What is the difference between refundable and nonrefundable tax credits?
Taxpayers subtract both refundable and nonrefundable credits from the taxes they owe. If a refundable credit exceeds the amount they owe, they receive the difference as a refund, but if a nonrefundable credit exceeds the amount they owe, the excess is lost.

REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

Tax credits directly affect tax liability, reducing it dollar for dollar. In contrast, exclusions, deductions, and exemptions indirectly reduce tax liability by reducing taxable income. Generally speaking, tax credits are worth the same amount to all taxpayers. For example, the child tax credit is worth $1,000 to everyone eligible to claim the full credit. The value of deductions and exemptions, however, depends on the taxpayer's marginal tax rate. For example, a $1,000 exemption is worth $350 to a taxpayer in the 35 percent tax bracket, but only $150 to a taxpayer in the 15 percent bracket.

The maximum value of a nonrefundable tax credit is capped at a taxpayer's tax liability. In contrast, taxpayers receive the full value of their refundable tax credits. The amount of a refundable tax credit that exceeds tax liability is refunded to taxpayers.

Most tax credits are nonrefundable. Notable exceptions include the fully refundable earned income tax credit (EITC), the premium tax credit for health insurance (PTC), the refundable portion of the child tax credit (CTC) known as the additional child tax credit (ACTC), and the partially refundable American Opportunity Tax Credit (AOTC) for higher education.

With the EITC, PTC, and ACTC, taxpayers calculate the value of these credits and receive the credit first as an offset to taxes owed, with any remainder paid out as a refund. The ACTC is equal to 15 percent of earnings in excess of $3,000, but limited to the amount of any unused child tax credit (that is, the amount of the child tax credit in excess of income tax liability). Students qualifying for the AOTC can receive 40 percent as a refundable credit.

BUDGET TREATMENT OF REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

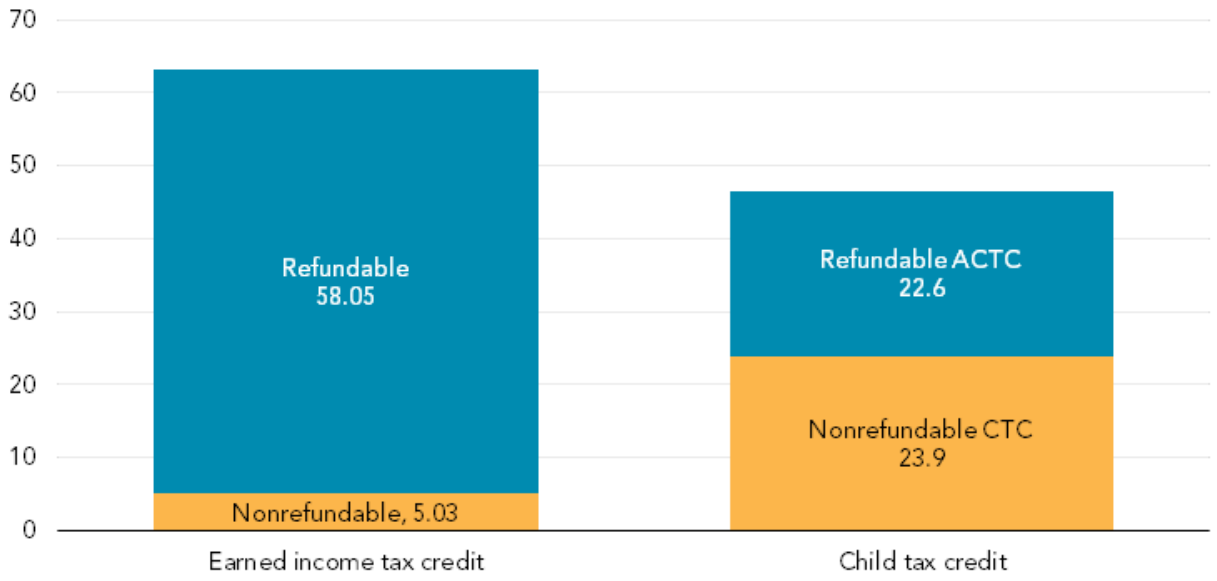
The federal budget distinguishes between the portion of a tax credit that offsets tax liability and the portion that is refundable, classifying the latter as an outlay. Most of the EITC—an estimated $58 billion of the FY 2015 total of $63 billion—will be

refunded. Much less of the child tax credit ($23 billion out of $47 billion) will be refunded in FY 2015 (figure 1).

FIGURE 1

Refundable and Nonrefundable Shares of EITC and the Child Tax Credit

Billions of dollars, FY2015



Source: Office of Management and Budget, Budget of the United States Fiscal Year 2016, Table 14-1.

ADVANTAGES AND DISADVANTAGES OF REFUNDABLE CREDITS

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. This is especially true for the EITC and the CTC: if the credits were not refundable, low-income households most in need of assistance would not benefit from them. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits, for their part, raise a host of objections:

- The tax system should collect taxes, not redistribute income.
- The government should not use the tax system to carry out social policies.
- Everyone should pay some tax as a responsibility of citizenship,
- Refundable credits increase administrative and compliance costs, and encourage fraud.

DATA SOURCES

Office of Management and Budget. "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2016: Tax Expenditures." Table 14–1. Estimates of Total Income Tax Expenditures for Fiscal Years 2014–2024.

FURTHER READING

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