Child care is a prerequisite for participating in the workforce, but the cost burden is steep and often a barrier for families. The Child and Dependent Care Tax Credit is an important, but often overlooked element of the child care landscape—a tax policy intended to help families offset a portion of their child or dependent care expenses by reducing their federal income tax liability. The underlying credit works in the following manner:

First, the family determines their child or dependent care expenses for the year, and may count up to $3,000 of these expenses per child or dependent towards the credit, for a maximum of two dependents and a total of $6,000 in expenses.

The family, based on their income level, can then receive between 20-35% of those expenses as their credit. The higher the income, the lower percentage they are allowed to claim.

There is no income level at which the credit phases out, meaning taxpayers of all incomes are eligible for the credit. However, the credit is not refundable, meaning taxpayers without any federal tax liability are ineligible for a refund through this credit. Only those with tax liability may benefit.
Mr. and Mrs. Jeffries live in Arizona with their 9-month-old and 4-year-old, both work full-time, and have an annual **combined income of $60,000**. They need full-time child care for both their children, but do not qualify for any state assistance in affording it. They are fortunate enough to enroll both of their children in the same family-based child care program. Their annual **child care costs are about $14,300 per year, or about 23% of their income.**

**Under the existing CDCTC structure,** they are only able to count up to $6,000 of these expenses towards the CDCTC. Based on their income, they can claim 20% of those expenses as the credit, meaning **they are eligible to receive a credit of $1,200, or less than 10% of their child care expenses for the year.**

**Under the American Rescue Plan,** for 2021, the Jeffries can count their entire $14,300 in child care expenses towards the credit, and can receive 50% of these expenses as their CDCTC. Therefore, **they may receive a credit of $7,150, or 50% of their child care expenses.**

As structured, the underlying version of the credit primarily benefits only a subset of working families—not the low- and moderate-income families in greatest need of the support—for three main reasons:

1. **Nonrefundability.** The existing CDCTC does not offer a refund beyond a family’s tax liability, and because the lowest-income families have little to no tax liability, they typically cannot receive a credit.

2. **Differing Expenses.** Families with higher incomes can afford greater child care expenses throughout the year, and therefore, claim larger expenses for the credit.

3. **No Phaseout.** Because there is no phaseout of the credit for higher-income families, those with incomes of $43,000 can receive the same as those with an income above $150,000.

After two decades without any improvement, the American Rescue Plan is the first law to alter the CDCTC, but only for one year. A summary of the underlying CDCTC structure is shown on the following page, alongside a comparison to changes made under the ARP for 2021.

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**In 2018:**

- 5.6% of recipients’ income was under $25,000, while 57% were above $75,000.
- Recipients with incomes between $15,000 and $25,000 received $347 on average. Those with incomes between $100,000 and $200,000 received almost double that ($603). The number of states transferring funds dropped from 46 to 26.
- 42% of aggregate CDCTC dollars went to families with an income above $100,000. Just 23.7% went to families with an income between $25,000 and $50,000.

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While the pandemic motivated these changes to the credit for 2021, the unaffordability of child care predated the pandemic. Building off the American Rescue Plan's temporary tax provisions, a combination of several key changes to the existing CDCTC structure beyond 2021 can better align the tax credit so that it works best for the families who need it the most:

1. As recommended in *A Bipartisan Case for Early Childhood Development*, make the credit fully refundable.

2. Consider enhancing the credit rate for the lowest-earning families, but phase out the rate for higher-income families.

3. Ensure that changes (1) and (2) coincide with a Child Tax Credit that is calculated independent of federal income tax liability.

4. Consider making the CDCTC advanceable.

5. Consider decoupling Dependent Care Assistance Plan exclusions from CDCTC expenditures for low-income workers.

To build a comprehensive system of child care support for families beyond the current health crisis, it is time to harness and refine all available mechanisms that can assist families. The CDCTC is one such powerful mechanism. *To learn more, read our full report.*