The Child and Dependent Care Tax Credit

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WHAT IS THE CHILD AND DEPENDENT CARE TAX CREDIT?

The Child and Dependent Care Tax Credit (CDCTC) is a tax benefit that allows some families to reduce the amount of federal income taxes owed by subtracting a portion of their yearly child care (or dependent adult care) expenses from their year-end federal tax bill. The credit is intended to help working parents defray the high cost of securing safe, professional care for their young children.

HOW DOES THE CDCTC WORK?

The size of the Child and Dependent Care Credit depends on several factors, including the total amount of money a family spent on child or dependent care throughout the year, the number of qualifying children and/or dependents, and the amount of the household's annual earned income. For a household with one qualifying child and income less than $15,000, the credit is calculated as 35% of up to $3,000 in eligible child care expenses. The percentage of expenses phases down as household income increases until, for households with an annual earned income above $45,000, the credit amounts to 20% of eligible expenses. For households with two or more qualifying children, the credit is calculated the same way, but the limit on eligible expenses is twice as high. In theory, the maximum credit for a one child family is $1,050, and twice that for a family with two or more children.

TAX CREDITS AND REFUNDABILITY.

Unlike tax deductions, which reduce overall taxable income, tax credits subtract directly from the amount the taxpayer owes. For example, a single taxpayer who makes $20,000 a year would owe, without any tax credits or deductions beyond the standard deduction, approximately $1,455 in federal income tax. If, however, that taxpayer qualified for a $1,000 tax credit, the actual amount she would be required to pay would be reduced to $455. In some cases, credits can reduce a taxpayer's liability all the way to zero, or even below zero. In these cases, if the credit is "refundable," the taxpayer receives the leftover in the form of a refund check. If, for example, the hypothetical taxpayer described above qualified for a $2,000 refundable credit, she would then receive a $545 refund check ($1455 - $2,000 = -$545, or $545 due the tax payer in the form of a refund).

The Child and Dependent Care Credit is not refundable. This means that, if a taxpayer owes no federal income tax at the end of the year, the CDCTC has no benefit for him or her. The practical impact of the CDCTC's nonrefundability is that the very families who are eligible for the maximum credit (households earning less than $15,000 a year) do not actually benefit from the CDCTC. This is because a low income in combination with eligibility for other deductions and/or credits, means that very few, if any, families earning less than $15,000 per year have positive income tax liability. As a result, these low-income families cannot and do not benefit from a nonrefundable credit like the CDCTC.

In fact, in 2006, less than 3% of the total dollars claimed by taxpayers through the CDCTC went to households earning less than $20,000.[1]

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IMPROVING THE CHILD AND DEPENDENT CARE CREDIT

The average annual cost of care for a young child in a licensed child care center surpasses $10,000 a year. Even less expensive, unlicensed, family care homes can cost more than $9,000 on average.[2] If the CDCTC is intended to help low-income families defray the high cost of childcare, it is failing.

The Child and Dependent Care Tax Credit was designed to direct the maximum credit to low-income families. Unfortunately, the fact that the CDCTC is non-refundable fully undermines this laudable goal. There is no doubt that the first, and most important improvement to be made to the CDCTC is to make it refundable, thus allowing low-income families to benefit just as middle and high-income families currently do.

The second necessary improvement is to increase the overall size of the credit. Child care costs have skyrocketed over the past decade, and the maximum credit covers just 10% of average child care costs. With households "eligible" for the maximum credit unable to actually benefit from the CDCTC, the average size of credit claimed in 2006 was only $541.[3] For a family living in Massachusetts, the most expensive child care state in the country, that $541 amounts to less than 4% of the average annual cost of care for just one infant.[4] Clearly, the credit is too small. In order to better reflect the current realities of childcare costs, Congress should not only increase the cap on eligible expenses, but also boost the percentage of expenses used to calculate the size of the credit.

CALCULATING THE CREDIT EXAMPLE

Mary and John Smith have two young children. John works full time, making $8.50 an hour, and Mary works part time at the federal minimum wage. Together, their annual household income is approximately $24,000 a year. The Smiths live in the relatively low-cost childcare state of Ohio, and spend about $450 a month (coming to $5,400 for the year) for a licensed child care center to care for the kids when Mary is working.

The Smiths certainly qualify for the Child and Dependent Care Credit as they pay for child care, are both employed, and earn income. With two qualifying children, child care expenses up to $6,000 can be used to calculate the size of the credit. Since the Smiths pay less than $6,000 a year for care, their credit, then, will be a percentage of the full $5,400 they spend on childcare. That percentage will be less than the maximum 35%, since their combined household income is over $15,000. In fact, with an income $9,000 above $15,000, the percentage declines by 4.5 points, to 30.5%. All told, the Smiths will be eligible for a $1,647 Child and Dependent Care Tax Credit.

However, with the standard deduction and dependency deductions for their two children alone, the Smiths will owe only approximately $600 in federal income taxes. Therefore, despite the fact that they are eligible for a $1,600 child care credit, their actual benefit will be only about one third of that. In practice, the CDCTC will help the Smith family cover only 11% of their childcare costs. If the credit were refundable, the CDCTC would subsidize three times that.

NOTES:

1 Internal Revenue Service, Statistics of Income Division
2 NACCRRA, "Parents and the High Price of Child Care: 2008 Update"
3 Internal Revenue Service, Statistics of Income Division
4 Massachusetts cost comes from NACCRRA, "Parents and the High Price of Child Care: 2008 Update"

FOR MORE INFORMATION, PLEASE CONTACT:

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