
The Child Tax Credit: Problems with the Refundable Portion

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This article discusses the current tax code with respect to the child tax credit (CTC), including some of the history of its evolution. Three specific problems with the refundable portion of the credit are described. These problems arise because of the poor wording and logical inconsistency in the current tax code, at least partly due to the evolution of this particular credit over time and partly due to technical tax corrections which are not consistent with Congressional intent. Suggestions for improving the tax code are given.

Key Words: Child tax credit, Refundable tax credits, Tax legislation, Tax policy

The child tax credit (CTC) was added to the Internal Revenue Code (IRC) in 1997.¹ It was intended to provide tax relief for families with children. The CTC is generally a nonrefundable tax credit, meaning it can only offset existing tax liability. However, in some cases, a portion of the CTC is refundable, meaning it can be refunded to the taxpayer even if no tax liability exists. The CTC legislation has been changed several times since its enactment.

This paper discusses the current tax code with respect to the CTC, including some of the history of its evolution. Because of changes made to the refundable portion of the CTC, the current tax code is poorly worded and is not consistent with documented legislative intent. These problems with the current tax code will be discussed. In addition, technical corrections to tax laws will be discussed. A technical correction is meant to conform the wording of a code section to its intended meaning as expressed in legislative committee reports. Since technical corrections are not intended to make substantive changes, Congress appears to pass them with little scrutiny. However, the history of IRC section 24 includes technical corrections which have changed the meaning of the law despite the clear intention of Congress.

¹ Section 24; P.L. 105-34. Section references are to the Internal Revenue Code of 1986, as amended.

Child Tax Credit Limitations

The CTC was intended to provide relief for families with children either in the form of a credit against their tax liability or, in some cases, as a refund. Certain limitations exist for this credit.

The first limitation is the dollar amount of the credit. Taxpayers are allowed a credit of up to \$1,000 for each qualifying child.² A qualifying child for the CTC must meet the following criteria: (1) the child must be the son, daughter, stepchild, foster child, brother, sister, stepbrother, or stepsister (or a descendant of any of these) of the taxpayer(s); (2) the child must be under age 17 at the end of the tax year; (3) the child must not have provided more than half of his/her own support for the tax year; and (4) the child must have lived with the taxpayer(s) for more than half of the tax year.³

The second limitation is an adjusted gross income limitation. The CTC begins to phase out when modified adjusted gross income (AGI) reaches \$110,000 for joint filers, \$55,000 for married

² Section 24(a), as amended by P.L. 108-311. Also, there is a sunset provision that will return the maximum per child credit to \$500 per child for tax years after December 31, 2010 (pre-2000 amount) unless additional legislation changes that sunset provision—see P.L. 107-16 and P.L. 108-311.

³ Section 24(c)(1); section 152(c).

individuals filing separately, and \$75,000 for single individuals. These thresholds are not indexed for inflation. The credit is reduced by a total of \$50 (not \$50 for each child) for each \$1,000, or fraction thereof, of modified AGI above the thresholds.⁴ Thus, the level at which the child tax credit is completely phased out depends on the number of qualifying children as well as the filing status.

The third limitation is a tax liability limitation. For the CTC, the tax liability which can be offset by the nonrefundable credit is equal to the regular tax plus the alternative minimum tax⁵ minus all other nonrefundable credits except the foreign tax credit, the adoption credit and the qualified retirement savings credit.⁶ Ordinarily, nonrefundable credits which cannot be used because the tax liability is not large enough are lost. However, some taxpayers may be able to claim the additional child tax credit, which allows some or all of the CTC to become a refundable credit.

Refundable Child Tax Credit

The refundable part of the CTC was originally available only to families with three or more children.⁷ If these families could not use the entire CTC as a nonrefundable credit, they could take a refundable credit for any portion of the unused credit for which they had social security taxes in excess of the earned income credit.⁸ Since at low income

amounts, the earned income credit is greater than the social security taxes, low-income taxpayers did not benefit from this refundable credit.

The tax code was amended to allow more taxpayers to qualify for the refundable credit.⁹ Beginning in 2001, all taxpayers otherwise qualifying for the CTC, regardless of the number of qualifying children, were allowed to claim unused nonrefundable CTC as a refundable credit based on the excess of 10 percent (15 percent starting in 2005) of earned income over \$10,000. Taxpayers with three or more qualifying children were allowed to claim unused nonrefundable CTC as a refundable credit based on the greater of (1) the excess of 10 percent (15 percent starting in 2005) of earned income over \$10,000, or (2) the excess of the social security tax over the earned income credit.¹⁰ The \$10,000 threshold is subject to cost-of-living adjustments.¹¹ Also, the 15 percent test was accelerated to 2004.¹² After indexing, the 2006 test is the excess of 15 percent of earned income over \$11,300.¹³

Because of the tax law wording and changes made over time, some problems exist in the current tax code. The first of these is a wording problem related to the order of claiming the nonrefundable and refundable portions of the credit which leaves the specific law unclear and subject to nonintuitive interpretation. The second is a problem with some of the limitations on the refundable credit, one of which makes another completely irrelevant. The third is an apparent mistake made in drafting a technical correction such that the tax code is no longer consistent with legislative intent.

Order of Nonrefundable and Refundable Credits

The tax code wording is unclear about the ordering of the nonrefundable and refundable credits and can lead to an unexpected interpretation. IRC section

⁴ Section 24(b)(1).

⁵ The ability to offset the alternative minimum tax portion is subject to a sunset provision. See P.L. 107-16.

⁶ Nonrefundable credits must be claimed in a specific order since the IRC limits the amount of credit that may be claimed in any year to the tax liability and because certain credits have carryforward provisions. The specific stacking order for these credits is beyond the scope of this paper and does not affect the analysis provided.

⁷ P.L. 105-34; P.L. 105-206.

⁸ Social security taxes means the employee's share of FICA taxes, 50 percent of self-employment taxes, and the employee's share of railroad retirement tax. However, social security taxes do not include amounts received as a refund because the taxpayer works for more than one employer and has a combined income in excess of the social security wage base; see section 24(d)(2) (originally section 24(d)(5) as created by P.L. 105-34, but changed to section 24(d)(2) by P.L. 105-206 and P.L. 107-

16).

⁹ P.L. 107-16.

¹⁰ Section 24(d)(1).

¹¹ Section 24(d)(3).

¹² P.L. 108-311; This 15 percent test for refundability is subject to a sunset provision and will not apply for years beginning after December 31, 2010—see P.L. 107-16.

¹³ Rev. Proc. 2005-70.

24(a), as limited by section 24(b)(3) provides for the nonrefundable credit.

24(a) ALLOWANCE OF CREDIT

There shall be allowed as a credit against the tax imposed by this chapter for the taxable year with respect to each qualifying child of the taxpayer an amount equal to \$1,000.

24(b)(3) LIMITATION BASED ON AMOUNT OF TAX

In the case of a taxable year to which section 26(a)(2) does not apply, the credit allowed under subsection (a) for any taxable year shall not exceed the excess of -

- (A) the sum of the regular tax liability (as defined in section 26(b)) plus the tax imposed by section 55 [alternative minimum tax], over
- (B) the sum of the credits allowable under this subpart (other than this section and sections 23 [Adoption Credit] and 25B [Qualified Retirement Savings Contributions Credit] and section 27 [Foreign Tax Credit] for the taxable year. (Bracketed items added.)

Thus, taxpayers are allowed a nonrefundable credit of up to \$1,000 per child against both their regular tax and their alternative minimum tax. Some taxpayers may also qualify to claim some or all of any unused CTC as a refundable credit as provided in IRC section 24(d). This is the intuitive way to treat nonrefundable and refundable credits—apply the nonrefundable credit first and then determine if any refundable credit is available. However, the wording in section 24(d) just below section 24(d)(1)(B)(ii)(II) states that:

The amount of the credit allowed under this subsection shall not be treated as a credit allowed under this subpart **and shall reduce the amount of credit otherwise allowable under subsection (a)** without regard to section 26(a)(2) [Tax liability limitation] or subsection (b)(3) [Tax liability limitation], as the case may be. (Emphasis and bracketed items added.)¹⁴

¹⁴ The basic wording of this sentence, although modified slightly by subsequent legislation, was added by

The subpart referred to here is the subpart of the IRC which defines the nonrefundable tax credits. Technically, section 24(d) references section 24(a) and presumably supersedes it. It provides that the refundable credit reduces the amount of the credit otherwise allowed without regard to the tax liability limitation. The sentence is worded poorly and can be construed in two different ways.

The first possible interpretation is that the refundable credit reduces the total amount of the CTC (\$1,000 per child) without regard to any tax liability limitation. This interpretation has the effect of applying the refundable part first.

The second possible interpretation is that the refundable credit reduces only the amount of the CTC not subject to the tax liability limitation (the CTC left over after applying the nonrefundable credit against the tax liability). The only way to read the sentence with this interpretation is to emphasize the “otherwise allowable” part and assume that it means the “otherwise allowable part over and above the tax liability limitation.” This interpretation would apply the tax credit as a nonrefundable credit against the tax liability first and then apply the refundable credit against the remaining tax liability, if any, and then toward a refund.

Although the first interpretation seems to be the easiest way to read the wording of the sentence, the resulting implication that the refundable credit comes before the nonrefundable credit makes no intuitive or logical sense. This ordering would also have the effect of eliminating some or all of the nonrefundable credit in situations in which any amount was refundable. Further, this ordering is not consistent with the committee reports corresponding to this tax law. Since this sentence was added as a technical correction to the Taxpayer Relief Act of 1997 by the IRS Restructuring and Reform Act of 1998, it is

P.L. 105-206. The section 24 changes made by this law were written as technical corrections to the original law creating the CTC (P.L. 105-34). Interestingly, section 24(d)(4) as originally established by P.L. 105-34 was clear in implying that the nonrefundable CTC would come first followed by any available refundable CTC. The technical correction is much more difficult to read than the original language and can be construed differently than the Congressional intent because of its poor wording.

important to look at the committee reports to ascertain the intent of Congress and whether the technical corrections did what they were supposed to do. Senate Committee Report 105-174 included two items which make the Congressional intent clear.

It is understood that there is also a stacking rule under which the income tax liability limitation applies between the nonrefundable personal credits, including the nonrefundable portion of the child credit. Generally, the nonrefundable portion of the child credit and the other nonrefundable personal credits which do not provide a carryforward are grouped together and stacked first followed by the nonrefundable personal credits which provide a carryforward for purposes of applying the income tax liability limitation.¹⁵

The bill clarifies the application of the income tax liability limitation to the refundable portion of the child credit by treating the refundable portion of the child credit in the same way as the other refundable credits. Specifically, after all the other credits are applied according to the stacking rules of the income tax limitation then the refundable credits are applied first to reduce the taxpayer's tax liability for the year and then to provide a credit in excess of income tax liability for the year.¹⁶

These comments restate the general understanding that nonrefundable credits are applied first (with non-carryover credits applied before those with carryover potential) followed by the refundable credits. The authors believe the second interpretation is the only one that matches Congressional intent as supported by committee reports. If so, the maximum potential refundable CTC is the difference between the total CTC (based on a dollar amount per qualifying child) and the nonrefundable CTC. Thus, some or all of the nonrefundable credit which would otherwise be lost

¹⁵ Senate Committee Report (S. Rep. No. 105-174); the Conference Committee Report (H.R. Conf. Rep. No. 105-599) indicates that the conference agreement follows the Senate amendment.

¹⁶ *Id.*

may be taken as a refundable credit. However, section 24(d), as written, is unclear.

Irrelevant Limitation on Refundability

Although the refundable portion of the CTC was originally intended for taxpayers with three or more children, it has been expanded with the addition of the 15 percent test. The IRC wording relating to the refundable portion prior to December 22, 2005 was as follows:

24(d)(1) IN GENERAL.

The aggregate credits allowed to a taxpayer under subpart C [refundable credits] shall be increased by the **lesser of** —

(A) the credit which would be allowed under this section without regard to this subsection and the limitation under section 26(a) [tax liability limitation], or
(B) the amount by which the aggregate amount of credits allowed by this subpart [nonrefundable credits] (determined without regard to this subsection) would increase if the limitation imposed by section 26(a) were increased by the **greater of** —

(i) 15 percent of so much of the taxpayer's earned income (within the meaning of section 32) which is taken into account in computing taxable income for the taxable year as exceeds \$10,000 [indexed to \$11,300 for 2006], or

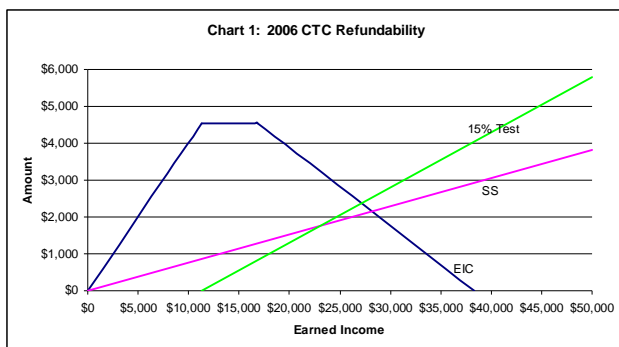
(ii) in the case of a taxpayer with 3 or more qualifying children, the excess (if any) of —

(I) the taxpayer's social security taxes for the taxable year, over
(II) the credit allowed under section 32 [earned income credit] for the taxable year.
(Emphasis and bracketed items added.)

Applied to 2006, this wording provides for a potential refundable credit equal to the greater of (1) 15 percent of the taxpayers' earned income in excess of \$11,300, or (2) for taxpayers with three or more qualifying children, the taxpayers' social security taxes minus any earned income credit (EIC). The sum of the nonrefundable CTC and the refundable

CTC cannot exceed the total of \$1,000 per qualifying child, so that is an additional limitation.

For 2006, the EIC for taxpayers (married filing jointly) with two or more qualifying children is 40 percent of the first \$11,340 of earned income minus 21.06 percent of earned income in excess of \$16,810. The taxpayer's portion of social security taxes is 7.65 percent of earned income. If a break-even point is calculated, it can be determined that the social security tax equals the EIC when earned income equals \$28,130.22. Only at earned income levels greater than this amount will the social security tax exceed the EIC. As illustrated in Chart 1, by the time this level of earned income is reached, 15 percent of earned income in excess of \$11,300 already exceeds the social security taxes and is increasing faster than the social security taxes. Thus, in no case will social security taxes minus the EIC be greater than 15 percent of earned income in excess of \$11,300.¹⁷



It seems from the tax code wording that taxpayers with three or more children should be able to use the greater of these two amounts in calculating the portion of the CTC that is refundable. However, this issue has been moot since 2004 when the 10 percent test first changed to 15 percent, because the 15 percent test is always the greater of the two. Thus, the social security taxes minus EIC test for the refundable portion of the credit is irrelevant. Only the 15 percent test is relevant in determining the refundable portion of the CTC.

¹⁷ If the taxpayer filing status is not married filing jointly, the EIC phaseout range changes. The resulting breakeven point also changes, but it is still true that at the level of earned income at which social security taxes begin to exceed the EIC, 15 percent of earned income in excess of \$11,300 is already greater.

Inconsistency with Legislative Intent

Prior to December 22, 2005, tax code wording allowed taxpayers with three or more children to calculate the refundable portion of the credit for 2006 by using the greater of two amounts: 15 percent of earned income in excess of \$11,300, or the excess of their social security taxes over the EIC. The greater amount was compared with the total CTC allowable less the nonrefundable CTC, and the lesser amount was the amount refundable.¹⁸ The IRC read as follows:

24(d)(1) IN GENERAL.

The aggregate credits allowed to a taxpayer under subpart C shall be increased by the **lesser of**—

(A) the credit which would be allowed under this section without regard to this subsection and the limitation under section 26(a), or

(B) the amount by which the aggregate amount of credits allowed by this subpart (determined without regard to this subsection) would increase if the limitation imposed by section 26(a) were increased by the **greater of**—

(i) 15 percent of so much of the taxpayer's earned income (within the meaning of section 32) which is taken into account in computing taxable income for the taxable year as exceeds \$10,000, or

(ii) in the case of a taxpayer with 3 or more qualifying children, the excess (if any) of—

- (I) the taxpayer's social security taxes for the taxable year, over
 - (II) the credit allowed under section 32 for the taxable year.
- (Emphasis added.)

On December 22, 2005, President Bush signed the Gulf Opportunity Zone Act of 2005.¹⁹ This law changed the wording of section 24(d)(1) to the following:

24(d)(1) IN GENERAL.

¹⁸ Section 24(d)(1).

¹⁹ P.L. 109-135.

The aggregate credits allowed to a taxpayer under subpart C shall be increased by **the lesser of**—

(A) the credit which would be allowed under this section without regard to this subsection and the limitation under section 26(a)(2) [tax liability limitation] or subsection (b)(3), as the case may be, or

(B) the amount by which the aggregate amount of credits allowed by this subpart (determined without regard to this subsection) would increase if the limitation imposed by section 26(a)(2) or subsection (b)(3), as the case may be, were increased by **the excess (if any) of**

(i) 15 percent of so much of the taxpayer's earned income (within the meaning of section 32) which is taken into account in computing taxable income for the taxable year as exceeds \$10,000, **or** [amount indexed to \$11,300 for 2006]

(ii) **in the case of a taxpayer with 3 or more qualifying children, the excess (if any) of**—

- (I) the taxpayer's social security taxes for the taxable year, over
- (II) the credit allowed under section [32] for the taxable year. (Emphasis and bracketed items added.)

Congress omitted the “greater of” language and changed it to “the excess (if any) of.” The effect of this change was to provide two different tests for the refundability of the CTC—one, the 15% test, and the other, a test for people with three or more children. Thus, for tax years after 2005, the refundable CTC for taxpayers with three or more children appears to be limited to the excess of their social security taxes over their earned income credit. If Congress intended to give taxpayers with three or more children a refundable credit based on the greater of these two amounts, the wording should have been left alone. In law, when Congress deliberately changes or omits one phrase, the new law should be read omitting the language. Congress appears to have rejected the option of taking the greater of the two amounts, thus leaving taxpayers with three or more children with

only one option. This remaining option offers much less refundable CTC for many families with three or more children and provides a different standard for taxpayers with three or more children than for those with fewer children.

The omission of the 15 percent test for taxpayers with three or more children seems to be inconsistent with legislative intent. The Joint Committee on Taxation, a standing Congressional committee, commented on a different but related portion of the same law. The Gulf Opportunity Zone Act of 2005²⁰ included a provision to codify the Katrina election from the Katrina Emergency Tax Relief Act of 2005²¹ and expand it to Hurricane Rita and Hurricane Wilma victims as well. This provision allows victims of these hurricanes to use the prior year earned income, rather than the current year earned income, in calculating tax benefits from the EIC and the refundable portion of the CTC for 2005. In introducing its comments on the codification of this provision, the committee summarized some information about the CTC.

Taxpayers with incomes below certain threshold amounts are eligible for a \$1,000 credit for each qualifying child (sec. 24). The child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of \$10,000. (The \$10,000 income threshold is indexed for inflation and is currently \$11,000 for 2005.) **Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of \$10,000 (indexed for inflation).** (Emphasis added.)²²

The part of the Gulf Opportunity Zone Act of 2005 which amended section 24(d)(1) was written in a different section of the Act which related specifically to technical tax corrections. However, it is interesting that the Joint Committee on Taxation, in introducing

²⁰ *Id.*

²¹ P.L. 109-73.

²² Joint Committee Taxation (J.C.T. Rep. No. JCX-88-05).

its comments about the Katrina election, seemed to verify Congressional intent that two tests were still available for refundability of the CTC for taxpayers with three or more children, whichever gave the greatest benefit.

In addition to the inconsistency between the wording and the expressed intent, the entire change to section 24(d)(1) seems out of place. Title IV of the Gulf Opportunity Zone Act of 2005 is labeled “Technical.” Subtitle A of Title IV is labeled “Tax Technicals,” and the short title for this subtitle is given as “Tax Technical Corrections Act of 2005”. Under this subtitle, section 402 provides amendments related to the Energy Policy Act of 2005,²³ with section 402(i) specifically providing amendments to section 1335 of that Act. Then in section 402(i)(3)(B), the amendments of IRC section 24 are given, including the changes to section 24(d)(1) mentioned above. These facts result in two problems.

First, although some of the minor wording changes may actually be technical tax corrections, it does not seem that removing the opportunity for taxpayers with three or more children to use the 15 percent test for refundability of the CTC is a technical correction. Instead, it would be a major policy shift from the benefits given to these taxpayers in prior CTC legislation.

Second, section 1335 of the Energy Policy Act of 2005 does not ever refer to IRC section 24.²⁴ Instead, it creates a new IRC section 25D to provide a credit for residential energy efficient property. Thus, even if the change in the wording of IRC section 24(d)(1) were a technical correction, it does not belong in a law claiming to be an amendment to section 1335 of the Energy Policy Act of 2005.

In addition to removing the “greater of” wording, changing the wording in section 24(d)(1)(B) to “the excess (if any) of” leaves the wording grammatically awkward, as section 24(d)(1)(B)(i) uses the word “exceeds” and section 24(d)(1)(B)(ii) also refers to “the excess (if any) of” a specific difference. The “greater of” language which was removed made more sense, preserved the legislative intent, and avoided

grammatical awkwardness. Also, the reference to section 32 (earned income credit) in section 24(d)(1)(B)(ii)(II) was left out of the new legislation—an apparent typo. Therefore, the tax law technically does not refer to section 32 where it should. It appears that this technical correction was not proofread adequately to catch this error, the awkward wording, and the major policy shift that was not consistent with Congressional intention.

It is unclear why this change to “the excess (if any) of” was made, especially if the Gulf Opportunity Zone Act of 2005 with respect to the refundable CTC and the EIC simply intended to allow taxpayers in certain disaster areas to use the prior year’s earned income in calculating these tax benefits. The change is seemingly inconsistent with legislative intent and reduces the potential refundable CTC available to taxpayers with three or more children.²⁵

Discussion

The tax code must be precise and often contains specific definitions and terminology. However, this requirement for precision sometimes leads to confusing wording that is not clear. This appears to be the case with the first problem discussed in this paper—the wording problem in IRC section 24(d) just below 24(d)(1)(B)(ii)(II). It seems possible to come up with wording that will unambiguously define the refundable portion of the CTC without leading to confusion as to which part of the CTC, the nonrefundable part or the refundable part, is applied first.

The second problem discussed may be a result of incremental changes to the tax code and indexing of amounts over time without careful analysis as to how these changes would affect the original and additional limitations. Economists routinely calculate the revenue effects of tax legislation as part of the

²³ P.L. 109-58.

²⁴ Nor is there a reference to section 24 anywhere else in the Energy Policy Act of 2005.

²⁵ The irrelevance of the social security taxes in excess of the EIC test for refundability of the CTC pointed out earlier in the paper would no longer be valid if, in fact, taxpayers with three or more children now have only this one test for refundability. However, the authors believe that Congressional intent would leave both tests in place for these taxpayers, thus making the social security test irrelevant rather than making the 15 percent test unavailable.

legislative process. Perhaps these calculations are based on assumptions of how many people will get specific tax benefits without looking at all of the ramifications of the interactive parts of the code that are difficult to determine without looking at specific examples.

The third problem seems to be a simple result of someone writing legislation that was not consistent with the intent of prior law and the presumed intent of Congress as reflected in the Joint Committee on Taxation report referenced earlier. Perhaps the change, part of the Gulf Opportunity Zone Act of 2005 which was signed on December 22, 2005, was the result of a rush to complete legislation related to the 2005 tax year prior to the Congressional holiday recess. Sometimes when legislation is rushed and amendments or technical corrections are added at the last minute, appropriate care is not taken to ensure accuracy of wording and intent, especially with the extreme complication of the current tax code.

Related to two of these problems is the concept of technical tax corrections. Although these are supposed to be changes to conform the language of the law to the intent, it appears that at least some of these technical tax corrections are changing the law from intentions rather than conforming it to intentions. If Congress expects technical corrections to simply change the law to previously specified intentions, it is likely that less attention is paid to the specific wording of these parts of legislative bills. If less attention is given, it is more likely that changes rather than corrections are slipping into tax law, either by sloppy writing or perhaps intentionally by those who know the change is unlikely to be noticed.

Conclusion

This paper has discussed three specific problems with the tax code relating to the refundable CTC. Congress needs to clarify the meaning of IRC section 24(d)(1) so the ordering of the nonrefundable CTC and the refundable CTC will be consistent with the traditional concepts of nonrefundable and refundable credits. Since the social security tax minus the EIC test is irrelevant in calculating the refundable CTC (assuming this is not supposed to be the only choice for taxpayers with three or more children), it makes no sense to leave this limitation in the tax code, as it

is simply confusing and misleading.²⁶ Removing this limitation from the tax code would remove an irrelevant limitation and return the 15 percent test as an option for taxpayers with three or more children to make the IRC consistent with legislative intent. On the other hand, if Congress intended to provide a lesser amount of refundable credit for taxpayers with three or more children, that should be made apparent and should have been fully discussed by Congress.

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²⁶ One possible reason for leaving this test in the tax code is if anyone really thinks the 15 percent test will be unavailable later because of the sunset provision. However, even if this is the case, it would make sense to remove this social security minus EIC test now and reinsert it later if needed.