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Dependent Care: Current Tax Benefits and Legislative Issues

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Summary

In the 2000 census, for over 60% of the households with children under 6, all parents in the household worked. For families with both parents working or a single working parent family, care for young children and individuals who are physically or mentally unable to care for themselves is critical to maintaining participation in the workforce. To assist these families current law provides two tax benefits related to dependent care: the dependent care credit and the exclusion from income for employer-provided dependent care assistance programs. Both provisions are for employment-related expenses for the care of dependents under the age of 13, or dependents (or a spouse) who are physically or mentally incapable of caring for themselves.

Legislation has been introduced in the 108th Congress that would clarify the tax treatment of dependent care programs for military personnel (H.R. 878, H.R. 1307, H.R. 1664, H.R. 3365, S. 19, S. 235, S. 289, and S. 351). H.R. 3365 passed both houses and was signed into law (P.L. 108-121) on November 11, 2003.

Other legislation introduced in the 108th Congress would eliminate the 2010 sunset for the dependent care provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16) (H.R. 210, H.R. 407, H.R. 493, H.R. 1612, and S. 96): make the credit refundable (H.R. 493 and S. 2030); expand the credit (H.R. 181, H.R. 936, H.R. 3666, S. 388, S. 448, and S. 1253); simplify the calculation of the credit (H.R. 22); provide a uniform definition of a child (H.R. 22, H.R. 936, H.R. 2392, H.R. 2718, H.R. 4132, S. 448, S. 755, S. 1173, S. 1174, and S. 1434); or expand the exclusion from income for employer-provided dependent care assistance programs (H.R. 4372 and H.R. 4379).

The Administration's budget proposal, and the House and Senate budget resolutions (H.Con.Res. 393 and S.Con.Res. 95) contain provisions which may impact tax benefits for dependent care. This report will be updated as legislative activity warrants.

Current Tax Benefits for Dependent Care

There are two current law tax provisions for dependent care: the dependent care tax credit (DCTC) and the exclusion from income for employer-provided dependent care assistance programs (DCAP). Both provisions use the same definitions of qualified employment related expenses and qualifying dependents.

Qualified employment-related expenses are those expenses for household services and care of a qualifying dependent necessary for the taxpayer to be employed. For the purposes of qualified employment-related expenses, a qualifying dependent is a:

- dependent less than 13 years of age for whom the taxpayer can claim a personal exemption;
- dependent of the taxpayer who is physically or mentally incapable of caring for themself; or
- spouse of the taxpayer who is physically or mentally incapable of caring for themself.

A family may pay either a private individual or a dependent care center for dependent care. A dependent care center is a facility that provides care for more than six individuals who are not residents and receives a fee or other payment for providing those services. However, payments to a dependent care center are qualified expenses only if the center meets all applicable state and local laws and regulations. Qualified expenses do not include payments to a child of the taxpayer under the age of 19, or payments to an individual the taxpayer can claim as a dependent for the personal exemption.

Dependent Care Credit (DCTC). The DCTC is calculated as a percentage (as high as 35% beginning in tax year 2003) of qualified employment-related expenses for qualifying dependents. In addition to meeting the requirements for employment-related expenses and a qualifying dependent, a taxpayer must maintain the household. That is, the taxpayer must provide more than 50% of the household expenses.

The qualified employment-related expenses for the DCTC, beginning in tax year 2003, are actual expenses capped at $3,000 for one dependent and $6,000 for two or more dependents. If the taxpayer has two or more children, the $6,000 need not reflect $3,000 per child. The per child allocation does not matter as long as part of the $6,000 is spent on each child. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) raised the expense limits from $2,400 for one child and $4,800 for two or more children, and increased the credit percentage from 30% to 35%, beginning in tax year 2003. EGTRRA also increased the income level at which the credit rate begins to phase down resulting in a higher credit rate for incomes between $10,000 and $43,000. The EGTRRA increases will sunset at the end of 2010, and the DCTC will revert to tax year 2002 levels.

For married taxpayers, the qualified expenses are also limited to the lesser of the taxpayer's or spouse's earned income. If the spouse is a full-time student or incapable of caring for themself they are often not employed and earning income. A special rule exists for this situation. Each month that the spouse is a full time student or incapable of caring for themself, the spouse's income for purposes of calculating the credit is assumed to be $200 for one child, and $400 for two or more children. If the spouse is a full-time student

all year, this results in an income for purposes of the credit equal to the tax year 2002 qualified expense levels of $2,400 for one child and $4,800 for two or more children.

Married taxpayers must generally file a joint return to take the DCTC, but special rules exists for couples who are legally separated or living apart. The 35% rate is reduced by 1% point for each $2,000 (or fraction thereof) by which income exceeds $15,000, but the rate is not reduced below 20%. As shown in **Table 1**, the credit is 20% at incomes above $43,000.

Table 1. Maximum Dependent Care Tax Credit by Level of Income

Adjusted gross income			Maximum credit based on number of qualifying individuals	
Over	**But not over**	**Applicable credit rate**	**One ($3,000 in qualified expenses)**	**Two or more ($6,000 in qualified expenses)**
$0	$15,000	0.35	$1,050	$2,100
15,000	17,000	0.34	1020	2,040
17,000	19,000	0.33	990	1,980
19,000	21,000	0.32	960	1,920
21,000	23,000	0.31	930	1,860
23,000	25,000	0.30	900	1,800
25,000	27,000	0.29	870	1,740
27,000	29,000	0.28	840	1,680
29,000	31,000	0.27	810	1,620
31,000	33,000	0.26	780	1,560
33,000	35,000	0.25	750	1,500
35,000	37,000	0.24	720	1,440
37,000	39,000	0.23	690	1,380
39,000	41,000	0.22	660	1,320
41,000	43,000	0.21	630	1,260
43,000	No limit	0.20	600	1,200

Source: Table prepared by the Congressional Research Service (CRS).

On the tax form, the DCTC is one of several nonrefundable tax credits[1] taken against the sum of regular and alternative minimum tax liability. In tax year 2000, a total of 26.3 million returns used the DCTC for a total credit of $19.6 billion. The nonrefundable nature of the credit results in many lower income taxpayers not being able to fully utilize the credit. For example, in tax year 2003, a married couple with two children, claiming

[1] Other nonrefundable credits include those for education, retirement savings, adoption, and the child credit (which is refundable for certain taxpayers).

a standard deduction and qualifying expenses of $6,000, would not have taxable income and taxes to offset with the credit until their total income was over $21,700 (the value of personal exemptions and the standard deduction). As shown in **Table 2**, it is not until income is above $35,000 that this married couple would be able to fully utilize the credit.

Table 2. Utilization of the DCTC by Income Level for a Married Couple with Two Children, Tax Year 2003

Gross income	Personal exemptions and standard deduction	Taxable income	Tax before credits	DCTC
$10,000	$21,700	$ -	$ -	$ -
15,000	21,700	-	-	-
20,000	21,700	-	-	-
25,000	21,700	3,300	330	330
30,000	21,700	8,300	830	830
35,000	21,700	13,300	1,330	1,330
40,000	21,700	18,300	2,045	1,320
45,000	21,700	23,300	2,795	1,200
50,000	21,700	28,300	3,545	1,200
55,000	21,700	33,300	4,295	1,200
60,000	21,700	38,300	5,045	1,200
65,000	21,700	43,300	5,795	1,200

Source: Table prepared by the Congressional Research Service (CRS).

Employer-provided Dependent Care Assistance Programs (DCAP)

A taxpayer can exclude from income up to $5,000 paid or incurred by an employer for qualified dependent care expenses under an employer-provided DCAP. The DCAP definitions for qualified dependent care expenses and qualified dependent are the same definitions as for the DCTC. An employer can provide direct payment to child care providers, provide on-site child care, or reimburse parents for child care they obtain. Similar to the DCTC, payments made to a dependent of the taxpayer or a child of the taxpayer under age 19 are not excluded from income.

These arrangements are often funded through salary reduction agreements. Under a salary reduction agreement, the employee agrees that a specified amount be set aside for the employer's DCAP[2]. The employer DCAP must be a written plan meeting certain rules for nondiscrimination among employees, but need not be funded by the employer. By using a salary reduction, an employee receives the benefit of the income exclusion during the tax year rather than at year's end. The tax savings from using a DCAP include for

[2] The plan will then reimburse the employee from the set aside amount (employee contributions) for dependent care expenses. This type of arrangement is also known as a flexible spending arrangement or flexible spending account, and is often offered as part of a cafeteria benefit plan, in which employees may choose from one or more taxable or nontaxable benefits.

federal taxes, the income set aside times the taxpayer's marginal tax rate;[3] the payroll taxes on the income set aside (if the taxpayer's income exceeds the maximum amount subject to payroll taxes there is no payroll tax savings); and any applicable state taxes on the income set aside. Therefore, for any given amount set aside, the higher the taxpayer's tax brackets (at the federal and state level) the greater the potential savings from using a DCAP.

The Employee Benefits Research Institute (EBRI) reports[4] that in 2002, 21% of employers with 10 or more employees offered a flexible spending arrangement (under a Section 125 Cafeteria Plan), and 14% of eligible employees participated in a dependent care flexible spending arrangement. The average contribution to a flexible spending arrangement was $3,024.

Interaction between the DCTC and the DCAP. Although both provisions use the same definition of employment-related expenses, the same expenses cannot be used for both the DCTC and DCAP. Taxpayers must choose between the two tax provisions for the same qualified dependent care expenses. For taxpayers in tax brackets higher than the DCTC credit rate, the DCAP using a salary reduction arrangement is more advantageous. However, because the DCTC has a higher limit ($6,000) in the case of two or more children, a higher income taxpayer may use up to $5,000 in a DCAP with a salary reduction, and use $1,000 of taxpayer paid employment-related expenses for the DCTC.

Current Legislative Issues

The legislative issues in the 108th Congress for the dependent care tax provisions can be broken down into three categories:

- Clarification for military personnel. Several bills have been introduced which would clarify that dependent care assistance programs for military personnel qualify as a military benefit and are excluded from income. Bills clarifying the tax treatment of military dependent care assistance programs are H.R. 878, H.R. 1307, H.R. 1664, H.R. 3365, S. 19, S. 235, S. 289, and S. 351. H.R. 3365 passed both houses and was signed into law (P.L. 108-121) on November 11, 2003.

- EGTRRA . Legislation has been introduced which would eliminate the current sunset for the changes to the credit made by EGTRRA. At the end of 2010, the sunset would result in a lower qualified expense limitation, and a lower credit rate, particularly for taxpayers between $10,000 and $43,0000. Bills containing a provision to eliminate the sunset for the EGTRRA provisions related to the credit are H.R. 210, H.R. 407, H.R. 493, H.R. 1612, and S. 96.

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[3] The marginal tax rate is the tax rate on an additional dollar of income.

[4] Employee Benefit Research Institute (EBRI), *Facts from EBRI, Flexible Spending Accounts*, October 2003. Data cited in the EBRI report are from a study by Mercer Human Resource Consulting.

- Other changes. Legislation has been introduced for a wide range of changes including:

  - making the DCTC refundable (H.R. 493, which also repeals the sunset for the EGTRRA provisions related to the credit, and S. 2030 which also expands the credit to include respite care).
  - expanding the credit by making one or more of the following changes: raising the credit rate; the income level at which the credit rate phases down; inclusion of non-working taxpayers or stay-at-home parents; including respite care; or raising the age of a dependent child (H.R. 181, H.R. 936, H.R. 3666, S. 388, S. 448, and S. 1253)
  - setting the qualified expenses at a single dollar amount and setting one credit rate to simplify the credit (H.R. 22)
  - creating a uniform definition for a child, or child dependent, for the dependent care and other child provisions (H.R. 22, H.R. 936, H.R. 2392, H.R. 2718, S. 448, S. 755, S. 1173, S. 1174, and S. 1434)

The Administration's Budget Proposal

The Administration's FY2005 budget proposal contains a provision to eliminate the sunset provisions in EGTRRA, which would prevent the DCTC from reverting back to the prior levels for the credit rate and allowable expenses. In addition, the budget proposal includes a provision to provide a more uniform definition of a child.

The Budget Resolutions

The Senate budget resolution (S.Con.Res. 95) contains a provision directing the Senate Finance Committee to reduce mandatory spending on programs under the committee's jurisdiction by $3.4 billion over the FY2005-FY2009 period. The Finance Committee is also directed to report a reconciliation bill reducing revenues by no more than $80.6 billion over the same period. This revenue reduction level would not be sufficient to repeal all of the sunset provisions of EGTTRA and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, JGTTRA), and may not eliminate the reduction to the DCTC after 2010. In addition, an amendment adopted on the floor requires that tax cuts be "paid for" by offsetting spending cuts. However, a tax cut bill with 60 or more favorable votes does not need offsetting spending cuts.

The House budget resolution (H.Con.Res. 393) directs the Ways and Means Committee to report changes (related to fraud waste, and abuse) to reduce the deficit by $8.3 billion over the FY2005-FY2009 period, and report legislation reducing revenues by no more than $137.6 billion over the same period. This revenue reduction level would be sufficient to repeal all of the sunset provisions of EGTTRA and JGTTRA.