Tax Insights

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Here come the child tax credit payments: What you need to know

The first advance payments under the temporarily expanded child tax credit (CTC) will begin to arrive for nearly 39 million households in mid-July 2021 - unless, that is, they opt out. Most eligible families won't need to do anything to receive the payments, but you need to understand the implications and why advance payments might not make sense for your household even if you qualify for them.

Understanding the CTC, then and now

The CTC was established in 1997. Unlike a deduction, which reduces taxable income, a credit reduces the amount of taxes you owe on a dollar-for-dollar basis. While some credits are limited by the amount of your tax liability, others, like the CTC, are refundable, which means that even taxpayers with no federal tax liability can benefit. Historically, the CTC has been only partially refundable in that the refundable amount was limited to $1,400.

The American Rescue Plan Act (ARPA) significantly expands the credit, albeit only for 2021. Specifically, the ARPA boosts the CTC from $2,000 to $3,000 per child ages six through 17, with credits of $3,600 for each child under age six. Plus, the CTC is now fully refundable. It also affords taxpayers the opportunity to take advantage of half of the benefit in 2021, rather than waiting until tax time in 2022.

Note, however, that there are limits to eligibility. The $2,000 credit is subject to a phaseout when income exceeds $400,000 for joint filers and $200,000 for other filers, and this continues under the ARPA - for the first $2,000. A separate phaseout applies for the increased amount: $75,000 for single filers, $112,500 for heads of household and $150,000 for joint filers.

Receiving advance payments

The ARPA directed the U.S. Treasury Department to begin making monthly payments of half of the credit in July 2021, with the remaining half to be claimed in 2022 on 2021 tax returns. For example, a household that's eligible for a $3,600 CTC will receive $1,800 ($300 in six monthly payments) in 2021 and would claim the balance of $1,800 on the 2021 return. The payments will be made on the 15th of each month through December 2021, except for August, when they'll be paid on August 13.

To qualify for advance payments, you (and your spouse, if filing jointly) must have:

- Filed a 2019 or 2020 tax return that claims the CTC or provided the IRS with information in 2020 to claim a stimulus payment,

- A main home in the United States for more than half of the year or file a joint return with a spouse who has a U.S. home for more than half of the year,
- A qualifying child who's under age 18 at the end of 2021 and who has a valid Social Security number, and
- Earned less than the applicable income limit.

If the IRS has your bank information, you'll receive the payments as direct deposits.

Because the IRS will base the payments on your 2020 tax return (or, if not yet available, your 2019 return), it's possible that you could receive excess payments over the amount you actually qualify for in 2021. In that case - unlike excess stimulus payments - you'll be required to repay the excess. The IRS will either deduct the amount from your 2021 refund or add it to the amount you owe.

Opting Out

The IRS will automatically enroll taxpayers for advance payments, but it's also providing an online portal at irs.gov where taxpayers can opt out. You might consider opting out if, for example, you were near the income limits in 2019 or 2020, expect to earn more in 2021, and want to avoid excess payments. Be aware that couples filing jointly must both opt out, otherwise the spouse who doesn't will receive half of the joint payment.

It's not only a change in expected income that could lead to excess payments; it's also a change in the number of dependents. For example, divorced couples who share joint custody may alternate the years in which they claim their children as dependents for CTC purposes. If 2021 is your former spouse's year, consider opting out (your former spouse won't receive the advance payments based on his or her 2020 tax return but, if eligible, can claim the credit on the 2021 return). Parents of children who will turn age 18 in 2021 also should consider opting out.

The deadline to opt out of the first payment was June 28, 2021, but you can still opt out for future payments.

Estimating – and reducing – 2021 income

When deciding whether to opt out, you can estimate your 2021 income using multiple methods. You could simply look at your modified adjusted gross income on your most recent tax return. You also could project your income for the year and reduce it by the standard deduction (for 2021, it's $12,550 for individual taxpayers and $25,100 for married couples filing jointly).

If you estimate that your income will be near the eligibility threshold but want to receive the advance payments, you can take measures to reduce your income before year end. You might, for example, increase your 401(k) plan contributions (the contribution limit for 2021 is $19,500). Taxpayers with high deductible health plans and health savings accounts (HSAs) can similarly reduce their income with contributions. The HSA contribution limits for 2021 are $3,600 for individual health plans and $7,200 for family health plans.

Beyond 2021

The expanded CTC is available only for 2021 as of now. President Biden has indicated that he'd like to extend it through at least 2025, and some Democratic lawmakers hope to make it permanent. But it'll be challenging to pass a bill to make either of these proposals happen. We'll keep you informed about any developments that could affect your tax planning. Contact us for more information.