

NOTE

Time for the Child Tax Credit to Grow Up: Preserving the Credit's Availability and Enhancing Benefits for Families

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Abstract

The Child Tax Credit is one of the largest subsidies in the tax code for families with children. The CTC provides a supplementary boost to families by providing cash income when they do not have income tax liability. The CTC has more recently been used as an economic recovery measure and as a work incentive. However, the Credit's own structure undermines its ability to serve these purposes. The Credit should be structured such that it will further the program's key purposes and remain available to more low-income families. Some beneficial structural changes include permanently setting the refundability threshold at \$3,000 and insulating the Credit's provisions from inflation.

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I. INTRODUCTION

For several decades, the government has used the tax code to provide subsidies for families caring for children. The Child Tax Credit (CTC), enacted in 1997, is among these subsidies. Over time, the CTC has become one of the largest subsidies benefiting children in the tax code. One of the primary benefits of the CTC is its refundability feature, which allows low-income families without any tax liability to receive a cash refund instead of a reduction of tax liability. The CTC sets forth a minimum level of income, called the refundability threshold, which families must meet in order to receive the refund. The CTC is currently in its most expansive iteration—the Credit is at its highest level and the refundability threshold is at its lowest.

The refundable portion of the Credit is meant to serve as a supplementary boost to income for families with children. More recently, the Credit has been used as an economic recovery measure as well as aid for low-income families, easing tax burdens

and helping to stabilize the financial condition of low-income families. The Credit also acts as a work incentive similar to the Earned Income Tax Credit.

The Credit's own structure, however, undermines its ability to serve these purposes. Currently, the most beneficial aspects of the Credit are subject to inflation and the threat of future expiration of provisions.¹ This inflation risk interacts perniciously with the refundability threshold, making the Credit increasingly incapable of fulfilling its goals as inflation rises. Additionally, expiration of certain provisions would decrease the effectiveness of the credit as an economic recovery measure, an aid for impoverished families, and an additional support for children.

Section II of this Note discusses the structure of the CTC, including the mechanics of the refundable portion of the credit. The most beneficial aspect of the Credit is its refundability feature, which provides cash to low-income families if they do not have any federal income tax liability to offset against the Credit. This section also discusses the history of the CTC, including its many revisions since its original enactment in 1997, as well as the availability and distribution of the CTC. The CTC's benefits are disproportionately distributed to families with higher incomes, in part because of the statutorily set refundability threshold. If the threshold at which families can receive refunds is too high, then many low-income families in need will not receive any benefit from the Credit. One potential solution for this problem would be to permanently reduce the refundability threshold to \$3,000. At this level, the Credit would continue to benefit the families most in need.

Building on Section II's discussion of structure, Section III considers the interaction between the CTC and other tax code provisions that benefit children, such as

¹ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 103(b), 124 Stat. 3296, 3299 (2010). When this Act expires, the CTC will revert to an earlier structure, with a changed value and refundability threshold.

the Earned Income Tax Credit and the Dependent Exemption. Section IV then goes on to discuss the varying roles of the CTC, including its role as a work incentive and an economic recovery measure. The CTC encourages work by providing disposable income, via the refundable portion of the Credit, to families once their earnings reach a certain level, while functioning as an economic recovery measure by providing cash to needy families and reducing their tax burdens. This extra cash plays an important role in stabilizing income for low-income families in times of economic hardship.

Section IV also discusses how the structure of the Credit interferes with its ability to act as a work incentive and economic recovery measure. The provisions of the CTC are especially vulnerable to inflation and are at risk of expiring in the coming years. The value of the Credit may soon be reduced by fifty percent, as the legislation that increased the level of the Credit is set to expire in 2013. At times, the government has considered reforms to the credit that would fix the refundability threshold at \$3,000 and eliminate indexing the refundability threshold to inflation.² The most recent adjustment to the Credit, in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act), does not implement any changes to the CTC's structure — rather, it merely extends the Credit's current provisions through 2013. Unfortunately, the Tax Relief Act does not take into account the negative effects associated with a future reversion of the Credit's value and refundability threshold.

This Note argues that the Credit should be structured such that it will further the program's key purposes and remain available to more low-income families. Otherwise, when the credit value decreases to \$500, from its current \$1,000 level, and the refundability threshold increases in 2013, many families will experience significant

² DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 4–5 (2009), *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/grnbk09.pdf>.

economic hardship.³ Additionally, the Credit should be reconfigured to insulate its value from inflation. When the refundability threshold is indexed to inflation, families have to make more money every year simply to keep up with the increasing refundability threshold to receive the Credit. A permanent elimination of indexing would allow families whose wages do not keep up with inflation to still be able to receive the Credit.⁴

II. THE CHILD TAX CREDIT

A. Structure of the CTC

The CTC provides a credit of \$1,000 to taxpayers for each child under the age of seventeen for whom a deduction is allowed under § 151 of the I.R.C.⁵ The \$1,000 credit may be used to offset existing tax liability. Families without any tax liability may still benefit from the CTC, as a portion of the credit may be, depending on the family's income level, refundable in a cash payment.⁶

A taxpayer only becomes eligible to receive the cash refund once his earnings reach the statutory threshold. The current income threshold ("refundability threshold") is set at \$3,000. Families with incomes above the refundability threshold that do not have tax liability are eligible to receive in cash a portion of the value of the CTC. This refundable portion, known as the "additional child tax credit" (ACTC) or "refundable CTC," is determined by calculating 15% of income above the refundability threshold, up

³ Families with incomes at and above \$10,000 would be eligible for a Credit worth \$1,000, but would only receive \$500. See discussion *infra* Part IV.B.2.

⁴ In general, low-income workers do not receive wages that rise to match inflation. The federal minimum wage is not adjusted annually to match inflation, and at times it has gone for almost a decade without an adjustment. See JARED BERNSTEIN & ISAAC SHAPIRO, CTR. ON BUDGET & POLICY PRIORITIES, NINE YEARS OF NEGLECT: FEDERAL MINIMUM WAGE REMAINS UNCHANGED FOR NINTH STRAIGHT YEAR, FALLS TO LOWEST LEVEL IN MORE THAN HALF A CENTURY 1-2 (Aug. 31, 2006), <http://www.cbpp.org/files/8-31-06mw.pdf>.

⁵ I.R.C. § 24(a) (2010). Other relevant requirements for the credit are that the child be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of the relations listed, that the child have lived with the taxpayer for more than half of the year, and that the child did not provide over half of his own support for the year. I.R.C. §§ 24(c)(1), 152(c) (2010).

⁶ I.R.C. § 24(d).

to the full value of the CTC (\$1000). For instance, a family with income of \$4,000 could receive \$150 in cash (15% of the \$1000 difference between the family's income of \$4,000 and the refundability threshold of \$3,000).⁷ The effect of this structure is that as earnings increase, the refundable portion of the Credit increases as well, with families earning \$1,000 above the threshold receiving \$150, while families earning \$2,000 above the threshold receive \$300.

The CTC becomes increasingly less available for taxpayers as income rises above a certain level (commonly referred to as a "phase-out"). The level at which the CTC begins to phase out is currently \$75,000 for single individuals or \$110,000 for married individuals filing jointly.⁸ For each \$1,000 (or fraction thereof) of AGI over \$75,000 for single individuals or \$110,000 for married individuals filing jointly, the credit is reduced by a total of \$50, with the reduction being unaffected by the number of children in the household.⁹

B. History of the CTC

The Child Tax Credit was first enacted as part of the Taxpayer Relief Act of 1997.¹⁰ The Credit had three stated objectives: (1) to reduce the income tax burden for

⁷ I.R.C. § 24(d)(1)(B)(i). Taxpayers may receive as a refundable credit the lesser of the amount equal to 15% above the earnings threshold, and the amount equal to the portion of the Credit not used to offset tax liability. For example, a household with earnings of \$4,000 may claim a refund of up to \$150 (15% of \$1,000, the amount of earnings over the threshold of \$3,000) if it has at least one qualifying child. This family must use the 15% figure (\$150) because it is lower than the portion of the Credit not used to offset tax liability (\$1,000). The Code also provides a separate test for determining the refundable portion of the credit for families with three or more qualifying children, found in I.R.C. § 24 (d)(1)(B)(ii). Under this test, a taxpayer would be allowed a credit of the excess of his social security taxes for the taxable year over the credit allowed under § 32 for the taxable year.

⁸ I.R.C. § 24(b).

⁹ I.R.C. § 24(b)(2).

¹⁰ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 101, 111 Stat. 788, 796 (1997) (codified as amended at I.R.C. § 24 (1997)).

families with dependent children, (2) to recognize the financial responsibilities of raising children, and (3) to promote family values.¹¹

The value of the original CTC was set at \$500 for the year in which it was passed and at \$400 for tax years beginning in 1998.¹² The original Credit was refundable only for families with three or more children. Families were not required to meet a refundability threshold; rather, the amount of unused credit that was available as a cash refund was determined by looking at the amount of the taxpayer's other nonrefundable personal credits and social security taxes.¹³ The Taxpayer Relief Act of 1997 set the phase-out level at \$75,000 for single individuals, \$110,000 for married couples filing jointly, and \$55,000 for married individuals filing separately.¹⁴

The Credit, as originally enacted, was primarily valuable for middle-class families.¹⁵ The Credit was of little to no value to low-income households because many of these families did not have any income tax liability and the Credit was only refundable for families with three or more children. High-income families, on the other hand, would not qualify for the Credit because their incomes exceeded the phase-out level.

¹¹ H.R. REP. NO. 105-148, at 310 (1997); Joint Comm. on Taxation, 105th Cong., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, PART TWO: TAXPAYER RELIEF ACT OF 1997.

¹² PUB. L. 105-34, TITLE I, § 101(A) (codified as amended at I.R.C. § 24(a) (1997)).

¹³ Taxpayer Relief Act § 101 (codified as amended at I.R.C. § 24 (1997)); STAFF OF THE JOINT COMM. ON TAX'N, 105ST CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 (Joint Comm. Print 1997). The explanation on page eight provides the following example of how the credit operates for a taxpayer with three or more children: "Assume that in 1999, A, an unmarried individual with three qualifying children and an adjusted gross income below \$75,000, incurs a regular tax liability in excess of the tentative minimum tax in the amount of \$1,000. Assume also that A's employee share of FICA taxes is \$3,000. Also assume that A is not entitled to any other credits. A is allowed a \$1,000 nonrefundable credit, as limited by section 26(a). A is also allowed a refundable credit of \$500 by reason of section 24(d). The amount of this credit is the lesser of (1) \$1,500 (the credit that would be allowed under section 24(a) without regard to the tax limitation of section 26) or (2) \$500 (the excess of \$1,500 (the amount of subpart A credits which would be allowed if A's \$3,000 social security taxes were added to the \$1,000 section 26(a) limit) over \$1,000 (the subpart A credits otherwise allowed))."

¹⁴ Taxpayer Relief Act § 101, PUB. L. 105-34, TITLE I, § 101(A) (codified as amended at I.R.C. § 24 (1997)).

¹⁵ Leonard E. Burman & Laura Wheaton, *Who Gets the Child Tax Credit?*, 109 TAX NOTES 387, 387 (2005), available at http://www.taxpolicycenter.org/UploadedPDF/411232_child_tax_credit.pdf.

In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) substantially changed the Credit by increasing both the value of the Credit and its availability for low-income families.¹⁶ EGTRRA was set to increase the credit level from \$500 to \$600 for years 2001-2004 and to further increase the credit value incrementally for tax years 2005-2010, reaching a credit level of \$1,000 for 2010.¹⁷ EGTRRA was scheduled to sunset after 2010, at which point the credit level would revert to the 2000 level of \$500.¹⁸

EGTRRA also significantly altered the refundability feature of the CTC. Unlike the Taxpayer Relief Act of 1997, which made the CTC only refundable for families with three or more children, EGTRRA extended the possibility of a refund to all families with children and created a refundability threshold, set at \$10,000 for 2001 and indexed for inflation for each subsequent year.¹⁹ EGTRRA limited the refundability of the Credit to 10% of earnings in excess of the refundability threshold for tax years 2001-2004 and 15% of earnings in excess of the refundability threshold for tax years beginning in 2005.²⁰

Although EGTRRA did not schedule the level of the credit to increase to \$1,000 until tax year 2010, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the level of the credit to \$1,000 for tax years 2003 and 2004.²¹

¹⁶ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 201, 115 Stat. 38 (2001).

¹⁷ *Id.* According to the legislation, for the following tax years the per child amount of the credit is as follows:

2001, 2002, 2003, or 2004.....	\$600
2005, 2006, 2007, or 2008.....	700
2009.....	800
2010 or thereafter.....	1,000.

Id.

¹⁸ EGTRRA § 901.

¹⁹ EGTRRA § 201.

²⁰ ELAINE MAAG & ADAM CARASSO, TAX POLICY CTR., TAXATION AND THE FAMILY: WHAT IS THE CHILD TAX CREDIT? (2011), www.taxpolicycenter.org/briefing-book/key-elements/family/ctc.cfm (last modified Feb. 4, 2011).

²¹ Jobs Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §101, 117 Stat 753 (2003).

JGTRRA only affected the level of credit and left EGTRRA's refundability provisions in place. In 2004, however, the Families Tax Relief Act of 2004 (WFTRA) increased the limitation on the refundability of the Credit to 15% for tax year 2004, while also extending the \$1,000 credit level from tax year 2004 through tax year 2009.²²

Table 1. The CTC as Enacted Under the Taxpayer Relief Act and as Amended by the WFTRA, JGTRRA and EGTRRA.

	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

Source: http://assets.opencrs.com/rpts/RS21860_20060406.pdf

For low-income families, the most common limitation on the portion of the credit received is not the size of the credit but is instead the limit on the amount of the credit that is refundable. Families that do not have incomes high enough to incur tax liability only benefit from a tax credit to the extent that such a credit is refundable as cash. As discussed above, prior to EGTRRA the limitation on refundability was defined according to both the number of children a taxpayer had and the taxpayer's nonrefundable personal credits and social security taxes. While EGTRRA changed the structure of the refundability limitation by introducing (1) an income threshold below which families were ineligible for a cash refund and (2) a percentage limitation on the credit value available, the subsequent reforms in JGTRRA only increased the value of the credit.

²² GREGG A. ESENWEIN, CONGRESSIONAL RESEARCH SERVICE, CRS REPORT FOR CONGRESS, THE CHILD TAX CREDIT 3 (2006), http://assets.opencrs.com/rpts/RS21860_20060406.pdf (last updated April 6, 2006).

Since JGTRRA left the refundability feature unchanged, this increase in the size of the credit did not necessarily translate into an increase in the benefits received by many low-income families.²³

This problem was addressed by the American Recovery and Reinvestment Tax Act of 2009 (ARRA), which reduced the refundability threshold for tax years 2009 and 2010 from the EGTRRA level, which would have been \$12,550 in 2009²⁴, to \$3,000.²⁵ The purpose of reducing the threshold to \$3,000 was to increase the number of taxpayers eligible for the refundable credit and to increase the portion of the credit eligible taxpayers could receive.²⁶ The Child Tax Credit provisions of the ARRA that reduced the refundability threshold were limited to tax years 2009 and 2010.²⁷ This past year, however, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act) was enacted and extended the ARRA's reduced refundability threshold of \$3,000 through tax year 2013.

C. Availability and distribution of the CTC

In 2007, the CTC distributed about \$45 billion to thirty-one million families.²⁸ However, the distribution of the Credit is not uniform across all income levels. Families with higher incomes often receive more benefits than low-income families.²⁹

²³ ANDREW LEE & ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, HOW THE NEW TAX LAW ALTERS THE CHILD TAX CREDIT AND HOW LOW INCOME FAMILIES ARE AFFECTED 1 (May 29, 2003), <http://www.cbpp.org/archiveSite/5-28-03tax3.pdf>.

²⁴ MAAG & CARASSO, *supra* note 20.

²⁵ American Recovery and Reinvestment Act of 2009 [hereinafter AARA], Pub. L. No. 111-5, § 1003, 123 Stat. 115, 313. Because the threshold is indexed to inflation, in the absence of ARRA § 1003, the threshold would have risen to \$12,550 for 2009 and \$12,600 for 2010.

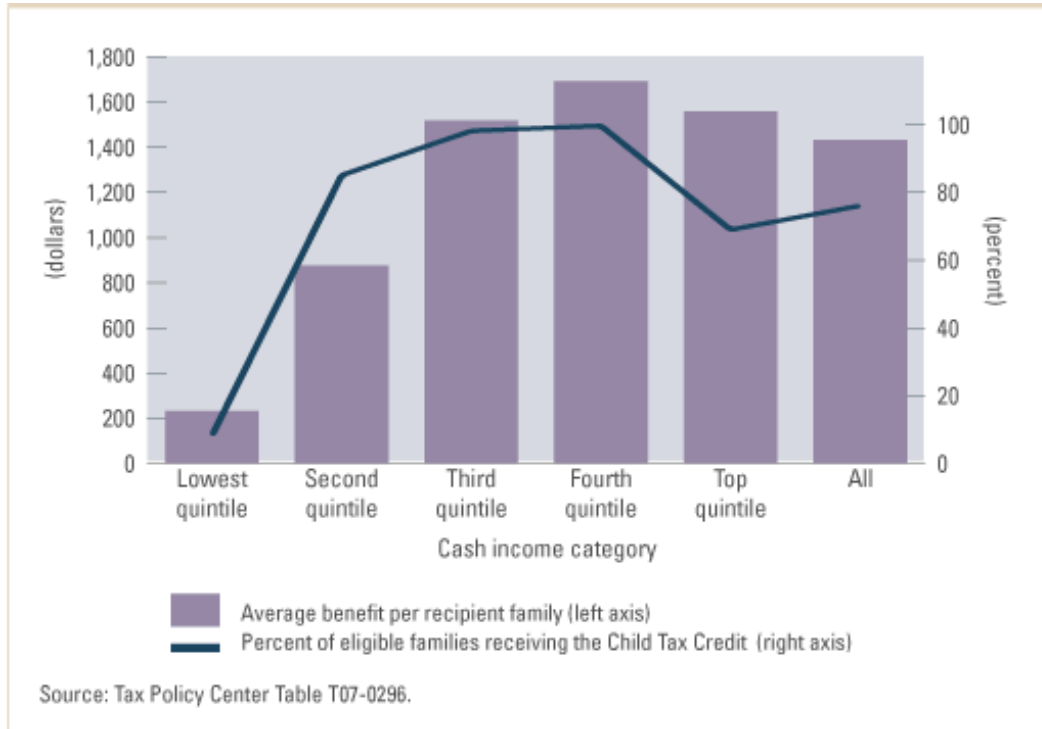
²⁶ *ARRA and the Additional Child Tax Credit*, I.R.S., <http://www.irs.gov/newsroom/article/0,,id=205670,00.html> (last visited Feb. 15, 2010).

²⁷ ARRA § 1003.

²⁸ MAAG & CARASSO, *supra* note 24.

²⁹ *Id.*

Table 2. Proportion of Eligible Families Receiving the CTC and Average Credit Received by Income Quintile, 2007



In 2007, a larger proportion of eligible families in higher income quintiles with at least one child benefited from the credit than those in the lowest income quintile. Sixty percent of eligible families in the fourth income quintile benefited from the credit, while only ten percent of eligible families in the lowest quintile benefited from the credit. Additionally, families in higher income quintiles received a larger average benefit from the credit. The fourth income quintile received approximately \$1,500 in benefits, while the lowest quintile received approximately \$200 in benefits.

The primary structural feature of the CTC responsible for the disproportionate distribution of benefits is the level of the statutorily-set refundability threshold. For families with no income tax liability, the cash refund is the primary benefit received from the CTC. If a family's income does not meet the threshold, they are prevented from receiving any cash refund. Even if they do meet the threshold, families with a small

difference between their incomes and the refundability threshold do not receive the full value of the credit. In 2007, approximately one-third of working families received less than the full credit because they earned too little and two-fifths of working families received no credit at all because the families' incomes were below the refundability threshold.³⁰

Under the EGTRRA-set refundability threshold, families with incomes just above the income threshold received fewer benefits than those with incomes significantly over the threshold. Under EGTRRA, the refundability threshold was set at \$10,000 for 2001 and was indexed to match annual inflation. In 2005, the refundability threshold was \$10,750³¹, and in that year 95% of cash refunds went to the 65% of the CTC-eligible families with incomes between \$20,000 and \$200,000.³² Additional empirical evidence indicates that the largest beneficiaries of the refundable portion of the CTC are families with incomes between \$75,000 and \$100,000.³³ While a substantial majority of the refundable portion of the CTC is distributed to higher income families, only 14% of families with incomes between \$10,000 and \$20,000 receive the refundable portion.³⁴

III. THE CTC AND OTHER TAX CODE SUBSIDIES FOR FAMILIES AND CHILDREN

Since 1960, there has been significant growth in many of the government's programs, especially those focusing on children.³⁵ Federal spending on children's

³⁰ *See id.*

³¹ GREGG A. ESSENWEIN, CONGRESSIONAL RESEARCH SERVICE, THE CHILD TAX CREDIT, CRS REP. FOR CONG. ORDER CODE RS21860, available at http://assets.opencrs.com/rpts/RS21860_20060406.pdf.

³² BURMAN & WHEATON, *supra* note 15, at 390. These families tax burdens were reduced by \$330 to \$605.

³³ *Id.*

³⁴ *Id.* at 390. Families with incomes between \$75,000 and \$100,000 receive an average benefit of \$605, and one-third of these families claim an average tax credit of \$1,729. Families with incomes between \$10,000 and \$20,000 receive an average benefit of \$80. *Id.*

³⁵ REBECCA L. CLARK ET AL., THE URBAN INSTITUTE, FEDERAL EXPENDITURES ON CHILDREN: 1960–1997 (2001), available at <http://www.urban.org/url.cfm?ID=310309>. In this report published by the Urban

programs has increased from \$55 billion in 1960 to \$354 billion in 2007, generally mirroring the growth of the economy over time.³⁶ As a share of GDP, spending on children's programs grew 39%, from 1.86% to 2.59% over the same period.³⁷

Initially, the dependent exemption³⁸ was the government's main tax mechanism for distributing money to children.³⁹ However, by 1997, the exemption comprised only 16% of federal support for children.⁴⁰ As a percentage of GDP, tax credits and exemptions related to children have declined from 1.28% in 1960 to 0.94% in 2007.⁴¹ This change reflects a 27% reduction in the use of the tax code to distribute money to children. Though the use of tax credits and exemptions as a share of GDP has decreased over time, they are still important vehicles by which the government distributes money for the benefit of children. Today there are more than a dozen tax programs that are directed at benefitting children; these programs remain the largest category of federal spending on children, totaling \$128.1 billion in 2007.⁴²

Institute, changes in federal spending on programs for children are examined. The report defined spending on children as federal programs for children and families across eight budget categories: tax credits and exemptions (including the Earned Income Tax Credit and the dependent exemption), income security (including Aid to Families with Dependent Children), nutrition (including Food Stamps), health (including Medicaid), education, social services, housing, and training. The report analyzed changes in spending through these programs over time.

³⁶ ADAM CARASSO ET AL. THE URBAN INSTITUTE, *KIDS SHARE 2008: HOW CHILDREN FARE IN THE FEDERAL BUDGET* (2008), available at <http://www.urban.org/url.cfm?ID=411699>. During this time, total federal spending grew from \$525 billion to \$2,370 billion. However, during this period, there was a sharp decline in the amount of spending on children due to a failure to keep the dependent exemption current with inflation. The decrease in value of the dependent exemption was corrected in 1984, when the exemption began to be indexed for inflation.

³⁷ *Id.* at 11.

³⁸ I.R.C. § 151 (2009). For 2009, the dependent exemption was \$3,650.

³⁹ CARASSO ET AL., *supra* note 36, at 3.

⁴⁰ CLARK ET AL., *supra* note 35, at 7.

⁴¹ CARASSO ET AL., *supra* note 36, at 15.

⁴² *Id.* at 15-16.

In addition to the CTC, the Dependent Exemption and Earned Income Tax Credit⁴³ are two important tax mechanisms designed to subsidize childcare. These tax provisions share both structural similarities and differences with the CTC.

Like the CTC, the EITC is a refundable credit; families with no tax liability are eligible to receive a portion of the credit as a cash refund.⁴⁴ The EITC's value ranges from \$457 (for no qualifying children) to \$5,657 (for three or more qualifying children).⁴⁵ Unlike the CTC, a taxpayer becomes eligible for the EITC refund with the first dollar of earnings; whereas, that same taxpayer is not eligible for the refundable CTC until he earns \$3,000 (the current refundability threshold).⁴⁶ Additionally, unlike for the CTC, the phase-out for the EITC begins at a much lower level of income. In 2010, the phase-out level for the EITC was \$13,440 if the taxpayer had no qualifying children and \$43,279 if the taxpayer had three or more children.⁴⁷ Finally, more low-income families receive benefits from the EITC than from the CTC.⁴⁸ In 2005, about twenty-two million families, representing 75-85% of eligible tax filers, benefited from the credit.⁴⁹

⁴³ These three tax provisions are most commonly cited when referring to child benefits distributed via the tax code. See LEONARD E. BURMAN ET AL. TAX SUBSIDIES TO HELP LOW-INCOME FAMILIES PAY FOR CHILD CARE (2005), available at http://www.taxpolicycenter.org/UploadedPDF/411190_TPC_DiscussionPaper_23.pdf. The government also spends billions on other types of financial support for children. In 2005, the Government Accountability Office identified sixty-nine programs administered through ten agencies that provided support for pre-kindergarten and child care. For more information on these programs, see Letter from Marnie Shaul, Director, Education, Workforce, and Income Security Issues, Government Accounting Office, to Michael B. Enzi, Lamar Alexander & George V. Voinovich, U.S. Senators (June 2, 2005), available at <http://www.gao.gov/new.items/d05678r.pdf>.

⁴⁴ CTR. ON BUDGET & POLICY PRIORITIES, POLICY BASICS: THE EARNED INCOME TAX CREDIT 1 (Dec. 4, 2009), <http://www.cbpp.org/files/policybasics-eitc.pdf>.

⁴⁵ *Id.*

⁴⁶ Elaine Maag, *Credits and Exemptions for Children*, 124 TAX NOTES 1375 (2009), available at http://www.urban.org/UploadedPDF/1001331_credits_children.pdf.

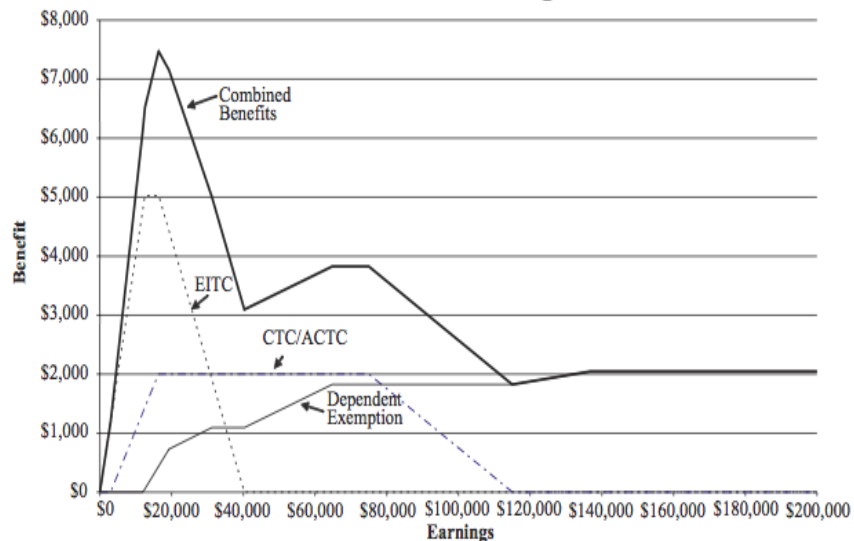
⁴⁷ *EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, I.R.S., <http://www.irs.gov/individuals/article/0,,id=150513,00.html> (last visited March 21, 2011). The threshold may be a different amount depending on the taxpayer's filing status.

⁴⁸ GREGORY ACS & MARGERY AUSTIN TURNER, THE URBAN INSTITUTE, MAKING WORK PAY ENOUGH: A DECENT STANDARD OF LIVING FOR WORKING FAMILIES (2008), available at http://www.urban.org/UploadedPDF/411710_work_pay.pdf. The EITC is currently the tax benefit that low-income families are most likely to receive.

⁴⁹ *Id.* In 2006, a married-parent family with two children may have received the maximum credit of \$4,536. *Id.*

The Dependent Exemption, on the other hand, is not a credit like the CTC or the EITC. Rather, the Dependent Exemption is a deduction claimed by a taxpayer that reduces his taxable income by a fixed amount for each qualifying child.⁵⁰ Unlike the CTC, where only the refundable portion of the Credit is subject to an income threshold, Taxpayers may not claim the exemption at all until income reaches \$12,000. The structure of the Exemption also includes a phase-out, which has been adjusted several times in the past few years.⁵¹ Currently, the Dependent Exemption begins to phase out when income reaches \$150,000 for married individuals filing jointly or \$100,000 for unmarried individuals.⁵²

Table 3. Value of Child Benefits at Various Income Levels: Single Parent with Two Children (2009)



Calculation assumes all income comes from earnings, both children are under age 17 and are qualifying children for the Child Tax Credit, Additional Child Tax Credit, Earned Income Tax Credit, and dependent exemption.

Source: Elaine Maag, *Credits and Exemptions for Children*⁵³

⁵⁰ Elaine Maag, *Who Benefits From the Dependent Exemption?*, 129 TAX NOTES 1275, 1355 (2010), available at <http://www.urban.org/UploadedPDF/1001478-Tax-Facts-Dependent-Exemption-Maag.pdf>. The current value of the exemption is \$2,000.

⁵¹ *Id.*

⁵² I.R.C. § 151(d)(3) (2010).

⁵³ Maag, *Credits and Exemptions for Children*, *supra* note 46, at 1. This figure shows that the EITC reaches its maximum value of \$5,028 when a single parent's earnings reach \$12,750, and maintains

The refundable portion of the CTC becomes available over the part of the income range in which the EITC reaches its maximum availability and subsequently phases out. Once the EITC has phased out and is no longer available to families, the CTC will still be available because the CTC's phase-out occurs at a much higher income level.⁵⁴ For example, as seen in Table 3, a single taxpayer with two children will receive no benefit from the EITC once his income reaches \$40,000, but will continue receiving the CTC. Once the taxpayer's income reaches \$115,000, he can only benefit from the dependent exemption.⁵⁵

Tax benefits provide money directly to children's parents, the taxpayers, and the government has generally moved during the past several decades towards providing benefits in this way. The EITC, for example, signaled a shift away from in-kind benefits towards programs that give parents discretion on how to spend the benefits. Such an approach has both benefits and costs, as the discretion that may help families meet their individual needs must be balanced against the need to ensure that the money is spent on true necessities for children.⁵⁶

In addition to changes in the structure of benefits for children, there has also been a shift in which children are the intended beneficiaries, with programs that had provided benefits to all children shifting towards focusing on providing benefits specifically to poor children. From 1960 to 2007, the portion of federal spending on poor children as a share of federal spending on all children rose from 11% to 59%.⁵⁷ The shift from broad-

this value until income reaches \$16,420, where the credit begins to phase-out. The CTC reaches its maximum level for a family with two children when income reaches \$16,333 and begins to phase-out when earnings exceed \$75,000. At the same time, the benefit of the dependent exemption phases-in and increases as the taxpayer crosses the threshold into a higher bracket.

⁵⁴ Elaine Maag, *Tax Credits, the Minimum Wage, and Inflation*, THE URBAN-BROOKINGS TAX POLICY CTR. (2007), available at <http://www.urban.org/publications/311401.html>.

⁵⁵ Maag, *Credits and Exemptions for Children*, *supra* note 46.

⁵⁶ CLARK ET AL., *supra* note 35, at 12-13.

⁵⁷ CARASSO ET AL., *supra* note 36, at 3.

based programs that benefited most families to targeted programs that benefited low-income families took place through the use of programs, such as the CTC, in which benefits are phased out at steep rates as income increases.⁵⁸ This trend can also be seen in the rise of the EITC as the most prominent tax transfer mechanism for poor families.⁵⁹

IV. ANALYSIS

The CTC was originally enacted to help families with children by reducing their tax burdens and by providing cash refunds if they insufficient tax liabilities. The CTC also serves other roles, such as that of an economic recovery measure and a work incentive. These goals, however, are undermined by the structure of the credit, which does not work to effectively achieve these purposes. Specifically, the Credit's purposes are hindered by the effects of inflation on the credit's value and by the future expiration of several structural provisions, including those increasing the Credit's value and those lowering the refundability threshold.

A. The roles of the CTC

1. *The CTC as an economic recovery measure and aid to impoverished families*

The refundability threshold of the CTC was most recently reduced to \$3,000 in the ARRA, as part of an economic recovery program, in order to provide greater benefits to low-income families. The increased availability of the refundable portion of the credit, due to the lower refundability threshold, provided cash to low-income families that would

⁵⁸ *Id.*

⁵⁹ CLARK ET AL., *supra* note 35, at 9. In 1980, the EITC expenditure was approximately \$3.7 billion. By 1997, the expenditure has reached \$27.1 billion, surpassing the dependent exemption and becoming the largest tax program aimed at benefiting children.

likely spend this additional income.⁶⁰ For tax year 2009, this change affected 15.8 million children, as they either became eligible for the cash refund or became eligible to receive a larger cash refund than they would have received under the scheduled EGTRRA threshold of \$12,550.⁶¹ This increased eligibility had a substantial effect on the families of these children. For a family with two children and combined annual income of \$10,000, the refundable portion of the credit for 2009 was 400% higher than the refundable portion of the credit for 2008.⁶²

The expansion of the credit in the ARRA was enacted as part of an economic recovery program, but another effect of the expansion has been to help fight against the trend of rising child poverty and hardship.⁶³ This effect is more important than ever, as the recession has caused the unemployment rate to increase, from 5.8% in 2008 to 9.6% in 2010, and has left approximately 23% of the total population with income below the poverty level in 2009.⁶⁴ If the refundability threshold were to increase to the EGTRRA levels, an estimated 18 million children aged 16 and under with working parents would lose at least part of their refundable portion of the credit. Additionally, 600,000 of these children would be pushed into poverty due to this change.⁶⁵

⁶⁰ NAT'L WOMEN'S LAW CTR., FAMILY TAX CREDITS IN THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 1 (2009), available at <http://www.nwlc.org/resource/family-tax-credits-american-recovery-and-reinvestment-act-2009-american-opportunity-tax-cre>.

⁶¹ Arloc Sherman, CTR. ON BUDGET & POLICY PRIORITIES, RECOVERY AGREEMENT TEMPORARILY EXPANDS CHILD TAX CREDIT FOR LARGE NUMBERS OF CHILDREN IN EVERY STATE 2 (2009), <http://www.cbpp.org/files/2-12-09tax.pdf>.

⁶² Family Tax Credits, *supra* note 60, at 1-2 ("Parents with two children earning \$10,000 a year, who are eligible for a refundable CTC of \$225 for 2008 (0.15(\$10,000-\$8,500)), would be eligible for a refundable CTC of \$1,050 in 2009 and 2010 (0.15(\$10,000-\$3,000)). (If they had only one child, they would be eligible for a maximum of \$1,000.) Compared with 2008, this change will make 2.9 million more children eligible for the credit and increase the credit for an additional 10 million children.").

⁶³ *Id.*

⁶⁴ BUREAU OF LABOR STATISTICS, EMPLOYMENT AND EARNINGS JANUARY 2011: HOUSEHOLD DATA ANNUAL AVERAGES, available at <http://www.bls.gov/cps/cpsa2010.pdf>

⁶⁵ Arloc Sherman & Marybeth J. Mattingly, *Over 3 Million Low-Income Children in Rural Areas Face Cut in Child Tax Credit if Recovery Act Improvement Expires*, CTR. ON BUDGET & POLICY PRIORITIES (2010), available at <http://www.cbpp.org/cms/index.cfm?fa=view&id=3210>.

The refundability feature of the CTC is also important in the fight against poverty because the cash received by families helps to stabilize income. On a macroeconomic level, refundable credits have an important effect on stability, in the face of economy-wide economic shocks, by smoothing consumption. For low-income families, refundable credits are especially important because during times of financial hardship these families may not have easy access to credit and, without assistance, such hardships may persist over long periods of time and may even be passed on to younger generations.⁶⁶ A refundable credit may reduce the impact of tax burdens in recessionary periods as well as lessen the impact of wage reductions, job disruptions, or job turnover.⁶⁷

2. *The CTC as a work incentive*

The EITC was enacted in 1975 and was designed to encourage taxpayers to become, and remain, employed by helping to offset the payroll taxes of low-wage taxpayers.⁶⁸ Today, the EITC may have the effect of providing a supplementary boost to income by up to 40% for families with the lowest, but still positive, level of earnings.⁶⁹ Empirical work has shown that the EITC has a strong positive effect on work by single

⁶⁶ Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 58 (2007). There are also a number of arguments against the use of refundable tax credits, some of which the article discusses. One concern is that the government should not be engaging in redistribution of wealth between different income groups. However, that argument is not strong enough to reject the use of refundable credits to subsidize socially beneficial behavior. Another argument against the use of credits suggests that all Americans should pay some taxes, as part of their duty to the country and as a way to feel invested in the country's decision making. However, this argument fails to acknowledge that low-income families do pay taxes outside of the federal income tax, such as other federal, state and local taxes. Further, over time, many of the families who receive the credit have a net positive federal income tax liability. This note is written under the assumption that wealth redistribution via the tax code in this context is desirable.

⁶⁷ Anne Alstott, *Why the EITC Doesn't Make Work Pay*, 73 LAW & CONTEMP. PROBS. 285, 308 (2010).

⁶⁸ CTR. ON BUDGET & POLICY PRIORITIES, POLICY BASICS: THE EARNED INCOME TAX CREDIT 1 (Dec. 4, 2009), available at <http://www.cbpp.org/files/policybasics-eitc.pdf>.

⁶⁹ Maag, *Tax Credits, the Minimum Wage, and Inflation*, *supra* note 54, at 2.

parents⁷⁰ and this is likely to be equally true for the CTC due to the structural similarities between the two programs. Because both programs condition benefits on having earned income, they both help to incentivize employment by the taxpayers benefitting from them.

If the goal of the CTC is to encourage taxpayers to work, then the credit must be structured in a way that increases the disposable income for low-income families while at the same time preserving incentives to earn more income.⁷¹ Permanently fixing the refundability threshold at a reduced level will strengthen the link between the CTC's benefit and employment by bringing the CTC's structure even more in line with that of the EITC.⁷² A taxpayer who earns \$5,000 a year will have less incentive to work more if he feels that the \$12,550 threshold, the former threshold for 2009, is unattainable. However, at a lower threshold the taxpayer receives the benefit of more work sooner and is therefore more encouraged to work.

Many programs that incentivize low-income taxpayers to be employed present a "catch-22" for families. This is because a credit's phase-in, where benefits increase along with earnings, creates an incentive to work, while a credit's phase-out, where benefits decrease as earnings rise above a certain level, creates disincentives to work.⁷³ Today, seven out of ten low-income families have at least one working parent.⁷⁴ For many families additional work, either via a second worker, higher wages, or additional

⁷⁰ DAVID T. ELLWOOD, *THE IMPACT OF THE EARNED INCOME TAX CREDIT AND SOCIAL POLICY REFORMS ON WORK, MARRIAGE, AND LIVING ARRANGEMENTS* (2000) available at http://www.northwestern.edu/ipr/jcpr/workingpapers/wpfiles/ellwood_eitc99_update.PDF.

⁷¹ Acs & Turner, *supra* note 48, at 8.

⁷² I.R.C. § 32 (2010). As discussed, the EITC's refundability feature is triggered with the first dollar of earnings.

⁷³ ELLWOOD, *supra* note 70.

⁷⁴ SHELLEY WATERS BOOTS ET AL., *THE URBAN INSTITUTE, FAMILY SECURITY: SUPPORTING PARENTS' EMPLOYMENT AND CHILDREN'S DEVELOPMENT* (2008) available at http://www.urban.org/UploadedPDF/411710_work_pay.pdf.

hours, does not result in a substantial increase in disposable income because the family becomes disqualified from several support programs as income rises.⁷⁵

Many question why the CTC uses work incentive phase-ins for eligibility when low-income families are already subject to work incentives delivered via the EITC.⁷⁶ If the CTC is meant to be a child subsidy, then the threshold, by acting as a work incentive and excluding many families who are in need of the credit, contravenes its primary purpose.⁷⁷ When viewed primarily as a subsidy for children, the notion that many families who need the most help receive little or no help from the CTC is difficult to understand.⁷⁸

B. The structure of the CTC undermines its purposes

1. *The effects of inflation*

The CTC is effective as a support measure for low-income families when the refundability threshold is low and credit value is high, but both its value and availability over time are eroded by inflation. There are two structural components of the CTC that make its provisions especially vulnerable to inflation. First, the amount of the Credit remains fixed, causing the value of the Credit to decline each year because of inflation. Secondly, the refundability threshold is indexed to inflation, which has the effect of reducing the availability of the Credit to low-income taxpayers with each passing year.

If the refundability threshold is indexed to inflation, families need to earn more money each year to continue to qualify for the new, higher threshold.⁷⁹ Structuring the refundability threshold this way hurts low-wage earners whose wages stagnate because

⁷⁵ Acs & Turner, *supra* note 48, at 1.

⁷⁶ Burman & Wheaton, *supra* note 15.

⁷⁷ *Id.* at 387; BOOTS ET AL., *supra* note 74, at 7.

⁷⁸ Burman & Wheaton, *supra* note 15.

⁷⁹ See Sherman, *supra* note 61. Under EGTRRA, the threshold was set at \$12,000. Each year, the threshold would rise, or indexed, to match inflation. Under this structure, due to inflation, the threshold would have risen to \$12,550 for 2009 and \$12,600 for 2010.

they will not be able to meet the inflation indexed rising refundability threshold. In 2007, when the Credit level was set at \$1,000, the minimum wage remained at 1997 levels and had not been increased to match the inflation of the previous decade.⁸⁰

The first solution for these issues is to build automatic adjustments into the credit value in order for the Credit to keep pace with inflation. Other credits, such as the EITC, have automatic adjustments embedded in their structure.⁸¹ However, even if the CTC had an automatic inflation adjustment built in, workers whose incomes fail to rise along with inflation would still receive a smaller refundable portion of the credit. Depending on a taxpayer's level of income, an increase or decrease in income may result in an increase or decrease in the refundable portion of the Credit received by the taxpayer. If the taxpayer's income is in the phase-in range, he receives a larger refundable portion of the credit as his income increases. If a taxpayer, on the other hand falls in the phase-out range, then a drop in his income will increase the amount of the credit received.⁸²

With regards to the refundability threshold, two helpful changes would be to either eliminate indexing of the threshold or to eliminate the threshold altogether. If the threshold were eliminated completely then the credit would be refundable starting with the first dollar of earned income, thus functioning in fashion similar to that of the EITC. The effect of this change would be to increase the amount of the credit that a family would qualify for, resulting in an increase equivalent to \$0.77 per hour in earnings for a minimum wage worker with one child.⁸³ Alternatively, the effect of eliminating indexing

⁸⁰ See Bernstein & Shapiro, *supra* note 4.

⁸¹ The value of the EITC is indexed for inflation. I.R.C. § 32(j) (2010).

⁸² Maag, *Tax Credits, the Minimum Wage, and Inflation*, *supra* note 54, at 2-3.

⁸³ *Id.* These calculations use the 2006 levels for the Credit and the 2006 minimum wage as a baseline. *Id.*

would be to end the “phenomenon of declining credits for workers with stagnating earnings” described above.⁸⁴

2. *Consequences associated with future structural changes to the CTC*

Future structural changes to the CTC will hinder its ability to serve as an aid for families with children, to help those in poverty, and to function as a work incentive. When the current CTC structure expires after 2012, with the expiration of the extension promulgated in the Tax Relief Act, the Credit will return to its EGTRRA structure. The Credit’s value will therefore fall from \$1,000 to \$500 and the refundability threshold will no longer be set at \$3,000. There are several problematic consequences associated with this reversion in the credit’s structure, including an increase in the effective marginal tax rate (EMTR) of low-income families and a decrease in the significance of the CTC as a subsidy for needy families with children. Allowing this reversion would increase the EMTR of low-income families who are in the phase-in range.⁸⁵ One problem with such an increase in the EMTR is that it reduces the rewards associated with earning more income, because each additional dollar of earnings is taxed at a higher rate.⁸⁶

A reduction in Credit value increases EMTRs for families with lower incomes, hindering the use of the Credit as a work incentive and resulting in an unraveling of the benefits associated with the original increase in the Credit’s value from \$500 to \$1,000. This unraveling occurs because the incentive effects of the Credit over the phase-in

⁸⁴ *Id.* at 7.

⁸⁵ KATHERINE LIM & JEFFREY ROHALY, *The Impact of the Presidential Candidates’ Tax Proposals on Effective Marginal Tax Rates*, THE URBAN-BROOKINGS TAX POLICY CTR. (2008), available at <http://www.urban.org/url.cfm?ID=411759>. The “Effective Marginal Tax Rate” (EMTR) is the proportion of an additional dollar of income that is paid in federal income tax. EMTRs are different from the statutory marginal tax rates due to the effects of phase-in and phase-outs of available credits and deductions in the Tax Code.

⁸⁶ *Id.* at 4.

period are curtailed if the phase-in is shorter and the maximum refundability level is reached at a low earnings level.

Much of the benefit associated with the increased availability of the refundable Credit, via the lower refundability threshold, will be offset by a reduction in the value of the Credit, from \$1,000 to \$500, if the current structure expires. Structured with a \$3,000 refundability threshold and a \$500 credit value, the Credit's value will become a significant limitation on the refundable portion of the Credit received by a taxpayer. The refundable portion of the credit will also become fully available at a very low earnings level.

The 15% limitation on the portion of the credit that is refundable will play a smaller role in limiting the refundable portion of the Credit.⁸⁷ This is because if the Credit's value is too low, then 15% of earnings over the threshold quickly outpace the value of the Credit itself. For example, if the Credit is limited to \$500, a taxpayer receives the full value of the Credit when his income reaches \$6,350 and there is no room for the value of the Credit to increase in tandem with earnings because the refundable portion of the Credit's value is already maxed out. A taxpayer with an income of \$7,000 would be eligible for a \$600 refund under the 15% limitation, but would be limited to a \$500 refund because of the new, lower level of the Credit. This structure is far more restrictive than the current structure of the Credit.⁸⁸

⁸⁷ I.R.C. § 24(d)(1)(B)(i) (2010).

⁸⁸ See discussion *supra* Part II.A.

Table 4. Availability of the CTC, \$500 Credit Level

Refundability Threshold	Earned Income	Credit Available	Credit Received
\$ 3,000	\$ 4,000	\$ 150	\$ 150
3,000	5,000	300	300
3,000	6,000	450	450
3,000	6,350	503	500
3,000	7,000	600	500
3,000	8,000	750	500
3,000	9,000	900	500
3,000	10,000	1,050	500

Additionally, a significant number of families that have been receiving the Credit for a number of years will see their benefits greatly reduced. Those with incomes at or above \$10,000 will have received credits of \$1,000 for tax years 2009 through 2012, but following expiration they would only receive \$500. The reduction in the value of the refundable portion of the credit would decrease the significance of the CTC as a subsidy for needy families with children.

If the stated goal of the CTC is to aid families with the many expenses related to raising a child, then a reduction in credit value would undermine the Credit and hurt low-income families. For many families childcare expenses can comprise a large portion of the family budget. In 1997, low-income families spent an average of \$217 per month on child care, an expenditure equaling approximately 16% of their total income.⁸⁹ The

⁸⁹ LINDA GIANNARELLI & JAMES BARSIMANTOV, THE URBAN INSTITUTE, CHILD CARE EXPENSES OF AMERICA'S FAMILIES 2, 7-8 (2000), available at <http://www.urban.org/url.cfm?ID=310028>.

amount of income devoted to a family's childcare budget could affect whether a family becomes reliant upon public or other family assistance.⁹⁰

A program, such as the CTC, that is aimed at reducing poverty and providing assistance to low-income families should be judged by the adequacy of its ability to provide adults and their children a decent standard of living on par with prevailing social standards.⁹¹ A significant change in the Credit's value may substantially affect poverty levels and deprive intended beneficiaries of necessary assistance.⁹²

V. CONCLUSION

The CTC is one of several government programs that deliver assistance to families via the tax code. Congress originally acknowledged the special needs of families with children with the enactment of the Credit and intended that the credit reduce some of the financial burdens associated with raising children. Tax credits are useful tools to distribute money to low-income families to meet these expenses and combat poverty, as low-income families benefit more from a tax credit than they do from a deduction due to the value of a tax credit being independent of their tax rates. Refundable credits in particular benefit these families because they provide cash to a family that does not have any tax liability, a not uncommon situation for families with especially low incomes. These provisions are particularly important given the current state of economic distress because low-income families and their children are especially vulnerable to economic instability and high unemployment.

⁹⁰ *Id.*

⁹¹ Alstott, *supra* note 67, at 291. The EITC's effect on poverty is often judged using such normative standards.

⁹² Sheldon Danziger & Peter Gottschalk, *The Impact of Budget Cuts and Economic Conditions on Poverty*, 4 J. POL'Y ANALYSIS & MGMT. 587 (1985). The effect of transfer programs effecting poverty levels was evident through the late 1960s and 1970s when the increases in Social Security corresponded with a decrease in poverty rates among the elderly.

There are several improvements that could be made to the Child Tax Credit to help it better serve its purposes. First, the consequences associated with a reversion in the Credit's structure after 2013 should be considered. When the Credit's value reverts to \$500, the CTC will no longer be a meaningful subsidy for low-income families. The maximum refundable value of the credit will peak at a very low level of income and families with incomes over this amount will be limited to a very small refundable portion of the Credit. Families with income as low as \$10,000 will see their CTC benefit reduced by 50%. The value of the credit should therefore be set at the \$1,000 level and indexed to inflation so that it remains an effective subsidy for all low-income families. Additionally, the refundability threshold of \$3,000 should be made permanent. This would continue the extension of CTC benefits to families with incomes below \$12,000 who were excluded from receiving the benefits under the threshold of previous legislation. Another adjustment would be to eliminate indexing the threshold to inflation. This amendment to the structure of the credit would benefit low-income families because indexing the threshold to inflation punishes taxpayers whose earnings do not keep pace with inflation by making them less eligible with each passing year.

These adjustments would allow the CTC to better provide benefits to low-income families in need of financial support, unhindered by rising inflation or the threat of future expirations of benefit provisions.