MEMORANDUM

To:	Individuals and Organizations Interested in Child Care
From:	Nancy Duff Campbell, Amy Korytowski Matsui and Rachel Rebouche
Date:	February 26, 2008
Re:	Developments in Federal and State Child Care Tax Provisions in 2007

Tax provisions for child and dependent care expenses can provide valuable assistance to families struggling to pay for the care necessary for them to earn a living. Currently, 28 states (including the District of Columbia) have child and dependent care (CADC) tax provisions, and the value of these provisions has increased in most of these states in recent years. But there is still much that can be done to expand the number of provisions, improve existing provisions, and inform families about these and other state and federal tax provisions that can help them meet their child care and other expenses.

Since the National Women's Law Center's January 2007 update to the April 2006 edition of its quadrennial report, *Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions* (MCLT) and accompanying state-by-state report card, *Making the Grade for Care*, which evaluated provisions in effect as of the end of 2005, two states – Oklahoma and Oregon – modified their provisions and one state – Louisiana – enacted a package of new provisions to supplement the state's existing provision. Although not a statewide provision, New York in 2007 enacted a new provision for residents of New York City. In addition, previously legislated changes in Georgia and Louisiana, described in *Making Care Less Taxing* (Louisiana) and the Center's January 2007 MCLT update (Georgia), took effect in tax year 2007. This memorandum reviews these developments and the attached chart summarizes them and supplements and updates Appendix A in *Making Care Less Taxing*.

At the federal level, new Internal Revenue Service regulations for the implementation of the federal CADC care credit were adopted and took effect in 2007. This memorandum provides highlights of the changes in these regulations. Finally, the memorandum describes materials available as part of the Center's Tax Credits Outreach Campaign to help advocates increase the number of families eligible for and claiming these federal and state tax provisions.

Changes in State Child and Dependent Care Tax Provisions in 2007

Oklahoma

In 2007, effective for tax year 2008, Oklahoma amended its tax code to require families to choose between the existing Oklahoma child care credit and a new child tax credit "whichever amount is greater," and to provide that neither credit is available if the family's federal adjusted

gross income (AGI) is over $100,000.[1] The Oklahoma child care credit is equal to 20% of the federal "credit for child care expenses allowed,"[2] for a maximum value of $210 for one child and $420 for two or more children. The new Oklahoma child credit is equal to 5% of the federal child tax credit "allowed," for a maximum value of $50 per child.

On the face of the new statute, the extent to which the amounts of the two Oklahoma credits are limited by the statutory directive to calculate the state credits based on the amount of each federal credit "allowed" is unclear. When a state credit, as here, is calculated as a percentage of a federal credit, an issue arises regarding calculation of the state credit for families who receive only part or none of the federal credit because the federal credit exceeds their tax liability but is not refundable – like the federal CADC credit – or because the credit is only refundable for some families and/or only partially refundable – like the federal child tax credit.[3] Is the state credit based on the amount of the federal credit actually received, or is it based on the amount the family could have received before the federal credit's nonrefundability (or limited refundability) provision limited the credit actually received? For example, if a federal credit is not refundable, and the family's federal credit is $800 but its federal tax liability is only $200, the family is able to claim a credit of only $200 on its federal tax return. If the family's state credit is 20% of the federal credit, is the family entitled to take 20% of $800 – for a state credit of $160? Or is the family only able to take 20% of $200 – for a state credit of $40? This issue is of particular concern to lower-income families who are most likely to have their federal credit limited by a nonrefundability provision.

New York City

In 2007, effective for tax year 2007, New York enacted a new refundable child and dependent care credit for residents of New York City with federal AGI of $30,000 or less.* Families with federal AGI of $25,000 or less may claim a credit equal to 75% of the New York State child and dependent care credit for expenses for children under the age of four. The amount of the credit declines rapidly to zero for families with federal AGI between $25,000 and $30,000. Eligible families may claim the New York City credit against their New York City income tax and New York State credit against their New York State income tax – for a maximum total value of $4,043 ($1,733 for the New York City credit and $2,310 for the New York State credit) – and both credits are clearly calculated based on a federal CADC credit that is unreduced by a family's federal tax liability.

* NEW YORK, N.Y., ADMIN. CODE § 11-1706(e) (2007).

With respect to Oklahoma's child care credit, the instructions to the state tax form for tax year 2007 resolve the meaning of "allowed" by directing the family to apply the state percentage to the amount of the federal credit after it is reduced by federal tax liability. In the above example, this would result in a state child care credit of only $40. It is therefore likely that the instructions to the state tax form for 2008 will similarly resolve the meaning of "allowed" with respect to the child tax credit by directing the family to apply the state percentage to the amount of the federal credit after it is reduced by federal tax liability. Because the federal child tax credit consists of two parts, however – one of which is not refundable and the other of which is partially refundable – it is important to ensure that the state tax instructions direct the family to include both parts of the federal credit in calculating the state credit.

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[1] OKLA. STAT. tit. 68, § 2357(B)(2) (2008).

[2] It is unclear from the Oklahoma statute and forms for tax year 2007 whether care expenses other than for children are eligible for this credit.

[3] The federal child tax credit is refundable only for families with earned income above a certain threshold ($11,750 for tax year 2007) and even for these families in most instances it is not fully refundable. 26 U.S.C. § 24(d) (2008).

Whether in the end an Oklahoma family is better off claiming the state child care credit or the new state child credit can only be determined on a case-by-case basis.

Oregon

In 2007, Oregon amended its tax code to make two changes to its working family child care credit.[4] The first change, which is effective for tax year 2007, clarifies the extent to which a family is eligible for the credit because the tax filer's spouse has a disability. The second change repeals the entire working family child care credit, effective January 2, 2014.[5]

Oregon's working family child care credit permits families with federal or Oregon AGI of up to 250% of the federal poverty level[6] to claim a refundable credit of up to 40% of expenses (without a dollar limitation) for care provided to a child under age 13 or to an older child with a disability. The statute specifies that the care must be "for the purpose of allowing the tax filer to be gainfully employed, to seek employment, or to attend school on a full-time or part-time basis." Prior to the 2007 amendments, Oregon interpreted this provision to require that both the tax filer and the tax filer's spouse be gainfully employed, seeking employment, or attending school on a full-time or part-time basis.[7] The 2007 amendments provide that a tax filer is not disqualified from claiming the Oregon credit solely because the tax filer's spouse has a disability if the disability is such that it prevents the spouse from providing child care, being gainfully employed, seeking employment and attending school. Disability is defined as "a physical or cognitive condition that results in a person requiring assistance with activities of daily living."[8]

Although the first change is a welcome clarification to the Oregon credit, the second change, by repealing the credit, would be a significant loss to low-income Oregon families, beginning in 2014. In the National Women's Law Center's ranking of state CADC provisions in 2006, contained in *Making the Grade for Care,* only two states' provisions received the highest ranking – New York and Oregon for its working family child care credit.

Louisiana

In 2007, Louisiana amended its tax code to provide four new refundable school readiness credits designed to offset some of the costs of families', providers', and businesses' use and support of child care facilities that have received a specified-level quality rating under the state's new voluntary quality rating system (QRS).[9] Louisiana's QRS, which was established by regulations of the Louisiana Department of Social Services issued in December 2007, evaluates

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[4] OR. REV. STAT. § 315.262 (2008).
[5] 2007 Or. Laws 868.
[6] The family's investment income and earned income must also be below a specified level. OR. REV. STAT. § 315.262(1)(d) (2008).
[7] Oregon Department of Revenue, 2006 Full Year Resident (Form 40, 40S, and instructions) 35 (2006).
[8] OR. REV. STAT. § 315.262(1)(c) (2008).
[9] LA. REV. STAT. ANN. §§ 47:6101-6109 (2008).

and rates the quality of child care facilities in ascending levels ranging from one to five, designated by "stars," with the fifth level and star representing the highest rating.[10]

Of the four tax credits in the school readiness package, one is available to individual families using child care facilities who are participating in the QRS, one is available to child care providers participating in the QRS,[11] one is available to businesses that support child care facilities participating in the QRS and resource and referral agencies,[12] and one is available to directors and staff working in child care facilities participating in the QRS.[13] All four credits are effective for tax year 2008, to the extent they are claimed against individual income or corporation income tax, and for tax year 2009, to the extent they are claimed against corporation franchise tax.

The credit for individual families, the child care expense credit,[14] provides families with a refundable credit for expenses for care provided to a child age five and under by a child care facility rated two stars or higher by the new QRS. The credit amount is a percentage of the existing state child care credit, with the percentage increasing as the rating of the child care facility increases. The credit percentages range from 50% for care in a two-star facility to 200% for care in a five-star facility. An eligible family can claim both the new state child care expense credit and the existing state child care credit, for a maximum combined value of $3,150 ($2,100 for the new child care expense credit and $1,050 for the existing child care credit). Like the existing child care credit, the new quality-based child care expense credit is refundable for families with federal adjusted gross income of $25,000 or less, and for families at that income level[15] both credits are clearly calculated based on the family's federal CADC credit before it is reduced by federal tax liability.

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[10] 33 La. Reg. 2783 (Dec. 2007). Thus far the QRS applies only to child care centers.

[11] Child care providers, defined as owners of child care facilities, may claim a refundable credit against individual income tax, corporation income tax or corporation franchise tax. LA. REV. STAT. ANN. § 47:6105 (2008). The amount of the credit is calculated by multiplying the average monthly number of children age five and under receiving state child care assistance who are attending the facility, by an amount based on the quality rating of the facility. The amount ranges from $750 (for a facility with a two-star rating) to $1,500 (for a facility with a five-star rating), increasing as the facility's quality rating increases.

[12] Businesses may claim a refundable credit against individual income tax, corporation income tax, or corporation franchise tax for a percentage of their "eligible business child care expenses." LA. REV. STAT. ANN. § 47:6107(A)(1) (2008). Eligible expenses include the costs of construction, renovation, expansion or major repair of an eligible child care facility, up to $50,000 annually; payments for child care services to support the business's employees made to an eligible child care facility, up to $5,000 annually per employee; and payments to purchase child care "slots" at an eligible facility for children age five and under of the business's employees, up to $50,000 annually. LA. REV. STAT. ANN. § 47:6102(5) (2008). The percentages range from 5% for expenses related to a facility with a two-star rating to 20% for expenses related to a facility with a five-star rating. LA. REV. STAT. ANN. § 47:6107 (A)(1) (2008). In addition, businesses may claim a refundable credit against individual income tax, corporation income tax or corporation franchise tax for payment of fees and grants to child care resource and referral agencies, up to $5,000 annually. LA. REV. STAT. ANN. § 47:6107(A)(2) (2008).

[13] Child care directors and staff members may claim a refundable credit against individual income tax that is based on the level of their professional qualifications, as determined by regulations of the Louisiana Department of Social Services. LA. REV. STAT. ANN. § 47:6106 (2008). The amount of the credit increases as qualifications increase, ranging from $1,500 for a "level one" director or staff to $3,000 for a "level four" director or staff. These amounts are adjusted annually for inflation.

[14] LA. REV. STAT. ANN. § 47:6104 (2008).

[15] For families at higher income levels, both credits are calculated based on the family's federal CADC credit after it is reduced by federal tax liability.

Other Changes in Provisions Effective in 2007

Previously legislated changes to child and dependent care provisions in Georgia and Louisiana, which are described in *Making Care Less Taxing* (Louisiana) and the Center's January 2006 update (Georgia) take effect in tax year 2007.

In Georgia, the amount of the state child and dependent care credit increased from 10% of the federal CADC credit, for a maximum value of $210 for tax year 2006, to 20% of the federal credit, for a maximum value of $420 for tax year 2007.[16] Beginning in tax year 2008, the Georgia credit will increase to 30% of the federal credit, for a maximum value of $630.[17]

In Louisiana, the amount of the state child care credit for tax year 2007 reverts to its pre-2006 value of 50% of the federal CADC credit for families with federal AGI of $25,000 or less, for a maximum value of $1,050.[18] This is an increase from 25% of the federal credit for these families for tax year 2006. As described above, the credit is refundable for these families and, for these families, is clearly calculated as a percentage of the federal credit before it is limited by the family's federal tax liability.

New IRS Regulations for the Federal Child and Dependent Care Tax Credit

In August 2007, the Internal Revenue Service (IRS) published the Final Rules on Expenses for Household and Dependent Care Services Necessary for Gainful Employment[19] for the federal CADC credit contained in section 21 of the Internal Revenue Code (the Code).[20]

Some of the new rules reflect changes required by the 2001 congressional amendments to section 21 of the Code.[21] For example, the new rules include the increase in the expense limits that took effect in tax year 2003 – from $2,400 to $3,000 for one child or dependent and from $4,800 to $6,000 for two or more children or dependents.[22] Other new rules formalize IRS policies and practices. For example, the new rules state that the $6,000 limit on expenses for the care of two or more qualifying individuals need not be divided equally among them[23] – a policy that was reflected in IRS publications but not in the prior regulations.[24] Other new rules provide

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[16] GA. CODE ANN. § 48-7-29.10 (2007).
[17] *Id*. The Georgia tax forms and instructions direct families to calculate their state credit based on the federal CADC credit after it is reduced by federal tax liability.
[18] LA. REV. STAT. ANN. § 47:297.4(A)(1)(a)(ii) (2008). There is no change in the credit amount for families with federal AGI above $25,000, for whom the credit percentage ranges from 30% to the lesser of 10% or $25.
[19] 26 C.F.R. § 1.21-1 to -4 (2008), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-15753.pdf.
[20] 26 U.S.C. § 21 (2008).
[21] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. Law. No. 107-16, § 209, 115 Stat. 38 (2001). Unless extended, the changes in this law expire after 2010. *Id*. § 901.
[22] 21 C.F.R. § 1.21-2(a) (2008).
[23] 26 C.F.R. § 1.21-2(a)(3) (2008). ("If your paid work-related expenses for the care of two or more qualifying persons, the $6,000 limit does not need to be divided equally among them.")
[24] *See* IRS, Publication 503 (Child and Dependent Care Expenses) 10 (2006).

better guidance with respect to particular issues, including by providing additional examples. For example, the new rules explicitly state that application fees, agency fees, and deposits that the tax filer is required to pay in order to obtain care may be claimed for the credit,[25] which was within the language of section 21 of the Code,[26] but was not explicitly stated in either the prior rules or other IRS publications. However, a few of the new rules change prior regulations and prior IRS policies and practices. In some instances these changes make it harder for some filers to claim the credit. For example, the new rules provide that costs incurred for a qualifying child to attend kindergarten may not be claimed for the credit,[27] a policy on which there was previously conflicting guidance.[28] In other instances, the new rules make it easier for some filers to claim the credit, as discussed below.

Transportation expenses. Section 21 of the Code provides that expenses may be claimed for the credit if they are "for the care of a qualifying individual."[29] The prior rules stated that the cost of transporting a qualifying individual between "the taxpayer's household and a place outside the taxpayer's household where services for the care of the qualifying individual are provided" did not constitute an expense for the care of a qualifying individual.[30] The new rules, however, state that the cost of transporting a qualifying individual to or from the place where care is provided may be an expense for the care of a qualifying individual *if* the transportation is provided by a dependent care provider.

Safe harbor for temporary absences. Section 21 of the Code requires that expenses for household and dependent care services claimed for the credit be incurred while a tax filer is gainfully employed (or seeking gainful employment) and for the purpose of enabling the filer to be gainfully employed. The prior rule stated that whether an expense is incurred for that purpose "depends upon the facts and circumstances of the particular case,"[31] and the new rules maintain that test.[32] In addition, as under the prior rules, the new rules require that if the household and dependent care expenses are claimed for a period during only part of which the tax filer is gainfully employed (or in active search of gainful employment), the expenses must be allocated by the filer on a daily basis and only the employment-related expenses may be claimed for the credit.[33]

The new rules, however, create an exception to the allocation rule for short, temporary absences from employment *if* the caregiving arrangement requires the taxpayer to pay for care

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[25] 26 C.F.R. § 1.21-1 (d)(11) (2008).
[26] 26 U.S.C. § 21(b)(2)(A) (2008). ("The term 'employment-related expenses' means amounts paid for the following expenses, but only if such expenses are *incurred to enable the taxpayer to be gainfully employed* for any period for which there are 1 or more qualifying individuals with respect to the taxpayer. . . ." (emphasis added).)
[27] 26 C.F.R. § 1.21-1(d)(5) (2008). Expenses for before- and after-school care for a child in kindergarten or a higher grade remain eligible care expenses. *Id*.
[28] *Compare* IRS, Publication 503 (Child and Dependent Care Expenses) 6 (2006) ("Expenses for kindergarten or a higher grade are not expenses for care.") *with* 26 C.F.R. § 1.44A-1(c)(3) (2006) ("Educational expenses incurred for a child in the first or higher grade level are not expenses incurred for the care of a qualifying individual.").
[29] 26 U.S.C. § 21(b)(2)(A)(ii) (2008).
[30] 26 C.F.R. § 1.44A-1(c)(3) (2006).
[31] 26 C.F.R. § 1.44A-1(c)(1)(i) (2006).
[32] 26 C.F.R. § 1.21-1(c)(1) (2008).
[33] 26 C.F.R. § 1.21-1(c)(2)(i) (2008).

during the absence.[34] Under the new rules, an absence of up to two consecutive calendar weeks automatically qualifies as a short, temporary absence.[35] For absences longer than two consecutive calendar weeks, the facts-and-circumstances test will apply to determine whether the absence constitutes a short, temporary absence.[36]

Allocation of expenses for part-time workers. As discussed above, both the new and the prior rules require that tax filers who incur expenses for a period during part of which they are gainfully employed or seeking gainful employment must allocate their expenses on a daily basis. The new rules create an exception to the allocation rule if the tax filer is required to pay for care on a periodic basis, such as weekly or monthly, that includes both days actually worked and days not worked.[37] Thus, if the tax filer works three days a week but is required to pay for care on a weekly basis, the filer is not required to allocate those expenses.[38] However, if the tax filer works three days a week and has the option of paying for only three days a week, but chooses to place a qualifying individual in care for the full five days a week, the filer must allocate the care expenses (claiming only care expenses for the three days a week actually worked).[39]

The Center's Tax Credits Outreach Campaign for Tax Year 2007

Each year, the Center conducts a national Tax Credits Outreach Campaign in partnership with state child care advocates to help families take advantage of federal and state child and dependent care tax provisions and other valuable tax benefits. In previous years, campaigns in the states have increased significantly the number of families claiming these tax benefits. To help with these campaigns, the Center has prepared materials to inform families about the benefits available for tax year 2007 from the federal child and dependent care credit, earned income credit, and child tax credit, including fliers that are available in English and Spanish, and in some instances, in Vietnamese and Chinese. The Center also has prepared state-specific fliers in English and Spanish for every state that has a child and dependent care tax provision, and a variety of other informational and campaign materials.

In addition to the Center's campaign partners who are working intensively in several states – including California, Iowa, Minnesota, Nebraska, New Mexico, New York, Ohio, and Oregon – many advocates across the country are working to get the word out to families through child care services and other networks, the media, large employers, and state agencies. To find out more about how you can help spread the word, check out the Center's Toolkit for Child Care Advocates, and download fliers and other materials for your state from www.nwlc.org/loweryourtaxes. Please contact Amy Matsui at amatsui@nwlc.org with any questions.

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[34] 26 C.F.R. § 1.21-1(c)(2)(ii) (2008). To this extent, the new rules modify the rule in prior IRS publications that tax filers are required to allocate care expenses paid while an employee is sick. *See* IRS, Publication 503 (Child and Dependent Care Expenses) 6 (2006).
[35] 26 C.F.R. § 1.21-1(c)(2)(ii) (2008).
[36] 26 C.F.R. § 1.21-1(c)(3)(Example 3, 4) (2008).
[37] 26 C.F.R. § 1.21-1(c)(2)(iii) (2008). The new rules state that a "day on which the taxpayer works at least 1 hour is a day of work." *Id.*
[38] 26 C.F.R. § 1.21-1(c)(3)(Example 6) (2008).
[39] 26 C.F.R. § 1.21-1(c)(3)(Examples 5) (2008).

Conclusion

For more information about state and federal tax credits for which families may be eligible, please visit http://www.nwlc.org/loweryourtaxes and http://www.nwlc.org/educationseries/. Center staff would be happy to work with you to establish or expand a child care tax provision in your state, improve state tax forms to make it easier for families to claim the credit, or connect with tax credits outreach campaigns in your area. Please contact Amy Matsui at amatsui@nwlc.org for more information.