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Tax Rebate Refundability: Effects and Issues

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Tax Rebate Refundability: Effects and Issues

Summary

Tax rebates provided as a short-term fiscal stimulus in 2001 did not make those tax provisions refundable. That is, taxpayers with no tax liability received no rebate, and taxpayers with liability smaller than the maximum rebate would receive a limited rebate. The issue of refundability has been subject to debate in the current consideration of a rebate. An initial Administration proposal would have reduced the 10% income bracket to 0% but provided no refundability. The initial proposal negotiated between the House leadership and the Administration would provide for some limited refundability for wage earners with at least $3,000 in income, with a more limited maximum rebate and a rebate for children. A proposal by Senate Finance Committee Chairman Baucus would extend refundability to senior citizens by allowing rebates for those who have at least $3,000 in social security benefits and this provision was retained in the final bill.

Non-refundable rebates can exclude, for typical households in examples presented, single individuals with incomes below $8,750 and married couples with three children with incomes below $30,000. Many individuals age 65 and over are also excluded from taxation because social security is largely exempt and because of extra personal exemptions and retirement credits.

A non-refundable rebate excludes approximately 37% of households due to lower incomes. The House/Administration proposal, which provides refundability for households with $3,000 or more of earnings would exclude about 20% of households, many of these likely to be elderly households who have neither tax liability nor earnings. The House/Administration proposal does appear to be progressive in a relative sense (on average incomes increase proportionally more at lower levels), although dollar amounts for the rebate are lower in the lower income quintile. The average rebate in the lowest quintile is $221 under the House/Administration plan as compared to $16 for a non-refundable rebate. The average rebate in the lower quintile in the Senate plan is $564, and under that plan, 6.5% of households would not receive a rebate because of low incomes. The final plan is similar to the Senate in its coverage of lower income households but the average rebate is in the lower income quintile is smaller, at $391.

Directing rebates to lower income individuals is likely to be a more effective short-term stimulus because lower income individuals tend to spend more of their income. Extending the rebate to lower income retired individuals, who tend to be non-filers, would enhance progressivity but present administrative difficulties.

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Introduction

Tax rebates provided as a short-term fiscal stimulus in 2001 did not make those tax provisions refundable. That is, taxpayers with no tax liability received no rebate, and taxpayers with liability smaller than the maximum rebate would receive a limited rebate. The issue of refundability has been subject to debate in the current consideration of a rebate.

The Administration had initially suggested a non-refundable tax rebate which would have apparently allowed a reduction in the 10% tax bracket to 0%, which would have produced rebates up to approximately $1,600 for married couples and $800 for singles.

A subsequent agreement between the House leadership and the Administration would have provided a rebate of $100 billion with refundability for taxpayers with earned income.[1] Under the initial version of H.R. 5140, married couples would have had a reduction from 10% to 0% for the first $12,000 of income in the current 10% bracket, and singles would have a reduction for the first $6,000, leading to a maximum rebate of $1,200 and $600 respectively. Those without tax liability would have received a $300 rebate for singles and a $600 rebate for married couples as long as they had earned income of at least $3,000. There would also have been a $300 dollar tax rebate for each child regardless of tax liability as long as the taxpayers had either $3,000 of earnings or $1 of tax liability. The rebate was to be phased out for single individuals with income over $75,000 and married couples over $150,000, with the benefit falling by 5% of income over these levels. Taxpayers with incomes above $87,000 if single and $174,000 if joint would receive no rebate. Thus, taxpayers who would receive no rebate include lower income taxpayers who have no earnings and no tax liability (mostly retired taxpayers) and high income taxpayers who are phased out of the rebate.

A measure reported out of the Senate Finance Committee, would have extended refundable rebates to senior citizens by also allowing rebates for those with at least $3,000 in social security benefits and the rebate would be set at $500 ($1,000 for a joint return).[2] The Chairman's initial proposal would have eliminated the phaseout at higher incomes and thus the rebate would be a flat payment to virtually all

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[1] Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions and Estimated Budget Effects of H.R. 5140, The Recovery Rebates and Economic Stimulus for the People Act of 2008*, JCX-5-08; revenue projections are in JCX-6-08, January 28, 2008.

[2] Joint Committee on Taxation, *Description of the Economic Stimulus Act of 2008*, JCX-08-08, January 28, 2008.

households, but a revision included a phase out of the rebate at $150,000 ($300,000 for married couples).

The final bill followed the initial House proposal in the size of the rebates and the phaseouts, but, as in the Senate proposal, it included social security payments in the determination of the $3,000 necessary to receive a rebate. These rebates are at the lower levels in the House bill ($300 for singles and $600 for couples).[3] A minimum rebate is also allowed if the household has at least $1 in tax liability and adjusted gross income equal to the standard deduction plus a personal exemption (two personal exemptions in the case of a couple).

This report discusses the income levels at which tax rebates would not be available in the absence of refundability, the magnitude and types of taxpayers likely affected, and the issues surrounding the existence and scope of refundability provisions.

Income Levels Affected by Refundability

This section first discusses taxpayers under 65 and then taxpayers over 65. Taxpayers with earnings, and especially those with children, tend to have higher income levels after accounting for tax credits that are largely or partially refundable (the child credit and the earned income credit). These levels differ from those that would trigger a change in tax liability through rate reductions. Taxpayers over 65 tend to have higher exempt levels due to rate reductions because they receive additional personal exemptions and the non-refundable retirement credit.

Taxpayers Under 65

Because of the earned income credit, some families can have relatively high incomes before they have any tax liability. If refunds are based on 2007 tax returns and tax laws, taxpayers with incomes below the amounts in column 2 of **Table 1** would receive no credit, if a rebate were restricted to families whose tax liability after all credits is greater than or equal to zero. (These examples assume all income is earned, the standard deduction and no credits other than the child credit and the earned income credit.)

As seen in the table these exempt levels can reach in excess of $50,000 for families with three or more children. Consider the level for a married couple with one child in 2007. The sum of a standard deduction of $10,700 and three personal

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[3] Two other provisions in the Senate Finance proposal that were adopted included provisions to allow a refundable rebate based on veteran's disability payments, and to eliminate payments by illegal immigrants by requiring the taxpayer identification number to be a social security number. Eligible benefits to qualify under the Social Security payments refundability benefit include old age, survivors and disability payments and tier I railroad retirement. The do not include supplemental security income (SSI) or pensions. The IRS has issued a fact sheet, FS-2008-16, that explains these refundable rebates. See: [http://www.irs.gov/irs/article/0,,id=179096,00.html].

exemptions of $3,400 means there will be no taxable income until income reaches $20,900. However, the family is eligible for a child tax credit of $1,000. To eliminate all tax on taxable income up to this point through the child tax credit would permit the family's income to rise to $30,900. This income would result in taxable income of $10,000 and a tax liability at a 10% rate (the first bracket rate) of $1,000. This liability would be eliminated by the child tax credit. The family would still be eligible for an earned income tax credit which does not completely phase out until income reaches $35,241. At the income level of $33,572, the increasing tax liability would be just offset by a falling earned income credit.

A different exempt level would occur if the benefit is in the form of a rate reduction that would affect tax applied before excess tax credits. For example, the initial proposal by the Administration was to reduce the 10% rate bracket to a zero rate bracket. Because this point occurs before credits, taxpayers would lose the rebate benefit at a lower level of income. If all credits were fully refundable the level at which no rebate benefit would occur would be the point where there is tax liability before credits, which for a typical taxpayer is the sum of personal exemptions and the standard deduction.

Table 1. Threshold for Receiving Tax Benefits Under Non-Refundable Rebates, 2007

Type of Return	No Tax Liability Including Refundable Credits	No Tax Liability Before Credits	Ineligible for Non-Refundable Tax Rate Reduction
Single	$10,416	$8,750	$8,750
Married- No Children	$17,500	$17,500	$17,500
Married- One child	$33,572	$20,900	$20,900
Married - Two Children	$42,850	$24,300	$24,770
Married -Three Children	$52,917	$27,700	$30,130
Head of Household- One Child	$29,276	$14,650	$14,150
Head of Household- Two Children	$36,674	$18,050	$21,760
Head of Household - Three Children	$44,183	$21,450	$27,630

Sources: Data in column 2 is from CRS Report RS22337, *Federal Income Tax Thresholds for Selected Years: 1996 Through 2007*, by Gregg A. Esenwein and Maxim Shvedov. Numbers in Column 3 are the sum of standard deductions and personal exemptions. Numbers in Column 4, where different from column 3, are where the sum of tax liability plus the limit on the refundable portion of the child credit equals the total allowable child credit.

For singles and married individuals who receive only the fully refundable earned income credit, that income remains at the level at which no rebate benefit is received. It also remains at the same level for the married couple with one child. In their case, taxable income is zero at $20,900 for 2007. The family would still be eligible for a

refundable child tax credit which is limited to 15% of income in excess of $11,750. Since that amount is larger than the $1,000 maximum child tax credit, both the child credit and the earned income credit are fully refundable at this point and the level at which no rebate benefit would be received does not change.

For families with two and three children the level at which no tax change would occur is somewhat higher. This occurs because the limit on the refundable tax credit is below the maximum credit for these families ($2,000 for two children and $3,000 for three children) and some of the credit they receive is against tax liability. When tax liability is lowered, the credit is also reduced. The point at which no tax benefit is received is when the tax liability plus the refundable credit equals the maximum credit.

The exempt levels in columns (3) and (4) apply regardless of whether income is earned or unearned, and therefore would also apply to retired individuals under 65, but would reflect earnings included in income (and not exempt social security benefits).

Note that the exempt levels in these tables would be higher if other credits are received such as the child care tax credit.

Exempt Levels for Those 65 and Over

This discussion considers only taxpayers without children but addresses the circumstances of those who are over 65. These taxpayers fall into three categories: single taxpayers over 65, married couples with one spouse over 65, and married couples with both spouses over 65. Taxpayers over 65 without children do not receive the child tax credit and do not receive the earned income tax credit if they do not have earnings. However, they have three provisions that tend to make their income higher before being taxed than families without children and that would reflect refundability that is based on taxable income. First, each taxpayer over 65 receives an additional standard deduction. Second, individuals over 65 are eligible for a retirement income credit, although the credit is reduced by exempt income such as social security and half of other income excess of a floor. Taxpayers with significant amounts of social security income would not receive this credit. However, social security income is not taxable unless adjusted gross income plus ½ of social security income reaches a given level, so that taxpayers can have much higher levels of actual income before they are subject to tax.

Table 2 shows the exempt level taking into account these provisions. The retirement credit, in the absence of social security income, slightly increases the exempt level for singles and for couples with both spouses over 65, but it is the additional personal exemptions that have the most effect (compare to column 3 in Table 1). Incomes can become considerably higher before there is taxable income with social security payments.

Table 2. Exempt Levels for Taxpayers Over 65, No Children

	Standard Deduction and Personal Exemption	Exempt Level, No Social Security Income	Exempt Level with $10,000 in Social Security
Single, Over 65	$10,050	$13,243	$20,050
Joint, One Over 65	$18,550	$19,171	$28,550
Joint, Both Over 65	$19,600	$21,914	$29,600

Source: CRS calculations.

Note: Column 3 reflects the effect of the retirement credit.

What Families Are Affected

Tax returns without tax liability and without taxable income (and therefore unlikely to be eligible for non-refundable credits) tend to be more concentrated among singles and single headed families, because they tend to have lower income, as shown in **Table 3**.

Table 3. Distribution of Tax Returns by Filing Status

	Share of 134.4 Million Returns Filed	Share of 30.1 Million Returns With No Taxable Income	Share of 43.8 Million Returns with No Tax Liability
Joint	39%	25%	29%
Married Separate	2%	1%	1%
Head of Household	15%	23%	31%
Single	44%	51%	40%

Source: Internal Revenue Service Statistics of Income.

In addition to the 30 million taxpayers or more who have no income tax liability and the excess of 30 million who would not be eligible for a rate reduction, there are also non-filers, which are estimated at around 23 million by the Urban Institute and Brookings Institution Tax Policy Center.[4]

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[4] See Tax Policy Center, Table T08-0012: [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1724&DocTypeID=7].

The Tax Policy Center also, in addressing the original proposal to allow a non-refundable rebate of the 10% bracket[5] found that after excluding approximately 7 million returns that were claimed as dependents on other taxpayers returns, 33 million returns filed would have no rebate benefit (corresponding closely to the 30 million without tax liability reported in Table 3). Thus, the combination of 33 million filers and 23 million non filers out of total filers of 127 million (excluding those claimed as dependents on other returns) and non filers results in 37% of households who would receive no rebate benefit because of low incomes. Out of this group of 56 million, 30 million had earnings, and 26 million did not. Thus out of the proposal that allows a benefit for earnings, 17 percent of households would not receive a benefit. These households are likely to be elderly: out of the group without a benefit due to low tax liability, 19 million were in elderly households, accounting for 12% of the total and 60% of all elderly households. A significant share would also receive a partial benefit under the original proposal: 21 million taxpayers, about 14% of households.

For the House/Administration proposal, with refundability based on income the Tax Policy Center[6] estimates 39 million returns with no rebate benefit (17 million filers and 22 million non-filers). According to distributional data about the plan,[7] 32% of the top income quintile would receive no rebate (presumably because of the phase out), about 9 million returns. Thus 30 million lower income returns, about 20% of households, would receive no rebate because they have no tax liability and little or no earnings. Of the total 39 million returns that would receive no rebate, 18 million are returns of households with age exemptions. Finally, another 44 million returns, 29% of households, would receive only a partial benefit (below the maximum of $600 for singles and $1,200 for joint returns).

For the initial Senate proposal, approximately 10 million returns would receive no rebate, 6.5% of the total.[8] Virtually all of these returns are in the lowest quintile. Of the 10 million with no benefit, 2 million have age exemptions. One million households, less than 1% of the total, would receive a partial benefit and the addition of the income phaseout would eliminate another 1.8% due to high incomes[9].

The bill as adopted retains the Senate refundability provisions, so that 6.5% of households would not receive a rebate because of low incomes. Overall, 13% do not receive a rebate, a change that largely reflects the high income phase-outs.[10]

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[5] Ibid.

[6] See Tax Policy Center, Table T08-0030: [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1742&DocTypeID=4].

[7] See Tax Policy Center, Table T08-0035:. [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1747&DocTypeID=4]].

[8] This number was from Tax Policy Center, Table T08-0042 for the original proposal without any phase out, no longer posted on the website.

[9] See Tax Policy Center, Table T08-0057: [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1769&DocTypeID=4].

[10] See Tax Policy Center, Table T08-0060.

Within the income distribution, the original Administration rebate proposal (without refundability) tends to favor the middle and upper income classes in dollar terms and to favor the middle class as a percentage of after tax income, a measure of relative distribution. **Table 4**[11] reports these measures for the original proposal to eliminate the 10% bracket without refundability; the House/Administration proposal that would limit the maximum, provide a rebate benefit for those without tax liability based on earnings and provide a rebate benefit for children, and the Senate proposal, which would provide a relatively flat payment. All proposals provide the largest dollar benefits for middle and upper middle income taxpayers, although the benefits have shifted down through the income distribution for the House/Administration proposal and even more so for the Senate plan. The refundability in the House proposal has increased the average benefit in the lowest 20% of the population from an estimated $16 to $221, while the refundability in the Senate proposal has increased the benefit to $564. Both the House and Senate proposals are progressive in a relative sense, in that the percentage increase in income falls on average as income rises. (Although this is clearly not true for every case, as some households do not receive a rebate). While the Senate proposal allows benefits for higher income taxpayers, they are small relative to incomes.

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[11] See Tax Policy Center, Tables T08-0034, T08-0011,T08-0055, and T008-0061: [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1723&DocTypeID=2], [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1746&DocTypeID=2], [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1767&DocTypeID=2], [http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1779&DocTypeID=2].

Table 4. Distributional Effects of Alternative Proposals

	Reduce 10% Rate to 0%, No Refundability		House/ Administration Bill (H.R. 5140)		Initial Senate Proposal		Final Bill	
	Average Rebate	Percentage Increase in Income	Average Rebate	Percentage Increase in Income	Average Rebate	Percentage Increase in Income	Average Rebate	Percentage Increase in Income
Bottom	$16	0.2	$221	2.7	$564	6.1	$391	4.3
Second	271	1.4	487	2.4	778	3.7	634	3.0
Middle	288	2.2	722	1.2	843	2.4	872	2.5
Fourth	1,155	2.2	1,021	1.9	875	1.6	998	1.8
Top	1,213	0.8	864	0.5	822	0.5	681	0.4
Total	668	1.3	663	1.2	775	1.4	715	1.3
80-90 Percentile	1,377	1.7	1,106	1.3	901	1.1	990	1.2
90-95 Percentile	1,363	1.2	1,092	0.7	911	0.8	622	0.6
95-99 Percentile	778	0.4	177	0.1	695	0.4	134	0.1
Top 1 Percent	561	0.1	61	0.0	99	0.0	66	0.0
Top 0.1 Percent	952	0.0	12	0.0	23	0.0	15	0.0

Source: Tax Policy Center, Urban Institute and Brookings Institution, Table T08-0011, Table T08-0034 and T08-0055.

Issues in Structuring a Rebate

There are three basic issues in structuring a rebate: effectiveness in achieving its purpose in stimulating the economy, fairness, and administrative feasibility. From an economic point of view, the most efficient way to have a large stimulus effect is to direct the tax benefit towards lower income households who have a greater tendency to spend the rebate.[12] On this basis, rebates that are refundable and increases in transfer programs have a greater likelihood of creating short-term economic stimulus. One macroeconomic model, for example, finds the multiplier (the increase in output per dollar of tax cut) to be 1.02 for a non-refundable rebate but

[12] See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are The Alternatives?* by Jane G. Gravelle.

1.26 for a refundable rebate.[13] It also finds a multiplier of 1.64 for unemployment benefit increases and 1.73 for food stamp increases, two alternative approaches to rebates. Thus refundability is likely to aid in a more effective short-term stimulus and that effectiveness would probably be increased if the elderly were covered as well.

There are different perspectives on fairness. For those concerned about progressivity of a tax cut, extending the cut to lower income individuals contributes to that progressivity, as shown above. Others feel that it is inappropriate to provide a rebate to those who do not pay taxes (although proposals to increase transfers would have that effect). Given that lower income households are to receive the rebate, some would see it as unfair to provide the benefits only to those with earnings and not to those who are retired and living on social security and pensions.

Perhaps the major reason for not extending refundability, especially to those without earnings such as the elderly, is that this population is mostly non-filers. Both compliance and administrative costs would be increased if non-filers are included in the group eligible. If all of these individuals filed returns,[14] the IRS could have to process another 23 million returns, and taxpayers would have to file these returns.

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[13] Mark Zandi, "Washington Throws the Economy a Rope," January 22, 2008, at [http://www.economy.com/home/article_ds.asp?cid=102598].

[14] Not all non-filers would be likely to file, since some may be evading tax by not filing returns and would not want attention called to them.