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 the age of six, all parents in the household worked. Some private surveys show that nearly 40% of those caring for aging parents and older individuals worked. For families, care for young children and older 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.

Some of the current tax provisions that were expanded in 2001 are set to expire after December 31, 2010. In addressing the expiration of these provisions, Congress may also consider whether to expand these tax incentives even more for working caregivers. The importance of this issue is underscored by the expansion of dependent care tax incentives in President Obama's Legislative Agenda through the White House Task Force on Working Families chaired by Vice President Biden.

This report discusses current tax treatment of dependent care expenses under the dependent care tax credit (DCTC) and the dependent care assistance programs (DCAP); and issues for Congress in expanding tax benefits for working caregivers (including the Obama-Biden proposal). This report will be updated as legislative activity warrants.

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Introduction

The demographics of the workforce has changed considerably in the past few decades, as has the nature of caregiving responsibilities. Not only has the share of women working increased considerably over the past three decades, but the overall workforce has aged. While many workers today still care for children, they are also increasingly more likely to be caring for aging parents.

To address dependent care costs for working caregivers, 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). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) expanded some of the tax provisions for dependent care that will expire (not be in effect) after December 31, 2010. In addressing the expiration of these provisions, Congress may also consider whether to expand these tax incentives even more for working caregivers. The importance of this issue is underscored by the expansion of dependent care tax incentives in President Obama's Legislative Agenda[1] through the White House Task Force on Working Families chaired by Vice President Biden.

This report discusses the following:

- current tax treatment of dependent care expenses under the DCTC and the DCAP; and
- issues for Congress in expanding tax benefits for working caregivers (including the Obama-Biden proposal).

Current Tax Benefits for Dependent Care

Under current law, there are two dependent care tax provisions targeted toward working caregivers: the DCTC is a tax credit and the DCAP is an exclusion from income for employer-provided dependent care assistance programs. These tax provisions are similar in that they both use the same definition of qualified employment-related expenses and qualifying dependent (discussed below). They differ, however, in how each affects tax liability by income category. The DCTC is a nonrefundable tax credit for qualified dependent care expenses and directly offsets tax liability dollar-for-dollar for working caregivers with a positive tax liability. The DCAP, on the other hand, is an income exclusion where the value of the tax benefit depends on a household's marginal tax rate. The DCAP is available to working caregivers whose employer offers it as a benefit. Working caregivers can only use one of these options. Both the DCTC and the DCAP rely on the same definitions of qualified employment related expenses and qualifying dependents. This section discusses these issues in greater detail.

Qualified Employment-Related Expenses

Qualified employment-related expenses are defined by the Internal Revenue Service (IRS) as those expenses for household services and care of a qualifying dependent necessary for the

[1] See http://www.whitehouse.gov/sites/default/files/Fact_Sheet-Middle_Class_Task_Force.pdf.

taxpayer to work or to look for work. A taxpayer's work can be for others or in their own business or partnership and can be either full time or part time. Work also includes actively looking for work but a taxpayer must have earned income to qualify in a given year.

The following are considered qualified employment-related expenses:

- Cost of care provided outside of one's home if the care is for a qualifying person who regularly spends at least 8 hours each day in his or her (i.e., taxpayer's) home.
- Care provided by a dependent care center is eligible only if the center complies with all state and local regulations.[2]
- Costs for transportation by a care provider to and from a dependent care center provided for a qualifying person (e.g., bus, subway, taxi, or private car) are also eligible. However, the transportation cost of the care provider coming to a working caregiver's home is not included.
- Fees and deposits paid to an agency to obtain the services of a care provider are included.
- Expenses paid for household services also meet the work-related expense test if they are at least partly for the well-being and protection of a qualifying person. Household services include ordinary and usual services done in and around your home that are necessary to run your home, and include services of a housekeeper, maid, or cook. However, they do not include the services of a chauffer, bartender, or gardener.

Expenses that cannot be included in this category include food, lodging, clothing, education, and entertainment. 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. Thus, costs of institutional care in a nursing home or assisted living facility are not included. However, payments to a dependent care center are qualified expenses only if the center meets all applicable state and local laws and regulations. However, a taxpayer can include small amounts paid for these items if they are incident to and cannot be separated from the cost of caring for the qualifying person. 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.

Definition of Qualified Dependent

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.

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[2] A dependent care center is a place that provides care for more than six person and receives a fee, payment, or grant for providing services of any of those persons, even if the center is not run for profit.

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

- qualifying child of the taxpayer (as defined for the personal exemption) who is less than 13 years of age, and for whom the taxpayer can claim a personal exemption;
- dependent of the taxpayer who is physically or mentally incapable of providing self care, and who has lived 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 and who has lived with the taxpayer for at least half the tax year.

Dependent Care Credit

The DCTC is calculated as a percentage (as high as 35%) of qualified employment-related expenses for qualifying dependents.

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 2001 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 qualified expense limitations 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[3] taken against the sum of regular and alternative minimum tax liability. In tax year 2007, a total of 6.5 million returns used the DCTC for a total credit of $3.5 billion.[4] 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 2006, working caregivers with adjusted gross income (AGI) under $15,000 would not likely be able to take the DCTC. As shown in **Table 2**, more than 50% of DCTC is claimed by households with AGI over $50,000.

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

[4] Internal Revenue Service, *Individual Complete Report (Publication 1304)*, Table 3.3, available at http://www.irs.gov/pub/irs-soi/07in33ar.xls.

Table 2. Utilization of the DCTC by Adjusted Gross Income
Tax Year 2007

Adjusted Gross Income	Percent of Returns Claiming the DCTC	Average DCTC ($)	Share of Total DCTC Claimed (%)
No AGI	0.0	0	0.0
$1 up to $15,000	0.1	142	0.1
$15,000 up to $25,000	2.9	402	7.1
$25,000 up to $40,000	4.9	630	21.2
$40,000 up to $50,000	5.2	523	8.7
$50,000 up to $75,000	6.8	521	19.8
$75,000 up to $100,000	9.1	536	16.5
$100,000 up to $200,000	10.4	552	22.1
$200,000+	6.8	507	4.5

Source: Table prepared by the Congressional Research Service (CRS) using data from IRS Data from Individual Complete Report (Publication 1304).

Employer-Provided Dependent Care Assistance Programs

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 and adult day 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 the age of 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.[5] 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

[5] 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.

taxpayer's marginal tax rate;[6] 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 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]

The tax benefit from a DCAP depends on the marginal tax rate of the working caregiver and the amount that the working caregiver allocates to the DCAP each year. The marginal tax rate is defined as the tax rate on the last dollar that the person earned that year and increases with income. Higher tax benefits from the DCAP accrue to individuals with higher marginal tax rates. Thus, higher income individuals receive a higher DCAP tax benefit than middle-and lower-income individuals. In 2005, the average amount of dependent care expenses claimed under the DCAP was $2,630, which is lower than the $5,000 maximum allowed under current law. [8] This difference may reflect the "use or lose" nature of the funds and changes in employment (for example, if an employee changes jobs from one employer who offers a DCAP to another who does not).[9] Funds for dependent care expenses not used by the end of the year revert back to the employer.[10] **Table 3** shows the potential tax benefit from a DCAP under different assumptions about the size of the contribution.

Table 3. Marginal Tax Rates in 2008

	Taxable Income Ranges		Potential Tax Benefit	
Marginal Tax Rates	Single Filing Status	Married Filing Jointly	From DCAP at Average of $2,630 of Qualified Expenses	From DCAP at Maximum of $5,000 of Qualified Expenses
10%	$1 up to $8,025	$1 up to $16,050	$464	$883
15%	$8,026 up to $32,550	$16,051 up to $65,100	$596	$1,133
25%	$32,551 up to $78,850	$65,101 up to $131,450	$859	$1,633
28%	$78,851 up to $164,550	$131,451 up to $200,300	$938	$1,783
33%	$164,501 up to $357,700	$200,301 up to $357,700	$1,341	$2,032
35%	Income over $357,700	Income over $357,700	$1,122	$2,133

Source: Table prepared by Congressional Research Service.

Notes: The potential tax savings are calculated using the 2008 marginal tax rates and an additional 7.65% for employment taxes (Social Security and Medicare).

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

[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.

[8] 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.

[9] Employers at their discretion may extend the deadline for using unspent balances up to 2½ months after the end of the plan year.

[10] See CRS Report RL32656, *Health Care Flexible Spending Accounts*, by Janemarie Mulvey.

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.

Issues for Congress

A key issue Congress may consider are expiring provisions relating the to maximum credit rate, the maximum amount of the qualifying expenses as well as other provisions relating to the integration of the dependent care tax credit with other areas of the tax code (such as EITC and AMT). In doing this, Congress may also look at whether these provisions are adequately addressing the costs for working caregivers. This issue is also at the forefront of President Obama and Vice President Biden's Initiatives for Middle-Class Families. Included in their blueprint is a proposal to double the child and dependent care tax credit.

In addition to addressing the expiration of a number of provisions, some areas Congress may look at for expansion include the following:

- Expand the definition of dependent to include care recipient populations that are not otherwise included under current law.
- Increase the amount of work-related expenses that are used for calculating the DCTC or DCAP formula.
- Expand the benefit to allow more lower-income caregivers to participate.

The following includes greater detail on each of these options.

Expiring Provisions

EGTRRA made several changes to the tax provisions for dependent care that will expire (not be in effect) after December 31, 2010. Changes made by EGTRRA that are set to expire include

- increasing the maximum credit rate for the DCTC from 30% to 35%;
- increasing the income level at which the credit rate for the DCTC phases down from $10,000 to $15,000; and
- increasing the maximum amount of qualifying expenses from $2,400 to $3,000 for one child, and from $4,800 to $6,000 for two or more children.

In addition to addressing these expiring provisions, Congress may look to further expand the DCTC and DCAP.

Expand Definition of Care Recipient

The demographics of the workforce has changed considerably in the past few decades, as has the nature of caregiving responsibilities. Not only has the share of women working increased considerably over the past three decades, but the overall workforce has aged. While many workers today still care for children, they are increasingly more likely to be caring for aging parents.

As noted earlier, one key requirement for a dependent to be covered is that the care recipient must be physically or mentally incapable of caring for themselves and he or she must live with the working caregiver for more than half the year. Example of legislative proposals introduced in the 111th Congress to expand this definition to include parent(s) or grandparent(s) not residing with the working caregiver is H.R. 517.

One of the key issues in expanding the definition of "dependent" is that the second criteria that requires the expenses to be work-related would still have to be met. It may be difficult to prove that expenses for someone currently not living with a working caregiver meet this IRS criteria.

Increase the Amount of Work-Related Expenses that Are Deductible or Credited

Neither the DCTC or DCAP maximum allowable amounts have been indexed for inflation and survey data that dependent care cost may far exceed existing thresholds. A recent survey from the National Association of Child Care Resource and Referral Agencies found that the average price of care for an infant in a center in2008 was $15,895. For a four-year-old, parents paid up to $11,678 a year for full-time care. Parents of school age children paid up to $10,719 a year for part-time care in a center.[11] Eldercare costs are also expensive. The annual cost of adult day care averages $13,397 a year.[12] Thus, the current amount of work-related expenses that are allowed as a deduction through a DCAP of $5,000 or taken as a tax credit through the DCTC (from $3,000 to $6,000 depending on number of children) may not be sufficient to adequately cover eligible expenses for working caregivers.

To increase the amount of the work-related expenses that are subject to either a deduction or a credit, one direct approach is to increase the maximum thresholds for both the DCTC and the DCAP.

Another way to indirectly affect the amount of the available credit under the DCTC is to modify the applicable credit rate or the income thresholds. Under current law, the amount of the work-related expenses eligible for the credit depends on a taxpayer's adjusted gross income. Lower-income individuals are permitted to take a higher share of expenses than higher-income taxpayers. Changing the applicable credit rate can increase the availability of the credit to middle-income households.

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[11] National Association of Child Care Resource and Referral Agencies, *Parents and the High Price of Child Care: 2009 Update*.

[12] Genworth Financial 2009 Cost of Care Survey, http://www.genworth.com/content/etc/medialib/genworth_v2/pdf/ltc_cost_of_care.Par.20922.File.dat/USA_gnw.pdf.

This later approach was recently proposed by President Obama and Vice President Biden as part of their policy agenda to support middle-class working families. Specifically, the Obama-Biden proposal is to increase the applicable credit rate to 35% for households with adjustable gross income over $15,000 up to $85,000. In addition, unlike current law, households with AGI over $85,000 would also be able to take advantage of the DCTC with a applicable credit rate that decreases by 1% as AGI increases. Households with AGI over $115,000 would not be eligible for the DCTC. **Table 4** shows the impact of the Obama-Biden proposal on the amount of the dependent care expenses that would be eligible for the credit.

Table 4. Maximum Dependent Care Tax Credit Under Obama-Biden Proposal

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	$85,000	0.35	$1,050	$2,100
85,000	87,000	0.34	1,020	2,040
87,000	89,000	0.33	990	1,980
89,000	91,000	0.32	960	1,920
91,000	93,000	0.31	930	1,860
93,000	95,000	0.30	900	1,800
95,000	97,000	0.29	870	1,740
97,000	99,000	0.28	840	1,680
99,000	101,000	0.27	810	1,620
101,000	103,000	0.26	780	1,560
103,000	105,000	0.25	750	1,500
105,000	107,000	0.24	720	1,440
107,000	109,000	0.23	690	1,380
109,000	111,000	0.22	660	1,320
111,000	113,000	0.21	630	1,260
113,000	No limit	0.20	600	1,200

Source: CRS Estimates.

Expand the Credit to Allow More Lower-Income Caregivers to Participate

A key concern of the DCTC is the inability of lower-income households to take advantage of the credit because the credit is nonrefundable. As noted earlier, a nonrefundable credit cannot be used in full if a working caregiver's tax liability is less than the amount of the credit. One legislative option is to make the credit refundable.

Lower-income households would benefit the most from making the tax credit refundable. As shown in earlier in **Table 2**, very few households with AGI up to $15,000 are eligible under

current law for the DCTC because they have no tax liability. Those taxpayers with AGI of between $15,000 to $25,000 would only be eligible for part of the DCTC because they would not have sufficient tax liability to offset the full DCTC amount. Under current law, 60% of the tax benefits from the DCTC accrue to taxpayers with AGI over $50,000.

Estimates by the Tax Policy Center show that if the DCTC had been fully refundable in 2006, an additional 1.6 million households would have claimed the credit and the cost of the credit (in lost revenues) would have increased by $1.7 billion.[13]

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[13] Roberton Williams, *President-Elect Obama's Tax and Stimulus Plans*, Tax Policy Center, January 2009. See also, Jeffrey Rohaly, *Reforming the Child and Dependent Care Tax Credit*, Tax Policy Center, May 30, 2007, The Urban Institute and Brookings Institution.