Interactions Between the CDCTC, DCAP, and 45F

By Caroline Osborn

INTRODUCTION

Raising children is expensive. One of the biggest challenges many parents face is affording child care, making up 8% to 19% of median family income.[1] Child care can cost more than college.[2] However, there are two federal tax provisions designed specifically to help reduce the financial burden of child care for working parents (CDCTC and DCAP) and one to help businesses offer child care to their employees (45F).

Tax Provision	Description	Goal
Dependent Care Assistance Program (DCAP)[3]	Allows employees to exclude up to $5,000 of dependent care assistance provided by their employer from their reported gross income. This may include direct payments by an employer for an employee's child care tuition, or employer-sponsored Flexible Spending Accounts (FSAs).	Employer-sponsored benefit program for working parents with child care expenses.
Child and Dependent Care Tax Credit (CDCTC)[4]	Nonrefundable credit that allows eligible taxpayers to offset a portion of their out-of-pocket child and dependent care expenses necessary for work. Taxpayers can claim up to $3,000 in expenses for one dependent and $6,000 in expenses for two or more. The maximum credit rate is 35% of eligible expenses, and it phases down with income until it reaches 20%.	Credit for working parents to help cover a portion of the cost of child care for children under age 13 or adult dependents.
Employer-Provided Child Care Tax Credit (45F)[5]	Nonrefundable tax credit for employers of up to 25% of qualified child care expenditures and 10% of qualified child care resource and referral expenditures. The credit maximum is $150,000.	Credit for businesses to offset the cost of providing or subsidizing child care for their employees.

The Child and Dependent Care Tax Credit (CDCTC) is the only tax credit specifically designed to offset out-of-pocket child care costs, but it is not accessed equally by all families.[6] In practice, more middle- and high-income working parents claim the credit due to having greater child care expenses and tax liability. The lowest-income families are not able to access it because the credit is nonrefundable, meaning taxpayers without any federal tax liability are ineligible and only those with tax liability may benefit.[7]

The Dependent Care Assistance Program (DCAP) allows working parents to set aside up to $5,000 from their gross income tax liability for child or dependent care expenses. And in some cases, employers contribute to these accounts. This is helpful because, unlike other employee benefits like healthcare, child care benefits are not included in the regular rate of pay.[8] Without the DCAP, employer child care contributions would be considered taxable income, reducing the benefit for employees when they pay taxes. To be eligible for the DCAP exclusion, child care assistance programs must follow certain requirements, such as not favoring highly compensating employees.[9]

Depending on the type of child care assistance an employer provides, they may be eligible to receive a tax credit for some portion of their contribution through the Employer Provided Child Care Tax Credit (45F).[10] This tax credit was designed to encourage employers to provide child care services to their employees.[11] It is a nonrefundable tax credit for employers of up to 25% of

qualified child care expenditures and 10% of qualified child care resource and referral expenditures. The credit maximum is $150,000. If the child care assistance complies with DCAP requirements, 45F can also offset some of the cost to employers of providing child care while also ensuring that their employees can receive up to $5,000 without impacting their tax liability.[12]

WHAT IS A FLEXIBLE SPEND ACCOUNT?

A Flexible Spend Account (FSA) is a type of DCAP in which an eligible employee may set-aside up to $5,000 from their gross income tax liability for child care expenses.[13] In some cases, an employer may contribute to these accounts. The amount an employee sets aside in this account decreases the maximum eligible expenses they can claim on the CDCTC. An FSA is just one of the many ways an employer may provide dependent care assistance that is eligible for the DCAP exclusion.

INTERACTION BETWEEN CDCTC AND DCAP

The CDCTC is the only tax credit designed specifically to help offset the out-of-pocket cost of child care for working parents. A DCAP is not a tax credit, but rather, a program that allows working parents to exclude up to $5,000 in child care benefits provided by their employer from their gross income tax. While most working parents with child care expenses are eligible to claim the CDCTC, only those with participating employers are eligible for a DCAP.

Unfortunately, when the CDCTC and DCAP are used together, it can reduce the impact for working parents. Individuals must decrease the maximum eligible expenses they can claim on the CDCTC dollar-for-dollar with employer contributions to child care through a DCAP.[14,15] Therefore, receiving DCAP benefits may change a taxpayer's CDCTC eligibility. Delinking these credits would ensure that all parents have equal access to these two tax provisions that can help reduce the overall cost of child care.

When determining eligibility for the CDCTC, taxpayers calculate:

CDCTC Maximum minus DCAP Contribution

If that number is equal to or less than zero, then the taxpayer is not eligible to claim the CDCTC. Generally, working parents with one child that max-out

their DCAP are not eligible to claim the CDCTC. Working parents with two or more children that max-out their DCAP may be able to claim up to $1,000 in eligible expenses on their CDCTC.

Employer: Offers employee benefit for child care subsidies of up to $5,000.[a] Employer claims 45F on their taxes and receives a tax credit equal to 25% of qualified expenditures, with a maximum credit of $150,000.

Employee: Enrolls in a DCAP to access the $5,000 subsidy from the employer to offset their cost of child care. For some, this subsidy only covers a fraction of the total cost of child care. Those employees would pay remaining expenses out-of-pocket.

Employee: Files taxes to determine CDCTC eligibility. In all cases the DCAP exclusion will reduce qualified expenses for purposes of the CDCTC dollar-for-dollar, and in some cases the DCAP exclusion will be large enough to render the employee ineligible to claim the CDCTC.

Example 1

Single mother Ann has a son aged 2. She works for a manufacturing firm that provides reimbursement for child care expenses up to $10,000 per year. Ann works the night shift and requires non-traditional hours of care, meaning her child care tuition is higher than average in her area. Her child care tuition amounts to $20,000 per year, so her employer reimbursement covers half.

Of Ann's $10,000 in employer-provided benefit, only $5,000 is eligible for DCAP tax-exempt status, so she must report the remaining $5,000 as taxable income. She calculates how much she can claim on the CDCTC and finds that she is no longer eligible for the tax credit:

CDCTC Maximum minus DCAP Contribution
$3,000 - $5,000= $-2,000

Even though Ann spends $10,000 out-of-pocket on child care, she cannot claim those expenses.

Example 2

John and Jane are married with two young children, ages six months and three years old. John works for an insurance company that provides subsidized, on-site child care for their three-year-old. Jane is returning to

a Employers may provide child care benefits greater than $5,000 to their employees, but any amount greater would be reported as taxable income by the employee.

work but decided they do not want to send their infant to a large center, and instead want to use a family child care provider. The cost of tuition at the center is $15,000 per year, but with the employer-provided discount, it is just $3,000 per year. The tuition at the family child care home is $18,000 per year.

CDCTC Maximum minus DCAP Contribution
$6,000 - $5,000 = $1,000

John and Jane receive $12,000 in child care support from John's employer, but only $5,000 is eligible for DCAP exempt status. The remaining $7,000 is reported as taxable income. Because John and Jane have two children, they are eligible to claim up to $6,000 in child care expenses. Even though they max out the DCAP with their employer contribution, they can still claim the CDCTC for $1,000 in eligible expenses for infant care because of the higher CDCTC expense cap for families with two or more children.

Example 3

Henry and Kay are working parents with a three-year old daughter. Kay works as a restaurant server and Henry works at a small construction firm. Their daughter attends a family child care home with a tuition of $7,000 per year. Henry's employer sponsors a Flexible Spend Account (FSA) and allows employees to contribute up to $2,000. This means they can set aside $2,000 pre-tax. When they file their taxes, they calculate the amount they can claim on the CDCTC:

CDCTC Maximum minus DCAP Contribution
$3,000 - $2,000 = $1,000

Because Henry and Kay do not contribute up to the DCAP maximum, they are still able to claim $1,000 of child care expenses on the CDCTC. Henry and Kay pay $4,000 in child care expenses out-of-pocket but cannot claim these expenses on the CDCTC.

WE NEED THE CDCTC, DCAP, AND 45F

Each of these tax credits serve a unique purpose to support working parents and businesses. DCAP and 45F help incentivize employers to become more involved in providing dependent care and child care for their employees.[16] The CDCTC, on the other hand, was designed to reduce the costs of child care to the taxpayer.[17]

The CDCTC does not incentivize business involvement in the provision of child care, in fact, it may have the opposite effect. A business considering taking on the expense of child care assistance, but when they realize this benefit may be cancelled out for the employee due to decreased eligibility for the CDCTC, they may rethink the value of investing their own dollars in child care benefits.

Having *only* DCAP does not help working parents without employer sponsored benefits, but having *only* CDCTC limits employer incentive to get involved with child care. To ensure that both the goals of affordability and business involvement are met, we need all three credits. Delinking the DCAP and CDCTC would allow them to best accomplish these dual objectives.

RECOMMENDATIONS

Employers who take steps to help their employees afford child care should be applauded, but employees should not be penalized for capitalizing on benefits offered by their employers.

To allow all working parents to feel the full effect of the CDCTC, employees should be able to claim the CDCTC up to the maximum allowable expenses for any out-of-pocket child care expenses, regardless of employer contribution.[18] Eligible individuals should also be able to claim out-of-pocket expenses that are greater than the maximum DCAP contribution. This change, when coupled with BPC's previous recommendations to make the CDCTC more accessible to lower-income families, will help make child care more affordable for working parents.[19]

ISN'T THIS DOUBLE DIPPING?

No. Individuals should not be able to claim the same expenses on the CDCTC that they claim through DCAP. Instead, eligible individuals should be able to claim out-of-pocket expenses that are greater than the maximum DCAP contribution.

Interactions between these tax codes have a substantial impact on working families' bottom line.[20] Understanding how these credits interact and why the DCAP and CDCTC should be delinked will is essential as policymakers and stakeholders design solutions to the child care crisis that work.

Endnotes

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