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CRS Report for Congress

Dependent Care: Current Tax Benefits and Legislative Issues

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Summary

In the 2000 census, for more than 60% of the households with children under age six, 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.

In the 110th Congress, legislation has been introduced that would increase the income level at which the credit rate is reduced, increase the maximum qualified expenses for the credit, or expand eligibility for the credit. 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. The Working Families Tax Relief Act of 2004 (P.L. 108-311) changed the definition of a qualifying dependent beginning in tax year 2005 to conform with changes made to the personal exemption for a more uniform definition of a child.

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 (beginning in tax year 2005, the dependent under 13 must be a qualifying child of the taxpayer as defined for the personal exemption);[1]
- dependent of the taxpayer who is physically or mentally incapable of providing self care (beginning in tax year 2005, the dependent who is physically or mentally incapable of providing self care must live with the taxpayer for at least half the tax year); or
- spouse of the taxpayer who is physically or mentally incapable of providing self care (beginning in tax year 2005, the spouse who is physically or mentally incapable of providing self care must live with the taxpayer for at least half the tax year).

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%) of qualified employment-related expenses for qualifying dependents. P.L. 108-311 eliminated, beginning in tax year 2005, the requirement that the taxpayer maintain the household.

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 providing self care, 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 providing self care, the spouse's income for purposes of calculating the credit is assumed to be $250 for one child, and $500 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

[1] For more information on the qualifying child definition see Internal Revenue Service (IRS), *Publication 501, Exemptions, Standard Deduction, and Filing Information*, available at : [http://www.irs.gov/pub/irs-pdf/p501.pdf].

2002 qualified expense levels of $3,000 for one child and $6,000 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	1,020	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[2] taken against the sum of regular and alternative minimum tax liability. In tax year 2005, a total of 6.5 million returns used the DCTC for a total credit of $3.5 billion.[3] 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 2007, a married couple with two children, claiming 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 more than $24,900 (the

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

[3] Internal Revenue Service, *Individual Complete Report (Publication 1304)*, Table 3.3, available at [http://www.irs.gov/pub/irs-soi/05in33ar.xls].

value of personal exemptions and the standard deduction). As shown in **Table 2**, it is not until income is near $40,000 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 2007

Gross Income	Personal Exemptions and Standard Deduction	Taxable Income	Tax Before Credits	DCTC
10,000	24,900	—	—	—
15,000	24,900	—	—	—
20,000	24,900	—	—	—
25,000	24,900	100	10	10
30,000	24,900	5,100	510	510
35,000	24,900	10,100	1,010	1,010
40,000	24,900	15,100	1,510	1,200
45,000	24,900	20,100	2,212	1,200
50,000	24,900	25,100	2,962	1,200
55,000	24,900	30,100	3,712	1,200
60,000	24,900	35,100	4,462	1,200
65,000	24,900	40,100	5,212	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.[4] 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 federal taxes, the income set aside times the taxpayer's marginal tax rate;[5] 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

[4] 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.

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

tax brackets (at the federal and state level) the greater the potential savings from using a DCAP.

The Employee Benefits Research Institute (EBRI) reports[6] that in 2005, the average employee contribution to a dependent care flexible spending plan was $2,630. The National Compensation Survey in March 2007 by the Bureau of Labor Statistics shows that 31% of employees had access to a dependent care reimbursement account under a Section 125 "cafeteria" benefit plan.[7]

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.

Legislation in the 110th Congress

In the 110th Congress, several bills related to the dependent care tax provisions have been introduced. H.R. 1911, H.R. 2902, and S. 614 would increase the income level at which the credit rate begins to phase down (from $15,000 to $75,000) and expand the credit to include care of parents and grandparents of the taxpayer not living with the taxpayer. H.R. 1871 would establish a credit rate of 40% for taxpayers with incomes below $100,000 and a credit rate of 20% for taxpayers with higher incomes. H.R. 1871 would also adjust the $100,000 income level for inflation and make the EGTRRA changes to the credit permanent. H.R. 1421 and S. 816 would establish a minimum income of $250 a month for a stay-at-home parent and alter the income level at which the credit rate is reduced by a combination of income and number of eligible dependents. H.R. 2021 would increase the maximum qualifying expenses from $3,000 ($6,000 for two or more eligible dependents) to $5,000 ($10,000 for two or more eligible dependents), and increase the income level at which the credit rate begins to phase down (from $15,000 to $20,000). H.R. 3758 and H.R. 2906 would repeal the sunset of the EGTRRA changes, making the changes permanent. H.R. 4039 would alter the credit by creating two credit rates: 40% for taxpayers with incomes of less than $70,000, and 20% for taxpayers with incomes of $70,000 or more. In addition, H.R. 4039 would adjust the expense limitation for inflation and make the EGTRRA changes permanent. H.R. 4164 would increase the limitation on qualified expenses, make the credit refundable, and provide a new deduction for dependent care expenses.

[6] Employee Benefit Research Institute (EBRI), *Data Book on Employee Benefits*, Chapter 48, updated March 2007. Data cited by EBRI are from a study by Mercer Human Resource Consulting.

[7] U.S. Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007*, Table 24, March 2007, p. 34. Available at [http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf].