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.

THE CHILD AND DEPENDENT CARE TAX CREDIT

The child and dependent care tax credit (CDCTC) provides a credit worth between 20 and 35 percent of child care costs for a child under age 13 or any dependent physically or mentally incapable of self-care.

TABLE 1

Child and Dependent Care Credit
2020

Adjusted gross income (dollars)	Credit rate (percent)	Maximum Credit (dollars)	
		One child	Two or more children
15,000 or less	35	1,050	2,100
15,001–17,000	34	1,020	2,040
17,001–19,000	33	990	1,980
19,001–21,000	32	960	1,920
21,001–23,000	31	930	1,860
23,001–25,000	30	900	1,800
25,001–27,000	29	870	1,740
27,001–29,000	28	840	1,680
29,001–31,000	27	810	1,620
31,001–33,000	26	780	1,560
33,001–35,000	25	750	1,500
35,001–37,000	24	720	1,440
37,001–39,000	23	690	1,380
39,001–41,000	22	660	1,320
41,001–43,000	21	630	1,260
43,000 and over	20	600	1,200

Sources: Internal Revenue Code § 21. "Expenses for household and dependent care services necessary for gainful employment." Accessed February 28, 2020, and Internal Revenue Service. "Publication 503–Main Content." Accessed February 28, 2020.

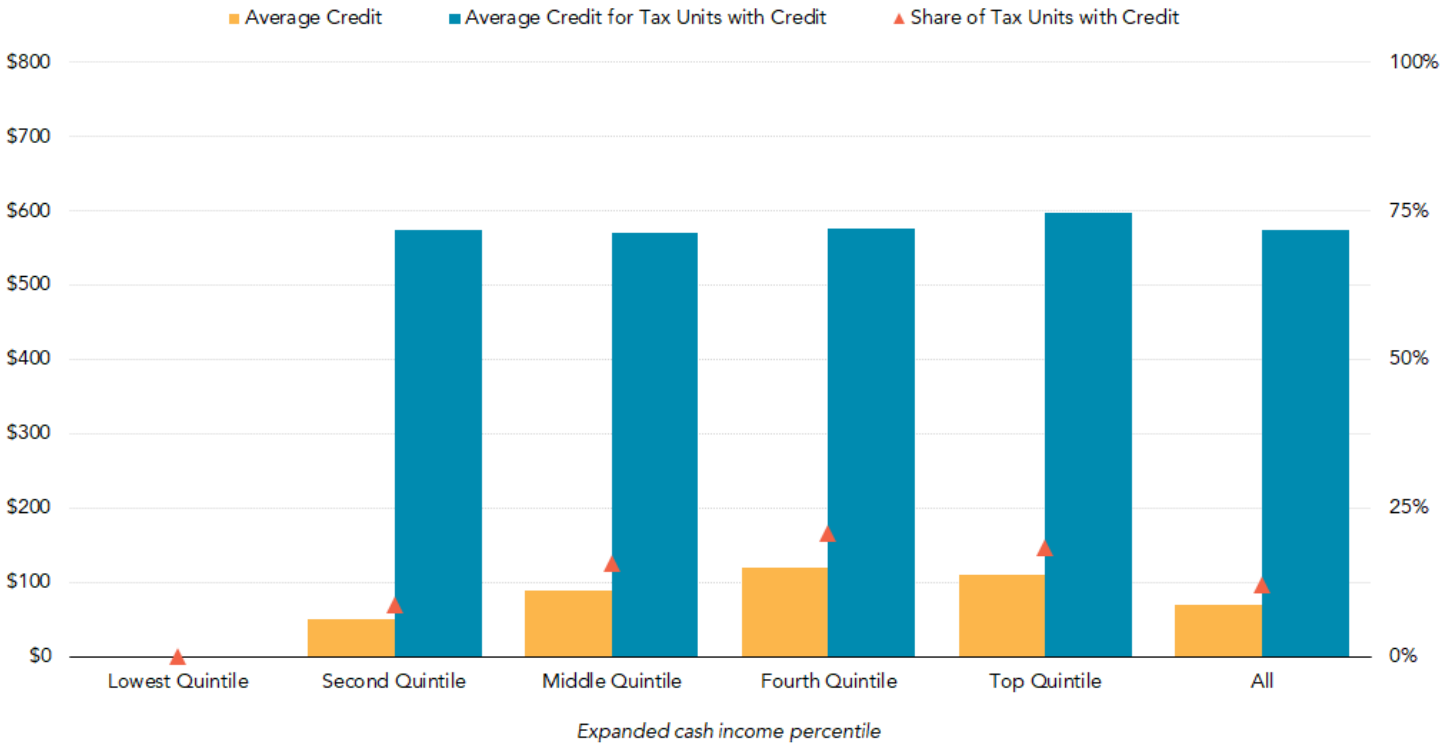
How does the tax system subsidize child care expenses?

Eligible child care expenses are 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. Families with incomes below $15,000 qualify for the full 35 percent credit. That rate falls by 1 percentage point for each additional $2,000 of income (or part thereof) until it reaches 20 percent for families with incomes of $43,000 or more. The credit is nonrefundable so it can only be used to offset income taxes owed—in other words, any excess credit beyond taxes owed is forfeited. As a result, low-income families who owe little or no income tax get little benefit from the credit (table 1).

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 were students or disabled to have their earned income assumed to be $250 per month ($500 if there is more than one qualifying child).

FIGURE 1

Distribution of the Child and Dependent Care Tax Credit for Tax Units with Children
2020



Source: Urban-Brookings Tax Policy Center. "TPC Microsimulation Model, version 0319-2."

The Urban-Brookings Tax Policy Center estimates that, in 2020, 12 percent of families with children benefited from the CDCTC. Some families with children will not benefit 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 $574. The only income quintile in which families' average benefits substantially differ is the lowest. (Each quintile contains 20 percent of the population ranked by household income.) Not only are their child care expenses likely to be lower than those

of families in higher-income quintiles, they are typically unable to benefit from the credit because the CDCTC is nonrefundable (figure 1).

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 $5,000 per year of their salary (regardless of the number of children) in an FSA to pay child care expenses. (FSAs are also available for health 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 ($3,000 per child under age 13, up to $6,000 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 $6,000 of expenses to apply toward a CDCTC. If that family excluded $5,000 from salaries to pay for child care expenses in an FSA, it may claim the difference between the two ($1,000) as child care expenses for a CDCTC.

Higher-income families generally benefit more from the exclusion than from the credit because the excluded income is free from both income and payroll taxes. Most higher-income families with child care expenses qualify for a credit of 20 percent of their eligible expenses. Because the combined tax saving from each dollar of child care expenses excluded from income exceeds $0.20, the exclusion is worth more than the credit. The exclusion, however, 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.

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