The Effects of the Child and Dependent Care Tax Credit on Child Care Affordability

How temporary changes to the Child and Dependent Care Tax Credit will affect child care affordability in 2021 and how we can think about improving the tax credit for the long term

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Executive Summary

The American Rescue Plan Act signed into law on March 11, 2021 includes a number of provisions that will help parents afford the quality child care they need in order to get back to work in 2021. Among these are landmark changes to an important, yet seldom publicized component of the tax code: the Child and Dependent Care Tax Credit (CDCTC).

The CDCTC is a tax policy intended to help offset a portion of families' child or dependent care expenses by reducing their federal income tax liability. However, as we have written before, the existing structure of the credit fails to meaningfully help low-income families afford child care.[1] After two decades without any improvement, the American Rescue Plan is the first law to alter the CDCTC, making it work for the families that need the tax credit the most.[a]

For 2021, the law increases the maximum amount of child care expenses families can claim, from $3,000 to $8,000 per child; increases the percentage of those expenses for which families will receive a credit from 35% to 50%; and by making the credit fully refundable, ensures that these changes will benefit the lowest-income families who have little to no tax liability.[2] But these long overdue changes are temporary, only lasting through 2021. The underlying structure that for decades has failed to support the families who need the credit most, remains.

The following brief has two aims; first, to explain the significance of the American Rescue Plan's changes in the context of the existing CDCTC structure. And second, to prompt an informed discussion on how to improve the CDCTC, and to ensure these changes are sustained for the families who can least afford quality child care. It is a certainty that the child care affordability crisis will not cease after 2021. For many families in the United States, child care was unaffordable before the pandemic,[3] and with the increased health and safety costs providers must cover going forward, will continue to be so after the pandemic. This brief intends to clarify this tax policy so that policymakers may consider how to better structure the credit to help low-income families afford child care beyond the the timeline of the American Rescue Plan and the current health crisis.

These long overdue changes are temporary, only lasting through 2021. The underlying structure that for decades has failed to support the families who need the credit most, remains.

a For purposes of this brief, we analyze the CDCTC based on its impacts for families with children, not for families who have other dependents.

To accomplish these goals, the brief first outlines the existing CDCTC, prior to changes made in the American Rescue Plan, and the reasons it fails to support low-income families. It then discusses several facets that policymakers could change to improve the credit and how such changes would affect families. Finally, this brief models the CDCTC under the American Rescue Plan. It examines how the changes could—both alone and in conjunction with changes to the Dependent Care Assistance Program (DCAP) exclusion—better support low-income families with child care needs and how the country can build off these temporary improvements going forward.

As a result of this analysis, the brief suggests that several key changes to the existing CDCTC structure beyond 2021 could better align the tax credit so that it supports low-income families:

1. As recommended in *A Bipartisan Case for Early Childhood Development*,[4] 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 (CTC) that is calculated independent of federal income tax liability.

4. Consider making the CDCTC advanceable.

5. Consider decoupling DCAP exclusions from CDCTC expenditures for low-income workers.

To help offset the high costs of child care for families, attention typically focuses on expanding the Child Care and Development Fund (CCDF)—the largest source of direct federal funding dedicated to subsidizing child care for low-income, working families. The CDCTC is too often left out of the conversation. But every dollar a family receives, whether from earned income, child care subsidies or tax credits, is critical for affording child care and for their long-term financial stability—57% and 46% of parents said they would prioritize saving for emergencies and retirement, respectively, if they had more disposable income.[5] Guided by the tax principles discussed in this brief, the country has an opportunity to ensure the CDCTC effectively contributes to the system of support for working families and their children beyond the pandemic.

HOW THE EXISTING CDCTC WORKS AND WHY IT FAILS TO SUPPORT LOW-INCOME FAMILIES[b]

The CDCTC is a tax policy aimed to offset a portion of families' child care expenses by reducing their federal income tax liability—the amount they have to pay in federal income taxes each year. The CDCTC reduces tax liability by an amount calculated using the following equation: [6]

Current CDCTC Credit = Tax Liability - (Credit Rate X Child Care Expenses)

The credit rate is determined by the taxpayer's adjusted gross income (AGI, gross income minus adjustments such as educator expenses, student loan interest, retirement contributions, etc.). Currently, the credit rate starts at a maximum of 35% for taxpayers with income under $15,000. The rate then declines by 1 percentage point for each $2,000 increase in income above $15,000 until the rate reaches a minimum of 20%.

A taxpayer may apply a maximum of $3,000 of child care expenses for one child and a maximum of $6,000 for two or more children. Currently, the CDCTC is nonrefundable, meaning even if the the credit rate multiplied by child care expenses produces an amount larger than a taxpayer's liability, the taxpayer may not receive the amount exceeding their tax liability (the refund).

Child Care Subsidies Do Not Affect the Tax Credit

Subsidies families receive from the Child Care and Development Block Grant (CCDBG) do not affect their tax credit size through either income or child care expenses.

Income: Supplement Pub. 525 to the Schedule 1 tax form indicates that benefits from a public welfare fund based upon need are not included as income.[7]

Child Care Expenses: According to the Internal Revenue Service, child care reimbursements may not be claimed as part of a taxpayer's child care expenses for the CDCTC.[8]

To examine how the credit could affect families with different incomes, it's not enough to simply multiply expenses by the credit rate; it is necessary to include tax liability estimates as well. Figure 1 models the theoretical tax credit for a

b The term "existing CDCTC" refers to the CDCTC structure that was in place before the American Rescue Plan and that the tax credit will revert to after 2021. It should be viewed as the underlying structure that was temporarily amended by the American Rescue Plan.

hypothetical family of four at all income levels. The model assumes that the parents are married and file jointly, have two children, their child care expenses meet the $6,000 maximum, they take the standard deduction of $24,800 (amount not taxable) but no other tax benefits, and they have only earned income which is equal to AGI.

Figure 1. Exisiting CDCTC for A Family With Two Children

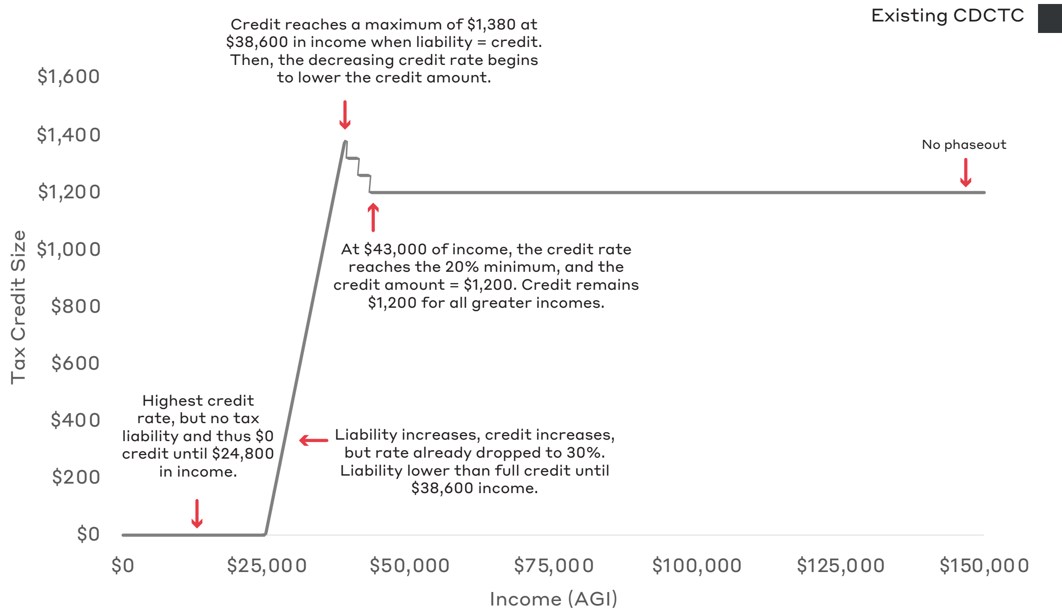

Figure 1 models the theoretical tax credit for a hypothetical family of four at all income levels. The model assumes that the parents are married and file jointly, have two children, their child care expenses meet the $6,000 maximum, they take the standard deduction of $24,800 (amount not taxable) but no other tax benefits, and they have only earned income which is equal to AGI.

Even though the current CDCTC offers its highest credit rates for the lowest-income families, its effect on families does not follow Figure 1 in practice. The credit primarily benefits middle- to high-income families for three main reasons:

- **Nonrefundablility:** The existing CDCTC does not offer a refund beyond a family's tax liability. Since the lowest-income families have little to no tax liability, they typically cannot receive a credit. Thus, as seen in Figure 1, the 35% credit rate given to taxpayers making under $15,000 affects very few families. In 2018, only 5.6% of CDCTC recipients had an income under $25,000, while 57% had an income above $75,000.[9]
- **Differing Expenses:** Families with higher incomes can afford greater child care expenses, and therefore, can receive larger credits. Research shows that higher-income families can afford

BPC's December 2020 survey of parents with children under age 5 found only one-fifth of families with an income below $50,000 can afford to pay more than $200 per week ($10,400 annually) for child care.[10] Over half (55%) of families with an income above $100,000 say they can afford that amount.

to (see box to the right) and do pay more for child care during the year. In 2014, the average child care expenses for families in the lowest-income quintile was $857, an amount significantly below the maximum qualifying expenses for just one child ($3,000), while the average child care expenses for taxpayers in the highest-income quintile met the maximum qualifying expenses for two children (both are $6,000).[11] Therefore, instead of enabling low-income parents to afford child care they need to cover in order to work, the CDCTC serves as a reward for families who can already afford more. Taxpayers in 2018 with incomes between $15,000 and $25,000 who received the credit received one of $347 on average, while those with incomes between $100,000 and $200,000 received credits almost double the size ($603 on average).[12]

- **No Phaseout:** Because there is no phaseout of the credit for higher-income families, those with income above $150,000 can receive the same $1,200 credit as families with an income of $43,000. In 2018, 42% of aggregate CDCTC dollars went to families with an income above $100,000, and just 23.7% went to families with an income between $25,000 and $50,000.[13]

Although the CDCTC is intended to help offset a portion of families' child or dependent expenses so that they may work or look for employment, the previous analysis shows that the credit primarily benefits only a subset of working families—not the low- and moderate-income families in greatest need of the support.

Interaction with the Child Tax Credit (CTC)

The CTC is another major tax credit available to families with children.[14] Because both the CDCTC and CTC operate by reducing a taxpayer's federal income tax liability, receiving the CDCTC affects how much a family can receive from the CTC. The Internal Revenue Service indicates that the CDCTC reduces tax liability first.[15] Then the CTC is calculated using post-CDCTC tax liability. If the CTC is not fully refundable, and a family claims both credits, the increased CDCTC may decrease the amount a family receives from the CTC, effectively canceling any net credit gains. However, if the CTC is fully refundable, as it is under the American Rescue Plan, there is no interactive effect.

It is important to be aware of this interaction when considering restructuring the CDCTC. However, this report does not go into greater detail on the CTC because it is a flexible cash benefit that helps working families with all the costs of raising a child, not child care costs specifically.

The Interaction Between CDCTC and the Exclusion for Employer-Provided Dependent Care Assistance

Section 129 of the tax code allows employees to exclude from their taxable income amounts up to $5,000 paid or incurred by their employer as part of a dependent care assistance program (DCAP).[16] A DCAP can include direct payments by an employer to a child care provider, on-site care offered by the employer, direct reimbursements for an employee's child care costs, or a flexible spending account through which employees can set aside a portion of their pretax salary for expenses like child care.

Families can claim both the CDCTC and the DCAP exclusion, but only for separate out-of-pocket child or dependent care expenses. Each dollar a taxpayer excludes for a DCAP results in a dollar-for-dollar reduction in the maximum expenses the taxpayer may apply toward the CDCTC. In effect, a family that sets aside $5,000 is unable to claim any CDCTC if they have one child, and only $1,000 of CDCTC if they have two children. While these two policies are intended to support families, it is unlikely that many are aware of their interconnected nature and how setting aside funds in a DCAP might actually limit their ability to receive a CDCTC credit at the end of the tax year. Figure 2 illustrates this intersection by modeling the CDCTC a married-couple could receive if they have two children, claim the maximum $6,000 of expenses for the CDCTC, but also take the maximum $5,000 DCAP exclusion.

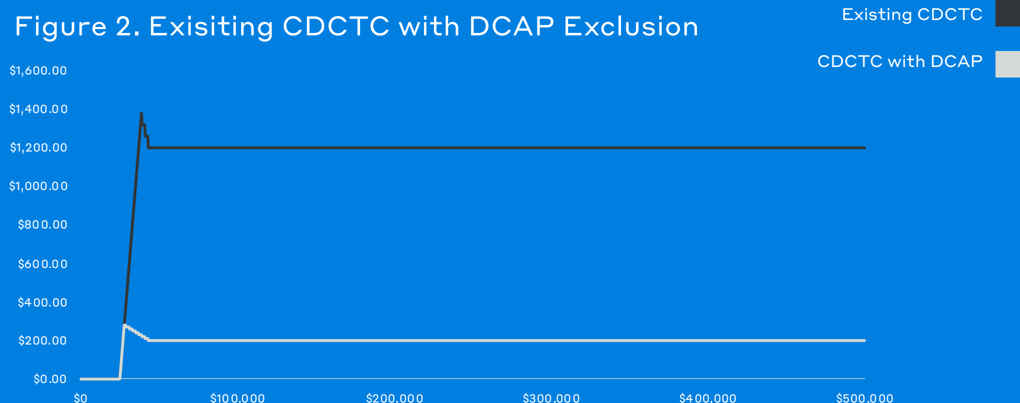

Figure 2 models the theoretical tax credit for a hypothetical family of four with and without the maximum DCAP exclusion. Assumes parents are married and file jointly, have two children, take the standard deduction of $24,800, have only earned income that is equal to AGI, have child care expenses that meet the $6,000 cap, and take the maximum $5,000 DCAP exclusion.

The DCAP exclusion from flexible spending accounts primarily affects higher-income families for three reasons. First, on the whole, only highly compensated employees at large companies have access to DCAPs such as flexible spending accounts. In 2017, only 19% of employees in the lowest quarter of the wage distribution had an employer that offered a DCAP flexible spending account, compared with 63% of employees in the top quarter of the wage distribution.[17] At the same time, only 20% of employees in companies with fewer than 50 employees had access to this benefit, compared with 72% of employees in companies with over 500 workers.[18] However, it is important to note that some companies only allow their highly compensated employees to make contributions to a DCAP if less-compensated employees participate at sufficient rates.

Second, as discussed previously, higher-income earners can afford to spend more on child care and are therefore more likely to have a substantial amount of funds to contribute to a flexible spending account, while low-income families are less likely to have the means to set aside funds in advance. And third, taxpayers with low incomes typically owe little to no federal income tax. Therefore, taking a DCAP exclusion would not further reduce their taxes.

Changes to the DCAP exclusion under the American Rescue Plan and how they interact with changes to the CDCTC are discussed later in this report.

WAYS THE CDCTC CAN BE CHANGED AND HOW SUCH CHANGES WOULD AFFECT FAMILIES

To preface the analysis of the CDCTC under the American Rescue Plan and to inform discussions about how the CDCTC could be restructured beyond 2021, it is useful to examine the universe of options policymakers have available to better target the tax credit toward low-income families. While, on their face, many of these changes might seem beneficial, not all of them would actually help low-income families. In fact, some seemingly helpful changes would actually benefit higher-income families more than the credit already does and leave many lower-income families behind. Below are three commonly considered options and estimates of their effects produced by the Congressional Research Service (CRS) using the TRIM3 microsimulation model.[19,c] Each explanation describes the effects if the option were implemented without other changes. A combination of the options could yield different results.

Current CDCTC Credit = Tax Liability - (Credit Rate X Child Care Expenses)

1. Increase Maximum Qualifying Expenses: One option is to increase the maximum amount of qualifying expenses a taxpayer could apply to the credit. Currently, a family with two children may apply up to $6,000 of child care expenses. If this maximum were doubled, estimates indicate that the top 40% of earners would receive 85% of the benefit from the enhancement. Such effects would primarily result from the higher child care expenses these families typically have and can therefore claim. As shown previously, most lower-income families do not have expenses that surpass or even meet the existing qualified expenses cap. Only the top 20% of taxpayers eligible for the CDCTC in 2014 had average child care expenses near the existing $6,000 cap for two children. Therefore, increasing the limit would have no effect on low-income families and would simply enable the highest-income families to receive reimbursement for an even larger amount of their child care expenses.

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c TRIM3 is a microsimulation model primarily funded by the U.S. Department of Health and Human Services and maintained by the Urban Institute. The model estimates the effects of policy changes on the U.S. population using census data and a number of assumptions. To accurately estimate the effects of CDCTC changes, it is necessary to incorporate estimates of families' child care expenses, instead of assuming each family has child care expenses that meet the qualified expenses cap. Therefore, the model incorporates census data on taxpayers' out-of-pocket child care expenditures. Because the model uses total money income, instead of adjusted gross income, it augments child care expenditure amounts with any child care subsidies the families would receive from the Child Care and Development Block Grant, although these subsidies are not included in the CDCTC calculation in reality. The model also adjusts child care expenses downward for higher-income taxpayers because it assumes they are more likely to use dependent care flexible spending accounts that subtract from the amount of expenses they can apply to the CDCTC.

2. Increase the Credit Rate: Another option is to increase the credit rate. Currently, the credit rate is set at a maximum of 35% for families with incomes under $15,000. It gradually declines until it plateaus at 20% for families with incomes of $43,000 and above. If the credit rate were increased to 50% for all families (eliminating the gradual rate decrease), estimates indicate that the top 40% of earners would receive 79% of the benefit of the reform. Such effects would again result from higher-income families receiving significantly higher credits because they would be able to apply a greater amount of child care expenses to the increased credit rate. Additionally, because the tax credit is nonrefundable, the increased rate would again fail to affect those who have little to no tax liability, and would disproportionately impact higher income families.

3. Make the CDCTC Refundable: An often-discussed option is to make the credit fully refundable. Doing so would delink the the tax credit from a taxpayer's federal income tax liability. Families with a calculated credit larger than their tax liability would see their tax liability reduced to zero—if they had any to begin with—and would receive any credit amount that exceeds their liability. The CRS estimates indicate that the bottom 40% of taxpayers would receive 94% of the nearly $1 billion in additional funds provided through this change.

Other Options: The three policy options discussed above are not the entire universe of possible changes. With the information above, it is clear that other policy options—such as advanced payments, or even a simplified calculation—would help the credit become more meaningful to the families who need it most. And with other realities, such as the higher costs of care for younger children, policymakers would do well to holistically review the tax credit so that it can truly support low-income families.

HOW CHANGES TO THE CDCTC BY THE AMERICAN RESCUE PLAN WILL AFFECT FAMILIES

As referenced above, on March 11, 2021, President Biden signed a budget reconciliation bill that makes long-overdue changes to the CDCTC for 2021 (not subsequent years) to help provide child care relief for parents during the pandemic.[20] Provisions in the bill increase the qualified expenses limit from $3,000 to $8,000 for one child, and from $6,000 to $16,000 for two or more children. They also increase the maximum credit rate to 50%, and move the income level at which the rate begins to decrease from $15,000 to $125,000. The rate still plateaus at 20%, but unlike under the existing CDCTC structure, begins to phase out to 0% when a taxpayer's income reaches $400,000, meaning that taxpayers making above $438,000 are ineligible for the credit. Finally, and most impactful for low-income families, the CDCTC is made fully refundable.

Figure 3 models the credit a family of four could receive at every income level with these changes. The model makes the same assumptions as were made in Figure 1, with the exception of one change: the family's child care expenses meet the new qualified expenses maximum of $16,000 for their two children.

Tax Refunds Do Not Affect CCDBG Eligibility

Any new tax refunds implemented by the American Rescue Plan will not affect families' eligibility for CCDBG subsidies. In 2013, the American Taxpayer Relief Act of 2012 (Sec. 6409) permanently established that any tax refunds or advance payments of refundable credits are not to be taken into account as income when determining eligibility for benefits or assistance under any federal program.[21]

Figure 3. Temporary Changes to the CDCTC Under the American Rescue Plan

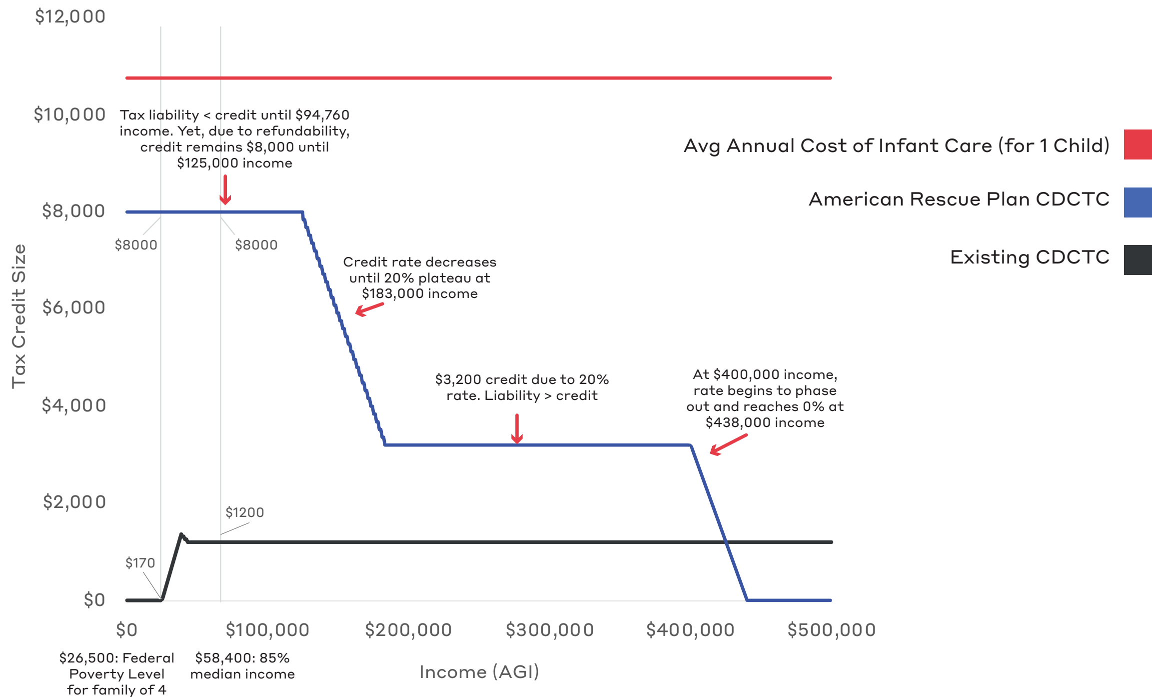

Figure 3 models the theoretical tax credit for a hypothetical family of four at all income levels. The model assumes that the parents are married and file jointly, have two children, their child care expenses meet the $16,000 maximum, they take the standard deduction of $24,800 (amount not taxable) but no other tax benefits, and they have only earned income which is equal to AGI. The average annual cost of infant care for one child was calculated by the Community for Economic Development: the median of the child care costs in all 50 states and Washington, DC collected by Child Care Aware® of America's January 2018 survey of Child Care Resource and Referral state networks.[22]

The changes for 2021 combine versions of all three policy changes discussed in the previous section for the intended goal of better supporting low-income families. The proposal's first change, making the credit fully refundable, primarily benefits low-income and moderate-income taxpayers who would not receive any credit, or would only receive a small credit under the current CDCTC rules. The second change, enhancing the credit rate to 50% for all taxpayers with an income below $125,000, benefits some low-income families who spend significant amounts on child care. Despite having little to no tax liability, these families may receive an increased credit because of the combination of the rate increase and shift to refundability. However, since upper-middle-income families have higher child care expenses, the increased credit rate will have a greater impact on upper-middle-income families than low- and moderate-income families.

While the rate still declines to 20% for higher-income families, and an added phaseout prevents the highest-income families from receiving the credit at all, the third change—increasing the qualified expense limit—will primarily affect families who can pay more for child care—those with higher incomes. Major increases to the expenses cap appear to boost the credit for lower-income families (Figure 3). But this effect is a result of assuming low-income families have child care expenses that meet the new $16,000 maximum (for two children in 2021). In reality, most low-income families cannot afford monthly child care expenses that would approach the new limits or even the original limits. Thus, increasing the qualified expenses cap would mainly increase

credits for the upper-middle-income and higher-income families who are more likely to have expenses that surpass the original limits.

All together, estimates by the Urban-Brookings Tax Policy Center indicate that the provisions provide much-needed and long-awaited improvements to the credit for low- to middle-income families, but they also provide some benefits to upper-income households.[23] Low- and middle-income families will primarily receive the benefits. The Tax Policy Center's recent analysis estimates that the lowest-income 40% of households will receive 30% of the related benefits—about a 0.4% increase in income after taxes—and middle-income households will receive one-quarter.[24] Mostly due to the heightened child care expenses cap, upper-middle-income families will receive significant credit increases as well—these families will receive about one-third of the benefits from the reform.[25] The credit phaseout, however, ensures that those in the top 20% of earnings will receive only small credit increases.[26] Preserving the American Rescue Plan provisions that effectively target the CDCTC toward lower-income families can ensure that the CDCTC is better targeted permanently.

Effects on Federal Revenues

According to estimates by the Joint Committee on Taxation, the existing CDCTC and DCAP exclusion reduce federal tax revenues by $4.7 billion annually.[27] The changes made to these tax policies by the American Rescue Plan are estimated to decrease revenues by a total of $8.1 billion.[28] The majority of these revenue effects are estimated to come from changes made to the CDCTC, rather than the enhanced DCAP exclusion. The enhanced DCAP exclusion is expected to account for only a total $117 million of the revenue decrease.[29]

The Effect of Increasing the DCAP Exclusion under the American Rescue Plan

The American Rescue Plan increases the maximum DCAP exclusion from $5,000 to $10,500 for 2021. This increase will allow families to place more money into a flexible savings account and save more on taxes. Because the increase coincides with an even larger increase to the CDCTC qualified expenses cap, families with two children would still be able to claim up to $5,500 for the CDCTC if they set aside the maximum $10,500 of expenses contributed to a DCAP. However, families that have one child and set aside any amount above $8,000 would be unable to claim any CDCTC. Figure 4 depicts the credit a married couple with two children could receive if they used the American Rescue Plan's maximum DCAP exclusion and then claimed the remaining $5,500 of qualified expenses allowable for the CDCTC.

Figure 4. American Rescue Plan CDCTC with DCAP Exclusion

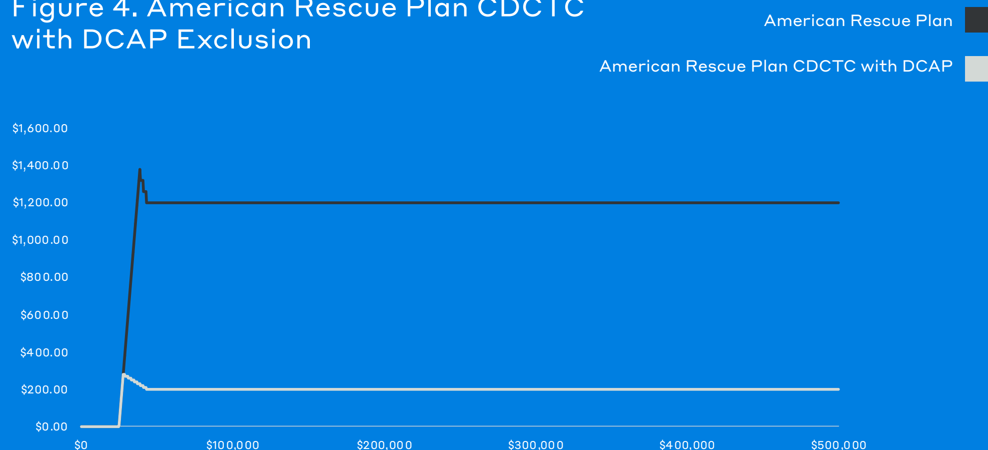

Figure 4 models the theoretical tax credit for a hypothetical family of four with and without the maximum DCAP exclusion under the American Rescue Plan. Assumes parents are married and file jointly, have two children, take the standard deduction of $24,800, have only earned income that is equal to AGI, have child care expenses that meet the $16,000 cap, and take the maximum $10,500 DCAP exclusion.

For the same reasons that increasing the CDCTC qualified expenses cap mainly benefits higher-income families, increasing the DCAP exclusion limit does too. Only higher-income families are likely to both have access to a flexible spending account and be able to contribute an amount that surpasses the existing $5,000 limit. Therefore, only higher-income earners will be able to contribute more to a flexible spending account than they would have been able to under the existing limit. And, assuming they have two children, only these families will have the remaining expenses to claim the CDCTC as well.

THE CDCTC BEYOND THE AMERICAN RESCUE PLAN

The American Rescue Plan is an important first step in better harnessing existing provisions in the tax code to ensure low- to middle-income parents can access the quality child care they need both to work and ensure their children have safe and developmentally appropriate care. While the pandemic motivated these long-awaited changes, they only last through 2021. By 2022, the CDCTC will assume the underlying structure that has for so long left the lowest-income families behind. But the problem of child care unaffordability existed before the pandemic, and will not vanish when the pandemic abates. The deeper reason for the lack of affordability remains unchanged: Parents cannot afford to pay the rates providers need to charge to cover the costs associated with providing quality care.

Thus, it is critical that policymakers and advocates work to support parents with child care needs beyond the health crisis. 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.*[30] This is the single most effective way to ensure the lowest-income families receive the CDCTC.

2. *Consider significantly enhancing the credit rate for the lowest-earning families, but phase out the rate for higher-income families*. Conditional on the credit being fully refundable, this rate enhancement will yield higher credits for low-income families without providing additional benefits to the families that can already afford child care.

3. *Ensure that changes (1) and (2) above coincide with a CTC that is calculated independent of federal income tax liability.* If a family claims both credits, the increased CDCTC may decrease the amount a family receives from the CTC, effectively cancelling any net gains.

4. *Consider making the CDCTC advanceable*. Since the existing CDCTC is retroactive (it acts as a reimbursement after families pay for child care), it may not meaningfully help low-income families afford quality child care if they cannot bear the cost burden for the period of time between paying for care and receiving the tax credit. Making the credit advanceable means taxpayers would receive the credit in advanced installments so they have the ability to pay for the child care they actually need throughout the year. Administering advance payments for a credit that is based on earned income and child care expenditures can be difficult. Doing so requires projecting a taxpayer's income and child care expenses for the year. Lessons from the Earned Income Tax

Credit's advance payment option and proposals to improve it can serve as starting points for crafting an advance payment design for the CDCTC.

5. *Consider decoupling DCAP exclusions from CDCTC expenditures for low-income workers*. Doing so would enable low- to middle-income workers to take a DCAP exclusion for activities like employer-sponsored care or set-asides for a flexible spending account without reducing the maximum amount of expenses they can claim for the CDCTC. Limiting this policy change to low-income taxpayers is critical. If the change is implemented for all taxpayers, it would primarily allow higher-income taxpayers to receive a significantly larger credit in addition to a larger DCAP exclusion.

While the conversation about how to help low-income families afford child care often centers around the child care subsidy system, it is critical that policymakers and advocates expand their focus to include the tax code. The child care cost burden is steep, and any financial support is beneficial to families as well as America's workforce. Such assistance would help more lower-income parents work, as 73% of parents with an income below $50,000 said in 2019 that finding child care affected their ability to stay in the workforce.[31] And it would help lower-income parents work more hours, as 77% of parents with an income below $50,000 said that finding child care affected their ability to work more hours.[32] To build a comprehensive system of child care support for families beyond the current health crisis, it is time that we harness and refine all available mechanisms that can assist families; the CDCTC is one such powerful mechanism.

Endnotes

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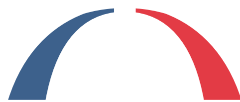

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