The Rate Reduction Tax Credit - "The Tax Rebate" - in the Economic Growth and Tax Relief Reconciliation Act of 2001: A Brief Explanation

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Summary

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) created a rate reduction tax credit (RRTC) for tax year 2001. The RRTC was structured to mimic a 10% income tax bracket. The tax relief provided by this credit was transmitted to taxpayers via an advance check that was mailed to taxpayers in 2001. These advance checks were based on information from income tax returns filed for tax year 2000. The advance checks were not a rebate of taxes paid in tax year 2000.

Congress adopted the RRTC and the advance check transmission mechanism to circumvent the problems associated with trying to provide immediate tax relief through income tax withholding. Congress later clarified how the RRTC would interact with the child tax credit and how dependents and nonresident aliens would be affected. The IRS reported that through mid-February 2002, more than 1 million returns had RRTC related errors.

Economic analysis of the rebates generally concludes that households spent between 20% and 40% of the rebate checks soon after receipt. The magnitude of the RRTC impact on the economy in 2001, however, is uncertain.

This report will not be updated.

Contents

Contacts

Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) generated considerable interest in the popular press. One provision that received prominent coverage was the so-called "tax rebate." In fact, the new tax law did not provide for a tax rebate, rather; it created a "rate reduction tax credit" (RRTC) in lieu of a 10% tax bracket for tax year 2001 for most taxpayers. Most taxpayers received the RRTC in the form of an advance check from the IRS. The advance checks, which were distributed between July and October 2001, were based on information contained in taxpayers' 2000 tax returns.

The complexity of the RRTC and the advance check for the RRTC led to much uncertainty. In the fall of 2001, the Treasury Department asked for and received guidance from Congress concerning how the RRTC should be calculated in light of new rules for the child tax credit. Also, at the request of the Treasury Department, the Chairman of the House Ways and Means Committee and the Chairman and Ranking Member of the Senate Finance Committee stated by letter their understanding that Congress had intended to allow dependent filers and nonresident aliens to be eligible for a 10% tax rate bracket in 2001, in lieu of the RRTC. The 2001 Act excluded dependents and non-resident aliens from coverage under the provisions of the RRTC. But, it was less certain whether or not they were eligible for the 10% bracket. The Treasury Department designed the 2001 tax forms in a manner that is consistent with the letter it had requested from the leaders of the congressional tax writing committees.

As formulated, the provision accomplished the objective of providing immediate tax relief, but the complexity and uncertainty regarding the advance checks and the RRTC led to numerous errors in the filing of 2001 federal income tax returns. The IRS reported that more than 1 million returns filed through mid-February 2002 had incorrectly reported the RRTC on their tax forms.[1]

This report explains the advance checks, the RRTC, the post-EGTRRA changes affecting the RRTC, and why the RRTC was implemented instead of a retroactive 10% rate bracket for 2001.

Explanation of the RRTC, Advance Checks, and 10% Tax Bracket

- The Economic Growth and Tax Relief Reconciliation Act of 2001 created a new 10% marginal income tax bracket for the first $12,000 of taxable income for joint returns ($6,000 for single individuals and $10,000 for heads of households). This new tax bracket is applicable for tax years beginning in 2002.
- For 2001, the act created a rate reduction tax credit (RRTC) in lieu of the 10% tax rate bracket for most taxpayers.
- The RRTC for 2001 is 5% of the income that would have been subject to the new 10% marginal income tax bracket. Hence, the maximum amount of the rate reduction tax credit was $600 (5% of $12,000) for married couples filing jointly, $500 for heads of households (5% of $10,000), and $300 for singles (5% of $6,000).

[1] See the following: http://www.irs.ustreas.gov/pub/irs-news/ir-02-19.pdf.

- EGTRRA excluded dependents and nonresident aliens from eligibility for the RRTC, but left unclear whether they would be eligible for the 10% tax bracket for 2001.
- EGTRRA also implied that the RRTC should be applied after all non-refundable personal tax credits. However, because EGTRRA also changed the refundability of the child tax credit, it was unclear whether the RRTC would be subtracted from tax liability before or after the child tax credit.
- EGTRRA explicitly stated that the RRTC could be credited against the alternative minimum tax (AMT).
- The RRTC was advanced to most taxpayers in the form of a check (the "advance check") from the U.S. Treasury Department in 2001. These advance checks were distributed primarily between July and October 2001.
- The advance check was calculated based on a taxpayer's 2000 tax information. Taxpayers who had no tax liability in 2000, along with dependents and nonresident aliens, were not issued an advance check.
- The advance checks were not rebates for taxes paid in 2000. The advance checks were credits against 2001 income tax liability paid before taxpayers filed 2001 tax returns. However, taxpayers were not required to repay excess credits.
- The advance checks were issued based on the last two digits of the taxpayer identification number (the taxpayer's Social Security number). The advance checks were issued beginning with the lowest last two digits of the taxpayer identification number.
- Taxpayers who received the maximum advance check for their filing status ($600 for joint returns, $500 for head of household returns, and $300 for single returns) did not have to reconcile their advance check with their RRTC when they filed their 2001 tax return.
- Taxpayers who did not receive an advance check or received an advance check that was less than the maximum RRTC for their filing status, were required to reconcile their advance check with their RRTC when filing 2001 taxes. After reconciliation, taxpayers that should have received a RRTC greater than the advance check, claimed the difference as a credit on their 2001 tax return. Again, taxpayers were not required to repay the Treasury if the advance check was greater than the RRTC to which they were entitled.

Clarification of the RRTC for Certain Groups

In a September 2001 statement released by the Senate Finance Committee, Representative William M. Thomas and Senator Charles Grassley noted that "[d]uring the drafting of the new tax forms, Treasury and Senate Finance Committee staff discovered that the statute could be interpreted in a manner not consistent with Congressional intent." Therefore, the Treasury Department sought clarification of congressional intent regarding how the RRTC should be applied to dependents and non-resident aliens. The Treasury Department also sought clarification on the calculation of the RRTC in relation to the child tax credit, because the child tax credit for families with two or fewer children was changed to a refundable credit by EGTRRA.[2]

[2] For more information on the child tax credit, see CRS Report RS20988, *The Child Tax Credit After the Economic Growth and Tax Relief Reconciliation Act of 2001*, by Gregg A. Esenwein.

In response to the Treasury Department request, Representative William M. Thomas, Senator Charles Grassley, and Senator Max Baucus sent a letter dated September 14, 2001, to Assistant Secretary of the Treasury for Tax Policy Mark Weinberger that clarified their understanding of the intent of Congress concerning the issues the Department had raised. In designing the 2001 tax forms, the Treasury Department interpreted the statute in a manner consistent with the congressional intent expressed in the letter of September 14, 2001. As a result:

- dependents and non-resident aliens who were not eligible for the RRTC (and the advance checks) would, instead, be eligible for the 10% tax bracket when they filed their tax returns for 2001;
- taxpayers who were entitled to claim child tax credits in 2001 were given the maximum benefits of the refundable features of the child tax credit. Thus, the child tax credit would be subtracted from a taxpayer's income tax liability after the RRTC had been subtracted;
- the RRTC is taken into account before the application of nonrefundable personal tax credits that provide for a carryforward of benefits (the adoption tax credit). Thus, the adoption tax credit would be subtracted from a taxpayer's income tax after the RRTC had been subtracted.

Why a RRTC Instead of a Retroactive 10% Tax Bracket?

Both the House and Senate versions of the tax cut legislation sent to the conference committee included a new 10% tax bracket. The House version phased in reductions in tax brackets, with the 10% tax bracket becoming fully phased in by 2006. The Senate version established the 10% bracket retroactive to the 2001 tax year. The conference agreement established a 10% tax bracket effective for tax years beginning in 2002. However, the conference agreement included the RRTC instead of a 10% tax bracket in 2001.

Proponents of the RRTC cited the need for immediate tax relief to stimulate the economy. They argued that the retroactive 10% rate bracket would not have delivered immediate tax relief as cleanly as the RRTC because of potential problems implementing changes in the withholding schedules. Under a retroactive 10% tax bracket designed to deliver immediate relief in 2001, the new withholding schedules would have to "under" withhold the second half of the year at double the amount to compensate for the "over" withholding the first half of the year. As a result, take-home pay would have appeared misleadingly large in the second half of 2001. Then, in 2002, the withholding schedules would revert to withholding schedules consistent for a complete year of income tax withholding. As a result, withholding in 2002 would have increased. The increase in withholding would have reduced take-home pay, and it would have appeared to taxpayers that their taxes had increased relative to the accelerated rate of withholding during the last half of 2001.

A second option, implementing changes in withholding schedules without compensating for the over withholding in the first half of 2001, would have delivered approximately half of the tax relief in 2001.

So, Congress adopted the RRTC, which was transmitted to most taxpayers via advance checks issued beginning in July 2001 an continued through October of 2001. The RRTC circumvented the problems associated with trying to provide immediate tax relief through income tax withholding. However, according to the IRS, the new line on tax forms made necessary by the relatively complex RRTC led to numerous taxpayer errors.

Impact of the RRTC

After the RRTC checks were distributed, economists evaluated the effectiveness of the RRTC in stimulating the economy. The challenge of such an evaluation is isolating the effect of the RRTC from all of the other components of the stimulus package. In a March 2003 paper, Shapiro and Slemrod (SS) surveyed households "to determine how the receipt of the rebate checks would change behavior." They found that "21.8% of those receiving the rebate reported that it would lead them mostly to increase spending."[3] SS report that 32.0% would save the rebate check and 46.2% would pay down debt. Both actions would do little to stimulate the economy in the short run.[4] Another key finding in the SS paper is that "low-income households were not more likely to spend the rebate."

More recently, in a paper published in December 2006, Johnson, Parker, and Souleles (JPS), found that

> households spent about 20% to 40% of the rebate checks on nondurable consumption goods during the three-month period in which the rebates were received ... and roughly two-thirds of their rebates cumulatively during the quarter of receipt and subsequent three-month period.[5]

These findings seem to counter the findings of SS though JPS explains that both studies discovered that most households did save the rebate check initially. JPS, however, tracked the households over a longer period after the checks were mailed and found consumption expenditures eventually did spike upward. JPS conclude that their findings "imply that the rebates provided a substantial stimulus to the national economy in 2001, helping end the recession."[6] But, JPS stopped short of indicating that one-time tax rebates will always have the same stimulative effect.[7]

Author Information

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[3] Mathew D. Shapiro and Joel Slemrod, "Consumer Response to Tax Rebates," *American Economic Review*, vol. 93, no. 1 (Mar. 2003), p. 381.

[4] Shapiro and Slemrod, Mar. 2003, p. 394.

[5] David S. Johnson, Johnathan A. Parker, and Nicholas S. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review*, vol. 96, no. 5 (Dec. 2006), p. 1606.

[6] Johnson, Parker, and Souleles, Dec. 2003, p. 1606.

[7] For more on the impact of the rebate checks, see U.S. Congressional Budget Office, *Options for Responding to Short-Term Weakness*, Jan. 2008, pp. 9-11.

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