

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: District Counsel, Pennsylvania District, Philadelphia
CC:NER:PEN:PHI, Attn: Carol-Lynn E. Moran

from: Assistant Chief Counsel (Income Tax & Accounting) CC:DOM:IT&A

subject: Significant Service Center Advice Request, Child Tax Credit

This responds to your request for Significant Advice, dated June 2, 1999, in connection with a question posed by the Philadelphia Service Center. In addition to answering your specific question, which concerned the refundable portion of the child tax credit, we also have discussed the treatment of the nonrefundable portion of that credit.

Disclosure Statement

Unless specifically marked "Acknowledged Significant Advice, May be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in CCDM (35)2(13)3:(4)(d) and (35)2(13)4:(1)(e). This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the question discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.

Issues

1. Does an overstatement of the nonrefundable portion of the child tax credit under § 24(a) of the Internal Revenue Code result in a deficiency that may be assessed under the deficiency procedures?
2. Does an overstatement of the refundable portion of the child tax credit under § 24(d) result in a deficiency that may be assessed under the deficiency procedures?

Conclusions

1. Yes. As in the case of any other nonrefundable credit, an overstatement of the nonrefundable portion of the child tax credit results in an assessable deficiency.
2. No. Because § 6211 was not modified, in a manner similar to the treatment of the earned income credit in § 32, to treat the refundable portion of the child tax credit under § 24(d) as "negative tax," an overstatement of that portion of the child tax credit does not result in a deficiency. A refund based on § 24(d) may be recovered through the erroneous refund procedures of § 7405 within the time limits of § 6532(b).

Facts

The issues are demonstrated by the following hypothetical examples:

Example 1:

Taxpayer filed a 1998 tax return as head of household showing income of \$27,750, five exemptions, Social Security tax withholdings of \$890, and an earned income credit of \$489. Taxpayer claimed the child tax credit for four qualifying children. Taxpayer calculated the tax as follows:

Adjusted Gross Income	\$27,750
Standard Deduction	(6,250)
Exemptions	<u>(13,500)</u>
Taxable Income	8,000
Tax	1,204
Nonrefundable Portion of Child Tax Credit	<u>(1,204)¹</u>
Net Tax	0
Portion of Child Tax Credit Refundable under § 24(d)	396 ²

Earned Income Credit

¹ Child tax credit of \$1,600 limited to \$1,204 by § 26 as in effect for 1998.

² The refundable credit under § 24(d) is limited to the lesser of (1) the credit that would be allowed under § 24 without the § 26 limitation [\$396], or (2) the excess of the Social Security taxes over the earned income credit [\$890 - \$489 = \$401].

Refundable under § 32 489

The Service later determined that Taxpayer could take a child tax credit for only three qualifying children. Taxpayer's tax liability was recomputed as follows:

Tax	\$1,204
Nonrefundable Portion of Child Tax Credit	(1,200)
Nonrefundable Portion of the Earned Income Credit	<u>(4)</u>
Net Tax	0

Earned Income Credit
Refundable under § 32 485

Example 2:

Taxpayer filed a 1998 tax return as head of household showing income of \$49,251, itemized deductions of \$22,553, six exemptions, and Social Security tax withholdings of \$3,767. Taxpayer was not eligible for the earned income credit. Taxpayer claimed the child tax credit for five qualifying children. Taxpayer calculated the tax as follows:

Adjusted Gross Income	\$49,251
Itemized Deductions	(22,553)
Exemptions	<u>(16,200)</u>
Taxable Income	10,498
Tax	1,571
Nonrefundable Portion of Child Tax Credit	<u>(1,571)³</u>
Net Tax	0
Portion of Child Tax Credit Refundable under § 24(d)	429 ⁴

³ Child tax credit of \$2,000 limited to \$1,571 by § 26 as in effect for 1998.

⁴ The refundable credit under § 24(d) is limited to the lesser of (1) the credit that would be allowed under § 24 without the § 26 limitation [\$429], or (2) the excess of the Social Security taxes over the earned income credit [\$3,767 - \$0 = \$3,767].

The Service later disallowed a \$1,256 deduction. Taxpayer's tax liability was recomputed as follows:

Taxable Income per Return	\$10,498
Disallowed Deduction	<u>1,256</u>
Corrected Taxable Income	11,754
Tax	1,766
Nonrefundable Portion of Child Tax Credit	<u>(1,766)⁵</u>
Net Tax	0
Portion of Child Tax Credit Refundable under § 24(d)	234

Discussion

As demonstrated by the examples above, § 24, which was enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997), and became effective in 1998, generally provides a credit of \$500 (\$400 for 1998) for each "qualifying child." A qualifying child must be a dependent who is under age 17 at year-end. The credit is phased out at higher income levels.

In general, tax credits are either nonrefundable or refundable. Nonrefundable credits may be applied to reduce tax, and certain excess nonrefundable credits may be carried to other years. However, unlike excess refundable credits, they may not be "refunded" to taxpayers in the year they arise. Nonrefundable personal credits are listed in subpart A of part IV, subchapter A, chapter 1, of the income tax subtitle ("subpart A"). Refundable credits are listed in subpart C of the same part ("subpart C").

The distinction between nonrefundable and refundable credits is reflected in two provisions of the Code relevant to the issues above. First, § 26 generally limits a taxpayer's total personal nonrefundable credits in subpart A to the taxpayer's "regular tax liability."⁶ Second, § 6401(b)(1) provides that if the refundable credits in subpart C exceed the taxpayer's liability, the excess is considered an overpayment that may be refunded under § 6402.

⁵ Child tax credit of \$2,000 limited to \$1,766 by § 26 as in effect for 1998.

⁶ Cf. § 38(c) (similar limit for business credits). For tax years other than 1998, § 26 limits subpart A credits to the excess of the regular tax over the tentative minimum tax.

With respect to these distinctions, the child tax credit in § 24 has a hybrid character. In general, it operates like the other nonrefundable credits in subpart A, such as the dependent care credit or the adoption credit. However, § 24(d) provides that in the case of a taxpayer with three or more qualifying children, "the aggregate credits allowed under subpart C shall be increased by" the amount of the child care credit disregarding the tax liability ceiling in § 26, up to the taxpayer's Social Security taxes for the year, reduced by any earned income credit. Consistent with this treatment, § 24(d) also provides that the portion of the child tax credit allowed under § 24(d) is not treated as a credit allowed under subpart A. For taxpayers with three or more qualifying children, this effectively splits the child tax credit into two portions: one nonrefundable under subpart A, the other refundable under subpart C.

Issue 1: Nonrefundable Portion of Child Tax Credit

Section 6211 provides the definition of "deficiency," in pertinent part, as follows:

(a) In General.-For purposes of this title ... the term "deficiency" means the amount by which the tax imposed ... exceeds the excess of-

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over-

(2) the amount of rebates, as defined in subsection (b)(2), made.

The basic definition in § 6211(a) is often expressed in the following formula: deficiency = correct tax (or "tax imposed") - [tax reported (or "tax shown on return") + prior assessments - rebates⁷]. See Kurtzon v. Commissioner, 17 T.C. 1542, 1548 (1952).

⁷ A "rebate" is an abatement, credit, or refund that was made on the ground that the correct tax was less than the tax as previously reported or adjusted. § 6211(b)(2). A refund that is claimed on a taxpayer's original return is not a rebate.

It has been argued that credits cannot be taken into account in the definition of a "deficiency" at all, because they are "amounts allowed as a credit against tax," rather than elements of the "tax" itself. However, with respect to nonrefundable credits such as the dependent care credit or the investment tax credit, it is settled that such credits are part of the "correct tax" and the "tax reported" in the deficiency definition.

In Martz v. Commissioner, 77 T.C. 749 (1981), for example, the Tax Court held that the Service properly included in its deficiency determination an adjustment to the taxpayer's investment credit, in addition to its adjustments to the taxpayer's taxable income. In so holding, the court stressed Congress' action in specifically removing certain credits from the deficiency calculation in § 6211(b),⁸ and reasoned by negative inference that "all taxes, credits, deductions, exclusions, etc., imposed or allowed in ... subtitle A ... , are to be taken into consideration in calculating the existence of a deficiency. Section 6211(b) provides exceptions to this general proposition." 77 T.C. at 753; see also Arc Electrical Construction Co. v. Commissioner, 923 F.2d 1005, 1008-1009 (2d Cir. 1991); Logan v. Commissioner, 86 T.C. 1222, 1227 (1986).

As discussed above, the child tax credit has a hybrid character: part nonrefundable and part refundable. To the extent it is nonrefundable, we see no reason to treat the child tax credit differently from the other nonrefundable credits in subpart A. Accordingly, we conclude that an overstatement of the nonrefundable portion of the child tax credit results in a deficiency within the meaning of § 6211, and can be assessed and collected following the deficiency procedures in chapter 63, subchapter B. Thus, if, in Example 1 above, the Service had determined that the taxpayer was not entitled to the child tax credit at all, the erroneous \$1,204 nonrefundable portion of the child tax credit would have been assessable as a deficiency.⁹

⁸ Section 6211(b)(1) provides as follows:

(1) The tax imposed by subtitle A and the tax shown on the return shall both be determined without regard to payments on account of estimated tax, without regard to the credit under section 31, without regard to the credit under section 33, and without regard to any credits resulting from the collection of amounts assessed under section 6851 or 6852 (relating to termination assessments).

⁹ Section 32(n) provides that in certain circumstances, a portion of the child tax credit is technically designated as a "supplemental child credit." This is merely a mechanism for

Issue 2: Refundable Portion of Child Tax Credit

Section 6211(b)(4) provides special treatment for the recovery of certain refundable credits through the deficiency procedures by treating those amounts as "negative tax" in the deficiency determination, as follows:

(4) For purposes of subsection (a)-

(A) any excess of the sum of the credits allowable under sections 32 and 34 over the tax imposed by subtitle A (determined without regard to such credits), and

(B) any excess of the sum of such credits as shown by the taxpayer on his return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits),

shall be taken into account as negative amounts of tax.

The operation of § 6211(b)(4) can be illustrated by an example involving the earned income credit, a refundable credit listed in subpart C, as follows:

Taxpayers filed a joint return, claiming one dependent, three exemptions, and reporting \$6,000 of adjusted gross income, all of which was earned income. Taxpayers showed zero tax due and claimed an earned income credit of \$500, which was refunded to Taxpayers. The Service later determined that Taxpayers had an additional \$1,000 of earned income. The Service calculated that Taxpayers had a tax liability of \$81 and were entitled to an earned income credit of \$378.

A deficiency of \$203 would be calculated under § 6211 as follows:

Correct Tax	
Without Earned Income Credit	\$81
With Earned Income Credit (§ 6211(b)(2)(A))	<u>(378)</u>

counting part of the child tax credit as earned income credit for revenue estimating purposes. Section 32(n) does not transform a nonrefundable child tax credit into a refundable credit or affect the amount of a taxpayer's tax liability. Accordingly, the Service is not requiring taxpayers to calculate the supplemental child "credit" or reflect it on a return. Our conclusions with respect to the nonrefundable portion of the child tax credit apply regardless of whether it is technically a "supplemental child credit."

	(297)
Reported Tax	
Without Earned Income Credit	0
With Earned Income Credit (§ 6211(b)(2)(B))	<u>(500)</u>
	(500)
Correct Tax	(297)
Less Reported Tax	<u>-(500)</u>
Deficiency	203

By expressly treating the refundable portion as "negative tax," the operation results in a positive amount for the deficiency, since subtracting a negative amount is the equivalent of addition.

However, when Congress enacted the child tax credit, it did not add corresponding language to § 6211(b)(4) to cover the portion of the credit that is refundable under § 24(d), or otherwise provide for assessment of that amount. Therefore, on the principle of statutory construction that the expression of one thing implies the exclusion of another, because the portion of the child tax credit that is refundable under § 24(d) is not listed in § 6211(b)(4), we conclude that the Service may not treat that amount as "negative tax" in making the deficiency determination.

Applying these principles to the examples above, as we concluded under Issue 1, the nonrefundable portion of the child tax credit is taken into account in calculating the deficiency. However, because the portion refundable under § 24(d) cannot be treated as negative tax, the deficiencies in the above examples would be calculated under § 6211 as follows:

	<u>Ex. 1</u>	<u>Ex. 2</u>
Tax Imposed	\$(485)	\$0
Tax Shown on Return	<u>-(489)</u>	<u>-0</u>
Deficiency	4	0

Note that this conclusion will, in some circumstances, prevent the Service from recovering a refund through assessment even when the adjustment in question involves an item other than the child tax credit. In Example 2 above, for example, the operation of §§ 24 and 6211 results in no deficiency, so that the Service is precluded from recovering by deficiency procedures the tax attributable to the disallowed deduction.

Although we conclude that an erroneous § 24(d) child tax credit refund cannot be recovered through assessment, it is still an "erroneous refund" resulting in a liability that can be

recovered, either through voluntary repayment or civil suit under § 7405, within the two-year limitations period of § 6532(b). It is settled that the Service has the option of employing this alternative means of recovering a refund, see Midland Mortgage Co. v. Commissioner, 73 T.C. 902 (1980), although for several reasons the Service generally employs assessment procedures where available.

Our conclusion that the refundable portion of the child tax credit is not part of a "deficiency" does not seem to have been intended by Congress. This office has suggested that legislation be proposed to correct the situation by including a reference to § 24(d) in § 6211(b)(4).¹⁰ In the absence of such legislation, however, the portion of the child tax credit that is refundable under § 24(d) cannot be included in a deficiency determination.

If you have any questions or comments regarding this matter, please call Amy Pfalzgraf at (202) 622-4930.

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By: _____
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¹⁰ If § 24 were included in § 6211(b)(4), deficiencies in the above examples would be calculated under § 6211 as follows:

	<u>Ex. 1</u>	<u>Ex. 2</u>
Tax Imposed	\$ (485)	\$(234)
Tax on Return	<u>-(396 + 489)</u>	<u>-(429)</u>
Deficiency	400	195