PERSPECTIVES ON LOW-INCOME WORKING FAMILIES

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Child-Related Benefits in the Federal Income Tax

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More than one-third of all federal assistance to families with children comes to families via the federal income tax system (Isaacs et al. 2012). The Tax Policy Center estimates that five major child-related tax benefits—the earned income tax credit (EITC), the child tax credit (CTC), the child and dependent care tax credit (CDCTC), the dependent exemption, and head of household filing status—will total nearly $171 billion in 2013 to families with children, with the average benefit for all families with children exceeding $3,400. Some families will receive benefits far above this average; for example, a married couple with two children can receive benefits totaling almost $7,700 in 2013, and a single parent with two children may qualify for more than $8,100. Although benefits are concentrated among low- and middle-income families, nearly all families with children receive some child-related tax benefits.

Three factors complicate the child provisions in 2013. First, the definition of a child is not the same among the various tax provisions. Qualifying factors for benefits vary, such as a child's age and citizenship requirements. Beyond adding complexity associated with calculating benefits, this non-uniformity in definition makes combining benefits into one child benefit difficult. Second, benefits phase in and out at different income levels, making it difficult for a family to predict tax benefits. Third, some child benefits are set to contract when parts of the American Taxpayer Relief Act of 2013 expire after 2017. All told, the combination of child benefits results in a complex system that can be difficult for the intended recipients to understand and for the IRS to administer.

This brief updates estimates in Maag, Rennane, and Steuerle (2011) for the EITC, CTC, and the CDCTC, credits intended primarily to subsidize working parents, and the dependent exemption, which adjusts for a family's ability to pay federal income taxes. The brief then adds estimates for head of household filing status, which further reduces taxes for a single parent by allowing a larger standard deduction and larger tax brackets versus what a single person without children would receive.[1] It describes the basic eligibility requirements for these benefits and estimates the average and total benefits for families with children in various income groups. The brief also describes changes currently scheduled to take place in some of these child-related tax benefits after 2017.

Child-related federal income benefits provide significant income support to low-income working families. However, the current income tax provisions have their shortcomings: their complexity, uneven application, and the temporary nature of some important provisions. A number of proposals would reform the child-related provisions to make them simpler, fairer, and more economically efficient. A future brief will examine options for reform.

Child-Related Tax Benefits

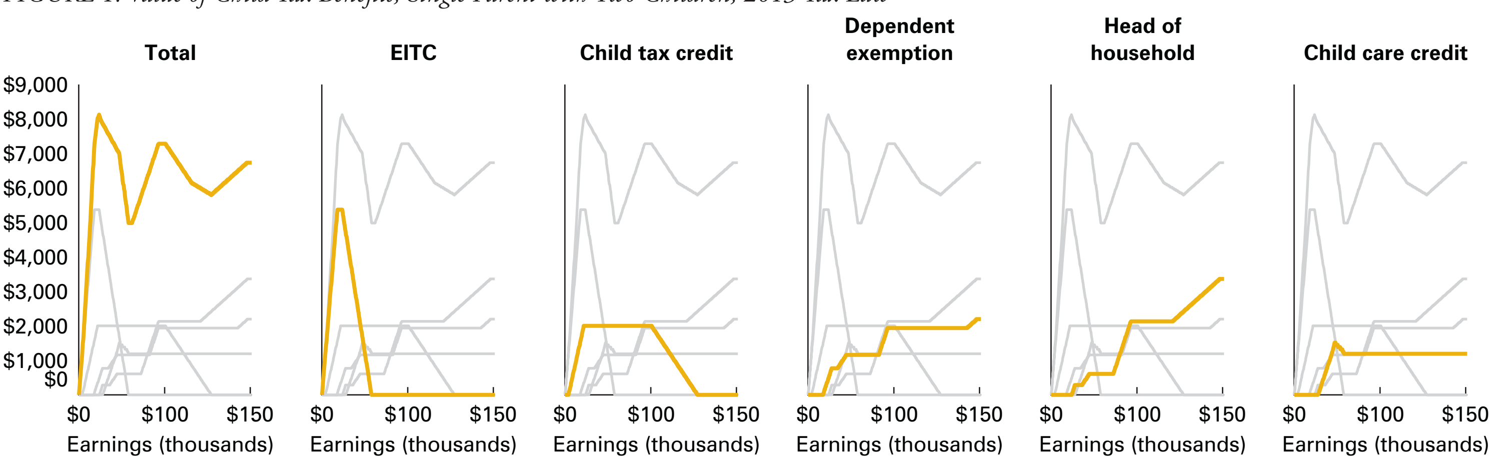
Three different rationales have guided the child-related provisions in the federal income tax. The oldest and most basic rationale is that income tax liabilities should vary with ability to pay, and the size of a family affects ability to pay. For example, a family of four tends to have larger expenses, and therefore less ability to pay taxes, than a family of two at any income level. A second rationale is simply that society should help support families with children. A third rationale is to encourage behavior deemed desirable, such as employment for parents. Although broadly consistent, these three rationales have led to key differences among provisions.

Tax Credits for Children: EITC, CTC, and CDCTC

The EITC provides significant income support to low-income working families. The credit equals a fixed percentage of earnings until the maximum credit is reached. As earnings continue to increase, families continue to receive the maximum credit until earnings reach a second threshold, at which point the credit declines with income until it disappears entirely. Both the credit rate and the maximum credit depend on how many children a family has.[2] Qualifying families with one child may receive 34 cents for every dollar earned in the phase-in range, families with two children receive 40 cents per dollar earned, and families with three or more children receive 45 cents per dollar earned. In 2013, the maximum credit is $3,250 for a family with one child, $5,371 for families with two children, and $6,044 for families with three or more children (figure 1 shows EITC benefits for a family with two children). Once a single parent's earnings reach $17,530, the EITC begins to phase out, and it disappears entirely once income reaches $37,870 for a family with one child, $43,038 for a family with two children, and $46,227 for a family with three or more children. In 2013, married couples may earn $5,340 more before their credit starts to phase out; likewise, the point at which the EITC phases out entirely is $5,340 higher for married couples than for single parents. To be considered a qualifying child for the EITC, a child must be either under age 19 or under age 24 and a full-time student in at least five months of the calendar year. Parents receiving the EITC must be US citizens.

The CTC provides families with a credit of up to $1,000 per child. Unlike the EITC, which is fully refundable and begins providing a subsidy at the first dollar of earnings, regardless of taxes owed, the CTC does not provide benefits until a family has at least $3,000 of earnings. At this point, the family receives 15 cents for every dollar of earnings, which account for the refundable portion of the CTC.[3] In addition to this refundable portion, the CTC offsets federal income taxes until the sum of the tax offset plus the refundable portion equals the full credit to which the family is entitled. The CTC begins to phase out for single parents once income reaches $75,000 (see figure 1); for couples, the credit begins to phase out once income reaches $110,000. To qualify for a CTC, a child must

FIGURE 1. Value of Child Tax Benefits, Single Parent with Two Children, 2013 Tax Law



Source: Author's calculations.

Notes: Assume all income is from earnings, both children qualify for all benefits, child care expenses of $6,000 per year, and all families take the standard deduction, rather than itemizing their deductions. Dependent exemption compares tax liability for a head of household with two dependent exemptions with tax liability for a head of household with 0 dependent exemptions. Head of household compares tax liability for a head of household with two exemptions to a single person with two exemptions.

be under the age of 17 and be a US citizen. The parents claiming the child need not be US citizens, although this regulation is disputed by the Treasury Inspector General for Tax Administration (2011).

The CDCTC provides a credit on out-of-pocket expenses for the care of a child or other dependent. The maximum amount of qualifying expenses is $3,000 per qualifying child (up to a maximum of $6,000 per family). The CDCTC is nonrefundable. It can only be used to offset income tax liabilities as calculated before subtracting credits. The credit ranges between 20 and 35 percent of that amount, depending on the taxpayers' adjusted gross income (AGI). Higher credit rates are available to families with lower AGIs, but the very highest credit rates are largely theoretical since families with such low incomes rarely have tax liability before the credit (figure 1 shows actual benefits for a sample family). For married couples to benefit from the CDCTC, both parents must be working or in school and the expenses claimed may not exceed the lower-earning parent's earnings. Qualifying children must be under age 13 and be either a citizen or resident of the United States, or a resident of Canada or Mexico.

Other Tax Benefits for Parents: Dependent Exemption and Head of Household Filing Status

The dependent exemption operates differently than a credit. Rather than directly reducing tax liability dollar for dollar, as a credit does, the dependent exemption reduces the amount of income subject to tax (that is, it reduces taxable income). In 2013, the dependent exemption reduces income subject to tax by $3,900 per child. How much that exemption is worth to parents depends on their marginal tax rate—the rate of income tax they would have paid on the $3,900. If a family would have paid income tax at a rate of 10 percent on the $3,900 exemption amount, the $3,900 exemption reduces their taxes by $390. If a family has higher income and would instead face a 25 percent tax rate on that same $3,900, its value in tax savings is $975. Families with very low incomes receive little or no benefit from the dependent exemption because even without it they would be exempt from income tax or subject to income tax at a low rate (as shown in figure 1). The dependent exemption is phased out for single parents with AGI above $275,000 ($300,000 if married). To qualify for a dependent exemption, a child must be under age 19 or between the ages of 19 and 24 and a full-time student in at least five months of the year. A qualifying child must be either a citizen or resident of the United States or a resident of Canada or Mexico—the same citizenship rules that apply for the CDCTC.

Single parents who maintain a home for one or more of their children for at least half the year can file as head of household. The head of household filing status provides two benefits relative to a childless single filer: a higher standard deduction (heads of household may exempt $8,950 from taxation rather than the $6,100 afforded to single people without children at home in 2013), and wider tax brackets, which means that more income of heads of household is taxed at lower rates. For example, in 2013 single individuals pay tax at a 15 percent tax rate starting at $8,925 of taxable income whereas heads of household don't face the 15 percent rate until their taxable income reaches $12,750.

As income changes, the value of child benefits change (figure 1). In addition, there are interactions between some of the child benefits so the total value is greater than the sum of each individual provision. Benefits shown in figure 1 are for a single parent with two children in 2013, assuming all income comes from earnings, both children qualify for all benefits, and the parent has the maximum allowed child care expenses ($6,000). Changes to any of these assumptions can decrease the benefits relative to what is shown in figure 1. The yellow line in the first image in figure 1 shows total child-related benefits at various income points, with the grayed-in lines showing the individual components. Subsequent images highlight each individual benefit with a yellow line, with the other benefits and sum shown as grayed-in lines for context. Total benefits phase in rapidly with the EITC and CTC and then phase down as the EITC phases out. The CDCTC, dependent exemption, and value of the head of household filing status offset some of the decline in the EITC. Benefits remain constant over a range of income, and then increase as statutory income tax rates increase. Finally, the CTC phases out, reducing child benefits for a single parent with income in excess of $75,000. At incomes above those shown in figure 1, the dependent exemption eventually phases out.

At the extreme, when all of these child benefits are totaled, a single parent of two children under age 17 who earns $17,500 can receive tax benefits of over $8,100, an income boost of almost 50 percent! A family with two children under age 17 headed by a married couple can receive tax benefits of almost $7,700 if they earn $23,000. Note that the EITC and the refundable portion of the CTC are only available to families where at least one parent works, and the CDCTC requires both spouses in a married couple to work or attend school in order to receive benefits. Total benefits for families with children that are at least age 17 are reduced by up to $2,000 (the amount of the CTC), and benefits for families with no child care expenses for children under age 13 are reduced by up to $1,500 (the amount of the CDCTC).

Who Gets the Child-Related Tax Benefits?

The various child-related tax benefits are aimed at different populations. The EITC only benefits families with low and moderate incomes, while benefits from the dependent exemption are generally larger for high-income families. Figure 2 shows, by income quintile, the average benefit from each provision for all families with children and for families with children who actually benefit from the provision.[4] The darkened horizontal line shows the average benefit across all income quintiles—first for all families with children and next for all families with children that actually receive a benefit. The middle panel of figure 2 shows the relative size of each benefit and the bottom panel shows the share of each benefit received by each income quintile.

The lowest income quintile of families with children receive an average benefit of $3,025 from the EITC, $850 from the CTC, $90 from the dependent exemption, $15 from head of household filing status, and almost no benefit from the CDCTC. On average, total benefits amount to $4,090—slightly higher than the sum you would get from adding each benefit separately, because of interactions among the benefit provisions and statutory income tax rates. Families in the first and second income quintiles receive a higher average benefit than families in the remaining three quintiles.

Because some families with children receive no benefit from each provision, families that actually receive a benefit have a higher average benefit than all families with children. These average benefits are shown in the right hand set of bars for each provision in figure 2. For example, families with children in the lowest income quintile that receive an EITC have an average EITC of $3,450 (compared to $3,025); those that receive a CTC have an average CTC of $1,200 (compared to $850). The middle panel of figure 2 shows TPC's estimates of the total amount of tax savings to families from each of the child-related tax provisions in 2013. The largest is the EITC ($64 billion) followed by the CTC ($54 billion). The dependent exemption is also quite large ($40 billion), whereas head of household filing status ($6 billion) and the CDCTC ($4 billion) are much smaller. All together, these benefits reduce tax liability or increase tax refunds by $171 billion in 2013.

The bottom panel of figure 2 shows the share of total benefits from each child-related tax provision received in each income quintile by families with children. Nearly half the benefits from the EITC flow to families in the lowest income quintile (49 percent), but these same families receive only 2 to 3 percent of benefits from the dependent exemption and head of household filing status. Families with children in each of the two lowest quintiles receive about 25 and 30 percent of all child-related tax benefits, respectively. Families with children in the next two income quintiles receive about 19 and 17 percent of all child-related tax benefits, respectively. Finally, families with children in the highest income quintile receive about 9 percent of all child-related tax benefits. Nearly all (94.2 percent) of all families with dependent children receive some child-related tax benefits.

Together, the tax benefits provide substantial assistance to low-income families. In 2011, not accounting for refundable tax credits would have resulted in a poverty rate of 24.4 percent, compared to 18.1 percent under the Supplemental Poverty Measure, which, among other things, includes tax credits as resources available to families (Short 2012).

Scheduled Changes in the EITC and CTC

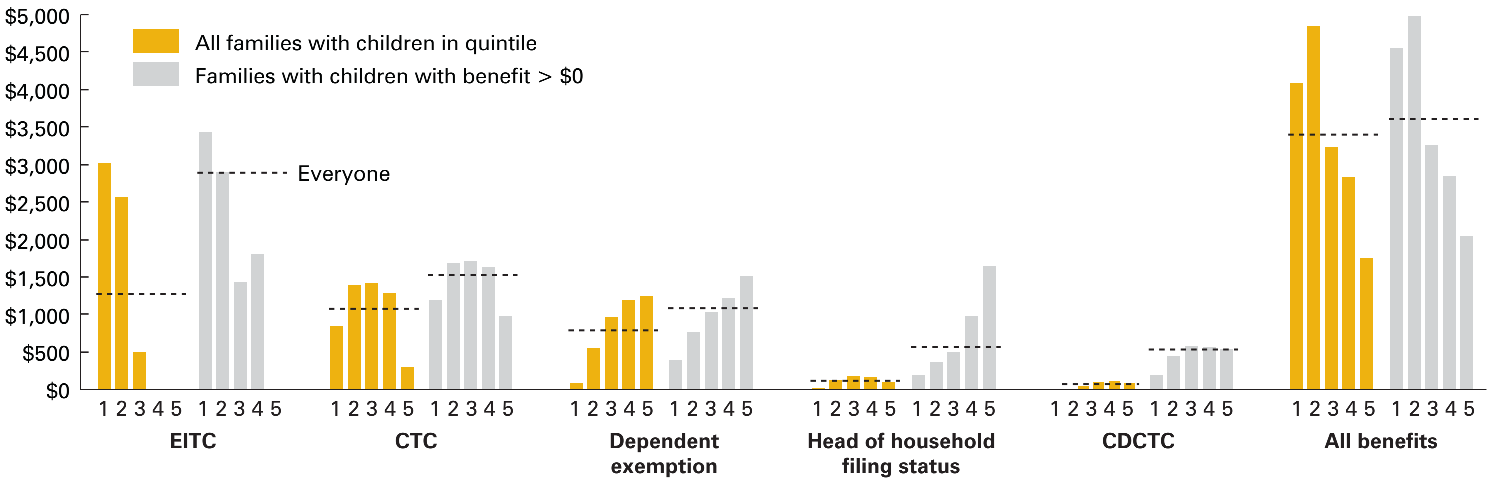
The 2009 American Recovery and Reinvestment Act made three temporary changes to the CTC and EITC. The point at which families could be eligible to receive a CTC was reduced to $3,000 (from $13,400 in 2013), families with at least three children began to receive an EITC with the higher phase-in rate of 45 percent, and the point at which the EITC begins to phase out for married couples was increased to $5,000 (indexed annually for inflation, so $5,340 in 2013). These provisions were extended through 2017 as part of the 2012 American Taxpayer Relief Act.

Absent legislative action, starting in 2018, the Tax Policy Center estimates the CTC will only be refundable for families with an estimated $14,750 of income (indexed annually), families with three or more children will be treated the same as families with two children for purposes of the EITC, and married couples will see their

FIGURE 2. Summary of All Child Benefits

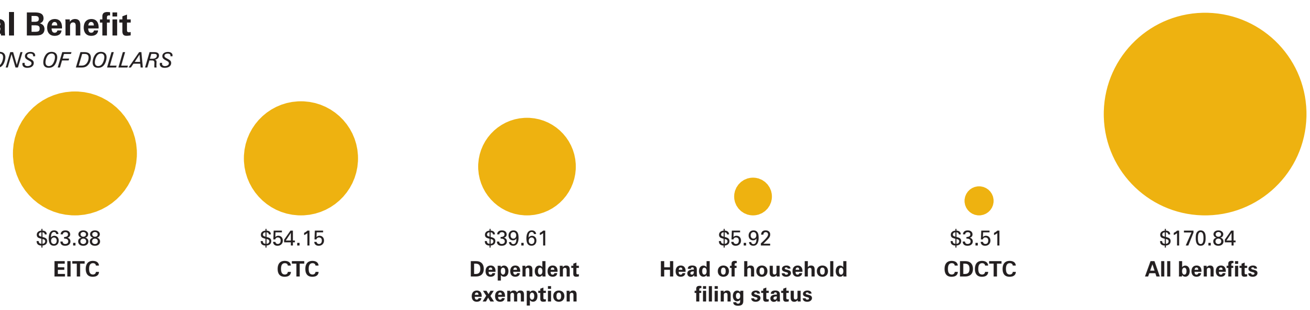
Average Benefit of Child-Related Tax Benefits for Families with Children at Various Income Levels

BY INCOME QUINTILE



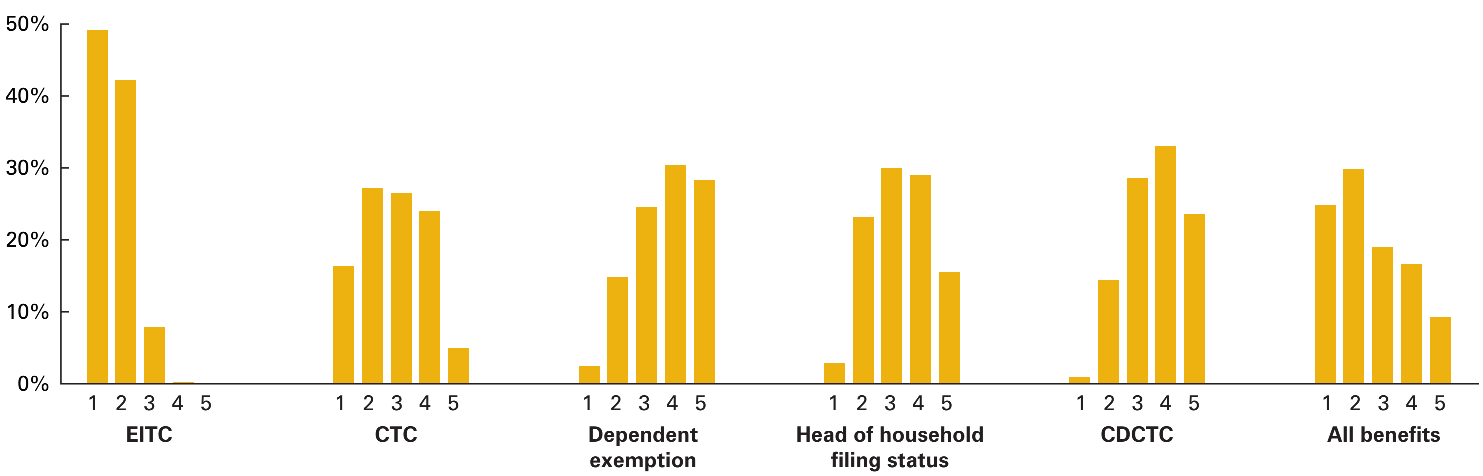
Total Benefit

BILLIONS OF DOLLARS



Who Benefits

SHARE OF TOTAL BENEFIT BY INCOME QUINTILE



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-1b), tables T13-0217, T13-0219, T13-0221, T13-0223, T13-0225, and T13-0227.

EITC begin to phase out once their income is $3,680 (indexed) greater than the phase-out point for single parents.

The Center on Budget and Policy Priorities estimates that in 2011, if tax provisions were included in the definition of poverty, the temporary CTC change lifted 900,000 people out of poverty (2013a) and the two temporary EITC provisions lifted 500,000 people out of poverty (2013b).

Benefits from the lower earnings threshold for receiving the refundable CTC are highly concentrated among low-income families. In 2013, two-thirds of families with children in the lowest income quintile received some benefit from the change and over 80 percent of the total change went to these families.[5] Nearly two-thirds of the temporary EITC changes are received by families with children in the second income quintile and one-third by those in the lowest income quintile.

Conclusion

Almost all families with children receive child-related federal income tax benefits. Some tax provisions only reduce the amount of federal income tax paid by families with children. But the EITC and CTC can provide additional benefits in the form of refundable tax credits. Child-related tax benefits are concentrated among low-income families, for which they can be an important source of income support.

In 2013, Tax Policy Center projects that the combination of the CTC, EITC, CDCTC, dependent exemption, and head of household filing status will provide $171 billion in tax benefits. Families with children in the first and second income quintiles receive larger benefits, on average, than families in higher income quintiles. Single parents with two children can receive a tax benefit as high as $8,100, and married couples with two children can receive a maximum tax benefit of $7,700. In some cases, this amounts to an income boost of 50 percent. Families with children at least age 17 can see their income lifted by up to $2,000 less than that because children must be under 17 to qualify for a CTC, and families with children at least age 13 will have reduced benefits because they cannot receive the CDCTC.

Both the CTC and EITC have temporary elements, scheduled to expire after 2017. With respect to the CTC, the expiration of the temporary elements will have the most impact on the very lowest earners. Families with income below $14,750 will no longer be eligible to receive the CTC and families with incomes just above that point will see their CTCs reduced. EITC changes will affect some married couples and some families with at least three children.

Although they are an important source of assistance to low-income families, the child-related provisions in the federal income tax could be made much simpler, fairer, and more economically efficient. Multiple reform proposals have been put forth, but the key difficulty is the impossibility of providing all families with children the same benefits they receive under current law in a simpler system. Most simplification proposals incorporate the idea that the eligibility standards for the EITC, CTC, and dependent exemption ought to all be the same. The current difference in eligibility for the various child-related tax benefits with the most impact is the differing ages at which a child qualifies for a tax benefit. A child must be under 17 to qualify for the CTC, but a child can be either under age 19 or 19–24 and a student to qualify for the EITC and dependent exemption. But in order to make the age eligibility uniform across these programs, policymakers must expand total benefits to limit the number of people who would owe more tax under a combined credit at substantial cost, or they must accept a large number of families who would owe more tax under a combined system, with a more limited cost overall.

Notes

1. This brief excludes child benefits that are either not broadly available or not focused on working parents, including the adoption tax credit, the American Opportunity Tax Credit, flexible spending accounts, and tax-preferred college savings opportunities.
2. A much smaller EITC is also available for very low-income working individuals and families without children.
3. The refundable portion of the CTC is called the additional child tax credit (ACTC).
4. The income percentile classes used in this analysis are based on the income distribution for the entire population and contain an equal number of people, not tax units. The incomes used are adjusted for family size by dividing by the square root of the number of people in the tax unit. The resulting percentile breaks (in 2012 dollars) are 20% $13,941; 40% $26,136; 60% $41,226; 80% $64,003.
5. Tax Policy Center microsimulation model (v0412-8) table T12-0246, families with children tab.

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