



Tax Policy Center

Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

TAXES AND THE POOR

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Taxes and the Poor: How does the federal tax system affect low-income households?

Low-income households pay relatively low federal taxes, primarily because tax credits reduce or eliminate their income tax liability, and some (called refundable credits) result in net payments to them. Stimulus measures enacted to offset the adverse effects of the 2008-09 recession further reduced the tax-burden on these families. In 2011, tax units in the lowest income quintile (that is, the 20 percent of all tax units with the lowest incomes) on average paid federal income, payroll, and estate taxes equal to 0.8 percent of their cash income, less than a twentieth of the 18.1 percent average effective tax rate for all tax units (see table).

Cash income percentile ¹	Effective Average Tax Rate				
	Individual income tax ²	Payroll taxes ³	Corporate income tax	Estate tax	All federal taxes ⁴
Lowest Quintile	-5.7	6.2	0.4	0.0	0.8
Second quintile	-2.8	8.1	0.5	0.0	5.7
Middle quintile	3.2	8.8	0.5	0.0	12.4
Fourth quintile	7.0	8.9	0.7	0.0	16.4
Top quintile	14.0	5.6	3.2	0.2	23.1
80-90 Percentile	9.3	8.9	0.9	0.0	19.1
90-95 Percentile	11.7	8.1	1.3	0.0	21.1
95-99 Percentile	15.1	5.3	2.4	0.1	23.0
Top 1 Percent	18.5	1.7	7.0	0.5	27.6
Top .1 Percent	19.1	0.8	10.3	0.7	30.8
All Tax Units	9.0	7.0	2.0	0.1	18.1

Notes:

(1) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units but excludes those that are dependents of other tax units

(2) After tax credits (including refundable portion of earned income and child tax credits).

(3) Includes both the employee and employer portion of Social Security and Medicare tax.

(4) Excludes customs duties and excise taxes.

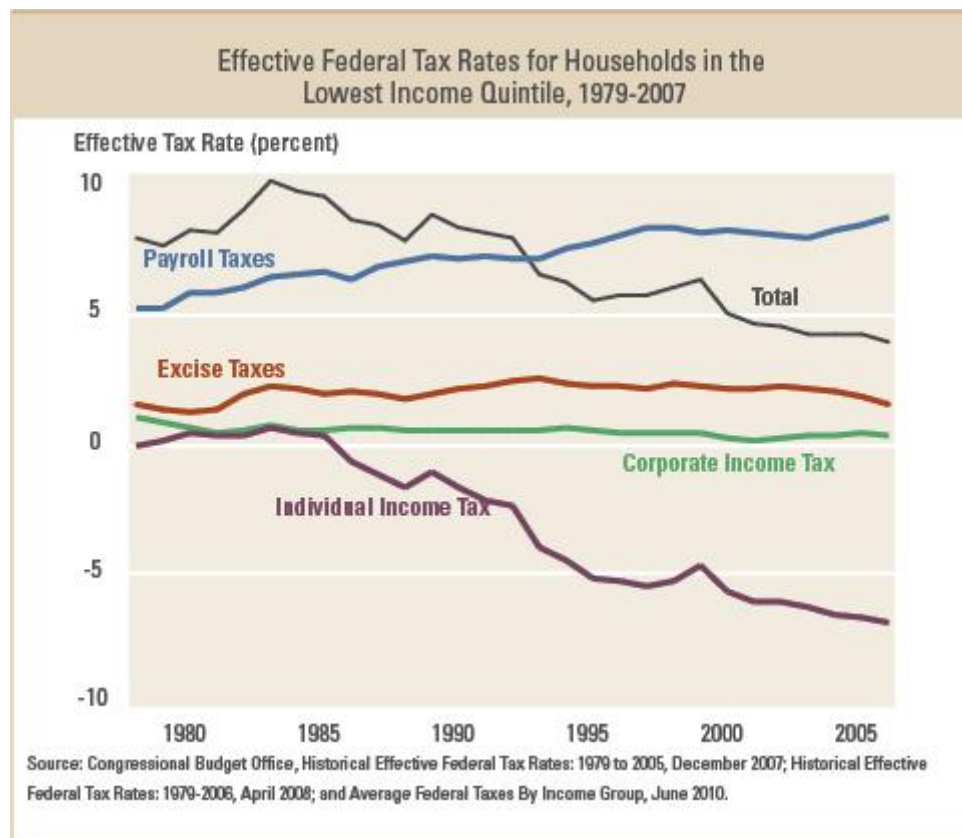
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-1)

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- Because the earned income tax credit (EITC) is refundable and the child tax credit (CTC) is partly so, the average effective individual income tax rate for the bottom two income quintiles in 2011 was negative; that is, the tax credits more than offset positive income tax liability, so that the average household in these quintiles received a net payment from the government.
- Low-income households face a lower than average effective payroll tax rate because they get less of their income from earnings and more from transfer payments than do higher-income households. In 2011, payroll taxes claimed 6.2 percent of the cash income of tax units in the lowest quintile, compared with 7.0 percent for all tax units.

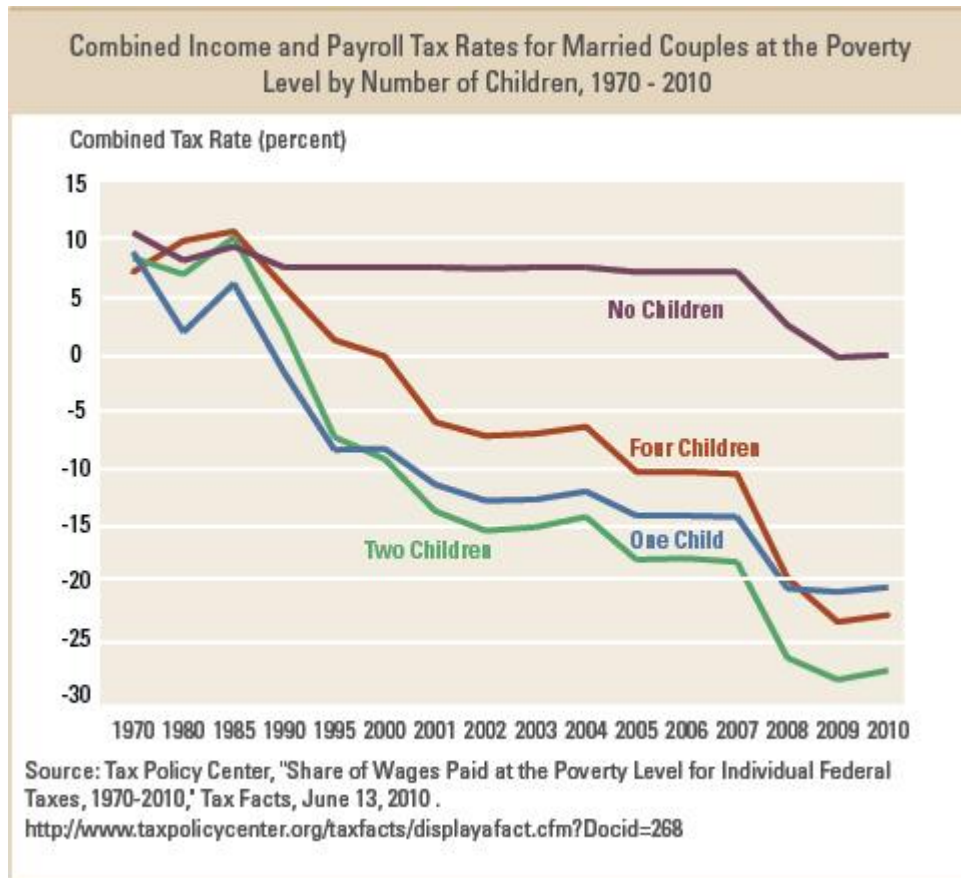
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- Tax units in the lowest income quintile pay about the same average effective tax rate on corporate income (passed through to them as shareholders) than units in the next two quintiles. That outcome occurs because low-income elderly households get a disproportionately large share of their income from their retirement savings.
- Not surprisingly, low-income households pay virtually no estate taxes. In 2011, the \$5 million threshold for estate tax liability (\$10 million for married couples) will exclude taxpayers in all but the highest income quintile from the tax.
- Effective tax rates on low-income households have changed markedly over the past quarter century (see figure 1). Creation of the CTC and expansion of the EITC both served to lower the effective individual income tax rate for these households from about 0.5 percent in the early 1980s to its negative value more recently. In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over the same period. The effective corporate income tax rate for low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.



Underlying Data: [Download](#)

- Low-income married couples with children have seen a marked decline in their taxes since 1970 (see figure 2). For example, the average combined income and payroll tax rate for married couples with two children and income at the poverty level fell from over 9 percent in 1970 to negative 27 percent in 2010. That decline resulted in large part from the creation and subsequent expansion of the refundable EITC and partially refundable CTC as well as the temporary stimulus measures in 2009 and 2010.



Underlying Data: [Download](#)

See Also

Taxation and the Family: [What is the child tax credit?](#)

Taxation and the Family: [What is the earned income tax credit?](#)

Taxes and the Poor: [Can poor families benefit from the child tax credit?](#)

Data Sources

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Author: Robertson Williams
Last Updated: June 22, 2011

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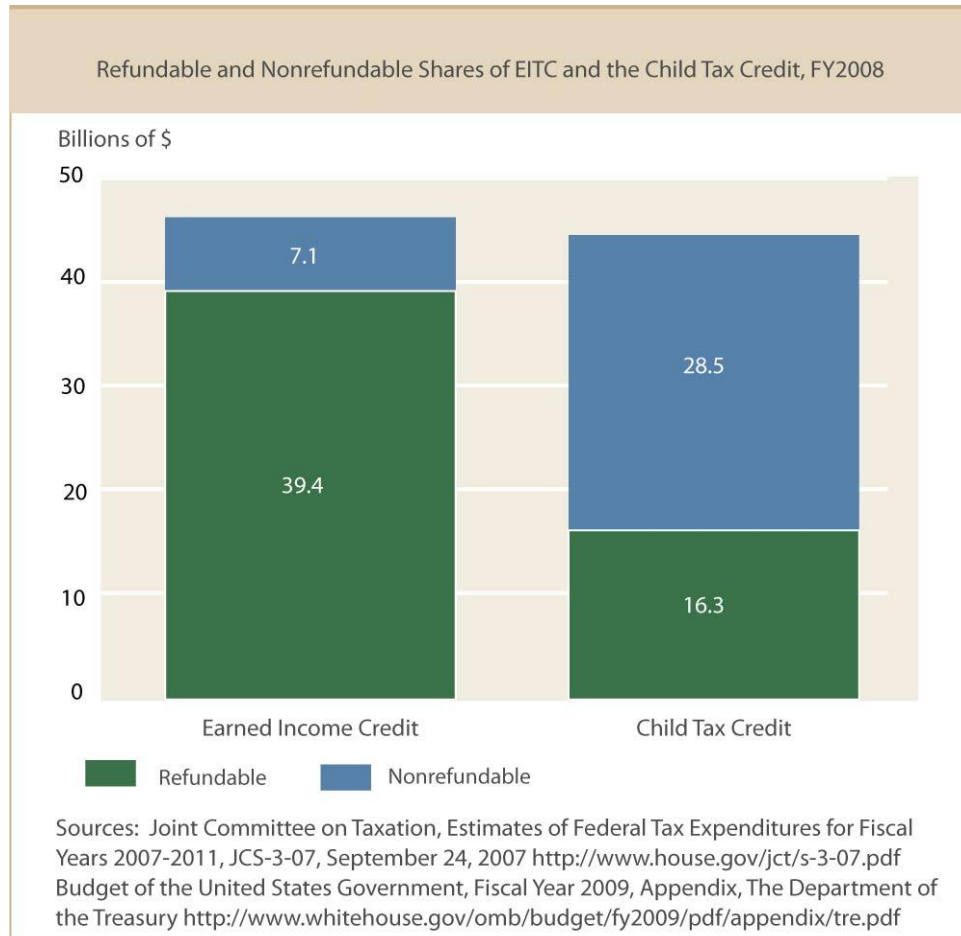
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Taxes and the Poor: How do refundable and nonrefundable credits differ?

Taxpayers may claim the full value of most tax credits only if their tax liability before applying the credit exceeds the value of the credit. Stated another way, most tax credits cannot reduce a person's tax bill below zero. Three tax credits—the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC)—do not face that limitation; they are termed refundable because they can generate cash refunds that exceed the taxpayer's tax liability. The EITC and the HCTC are fully refundable: taxpayers may receive their full value regardless of their other tax liability. In contrast, the CTC is only partially refundable because it can result in negative tax bills only in specified circumstances.



- The federal budget distinguishes between the portion of a tax credit that offsets positive tax liability and the portion that is refundable. Most of the EITC—an estimated \$39.4 billion of the 2008 total of \$46.5 billion—is refundable. Much less of the CTC is refundable: \$16.3 billion out of \$44.8 billion in 2008.
- Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. Particularly in the cases of the EITC and the CTC, precisely those low-income households most in need of assistance would be denied the benefit of the credits if they were not refundable. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

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- Opponents of refundable credits raise four objections: that the tax code should not redistribute income; that the government should not use the tax code to carry out social policies; that everyone should pay some tax as a responsibility of citizenship; and that refundable credits increase administrative and compliance costs and encourage fraud and abuse.
- Like the federal government, states have few refundable tax credits. However, fourteen states—Colorado, Illinois, Indiana, Kansas, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin—and the District of Columbia do provide a refundable EITC. Part of Maryland’s EITC is refundable and part is not. Four states—Delaware, Iowa, Maine, and Virginia—have a nonrefundable EITC.

See Also

Taxation and the Family: What is the earned income tax credit?

Taxation and the Family: What is the child tax credit?

Income Tax Issues: What is the difference between tax deductions and tax credits?

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Author: Roberton Williams
Last Updated: April 9, 2008

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Taxes and the Poor: Can poor families benefit from the child tax credit?

Taxpayers may claim a child tax credit (CTC) of up to \$1,000 per qualifying child under age 17. The CTC is partially refundable, technically as an "additional child tax credit" (ACTC): in 2009 the credit can exceed tax liability by up to 15 percent of earnings above \$3,000. Thus, for example, a family with two or more qualifying children and earnings of \$15,000 may claim a refund of up to \$1,800 over and above any tax liability. However, low-income families that earn \$3,000 or less receive no CTC or ACTC.

- In 2005 more than one-quarter of all qualifying children were in families that could not receive the full CTC because they earned too little. Nearly half of those children were in families that received no credit at all
- The families of nearly half of all black children and 46 percent of Hispanic children received less than the full CTC in 2005 because they earned too little.
- Prior to 2001, only families with three or more children could receive the ACTC. The refundable portion of the CTC was limited to the amount by which a family's Social Security and Medicare taxes exceed their earned income tax credit (EITC). Few families qualified for the ACTC.
- The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the ACTC to equal 15 percent of a family's earnings over a threshold - set at \$10,000 in 2001 and indexed annually for inflation. Indexing the threshold meant that poor families whose earnings failed to keep pace with inflation received less and less ACTC over time.
- The American Recovery and Reinvestment Act of 2009 temporarily reduced the ACTC threshold to \$3,000 for 2009 and 2010, extending refundability to more poor families.
- The ACTC provisions of both EGTRRA and ARRA expire after 2010. Unless Congress acts, the ACTC will again be limited to families with at least three children with significant earnings.

See Also

Taxation and the Family: What is the child tax credit?

Author: Roberton Williams
Last Updated: May 20, 2009

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Taxes and the Poor: Why do low-income families use paid tax preparers?

Many low-income families do not have to file federal income tax returns because they owe no tax, but not filing can cost them tax benefits such as the earned income tax credit (EITC). Those who do file often need help preparing their returns, which nearly always comes from a paid preparer. Getting that help—and associated services such as refund anticipation loans (RALs)—erodes the value of the EITC and other refundable credits for these families. That cost might be worth bearing if preparers help their clients claim tax benefits that otherwise might be missed, but evidence suggests that some families who use paid preparers and qualify for the EITC still fail to claim the credit. On the other hand, some preparers not only do inform their low-income clients of their EITC eligibility, but further help them by identifying nontax forms of assistance for which they might qualify, and some even assist in the application process.

- A majority of low-income families that file tax returns receive help to do so. In 2002, two-thirds of families with income below twice the poverty line (about \$36,500 for a couple with two children, for example) received help, and virtually all used paid preparers. Hispanic and African-American families and families with less than a college education were more likely than the average low-income family to receive help.
- Using a paid preparer does not appear to make tax filers more aware of available tax benefits such as the EITC, but it does increase the likelihood that a filer who knows about the EITC will claim the credit. Roughly 70 percent of low-income tax filers reported knowing about the EITC in 2002, but among those who knew of the credit, about 80 percent of those using paid preparers actually claimed the credit, compared with 70 percent of those who filed on their own.
- Some paid preparers help their low-income clients apply for nontax benefits. For example, one firm provided food stamp applications to all qualifying clients in the largest states, along with assistance in completing and filing the forms.
- Low-income tax filers who use paid preparers can take advantage of refund anticipation loans (RALs), which are immediate cash loans from private lenders, backed by the tax refunds the borrowers have claimed on their prepared returns. RALs proliferated after 1999, when the Internal Revenue Service reinstated the debt indicator program, which allows tax preparers to find out whether a filer's tax refund will be redirected by the Internal Revenue Service to pay that filer's debts. The National Consumer Law Center reports that in 2006 nearly 9 million taxpayers took out RALs. Although that number was down from the 2004 record high of 12.4 million, tax filers still paid nearly \$1 billion in loan and other fees. Another 10.8 million taxpayers spent \$324 million on other types of financial products to receive their refunds more quickly. A 2005 study found that RAL fees for a \$2,000 refund typically ran between \$35 and \$115, resulting in effective annual interest rates between 40 percent and over 700 percent (because of the short duration of the actual loan).
- EITC recipients are much more likely than nonrecipients to take out RALs. In 2006 nearly two-thirds of RALs went to tax filers claiming the EITC, even though they filed just one-sixth of all tax returns.

See Also

Taxation and the Family: What is the earned income tax credit?

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Last Updated: April 22, 2008

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