Tax Credit or Income Transfer?

Tax season will soon be over. Although this doesn't mean that paying taxes is over for the year, it does mean that we will no longer see the glut of roadside signs advertising tax preparation services that claim they can get you a tax credit of up to $4,169 per child.

Now, in principle, tax credits, like tax exclusions, tax exemptions, tax deductions, tax shelters, tax incentives, and tax loopholes, are a good thing because they allow people to keep more of their money in their pockets and out of the hands of the government.

After both tax rates and tax brackets increased during the Bush Sr. and Clinton years, the so-called Bush tax cuts — the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) — fixed the tax brackets at 10, 15, 25, 28, 33, and 35 percent, increased to $1,000 the child tax credit, set the long-term capital gains and qualified dividend tax rates at 15 percent, increased the section 179 expense deduction for small businesses to up to $250,000, and gradually reduced the estate tax.

The tax code was most recently changed by the "American Tax Relief Act of 2012," (ATRA) passed by the lame-duck Congress to keep from going over the "fiscal cliff." The Bush-era tax cuts were made permanent, but only for those making under $400,000 a year ($450,000 for married couples); the estate tax increased to a maximum rate of 40 percent with a $5.25 million exemption; the top marginal tax rate was increased to 39.6 percent; and some tax credits were extended.

A tax credit is a dollar-for-dollar reduction of the amount of income tax owed. Current tax credits include the credit for child and dependent care expenses, education credits, the foreign tax credit, the retirement savings contributions credit, the child tax credit, the adoption credit, the plug-in electric vehicle credit, and residential energy credits. Tax credits may reduce the tax owed to zero, but if there is no taxable income to begin with, then no credit can be taken.

Unless the tax credit is refundable.

Refundable Tax Credits

When Americans think of government welfare programs, they generally think of things like Temporary Assistance to Needy Families (TANF), which replaced Aid to Families with Dependent Children (AFDC); Head Start; Medicaid; or food stamps, now known as the Supplemental Nutrition Assistance Program (SNAP).

Other welfare programs that might be mentioned include the National School Lunch Program (NSLP); Women, Infants, and Children (WIC); energy assistance; housing assistance; the State Children's Health Insurance Program (SCHIP); and Supplemental Security Income (SSI).

But it would be rare indeed that anyone would consider a tax credit to be welfare. But unfortunately, that's just what refundable tax credits are — all of them.

A refundable tax credit is treated as a payment from the taxpayer, such as federal income tax withheld or quarterly estimated taxes paid. Current refundable tax credits for individuals include the additional child credit, the earned income credit, the health coverage credit, and the American opportunity credit. If the tax credit "payment" is more than the tax owed, the taxpayer receives a net payment from the government — a refund of money he never paid in. Refundable tax credits are the ultimate form of welfare because they are payments made in cash instead of payments made to third parties, as in Medicaid, or an amount deposited on an Electronic Benefit Card (EBC), as in the food-stamp program. And no amount received as a tax refund is counted as income when determining eligibility for federally funded welfare programs such as TANF, SSI, or SNAP.

There are two types of refundable tax credits: earnings-based and expenditure-based. Earnings-based credits are based on earning money from work, as opposed to earning money from investments. Expenditure-based credits are based on the purchase of a particular good or service, like paying college tuition.

The number and costs of refundable tax credits have both grown and varied since the first one appeared on Americans' 1040 tax forms for tax year 1975. According to the Congressional Budget Office, the number of credits peaked at 11 in 2010, with the cost to the taxpayers of these credits reaching a high of $238 billion in 2008.

For tax years 2008 through 2010, there was a refundable first-time homebuyer credit of up to $4,000 ($8,000 for married filing jointly) on homes whose purchase price did not exceed $800,000, as long as the taxpayer's modified adjusted gross income was not over $125,000 ($225,000 for married filing jointly).

For tax year 2008, an economic stimulus payment (defined by law to be a refundable tax credit) of $300 ($600 for married filing jointly) was available to filers with at least $3,000 in positive income-tax liability. Each qualifying child under 17 increased the payments by $300. The credit began to phase out once the taxpayer's adjusted gross income went over $75,000 ($150,000 for married filing jointly).

For tax years 2009 through 2010, there was the Making Work Pay credit, a provision of the American Recovery and Reinvestment Act of 2009. It equaled the lesser of 6.2 percent of an individual's earned income or $400 ($800 for married filing jointly). Thus, any taxpayer whose earned income was $6,451 or more was eligible for the maximum amount of the credit. The credit began to phase out once the taxpayer's modified adjusted gross income reached $95,000 ($190,000 for married filing jointly).

The COBRA (Consolidated Omnibus Budget Reconciliation Act) premium assistance credit covered 65 percent of health insurance premiums for workers who were involuntarily terminated between September 1, 2008, and May 31, 2010. It was phased out once the taxpayer's modified adjusted gross income exceeded $125,000 ($250,000 for married filing jointly).

For tax years 2007 through 2012, there was a prior-year alternative minimum tax (AMT) credit that allowed taxpayers to claim a credit for a portion of AMT liabilities in a prior year resulting from certain income that would not have been subject to the regular income tax. The credit is still in existence, but is no longer refundable.

Beginning in tax year 2002, but due to expire in tax year 2013, is a refundable health coverage tax credit that covers 72.5 percent of health insurance costs for households eligible for trade adjustment assistance or that have pension plans that have been taken over by the Pension Benefit Guaranty corporation.

For tax years 1997 through 2009, the adoption credit was nonrefundable, as it is now. But for years 2010 and 2011, the credit of up to $13,360 was fully refundable for modified adjusted gross incomes up to $185,210 and partially refundable as that number increased up to $225,210. Taxpayers adopting a special needs child could qualify for the full amount of the credit even if they paid few or no adoption-related expenses, and the credit could even be claimed for an adoption that was never finalized.

Thanks to ObamaCare, coming in 2014 will be a premium assistance credit that will subsidize the purchase of health insurance for some people through the newly established insurance exchanges. The credit will cover the difference between the reference premium for a locality and the household's contribution. Taxpayers with modified adjusted gross incomes of between 100 and 400 percent of the federal poverty guideline may be eligible for the credit.

The American opportunity credit is 100 percent of the first $2,000 plus 25 percent of the next $2,000 in qualified tuition and related educational expenses the taxpayer pays for each eligible student. No credit can be claimed if the taxpayer's modified adjusted gross income reaches $90,000 ($180,000 for married filing jointly). Forty percent of the American opportunity credit is refundable. That means that an amount up to $1,000 per student can be refunded over and above what the taxpayer paid in.

The child tax credit was introduced as part of the Taxpayer Relief Act of 1997. Originally worth up to $400 for tax year 1998, it is now worth up to $1,000 for each child under age 17 that is claimed as a dependent. Tax law changes in 2001 included two major changes to the child tax credit. First, the amount of the credit was scheduled to double, in stages, from the $500 per child that the credit was in tax years 1999 and 2000 to $1,000 per child by tax year 2010. (This was modified in 2003 by the JGTRRA when Congress accelerated the timing of the child tax credit benefit increase, raising it to $1,000 per child in tax year 2003.) And second, the credit was made partially refundable, with the refundable portion termed the additional child tax credit. It is available to taxpayers with a qualifying child who receive less than the full amount of the $1,000 per child tax credit because their tax owed is less than the allowable child tax credit. In that case the amount of the additional child tax credit is the smaller of the remaining child tax credit and 15 percent of the taxpayer's taxable earned income. The income phase-out amount begins, as with the child tax credit, when adjusted gross income exceeds $75,000 ($110,000 for married filing jointly).

The Earned Income Credit

The crown jewel of refundable tax credits is the earned income tax credit (EITC) or earned income credit (EIC). With a maximum benefit for 2012 of $5,891, the EIC is not just welfare for the masses; it is a huge wealth redistribution scheme. According to the IRS, "Nationwide last year, over 27 million eligible individuals and families received nearly $62 billion in EITC." And according to the Congressional Budget Office, that number is expected to rise to $68 billion for 2013, with $60 billion of that amount being payments that exceed tax liabilities. Many states and some cities and counties also offer their residents an earned income credit.

The EIC program has always received wide bipartisan support in Congress. Like many federal programs that eventually grew exponentially beyond what they were ever intended, the EIC had modest beginnings. A seemingly innocent provision of the Tax Reduction Act of 1975 was a refundable tax credit for low-income taxpayers with children that provided them with up to $400. The credit was soon extended for 1976, 1977, and 1978. By 1978, the maximum a family could receive went up 25 percent to $500, with a partial credit given on incomes between $5,000 and $10,000. Beginning in 1979, the EIC was made a permanent fixture on IRS tax forms. Workers could also begin to elect to receive a partial credit in advance as a payment from their employers along with their regular pay and claim the rest of the credit when filing their tax return. The participation rate for this provision was never very high, and it was rescinded in the Education Jobs and Medicaid Assistance Act of 2010.

By 1990, the maximum EIC was up to $953, with a partial benefit available for incomes up to $20,264. In 1990, the system was greatly expanded for the next three years. Not only did benefits go up, more dollars were awarded if the taxpayer had two or more children instead of one. Also new was an additional credit of up to $357 if a child was less than one year old. By 1993, the maximum credit was up to $1,511.

Although the EIC was introduced under President Ford, and steadily increased under Presidents Carter, Reagan, and Bush, it skyrocketed under President Clinton — even though he had a Republican majority in Congress for the last six years of his presidency. The Omnibus Reconciliation Act of 1993 increased the maximum EIC payment in 1994 by more than $1,000 to a whopping $2,528. Also new in 1994 was an EIC payment for a single person with no dependents.

But not only did the EIC go up every year that the Republicans controlled the Congress under Clinton, it likewise increased when the Republicans had an absolute majority in Congress and the White House for more than four years under George W. Bush. Beginning in 2009, EIC payments were increased for taxpayers with three or more children. That increase has been extended to 2013, when the maximum benefit is scheduled to rise to $6,044, with a partial benefit available for taxpayers with incomes up to $46,227 ($51,567 for married filing jointly).

For tax year 2012, those who qualify for the EIC can receive a credit from:

•$2 to $475 with no qualifying children

•$9 to $3,169 with one qualifying child

•$10 to $5,236 with two qualifying children

•$11 to $5,891 with three or more qualifying children

Now we can see the reason for the roadside signs offering a tax credit of up to $4,169 per child: a $1,000 additional child tax credit and a $3,169 earned income tax credit. In reality, most people don't receive the maximum amount. According to the IRS, the average credit last year was $2,200.

To be eligible for the EIC, one's income must be below certain limits. For tax year 2012, both earned income and adjusted gross income must each be less than:

•$13,980 ($19,190 married filing jointly) with no qualifying children

•$36,920 ($42,130 married filing jointly) with one qualifying child

•$41,952 ($47,162 married filing jointly) with two qualifying children

•$45,060 ($50,270 married filing jointly) with three or more qualifying children

Those with no qualifying children must also be at least age 25 but under age 65.

The EIC program is always said to encourage work and discourage welfare. Ronald Reagan once heralded it as "the best anti-poverty, the best pro-family, the best job creation measure to come out of Congress." According to the IRS:

EITC, the Earned Income Tax Credit, sometimes called EIC, is a tax credit to help you keep more of what you earned. It is a refundable federal income tax credit for low to moderate income working individuals and families. Congress originally approved the tax credit legislation in 1975 in part to offset the burden of social security taxes and to provide an incentive to work. When EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit.

According to a report on the EIC by the General Accounting Office (now called the Government Accountability Office) for the Senate Finance and House Ways and Means committees, Congress enacted the EIC: "(1) to assist low-income wage earners who were adversely affected by rising prices; (2) to offset the effects of social security taxes paid by these workers; and (3) to encourage these workers, who might otherwise receive welfare benefits, to seek employment."

But how can a program that is itself welfare be said to discourage welfare? How can the EIC be called a tax refund when it is other people's money that is refunded? Why do "low to moderate income working individuals and families" need a tax credit, when they generally pay no federal income taxes in the first place? If Social Security taxes are a "burden," then why not reduce the Social Security tax rate as was done in 2010 and 2011? And since when is it the job of government to provide incentives, assist low-income wage earners, monitor prices, or encourage anyone to do anything?

A Masquerade

Refundable tax credits can amount to a significant part of a family's income. Consider a typical American family with two children. For tax year 2012, they can make up to $27,104 and not only owe nothing in taxes, but get a $4,220 earned income credit plus a $1,000 per child additional tax credit refunded to them. This effectively gives them an artificial income of $33,324. This is better than a real income increase of that amount because the family's income is still $27,104 when qualifying for public assistance and when figuring the taxable wages for Social Security and Medicare. To get a maximum earned income credit of $5,236 for having two children, a couple can still make $22,299, thus giving them an artificial income of $29,535 with the addition of two $1,000 per child refundable tax credits.

According to the latest data from the IRS, in tax year 2010, the top one percent of taxpayers (in terms of adjusted gross income) paid 37.38 percent of all federal income taxes. The top five percent of taxpayers paid 59.07 percent. The top 10 percent of taxpayers paid 70.62 percent. The top 25 percent of taxpayers paid 87.11 percent of the taxes, and the top 50 percent paid a whopping 97.64 percent. But not only do half of Americans pay little or no federal income tax, most of them receive payments from the government via refundable tax credits.

Refundable tax credits were created to meet social policy goals. The government using the tax system to achieve these goals is no different than the government using spending programs. It is only a difference in administration. But aside from the fact that it is neither constitutional nor the proper role of government to set social policy goals in the first place, since refundable tax credits paid to non-taxpayers are funded by taxes collected from taxpayers, they are nothing but income transfer programs and wealth redistribution schemes.

Short of Congress lowering the tax rates, eliminating the progressivity of the tax code, or abolishing the income tax altogether, Americans need all the tax credits, tax exclusions, tax exemptions, tax deductions, tax shelters, tax incentives, and tax loopholes that they can get. But all refundable tax credits should be abolished because they are nothing but income transfer programs masquerading as tax credits.

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