

# Reducing the Cost of Child Care Through State Tax Codes in 2018

## OVERVIEW

The high cost of quality child care is a budget constraint for many working families. The average cost of full-time child care can range from \$3,000 to \$17,000 per year depending on the age of the child and location of the family. This cost is particularly daunting for parents who are working but earning low wages. Families in poverty contribute over 30 percent of their income to child care compared to about 6 percent for families at or above 200 percent of poverty.<sup>1</sup> Most families with children need one or more incomes to make ends meet which means child care expenses are an increasingly unavoidable and unaffordable expense. This policy brief examines state tax policy tools that can be used to make child care more affordable: a dependent care tax credit modeled after the federal program and a deduction for child care expenses.

## HOW THE FEDERAL DEPENDENT CARE CREDIT WORKS

The federal government allows a nonrefundable income tax credit to help offset child care expenses. In 2018, working parents with children 12 years of age or younger could claim a credit to partially offset up to \$3,000 of child care related expenses for one child and up to \$6,000 of expenses for two or more children; low-income taxpayers could receive a credit of up to 35 percent of these expenses. In

TABLE 1  
**Refundable and Non-refundable Approaches to Reducing Child Care Expenses via State Tax Credits**

Background	
Family Income (couple with one child)	<b>\$32,000</b>
State Taxable Income (after exemptions, deductions)	\$3,700
Annual child care expenses	\$12,000
Federal Child & Dependent Care Credit	\$1,560
<b>State Income Tax Owed Before Credits</b>	<b>\$139</b>
Option 1: Non-refundable Child Care Credit	
RHODE ISLAND CURRENT LAW	
Potential Child Care Credit (15% of federal credit)	<b>\$234</b>
Actual Child Care Credit Received (limited to pre-credit tax liability)	\$139
<b>True Percentage of Federal Child Care Credit Received</b>	<b>9%</b>
Option 2: Refundable Child Care Credit	
POTENTIAL REFORM	
Potential Child Care Credit (15% of federal credit)	<b>\$234</b>
Actual Child Care Credit Received	\$234
<b>True Percentage of Federal Child Care Credit Received</b>	<b>15%</b>
<b>Tax Cut (compared to nonrefundable credit)</b>	<b>\$95</b>

*\* Rhode Island is used as the example state. RI currently allows a nonrefundable credit equal to 15% of the federal credit. This example illustrates how a refundable credit at the state level can be more valuable to low-income families than a nonrefundable credit. Note that RI also offers a refundable EITC that would reduce final state income tax payments by this family.*

2018, this meant a maximum credit of \$2,100. The credit percentage gradually falls from 35 percent, for those with income under \$15,000, to 20 percent of expenses for higher-income taxpayers. The credit drops by one percentage point for every \$2,000 of income; taxpayers with incomes over \$43,000 can claim the minimum credit of 20 percent of child care expenses. This “sliding scale” approach helps to target tax reductions somewhat more effectively to low-income taxpayers, although the credit is available to even the wealthiest taxpayers. In 2016, the income group with the largest proportion of benefit from the credit was those with incomes between \$100,000 and \$200,000.<sup>2</sup>

## **OPTIONS FOR STATE DEPENDENT CARE TAX REDUCTIONS**

Nearly half of the states offer some form of state income tax break for families with dependent care expenses. Of those, the majority (23 states including the District of Columbia) model their state credit after the federal credit. This section looks at the various approaches states have taken—and assesses the usefulness of each approach in reducing the cost of low-income child care.

### *Credits vs. Deductions*

The most basic choice to make in reducing taxes for dependent care is between a tax credit and a tax deduction. Almost all of the states that currently provide dependent care tax breaks use tax credits, which reduce taxes on a dollar-for-dollar basis. However, a few states allow income tax deductions for child care expenses. Deductions reduce taxable income on a dollar-for-dollar basis. In states with graduated income taxes (that is, income taxes that apply higher rates to higher-income taxpayers), deductions will be a better deal for wealthier taxpayers than for low-income parents. As shown in the accompanying hypothetical examples, a \$3,000 child care deduction will be worth slightly more to a family earning \$100,000 than to a family earning \$20,000, while a tax credit based on the federal “sliding scale” rules will give a larger tax break to the lower-income family than to the wealthier taxpayer.

### *Limiting Eligibility by Income*

Lawmakers must also choose whether to impose income eligibility limits. While the federal credit is available to taxpayers at all income levels, some states have chosen to restrict their credits to low- and middle-income taxpayers. Ten states currently have such an income limit, ranging from \$30,160 in New Mexico to \$100,000 in California and Oklahoma. By imposing income limits, states can reduce the cost of tax cuts for dependent care while targeting the benefits to those lower- and middle-income taxpayers for whom child care expenses are most burdensome.

As noted above, all states with child care credits use a “sliding scale” (modeled after the federal credit) that gives lower-income families a larger credit. But some states take additional steps to target tax cuts more precisely to low-income families. For example, the Nebraska credit is calculated as 100 percent of the federal credit at low income levels and 25 percent of the federal credit at higher income levels. This approach targets the benefits of the Nebraska credit much more efficiently to low- and middle-income parents than does the federal credit.

## *Refundability*

For states allowing tax credits, possibly the most important policy choice is whether the credit should be refundable or non-refundable. A non-refundable tax credit can only be used to reduce income taxes to zero. A refundable credit, by contrast, does not depend on the amount of income taxes paid: if the credit amount exceeds your income tax liability, the excess amount is given as a refund. Refundability is an especially valuable feature in state credits for two reasons: first, low-income parents with substantial child care expenses and little or no income tax liability will receive little to no benefit from a non-refundable credit, and second, because the federal credit is nonrefundable, the state credit may be the only income-boosting tax cuts for child care expenses available to these families.

## *Tying Benefits to Inflation*

States must also decide whether to preserve the real value of these tax breaks by tying their value to inflation (See ITEP Brief, [\*\*“Indexing Income Taxes for Inflation: Why It Matters”\*\*](#) for more information). The impact of inflation means that the maximum \$2,100 federal credit is worth slightly less every year. This problem affects both the income eligibility limits and the maximum credit amount. Very few states have taken steps to avoid this problem—which means that the value of this credit in reducing the cost of child care falls every year.

## **ARE TAX BREAKS THE BEST APPROACH TO MAKING CHILD CARE AFFORDABLE?**

Tax credits are not the only way to reduce child care costs. Other policy tools are available, including direct subsidies to the families incurring these costs. States need to determine which approach works best for their budgeting process and spending priorities. That being said, the sizable, increasing portion of income average Americans spend on child care can and should be addressed at the state level.

Income tax breaks for dependent care have become an established practice. A majority of states now follow the federal government’s lead in providing income tax credits or deductions to make child care more affordable. As this policy brief has noted, some states do a better job than others in targeting tax cuts to the low- and middle-income taxpayers for whom child care represents a substantial expense. States seeking to provide targeted reductions to the cost of dependent care can do so most effectively by enacting a refundable tax credit with relatively low-income limits.

## ENDNOTES

1 National Women's Law Center. "Improving the Child and Dependent Care Tax Credit Would Help Working Families with the High Cost of Child Care," September 2018. <https://nwlc-ciw49tixgw5lbab.stackpathdns.com/wp-content/uploads/2018/09/Improving-the-CDCTC.pdf>

2 Ibid.

## APPENDIX A

### State Dependent Care Credits and State Child Credits in 2018

State	Description of Credit
AR	Nonrefundable 20% of federal credit; Refundable 20% of federal credit for children under 6
CA	Capped nonrefundable credit; percent of credit varies on FAGI; limited to taxpayers with income under \$100K
CO	Capped refundable credit; percent of credit varies on FAGI; limited to taxpayers with income under \$150K
DC	Capped nonrefundable 32% of federal credit
DE	Nonrefundable 50% of federal credit
GA	Capped nonrefundable 30% of federal credit
HI	Capped refundable credit; percent of credit varies on state AGI
IA	Capped refundable credit; percent of credit varies on state net income; limited to taxpayers with income under \$45K
KY	Capped nonrefundable 20% of federal credit
LA	Refundable credit for taxpayers with incomes below \$25K; nonrefundable credit for all other taxpayers; percent of credit varies on FAGI
MD	Nonrefundable credit; percent of credit varies on FAGI
ME	Refundable 25% of federal credit up to \$500; nonrefundable 25% of federal credit over \$500; percentage varies on service provider
MN	Capped refundable credit; limited to taxpayers with income under \$39,400
NE	Refundable for taxpayers with income under \$29K; nonrefundable for taxpayers with income over \$29K; percentage of credit varies on FAGI
NJ	Capped nonrefundable credit; limited to taxpayers with income under \$60K
NM	Capped refundable 40% of federal credit; limited to taxpayers with income under \$31,160
NY	Refundable credit; percent varies on state AGI
OH	Capped nonrefundable credit; percent of credit varies on state AGI; limited to taxpayers with income under \$40K
OK	Offers choice of greater between nonrefundable 5% of federal child tax credit and nonrefundable 20% of federal CDCTC
OR	Capped refundable credit; percent of credit varies on greater between state AGI and FAGI, age and disability of dependents; limited to taxpayers with income below 300% of federal poverty
RI	Nonrefundable 25% of federal credit
SC	Refundable 7% of federal credit
VT	Refundable 50% of federal credit for filers with incomes below \$30K if single \$40K if married; nonrefundable 24% of federal credit for all other filers

*Notes: ID, MA, MT and VA offer deductions for child and dependent care expenses*

### State Child Credits

State	Description of Credit
CA	Refundable income-limited Dependent Exemption Credit (\$353/dependent) higher than state's Personal Exemption Credit (\$114/filer)
CO	Refundable credit for children under age 6; limited to FAGI under \$60,000; credit ranges from 5 to 30% of federal credit based in FAGI Note: Colorado's credit passed in 2013, but the legislation tied funding to federal and state online sales tax legislation. The US Supreme Court ruled in favor of marketplace fairness in 2018, but the Colorado legislature has, to date, not funded the credit.
ID	Nonrefundable \$205 credit
OK	Offers choice of greater between nonrefundable 5% of federal child tax credit and nonrefundable 20% of federal CDCTC
NY	Refundable credit of the greater of \$100 per qualifying child or 33% of the taxpayer's allowed federal credit
NC	Nonrefundable income-limited \$100 per child tax credit (\$125 for filers with income under \$40,000)
WI	One time \$100 child tax rebate in 2018