a taxpayer's earned income in excess of $10,000. Refundability was scheduled to increase to 15% for 2005 and later years. The $10,000 threshold was indexed for inflation beginning in 2002. In addition, the 2001 Act permanently allowed the child tax credit to offset alternative minimum tax liability. All of the provisions of the 2001 Act, however, are scheduled to sunset at the end of 2010.

The Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the child tax credit to $1,000 for tax years 2003 and 2004. In the summer of 2003, the $400 increase in the credit for tax year 2003 was paid, via a check from the Treasury Department, in advance to many families who qualified for the child tax credit. The checks were distributed based on information contained on taxpayers' 2002 income tax returns. The JGTRRA provisions were scheduled to expire after 2004 and the child tax credit would have reverted to its scheduled level under the EGTRRA provisions, $700 in 2005.

In September 2004, Congress passed the Working Families Tax Relief Act of 2004 (WFTRA). This act extended the $1,000 child tax credit through 2009 (for 2010, the EGTRRA provisions apply and the child tax credit will remain at $1,000). In addition, WFTRA accelerated, to 2004, the increase in the refundability of the child tax credit. For 2004 through 2010, the child tax credit will be refundable to 15% of a taxpayer's earned income in excess of the applicable threshold. The 2004 Act also contained a provision including combat pay in earned income for purposes of computing child tax credit refundability. **Table 1** shows the actual values for the child tax credit under current law and the values as enacted under the 2001, 2003, and 2004 tax changes.

Table 1. The Child Tax Credit Under Current Law and as Enacted Under the 2001, 2003, and 2004 Tax Acts

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Actual	$400	$500	$500	$600	$600	$1,000	$1,000
WFTRA (2004)	—	—	—	—	—	—	—
JGTRRA (2003)	—	—	—	—	—	$1,000	$1,000
EGTRRA (2001)	—	—	—	$600	$600	$600	$600
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Current law (scheduled)	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$500
WFTRA (2004)	$1,000	$1,000	$1,000	$1,000	$1,000	—	—
JGTRRA (2003)	—	—	—	—	—	—	—
EGTRRA (2001)	$700	$700	$700	$700	$800	$1,000	—

Policy Issues and Recent Legislative Action

Three main issues have dominated recent policy discussions about the child tax credit: (1) the refundabilty limits on low-income families, (2) the expiration, at the end of 2010, of the EGTRRA expansion of and increases to the child tax credit, and (3) concern over the effects of tax cuts on the budget deficit.

JGTRRA accelerated, to tax years 2003 and 2004, the scheduled increase in the child tax credit from $600 to $1,000. However, it did not accelerate the increase in the refundability of the child tax credit scheduled to take effect in 2005. (In 2005, the child tax credit was scheduled to be refundable to the extent of 15% of a taxpayer's earned income in excess of a specified threshold.)

As a result, many low-income families did not benefit from the JGTRRA increase in the amount of the child tax credit. For example, in 2003, a family filing a joint return with one qualifying child and earned income of $16,500 would not owe federal income taxes. They would, however, have received a refund of $600 for the child tax credit. The $600 refund would have been the same as under prior law (10% of the excess of $16,500 earned income over the $10,500 threshold). Hence, even though the 2003 Act increased the child tax credit to $1,000, this family saw no increase in their refundable child credit compared to prior law. If the refundability of the child tax credit had been accelerated to 15%, then this family would have received a refundable child tax credit of $900 in tax year 2003 (15% of the excess of $16,500 earned income over the $10,500 threshold).

The fact that JGTRRA did not increase the refundability of the child tax credit caused some controversy in Congress. Although additional legislation accelerating the increase in refundability was contained in bills passed in 2003 by both the House and the Senate, it was not enacted into law. Congress addressed this issue again in 2004 and, with the passage of the WFTRA, increased refundability to 15% effective in 2004.

The second policy issue facing Congress concerns the sunset provisions of EGTRRA and the child tax credit. All the tax provisions in EGTRRA will sunset (revert to prior law levels) after 2010. This means that, absent legislative action, in 2011, the child tax credit will fall to $500 per qualifying child, the credit will no longer be refundable for families with fewer than three children, and the child tax credit will not be allowed in full against a taxpayer's alternative minimum tax.

Finally, a counterweight to the congressional desire to provide continued tax relief to families is congressional concern over the current and projected size of the federal budget deficit. The revenue costs associated with extending the child tax credit changes beyond 2010 would be approximately $33 billion a year.

To date, the following bills affecting the child tax credit have been introduced in the 109th Congress.

S. 6. Introduced Jan. 24, 2005. Among other things, this bill would make the 2001 legislative changes to the child tax credit permanent.

H.R. 1555. Introduced April 12, 2005. This bill would make the refundable portion of the child tax credit available to taxpayers in Guam and the Virgin Islands.

H.R. 1597. Introduced April 13, 2005. This bill would make the child tax credit available for children under the age of 19.

H.R. 2950. Introduced June 16, 2005. Among other things, this bill would provide for a uniform phaseout of the child, adoption and education tax credits.

S. 1305. Introduced June 23, 2005. Among other things, this bill would make the increase in the child tax credit permanent and would index the credit for inflation.

H.R. 3080. Introduced June 27, 2005. Companion bill to S. 1305.

H.R. 3317. Introduced July 14, 2005. This bill would make the 2001 changes to the child tax credit permanent and would index the credit for inflation.

H.R. 3441. Introduced July 26, 2005. This bill would allow the child credit with respect to a taxable year for a child born within nine months after the close of said taxable year. It would also allow the credit for a child that is stillborn or dies in utero during the taxable year.

H.R. 3844. Introduced Sept. 21, 2005. This bill would allow for an advance payment of the earned income tax credit and child tax credit to families affected by Hurricane Katrina.

S. 1770. Introduced Sept. 26, 2005. Companion bill to H.R. 3844.

S. 1757. Introduced Sept. 22, 2005. This bill would make residents of Puerto Rico eligible for the refundable portion of the child tax credit.

S. 1775. Introduced Sept. 27, 2005. This bill reduces and repeals the indexation of the income threshold used to calculate the refundable portion of the child tax credit.

H.R. 4030. Introduced Oct. 7, 2005. Repeals indexation of threshold for determination of refundable credit.

H.R. 4451. Introduced Dec. 6, 2005. Makes residents of Puerto Rico eligible for refundable portion of tax credit.

H.R. 4708/S. 2257. Introduced Feb. 8, 2006. Increases refundable credit for taxpayers affected by Hurricane Katrina.

S. 2319. Introduced Feb. 26, 2006. Increases access to refundable portion of the child tax credit.

Analysis

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. In this view, children should be considered an investment in the future and as such the costs associated with child rearing should be deducted as are other investment costs. 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.[4]

The child tax credit represents a departure from past policy practices because it is not designed primarily as a means of differentiating between families of different size at or near the poverty threshold, but rather is designed to provide general tax reductions to middle and upper income taxpayers with dependent children under the age of 17.

On occasion, Congress has debated the merits of increasing the AGI phase out limits on the child tax credit. However, increasing the AGI phase-out limits for the child tax credit would significantly expand the tax benefits of the child tax credit and provide tax reductions to much higher-income families than the original 1997 legislation.

On the other hand, increasing the refundability percentage from 10% to 15% of earned income and the inclusion of combat pay for purposes of calculating refundability provided only modest tax benefits to taxpayers at the bottom of the income spectrum. Families with income below $10,750 receive no tax benefits from the refundable child tax credit. In fact, since the earned income limit for refundabilty is indexed for inflation, each year it will increase in nominal terms, and more low-income families will lose tax benefits from the refundable child tax credit.

The empirical evidence suggests that for families with children (except those families in the highest income quintile), the overall federal tax burden fell between 1979 and 2000.[5] The 2001, 2003 and 2004 tax acts (with their reductions in marginal income tax rates, reductions in taxes on capital gains/dividend income, and marriage penalty tax relief) continued the trend of reducing federal taxes on families, especially high-income families filing joint returns.

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

[5] Congressional Budget Office, *Effective Federal Tax Rates: 1997 to 2000*, Aug. 2003.