How does the tax system subsidize child care expenses?

Q. How does the tax system subsidize child care expenses?

A. Working parents are eligible for two tax benefits to offset child care costs: the child and dependent care tax credit and the exclusion for employer-provided child care.

Though the child and dependent care tax credit was temporarily expanded and made refundable for 2021, it benefits only a small share of parents because relatively few have formal child care expenses that qualify for the credit.

THE CHILD AND DEPENDENT CARE TAX CREDIT

The child and dependent care tax credit (CDCTC) provides a refundable credit of up to 50 percent of child care costs for a child under age 13 or any dependent physically or mentally incapable of self-care. Eligible child care expenses are limited to $8,000 per dependent (up to $16,000 for two or more dependents). After 2021, the credit will be nonrefundable and the maximum credit rate will return to 35 percent. Eligible child care expenses will be limited to $3,000 per dependent (up to $6,000 for two or more dependents).

Higher credit rates apply to families with lower adjusted gross income. For 2021, there is a two-part phase-out for the 50 percent credit rate. Families with adjusted gross income below $125,000 qualify for the full 50 percent credit. That CDCTC rate then falls by 1 percentage point for each additional $2,000 of adjusted gross income (or part thereof) until the rate reaches 20 percent (at $183,000 of income). Under the second part, the credit rate is reduced from 20 percent to 0 percent by one percentage point for each additional $2,000 of adjusted gross income (or part thereof) above $400,000 of adjusted gross income. The credit is fully phased out at $438,000 of adjusted gross income. After 2021, only the first part of the phase-out applies, the credit rate is not reduced below 20 percent (figure 1).

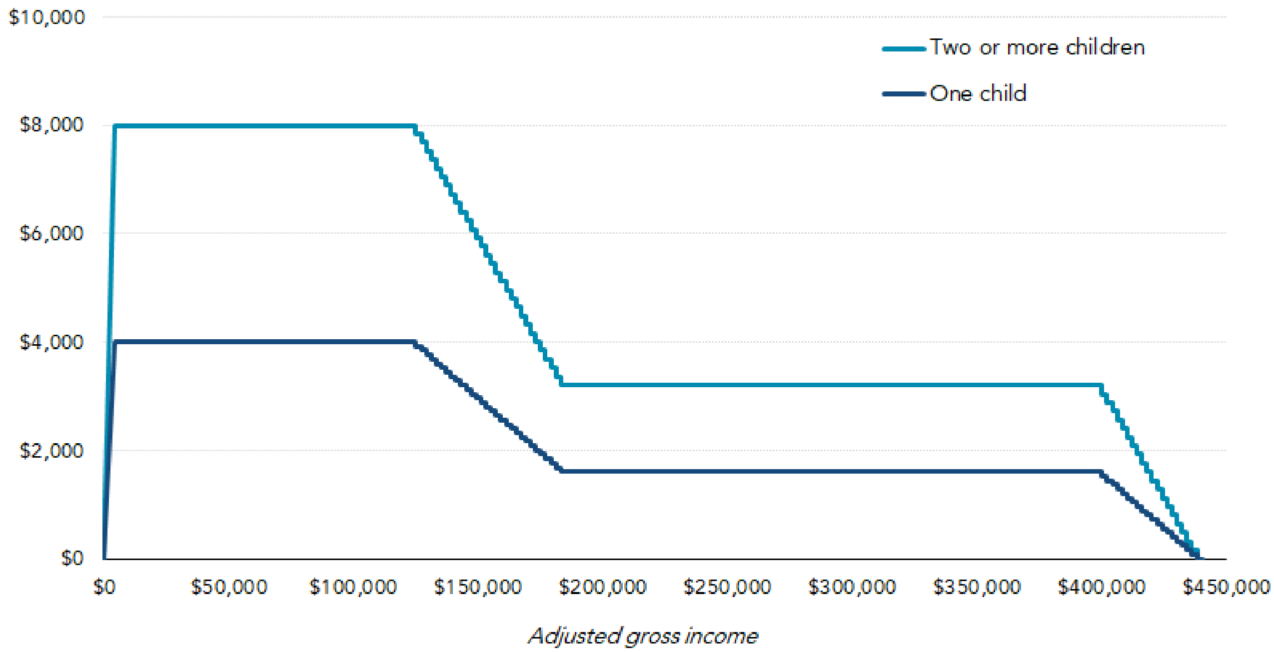
Prior to the ARP, the CDCTC was nonrefundable. That is, it could only be used to offset taxes owed. Under the ARP, if a family qualifies for a CDCTC that exceeds taxes owed, they can receive the difference as a tax refund. In 2022, the CDCTC will revert to its pre-ARP rules.

TAXES AND THE FAMILY

How does the tax system subsidize child care expenses?

FIGURE 1

Child and Dependent Tax Credit, Single Parent
Tax year 2021



Source: Urban-Brookings Tax Policy Center calculations.
Note: Assumes all income comes from earnings, and child or children meet all tests as a CDCTC-qualifying dependent. The credit is fully refundable.

To qualify for the CDCTC, a single parent must be working or in school. For married couples, both adults must be working or attending school. In general, allowable expenses are capped at the earnings of the lower-earning spouse. Special rules allow individuals who are students or disabled to have their earned income assumed to be $667 per month ($1,334 if there is more than one qualifying child).

The Urban-Brookings Tax Policy Center estimates that, in 2021, 14 percent of families with children will benefit from the CDCTC. Under the pre-ARP rules, 12 percent of families benefited from the credit. Some families with children will not benefit from the CDCTC because they do not have child care expenses or, in the case of married couples, only one partner works or goes to school.

Among families with children who benefit from the CDCTC, taxes will be reduced by an average of $2,174. Under the pre-ARP rules, the average credit among families who claimed it was $593.

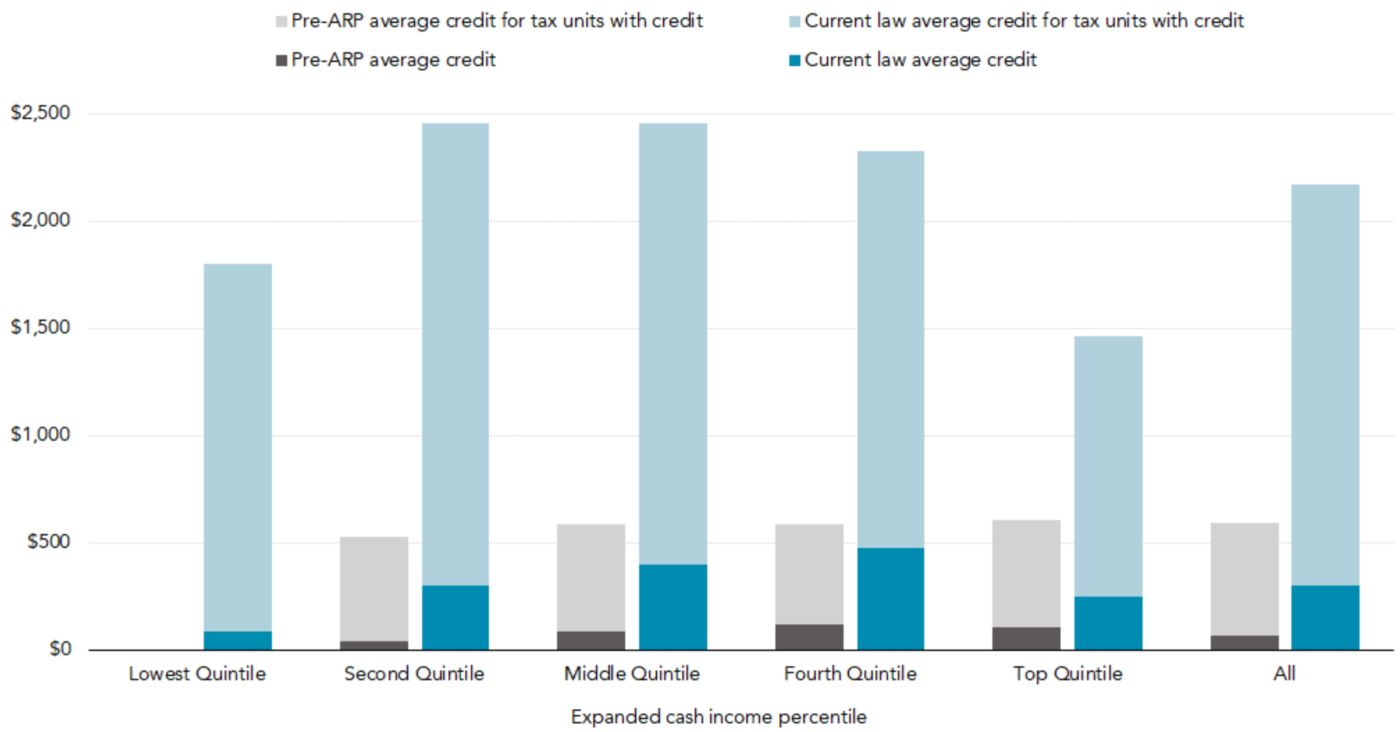
Under the 2021 rules, average benefits for the lowest and highest income quintiles are lower than those for the middle three income quintiles. Under pre-ARP law, average benefits for families in the lowest income quintile were lower than for all other income quintiles. Families in the lowest income quintile are likely to have lower child care expenses than families in higher-income quintiles, while families in the highest income quintile may be subject to the credit phase-out in 2021 (figure 1).

How does the tax system subsidize child care expenses?

FIGURE 2

Distribution of the Child and Dependent Care Tax Credit for Tax Units with Children: Pre-American Rescue Plan and Current Law

2021



Source: Urban-Brookings Tax Policy Center. "TPC Microsimulation Model, version 0920-2."
Note: ARP = American Rescue Plan Act of 2021.

EMPLOYER EXCLUSION: FLEXIBLE SPENDING ACCOUNTS

Employer-provided child and dependent care benefits include amounts paid directly for care, the value of care in a day care facility provided or sponsored by an employer, and, more commonly, contributions made to a dependent care flexible spending account (FSA).

Employees can set aside up to $10,500 (half for a married individual filing separately) per year of their salary, regardless of the number of children, in an FSA to pay child care expenses. The money set aside in an FSA is not subject to income or payroll taxes. Unlike the CDCTC, though, which requires both partners in a married couple to work to claim benefits, only one parent must work to claim a benefit from an FSA. In 2014, 39 percent of civilian workers had access to a dependent care FSA (Bureau of Labor Statistics 2014). Lower earners are less likely to have access to an FSA than higher earners (Stoltzfus 2015).

INTERACTION OF CDCTC AND FSAS

If a family has child care expenses that exceed the amount set aside in a flexible spending account, the family may qualify for a CDCTC. Families first calculate their allowable CDCTC expenses ($8,000 per child under age 13, up to $16,000 per family). If this calculation exceeds the amount of salary set aside in an FSA, a parent may claim a CDCTC based on the difference. For example, a family with two or more children can qualify for up to $16,000 of expenses to apply toward a CDCTC. If that family excluded $10,500 from salaries to pay for child care expenses in an FSA, it may claim the difference between the two ($5,500) as child care expenses for a CDCTC. The exclusion is only available to taxpayers whose employers offer FSAs.

Neither the CDCTC nor the FSA are indexed for inflation. Thus, each year, the real (inflation-adjusted) value of benefits from the two provisions erodes.

Updated May 2021

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