Supporting Child Care Through Tax Policy

Child care is necessary for working parents with young children. However, families frequently struggle with the high cost of care that in turn impacts their ability to find and keep stable employment and to provide for their family and the healthy development of their children. As such, every dollar a parent receives, through earned income, child care subsidies, tax credits, or other benefits, is critical.

Advocates for families and children often focus on improving and increasing direct assistance programs as a way to help working parents access and afford child care, such as the Child Care and Development Block Grant, the Temporary Assistance for Needy Families program, and Head Start. However, this ignores another significant policy option available to support families with young children – the tax system. The tax code includes a variety of policies that encourage work, benefit families with children, and offset the cost of child care, all providing clear immediate and long-term benefits.

Children under age six have the highest poverty rates among any demographic nationally, and financial instability during early childhood can have significant, long-lasting consequences.[1] A growing consensus of neuroscience and developmental research demonstrates the critical importance of a child's earliest years, meaning there is high potential for the conditions of poverty to "compromise children's life achievement and employment opportunities" by failing to foster their cognitive, social, and emotional development.[2]

While many federal programs with direct spending exist to support the wellbeing of families with children, the tax code includes two provisions that specifically help working parents pay for their child care expenses: the Child and Dependent Care Tax Credit (CDCTC) and an exclusion for employer-provided child and dependent care assistance (often called Dependent Care Assistance Plans, or DCAP). Two additional tax credits—the Earned Income

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Tax Credit and Child Tax Credit—are important components of the tax code for many low-income workers, designed to subsidize their income and foster financial stability. Because helping parents afford the high costs of child care is such a critical component of their path to financial stability, this brief focuses on those elements of the tax code that specifically offset the high costs of care.

Child and Dependent Care Tax Credit

The CDCTC allows eligible taxpayers to offset a portion of their out-of-pocket child and dependent care expenses necessary for them to stay employed. Specifically, taxpayers may claim: (1) up to $3,000 of expenses to acquire care for one qualifying dependent, defined as a child under 13 or an individual incapable of caring for him or herself, or (2) up to $6,000 for two or more dependents. The credit rate varies based on one's Adjusted Gross Income (gross income minus adjustments) and is calculated by multiplying the amount of qualifying expenses (up to the maximum credit amount) by the appropriate credit rate based on one's income. The maximum rate is 35% for taxpayers with an AGI of $15,000 or less, and gradually declines to a rate of 20% for taxpayers with an AGI above $43,000.[3]

The aggregate data on recipients of the CDCTC illuminates several realities. First, even though the credit rate is more generous toward lower-income taxpayers, many low-income families do not receive the credit because the CDCTC is not refundable.[4] A nonrefundable credit means the amount the taxpayer is potentially eligible to receive is limited to their tax liability. Therefore, taxpayers with little or no income tax liability receive little or no benefits from nonrefundable tax credits, including the CDCTC. As such, most CDCTC benefits accrue to middle- and high-income families rather than the low-income families who most need assistance affording child care. In 2015, only 4% of aggregate CDCTC dollars went to families with incomes under $25,000, while 55% went to families making over $75,000.

Second, on average, just 13% of taxpayers with children claim the credit, but the participation rate is even lower for those with lower incomes: fewer than 1% of all taxpayers with incomes under $15,000 claim the CDCTC, compared to almost 30% of those with incomes between $100,000 - $200,000.[5]

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Lastly, those with the lowest incomes receive, on average, the lowest credits: for those with incomes under $15,000, the average credit amount is $121, while for those with incomes over $25,000, the average credit amount is between $500 and $600. For those with incomes over $500,000, the average credit amount is $620.[6]

Employer-Provided Child or Dependent Care Assistance Plans (DCAP)

Employers can support their employees' child and dependent care needs by offering dependent care assistance plans, including flexible spending accounts (FSAs) where employees can set aside a portion of their pre-tax salary for expenses including child care, preschool, summer camp, and before or after school programs. Specifically, taxpayers can set aside up to $5,000 of their pre-tax wages per year for these benefits, which are not subject to income or payroll taxes. In addition to an FSA, a DCAP could also consist of direct payments by an employer to a child care provider, on-site care offered by an employer, or direct reimbursement of an employee's costs for child care.[7]

Data from the Bureau of Labor Statistics indicate that only about 42% of workers were employed at a company that offered a Dependent Care FSA in 2019 (though it is important to note that does not indicate the take-up rate of such benefits).[8] These workers are generally higher-compensated employees at larger companies—in 2017, 19% of those in the lowest 25% of wage distribution had access to a Dependent Care FSA, compared to 63% of those in the highest 25% of wage distribution. At the same time, only 20% of employees in companies with under 50 employees had access, compared to 72% of those in companies with over 500 workers.

Interaction Between CDCTC and Employer-Sponsored Care

Taxpayers can claim both the CDCTC and set-aside funds for a DCAP if they are for separate out-of-pocket child or dependent care expenses. However, for each dollar contributed to a DCAP, the taxpayer must reduce their maximum qualified expenses for the CDCTC credit by the same amount. Therefore, once an individual with one child contributes $3,000 into a Dependent Care FSA, they are no longer able to claim a CDCTC credit. When an individual with two or more dependents contributes the maximum of $5,000 into their FSA, they are only able to apply for the CDCTC up to the $1,000 difference.

In most cases, the average cost of care each year is much greater than both the contribution limits for dependent care assistance plans and credit rates under the CDCTC. Families with more than one child face an even steeper burden, as do families with infants for whom care is the costliest, and the lowest-income families, who must contribute a greater percentage of their income to child care.

Endnotes

1. Chuck Marr, Chloe Cho, and Arloc Sherman, "A Top Priority to Address Poverty: Strengthening the Child Tax Credit for Very Poor Young Children," Center on Budget and Policy Priorities, August 10, 2016. Available at: https://www.cbpp.org/research/a-top-priority-to-address-poverty-strengthening-the-child-tax-credit-for-very-poor-young.

2. Greg J. Duncan and Katherine Magnuson, "The Long Reach of Early Childhood Poverty," Pathways, Winter 2011. Available at: https://inequality.stanford.edu/sites/default/files/PathwaysWinter11_Duncan.pdf.

3. For purposes of this brief, "income" and "AGI" are used interchangeably.

4. Congressional Research Service, Child and Dependent Care Tax Benefits: How They Work and Who Receives Them, 2020, Available at: https://crsreports.congress.gov/product/pdf/R/R44993.

5. Ibid.

6. Ibid.

7. Internal Revenue Service. "Publication 15-B (2021), Employer's Tax Guide to Fringe Benefits," 2021. Available at: https://www.irs.gov/publications/p15b#en_US_2017_publink1000193662.

8. U.S. Bureau of Labor Statistics. "Flexible Benefits in the Workplace," 2021. Available at: https://www.bls.gov/ncs/ebs/factsheet/flexible-benefits-in-the-workplace.htm.