CENTERING **FAMILIES** IN THE US TAX CODE

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CHILDREN'S EQUITY PROJECT

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INTRODUCTION

Children under age five are the most likely age group to live in poverty in the United States. Today, more than one in six children under five live in poverty, impacting children of all races and ethnicities, but falling disproportionately hard on historically and contemporarily marginalized groups, including Black, Latine, and Native American children.[1]

In 2020, 14 million children lived in households where workers made below $15, what many consider to be the benchmark for a minimum wage.[2] Children's earliest years, some of the most critical in the life course, happen to correlate with a period of financial hardship for families. Parents in this stage are generally earlier in their careers and places of employment, and are not at their earning peak. Taken together, many families experience acute stress and financial hardship during a critical part of their parenting journey and their child's development.

In more than 60% of families with children under the age of six, all parents in the household work.[3] This requires that parents arrange for child care so that they can maintain or seek employment.[4] However, the price of child care remains prohibitively high. The average annual price of child care has increased by 23% since 2019.[5] That price currently hovers around $11,500 on average.[6] Based on a national database maintained by the U.S. Department of Labor, the median child care prices for infant and toddler care in a center was more than $17,000.[7] Yet, families with low incomes spend disproportionately more than higher-income families for child care. Those earning up to $34,000 devote as much as 31% of their income to child care expenses.[8] In Maricopa County, Arizona, the amount a family of four pays on child care eclipses every other household expense except for the cost of housing.[9]

Families have few available supports to help defray the costs of raising children, including affording child care. The federal child care subsidy program–geared toward making child care more affordable for working families earning up to 85% of their state's median income–reaches 16% of eligible children.[10] Similarly, only 10% of families eligible for Early Head Start receive services, and fewer than half or preschoolers eligible for Head Start receive services.[11] While enrollments are reaching record-highs, state preschool programs still serve only 7% of three-year olds and 35% of four-year olds.[12]

While some workers may be able to gain child care benefits through their employers, access is limited and disproportionately available to higher income workers. The most recent data show that only 6% of those workers in the lowest quartile of wage earners receive child care benefits (e.g., on-site child care, child care subsidies, access to flexible spending accounts for dependent care, etc.).[13] In contrast, nearly 20% of workers in the highest quartile of wage earners have access to these benefits.[14]

There are incentives in the tax code to help families pay for raising children, including child care. These include the Child and Dependent Care Tax Credit (CDCTC) and the Dependent Care Assistance Program (DCAP). Additionally, Congress has provided tax incentives to encourage employers to offer child care benefits in Section 45F of the Internal Revenue Code. We also provide families with young children a more generalized benefit in the form of the Child Tax Credit, which can be used to cover any expenses a family with children may incur.

Although the tax code is not an efficient way of addressing the structural issues in child care—high costs, poor compensation and job-quality for care workers, uneven quality, and inadequate supply–it can be used as a tool to help defray the cost of raising children, helping families through a period of liquidity constraints - a period most acute for families with young children.

In the next Congress, provisions included in the Tax Cuts and Jobs Act of 2017 will expire, precipitating action by lawmakers to preserve or expand some of the tax incentives included in that law, while considering other ways to ease the tax burdens of businesses and individuals. Federal tax laws are rarely the subject of serious deliberation in Congress and the credits and programs referenced above have not been permanently improved in years. Congress should take the opportunity to revise the tax code with provisions that are meant to help families with young children, craft meaningful incentives for businesses to extend child care benefits to their employees, support child care providers, and help spur child care supply.

This brief reviews existing levers in the tax code and provides a set of recommendations to craft a family first tax policy. Congress should broaden the pool of families eligible for benefits, remove barriers to tax credits' use, and make it simple for every eligible family to navigate the process of securing benefits. Congress should consider expanding the child tax credit, especially for those families with children who are not yet school-aged, so that we can move closer toward eliminating child poverty. It should preserve and optimize those credits dedicated to helping families pay for child care. For businesses, Congress should address the existing shortcomings of 45F by making the credit more generous, particularly for small businesses. Congress can also tap into other parts of the code to spur child care supply in Opportunity Zones and support the early educator workforce through tax breaks.

OVERVIEW OF EXISTING PROGRAMS

Child Tax Credit

Established in 1997, the Child Tax Credit (CTC) provides a non-refundable tax credit of $1,000 per child zero to sixteen years old.

There is also a refundable portion of the credit, referred to as the Additional Child Tax Credit (ACTC), which provides very low-income families who may have low or no tax liability access to $1,000.

The Tax Cuts and Jobs Act of 2017 made temporary changes to the CTC that are available until December 2025. These changes include increasing the credit to $2,000 per child and increasing the ACTC to $1,400 per child. Accordingly, the CTC is partially refundable. However, because the CTC is not fully refundable, roughly 24 million children in low-income families receive a smaller credit than those in middle-income families.[15] CTC benefits phase out for married taxpayers with income greater than $400,000 and unmarried taxpayers with income greater than $200,000.

The ARP made additional temporary adjustments to the CTC available only for the 2021 tax year, including making the CTC fully refundable; increasing the tax credit to $3,000 per child, with an additional $600 for those with children under six; and increasing the age of eligible children to seventeen years old.

The changes made as a part of the ARP reduced child poverty to a record low 5.2% in 2021.[16] The following year, child poverty jumped to more than 12%,[17] and the expiration of the CTC enhancements in the ARP contributed to more than half of that increase.[18]

The cost of the ARP modifications to the CTC amounted to nearly $30 billion in 2021, and according to recent estimates the cost of maintaining these improvements over the next decade would cost $1.6 trillion.[19]

Child & Dependent Care Tax Credit

Established in 1976, the CDCTC is the only tax credit available to help families offset the costs they incur for child care. The CDCTC is non-refundable, meaning it can reduce an individual's tax liability but it cannot increase an individual's tax refund or create a refund an individual would otherwise not have. For this reason, the CDCTC does not benefit many low-income families who have low, or no, tax liability.

The CDCTC is available to those who incur qualifying expenses for dependent care of a qualifying individual (e.g., a child or someone who is incapable of taking care of themselves) so that the tax filer can work or look for work.[20] The amount of the credit is calculated by multiplying a capped amount of care-related expenses ($3,000 for one qualifying individual and $6,000 for two qualifying individuals) to a credit rate based off of the tax filer's adjusted gross income (AGI). Currently, the credit rate is set at 35% for those with $15,000 or less in AGI and is reduced by 1% for each additional $2,000 in AGI up to $43,000 when the credit reaches its statutory minimum of 20%.[21]

Based on analysis conducted by the Congressional Research Service in 2018,[22] CDCTC is limited in a few key respects.

Shallow Impact on Affordability: The average credit for most families does not exceed $600 on average and lower-income families (those earning $30,000 or less) receive considerably less than this amount (between $125 and $350).

Skewed Toward Higher Income Families: Middle and upper income families represented the lionshare of those benefiting from the credit. More than 54% of the claimed CDCTC dollars were for earners making more than $75,000 a year. While the CDCTC is designed to target low-income families, and to apply the most generous rate for those earning the least, less than 5% of claimed CDCTC dollars were claimed by those making $30,000 or less (likely due to its non-refundable nature).

Limited Reach: Only 13% of families with children claimed the credit, though the data show that significantly more families rely on some form of non-parental care to work.

Insensitive to Inflation: Because the credit has not been adjusted, the credit has lost a third of its value adjusting for inflation. Fixing the credit amount in a manner that does not account for inflation is particularly challenging considering that the increase in the price of child care outpaces the consumer price index by 2:1.[23]

The American Rescue Plan Act (ARP) modified the CDCTC for tax year 2021. These were the first changes made to the CDTCT in twenty years. The ARP made three major changes to strengthen the CDCTC:

Refundability: The ARP made the CDTCT refundable, making it more likely that low-income families would experience the credit's benefit.

Increased Cap on Qualifying Expenses: Qualifying expenses that could be applied toward the credit were increased from $3,000 to $8,000 for one qualifying individual and $6,000 to $16,000 for two qualifying individuals.

More Generous Rate: The CDCTC credit rate for those earning at or below $125,000 was 50%. The credit gradually reduces by 1% for every $2,000 earned in excess of the $125,000 base until it reaches 20% at $183,000. For workers earning between $183,000 - $400,000, the rate stayed at 20%. For workers earning more than $400,000, the credit was reduced by 1% per additional $2,000 until reaching a 0% rate at $438,000.

These modifications increased the average credit for families by more than three-fold: In 2021, the average credit was nearly $2,100.[24] The cost of these enhancements for 2021 was $8 billion.[25] Congress did not extend these modifications after the 2021 tax year.

Dependent Care Assistance Program

The Dependent Care Assistance Program (DCAP) is not a tax credit for individual families, but rather a program where employers allow their employees to exclude a certain amount of their gross income to pay down dependent care expenses. The law allows employees who have access to this program to exclude up to $5,000 of their gross income for care. Typically, employers will offer DCAP in the form of a Flexible Spending Account (FSA) that allows employees to set-aside $5,000 in pre-tax dollars for child care expenses.

Like with the CDCTC, the ARP also enhanced DCAP by increasing the amounts that families could exclude from their gross income from $5,000 to $10,500. The cost of the one-year enhancement to DCAP was $117 million.[26]

DCAP almost exclusively benefits middle- and upper-income earners. Based on data from the Treasury, in 2020 $938 million were distributed in DCAP benefits. Those earning $60,000 or more consumed $900 million of those benefits (96%) and of the 1.5 million individuals who benefited only 69,000 earned less than $30,000.[27]

45F

Established in 2001, Internal Revenue Code Section 45F (45F) provides a tax incentive for employers to extend certain child care benefits to their employees.[28] Employers are eligible for a nonrefundable tax credit of up to 25% of qualified child care expenditures and 10% of qualified child care resource and referral expenditures, capped at $150,000. Meaning employers must spend approximately $600,000 on child care expenditures of $1.5 million to receive the full credit.[29] According to the IRS,[30] qualified child care expenditures under 45F include:

- **Costs associated with acquiring, constructing, rehabilitating or expanding property** used as the taxpayer's qualified child care facility.
- **Qualified child care facility expenditures are operating expenses made by the taxpayer,** including amounts paid to support child care workers through training, scholarship programs, and providing increased compensation to employees with higher levels of childcare training.
- **Qualified resource and referral expenditures** which include amounts paid or incurred under a contract with a qualified child care facility to provide child care services to employees of the taxpayer.

Take-up of this credit is limited. The Government Accountability office, reviewing the most recent IRS data, found that between 169 - 278 corporate tax returns in 2016 claimed this credit out of an estimated 70,000 - 78,000 corporate returns submitted for that year.[31] Challenges cited by the GAO in uptake for 45F include: the substantial capital costs associated with investing in child care subsidization or the construction of a facility; the limited awareness among the business community of the credit; and the the limitations around what qualifies as a qualifying expenditure and the modest level of the capped credit available to businesses.

Opportunity Zones

Congress created Opportunity Zones, or OZ's, as part of the 2017 Tax Cuts and Jobs Act to incentivize private investments in economically distressed communities in order to address the persistent lack of growth. The original concept was endorsed by nearly 100 bipartisan Congressional cosponsors in both the House and Senate. Investors with capital gains can invest in Opportunity Zones (OZ) and can defer and substantially reduce their capital gains taxes. The amount of taxes owed by the investor is reduced incrementally and if the investor leaves the funds for 10 years their tax liability is reduced to zero.

An "OZ" is defined as a census tract that is an economically depressed community where new investments, under certain conditions, are eligible for preferential tax treatment. Nearly 9,000 OZ's were nominated by each states' Governor to the Department of Treasury and had to be: 1) a qualified low income community (LIC) using the same criteria as eligibility for the New Market Tax Credit or; 2) a tract that was contiguous with an LIC as long as the median family income did not exceed 125% of the LIC.

Approximately 35 million people reside in OZs with nearly a quarter under the age of 18. They are characterized by census tracts with higher poverty rates and lower educational attainment. The poverty rate in OZs is nearly twice that of other census tracts. They are also characterized by higher unemployment rates, higher rates of incarceration and low property values and rates of homeownership. More adult residents of OZs lack a high school diploma than have obtained a college degree. The child care gap is also higher in OZ's.

Although investments in child care have the potential to be a powerful driver of economic growth and research has demonstrated a strong return on investments, there is little incentive for investors to invest in child care. Based on the current business model for child care, there is little, if any, profit to be made and as a result, child care does not naturally attract investors.

Educator Expense Deduction

The deduction for Out-of-Pocket Teacher expenses was first created as part of the Job Creation and Worker Assistance Act of 2002 and was subsequently extended six times as part of the tax extenders legislations until made permanent in the Protecting Americans from Tax Hikes Act (PATH Act) of 2015. The Path Act allows teachers to deduct out-of-pocket teacher expenses (now up to $300 per year).

A teacher is defined as someone who works as a kindergarten through grade 12 teacher, instructor, counselor, principal or aide for at least 900 hours a school year in a school that provides elementary or secondary education as determined under state law. This provision excludes early childhood teachers including Pre-K teachers even if employed in public schools.

An eligible educator can deduct up to $300 of unreimbursed trade or business expenses. Qualified expenses are amounts paid or incurred for participation in professional development courses, books, supplies, computer equipment (including related software and services), other equipment, and supplementary materials that are used in the classroom.

Student Loan Assistant for Early Educators

Numerous studies demonstrate the long-term positive impact of high-quality, early care and education on the cognitive, social and emotional development of young children. Research over decades also shows that the quality depends almost entirely on the quality and stability of adult-child interactions. Recruiting and retaining qualified, competent teachers in the earliest years has been a longstanding challenge. This is due in large part to the low pay of the ECE workforce and high costs associated with obtaining a college degree. ECE teachers are historically poorly paid, making less than half of what an elementary teacher makes with little or no benefits. Nearly half qualify for some type of public assistance.

Today, the average student debt is nearly $42,000 while the annual median salary of an early educator is $30,370. ($14.60/hr.)[32] and the median for a Kindergarten teacher is $63,670.[33] The pay gap, compounded by the reality that individuals in similar industries receive higher pay, benefits and are eligible for other benefits such a student loan forgiveness leave little incentive to work in the ECE field. Thus, providing any assistance to early educators to help ease the burden associated with entering and staying in the profession, including assistance in servicing the debt incurred pursuing higher education, would serve as a boon to these workers. According to data from the RAPID Survey based out of the Stanford Center for Early Childhood, one in five early educators holds student debt, a higher rate compared to the national average of student debt holders.[34]

RECOMMENDATIONS

As families gain greater work experience they are more likely to have higher incomes, greater access to credit, and attain other wealth-building tools including home ownership and savings. But families with young children face acute economic pressure and, as documented by the U.S. Treasury, they face the greatest liquidity constraints when their children are in their first years of life.[35] Families are struggling and adjusting the US tax code to put more money in parents' pockets could be a significant step forward.

The current patchwork of tax credits that are available to help families defray the cost of raising children are inadequate. All of them are too modest in terms of what they offer, none of them allow adjustments for inflation, and most of them skew more heavily in favor of helping middle and upper income families due to their non-refundable nature. Moreover, the system lacks efficiency, and navigating these various benefits is burdensome, costing families precious time they do not have.

Further, there are harmful interactive effects across these programs. For instance, both the CDCTC and CTC, which are non-refundable, serve to reduce a family's tax liability. The IRS states that the CDCTC must be counted first, meaning that any credit taken for the CDCTC may reduce the credit a family receives under the CTC. Further, any funds that are excluded for DCAP are reduced dollar-for-dollar in the maximum expenses toward CDCTC. Meaning that if a family excludes the maximum amount under DCAP, they cannot benefit from the CDCTC.

1 Establish the CTC Plus

Families facing the greatest income restraints solely by virtue of raising young children who are not yet school-aged should be eligible for a higher benefit. This could be considered the "CTC +".

Congress recognized the differences these families face when they provided the $600 supplement to the CTC in the American Rescue Plan. We recommend that Congress permanently establish a fully-refundable, advanceable Child Tax Credit that will offset the often prohibitively high costs of raising healthy, happy, well cared for children in this country. This new credit would make the enhancements from the ARP permanent, **while doubling the base amount available under ARP for families with children under the age of six**, so that families with children under six receive $6,000. Further, the credit should be advanceable, meaning that families need not have to wait for tax filing to receive the benefit. Instead, the family should be able to receive some, or all, of the benefit on a monthly basis relying on the prior year's tax filings–similar to what took place with the ARP. The credit's eligibility and phaseout should mirror what was in the ARP, with the credit phasing out completely for families earning up to $400,000 (or $200,000 for single parent households). Further, the tax code should make clear that the credit families receive does not count as income for purposes of determining eligibility for other federal programs. Finally, the credit should be indexed to inflation to account for the rising costs that families experience over time.

2 Optimize Our Existing Credits & Programs Dedicated to Child Care

CDCTC & DCAP: Congress should make permanent the changes included to CDCTC as a part of the ARP, including making the credit refundable, increasing the capped amounts for qualifying expenses, and updating the rates for applying the credit toward higher levels of income. Based on data from the U.S. Department of the Treasury, these changes markedly changed the distribution of CDCTC dollars, such that families in the bottom two quintiles of earners gained more than 25% of CDCTC dollars, compared to roughly 10% under the current law.[36] As stated above, it also considerably increased the average amount of the credit, thereby helping families cut more into qualifying expenses.

Currently, however, the CDCTC precludes the parent of the child from serving as a qualifying provider for the purposes of eligibility. This prohibition is insensitive to family needs and preferences, including those that choose to have one parent serve as the child's primary caregiver and those who have no other choice than to have a parent serve as the primary caregiver. These parents are typically referred to as "stay-at-home" parents, a term which we do not endorse as it carries the implication that it is a station of choice for parents, and is typically associated with parents of means that do not come from historically marginalized communities. According to recent work from the Federal Reserve, nearly four in ten mothers who stay at home with their children and forewent working for pay did so because of child care.[37] Congress should honor family preferences and consider how our country can provide reimbursement for what is currently unpaid work taking place in homes across the country. Congress could eliminate the preclusion for spouses, or parents of the child, to serve as a qualifying care provider for the CDCTC.

With respect to DCAP, as stated above, it is tilted heavily toward middle- and upper-income earners and is reliant on the sponsorship of an employer to provide the benefit. That said, the price of child care remains considerably high for most families with young children. This recognition is implicit in the phaseout structure Congress set in place for the CDCTC as a part of the ARP, allowing families earning as much as $438,000 to benefit. Maintaining DCAP could serve to boost job retention and productivity in those settings where the benefit is offered, consistent with recent survey data of executives from across the country.[38] Still, some level of income targeting for each of these programs should be considered so that the tax code helps those families struggling most to bear the cost of child care. Bipartisan interest in making these types of changes is clear based on the legislation that has been introduced on this topic during the most recent legislative session.[39]

3 Encourage More Businesses to Help with the Costs of Care

45F: Congress should adopt the recommendations included in the GAO report,[40] as well as those additional recommendations offered by the Bipartisan Policy Center.[41] These include: expanding the credit amount; expanding the definition of services eligible for the credit, including in-home care; extending the credit to those employers who may have no tax liability, including nonprofits; allowing multiple employers to jointly contract to construct or renovate a facility, or engage a child care provider to deliver services to their employees; and making the credit fully refundable.

4 Incent Investments in Early Childhood & Support Early Educators

Early Educator Loan and Supplies Assistance: Modeled on the current Teacher Loan Forgiveness program, Congress should establish an early childhood professional loan assistance program for AA, BA, or Masters degree teachers who are employed full-time in programs that serve children eligible for CCDBG, Head Start or private Pre-K programs eligible for federal funds pursuant to the definition of early childhood education program in the Higher Education Act.[42] Teachers would be eligible for up to $6,000 ($30,000 total) in loan forgiveness if they agree to work full time (30 hours per week), receive an annual salary below 250% of federal poverty, and remain employed for five years. Congress should also expand the definition of those eligible for the out-of-pocket deduction extended to educators; Congress could simply add that those working in early childhood education programs as defined in the Higher Education Opportunity Act are also eligible for the deduction.

Opportunity Zones and Child Care: Congress should create a tax incentive for investments in socially conscious investments in opportunity zones. This could include investments in child care facilities, higher education or health care facilities.

CONCLUSION

Congress has the opportunity to broaden and improve those parts of the tax code meant to give children and families more breathing room. It should take the lessons learned from the ARP, as well as those recommendations offered by the GAO, as it approaches its deliberations on what to do upon the expiration of the current tax provisions.

Of course, the recommendations here do not address the fundamental and structural issues that exist in early care and education, including reining in unsustainably high costs for families: shoring up the workforce through greater support and compensation; and building supply, particularly in those areas where none exists. The recommendations we offer are not a substitution for the transformative, durable levels of investment that are necessary to transform the way we support children and families in this country. Still, Congress should not ignore these tax credits and programs, and their potential for improvement, in any upcoming revenue vehicles - the opportunity is too rare and the stakes for families are too high.

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