COVID-19 and Direct Payments to Individuals: Considerations on Using Advanced Refundable Credits as Economic Stimulus

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In response to concerns about an economic slowdown stemming from the COVID-19 pandemic, policymakers have been considering a broad array of policy options. Some are targeted directly toward the individuals and industries that may be most affected. Others would more broadly seek to stimulate the economy. Among this latter category of policies, some have suggested a payroll tax cut, while others have proposed direct cash payments—"recovery rebates"—to virtually all households. One mechanism to provide cash payments relatively quickly is to create a new refundable tax credit and then advance it to households before they would otherwise claim it on their income tax returns. A similar policy was enacted most recently in 2008. This Insight addresses some common questions about advanced refundable tax credits.

What is a refundable tax credit?

Tax credits reduce income taxes owed dollar for dollar; each dollar in tax credit is a one-dollar subtraction from income tax liability. Nonrefundable credits are limited by the taxpayer's income tax liability, while refundable credits are not. Hence, taxpayers with little to no income tax liability—including many low-income taxpayers—can benefit from refundable tax credits. Refundable tax credits targeted toward low-income individuals and families are estimated to have relatively large stimulative effects compared to other policies—a large "bang for the buck"—because low-income populations tend to spend these amounts quickly. Some economists were concerned that the 2008 credit would not be effective because a lump-sum payment might be saved rather than spent. Empirical evidence based on studying a prior rebate found, however, that the rebate was largely spent.

Current refundable tax credits—the earned income tax credit (EITC) and the refundable portion of the child credit—benefit low-income families that include workers and children. These tax credits are received once a year when federal income tax returns are filed. Tax credit amounts are primarily based on...
What does “advancing” a tax credit mean?

Advancing a tax credit effectively means issuing a tax credit for a given year before the tax return for that year has been filed (and before income taxes for that year have been calculated). The 2008 recovery rebates for individuals included in P.L. 110-185 were refundable tax credits against 2008 income taxes. However, taxpayers did not need to wait to file their 2008 income tax returns in early 2009 to receive these credits. Instead, the law allowed the IRS to advance these credits in 2008, basing the advanced amount on income and family structure information from tax returns filed for the 2007 tax year. The credit equaled up to $600 per person ($1,200 for joint filers), with an additional $300 per dependent child. Lower-income taxpayers tended to receive a smaller credit, while the credit phased out for taxpayers with incomes over $75,000 ($150,000 for married joint filers).

Advancing tax credits based on prior data can pose challenges if any of the parameters used to calculate the credit—like income and number of children—change from these prior values. For example, if a taxpayer’s 2019 income is significantly greater than their income at the end of 2020, an advanced credit estimated based on 2019 income may be larger than what a taxpayer is ultimately eligible for in 2020. (Even if an advanced payment is a fixed amount per person [does not vary by income], the final amount can still vary if family structure changes during the year.) This could result in taxpayers having to pay back the excess credit when they file their 2020 income tax returns (in early 2021). Insofar as this is a concern, policymakers can limit how much taxpayers have to pay back (for example, as is done with the advanced premium assistance tax credit), or they can bar repayments of excess advanced payments entirely, as was done with the 2008 recovery rebates.

How long would it take for the IRS to begin issuing advanced credits?

Past experiences with the IRS issuing advanced refundable tax credits may provide some guide on how long these policies take to implement. On January 28, 2008, H.R. 5140, which included the 2008 recovery rebates for individuals, was introduced in the House. Two weeks later, on February 13, 2008, it was enacted as P.L. 110-185. Sixty-two days later, the IRS began issuing the first one-time rebate checks. More than 120 million taxpayers received their payments by mid-July 2008. Taxpayers who had filed their 2007 tax returns and received a refund via direct deposit also received the 2008 recovery rebates via direct deposit. Otherwise, paper checks were mailed out to taxpayers using address information from 2007 income tax returns. A 2007 tax return had to be filed to receive a recovery rebate check. Those who did not receive a recovery rebate check could claim the benefit when filing a 2008 income tax return.

How many individuals could receive an advanced refundable tax credit?

One concern that some have about using the federal tax system to administer direct cash payments to households is that not all individuals in the United States file income tax returns—either because their income is below the filing threshold or because they are not complying with federal tax laws. A 2017 CBO analysis estimated that of 292.6 million individuals who could be included on a federal income tax return (as the taxpayer, spouse, or dependent), 251.9 million were actually included—or 86%. The study estimated that the greatest share of nonfilers were lower-income individuals, especially those 65 years or older. As was noted above, the 2008 recovery rebate could be claimed by taxpayers who did not file a
2007 tax return. These nonfilers—which included many low-income individuals and seniors—could claim the credit on their 2008 returns when they filed them in 2009. The federal income tax system is limited in its ability to provide cash assistance to individuals quickly, particularly when those individuals are nonfilers.

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