

Big Changes to the Child Tax Credit for 2021

The American Rescue Plan Act (ARPA) significantly liberalizes the rules for the federal child tax credit, which means more money in the pockets of eligible parents this year. However, the liberalizations are only for the 2021 tax year. Here's the story.

Pre-ARPA Rules

Before the ARPA, there was one set of rules for parents who qualified for the child tax credit. Now, for 2021, there are two. Under prior law, the maximum annual tax credit for 2018 through 2025 was \$2,000 per qualifying child for all taxpayers. A qualifying child was defined as an under-age-17 child who could be claimed as your dependent for the year. Basically, that means the child:

- Lived with you for at least six months during the year,
- Didn't provide over half of his or her own support, and
- Was a U.S. citizen, national or resident.

Before the ARPA, the \$2,000 child credit for 2018 through 2025 was phased out (reduced) if your modified adjusted gross income (MAGI) for the year exceeded \$200,000 (\$400,000 for a married couple who files a joint return). The credit was phased out by \$50 per \$1,000 (or fraction of \$1,000) of MAGI in excess of the applicable phase-out threshold.

Under prior law, the child credit for 2018 through 2025 was partially refundable, meaning you could collect the refundable amount even if you have no federal income tax liability for the year. The refundable credit amount generally equals 15% of your earned income above \$2,500. An alternative formula for determining refundability applies if you have three or more qualifying children. In any case, the maximum refundable credit amount before the ARPA was limited to \$1,400 per qualifying child.

New, Liberalized Rules for 2021

For 2021 only, the ARPA makes the following taxpayer-friendly changes:

Broadened definition of qualifying child. The definition of a qualifying child includes children who are age 17 or younger as of December 31, 2021. As was the case before the ARPA, you must include a qualifying child's name and Social Security number (SSN) on your 2021 tax return to claim a credit for the child. In addition, the SSN must have been issued before the due date for filing your 2021 return.

If you don't meet these SSN requirements for a qualifying child, you can claim a smaller \$500 nonrefundable credit for the child. You also can claim a \$500 nonrefundable credit for the 2021 tax year for a dependent who doesn't meet the ARPA's expanded definition of a qualifying child. The most common situation when this smaller credit will be available is when you have dependent child who will be age 18 or older as of December 31, 2021. However, the smaller credit can also be claimed for other qualifying relatives, as defined by the tax law. The MAGI phase-out rule for this smaller credit is the same as the phase-out rule for the "regular" child credit explained earlier.

Bigger maximum credit, subject to separate income phase-out rule. The maximum child credit is increased to \$3,000 per qualifying child or \$3,600 for a qualifying child who is age 5 or younger as of December 31, 2021. (Parents can claim as many credits as they have qualifying children. There's no limit.) However, the increased credit amounts are subject to their own phase-out rules. So, for 2021, the credit is subject to two sets of phase-out rules:

1. The increased credit amount (\$1,000 or \$1,600, whichever applies) is phased out for single taxpayers with MAGI above \$75,000, for heads of households with MAGI above \$112,500 and for married couples who file joint returns with MAGI above \$150,000. The increased credit amount is phased out by \$50 per \$1,000 (or fraction of \$1,000) of MAGI in excess of the applicable phase-out threshold.
2. The "regular" \$2,000 credit amount is subject to the pre-ARPA phase-out rule explained earlier.

Important: If you're ineligible for the increased child credit amount for the 2021 tax year, you can still claim the regular \$2,000 credit, subject to the pre-ARPA phase-out rules.

The credit is fully refundable for eligible taxpayers. For the 2021 tax year, the child credit is fully refundable if you (or your spouse if you filed a joint return) have a principal place of abode in the United States for more than one-half the year or are a bona fide resident of Puerto Rico for the year. For the 2021 tax year, if you're a member of the U.S. Armed Forces who is stationed outside the United States while serving on extended active duty, you're treated as having a principal place of abode in the United States.

The MAGI phase-out rules explained earlier apply in determining your allowable fully refundable child credit for the 2021 tax year.

IRS will make advance payments, starting in July. Pursuant to another ARPA provision, the IRS is directed to establish a program to make monthly advance payments of the child credit (generally via direct deposits). Such advance payments will equal 50% of the IRS's estimate of the taxpayer's allowable credit for the 2021 tax year.

These advance payments will be made in equal monthly installments in July through December of this year. To estimate your advance child credit payments, the IRS will look at the information presented on your 2020 Form 1040 or on your 2019 return if your 2020 return hasn't yet been filed.

However, if IRS determines that it's not feasible to make monthly advance credit payments, it can make advance payments based on a longer interval and adjust the amount of the advance payments accordingly.

If you receive advance child credit payments in excess of your allowable credit for the 2021 tax year, you'll generally have to repay the excess in the form of an increase in the federal income tax liability shown on your 2021 return. However, you may be allowed to keep some or all of the excess payments under a safe-harbor rule, if your MAGI is below \$80,000 (\$100,000 for heads of households or \$120,000 for married couples who file joint returns).

For example, Olivia is entitled to a child credit of \$6,000 for 2021, based on her two qualifying children. Under the advance credit payment deal, the IRS would advance a total of \$3,000 to Olivia (50% of her allowable credit) via monthly payments of \$500 each for July through December. Olivia would collect her remaining credit of \$3,000 after filing her 2021 return.

To facilitate the advance payment deal, the IRS is supposed to create an online portal that will allow taxpayers to:

- Change the number of their qualifying children,
- Change their marital status,
- Reflect significant changes in income, and
- Update other factors as determined by the IRS.

Important: These changes are only temporary. After 2021, the child credit rules that were in place before the ARPA will apply through 2025, unless Congress takes action to change the rules.

Who Qualifies for the Expanded Credit?

The rules for qualifying for the newly expanded child credit are complicated. (See main article.) Here are a couple examples to help clarify who's eligible and who's not.

1. Xavier will file as a head-of-household with MAGI of \$140,000 for 2021. He has one qualifying child who will be 12 as of December 31, 2021. Unfortunately, Xavier doesn't qualify for the increased credit of up to \$1,000, because his MAGI is too high. The increased credit of up to \$1,000 is phased out at the rate of \$50 for each \$1,000 of Xavier's MAGI over the \$112,500 phase-out threshold for a head of household filer.

His MAGI exceeds the threshold by \$27,500 (\$140,000 - \$112,500), which is rounded up to \$28,000. The allowable increased credit amount is reduced, but not below zero, by \$1,400 (\$50 x 28). So, the phase-out rule completely wipes out the increased credit.

However, because Xavier's MAGI is under the \$200,000 phase-out threshold for the "regular" child credit, he can claim the maximum \$2,000 "regular" credit for 2021. In addition, Xavier's credit for 2021 is fully refundable. He can collect the allowable credit amount even if he has no 2021 federal income tax liability due to lower MAGI and/or other tax breaks for which he is eligible

2. Sara will file as a head-of-household with MAGI of \$110,000 for 2021. She has one qualifying child who will be 9 as of December 31, 2021. Because her income is below the \$112,500 phase-out threshold for the increased child credit of up to \$1,000 for a 9-year-old child, Sara can collect the full increased credit of \$1,000 on top of the full "regular" credit for a total child credit of \$3,000.

In addition, Sara's credit for 2021 is fully refundable. She can collect the allowable credit amount even if she has no 2021 federal income tax liability due to lower MAGI and/or other tax breaks for which she is eligible.

Important: If Sara's child will be age 5 or younger as of December 31, 2021, Sara can collect the full increased credit of \$1,600 on top of the "regular" credit for a total child credit of \$3,600.

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