Recent Expansions to the Child
And Dependent Care Tax Credit

By Elaine Maag

The Child and dependent care tax credit (CDCTC) provides tax relief to those who are working or are looking for work and are paying for the care of children under age 13, a disabled spouse, or other dependent. The credit equals a percentage of qualified expenses up to a cap. To qualify for the credit, the person must have earned income. Because it is not refundable, the credit is only of value to those who owe income tax before refundable credits.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the credit in two ways. Effective in 2003, the maximum allowable expenses that could be used to claim the credit increase from $2,400 to $3,000 per child, and up to $6,000 per family. Qualified expenses are generally limited to the earned income of the lesser earning spouse, but the caps are not adjusted for inflation so they decline in value over time. The legislation also increased the maximum credit rate from 30 percent to 35 percent. As under prior law, the credit rate decreases to 20 percent for higher-income taxpayers, but the phaseout rate is slower so more people qualify for the higher rates. Like the rest of EGTRRA, the changes expire at the end of 2010.

The figure illustrates how a single parent with two children and the maximum allowable expenses would be affected by the changes. The value of the CDCTC equals tax liability absent the CDCTC minus tax liability with the CDCTC. Since the credit is not refundable, there is less to the expansions than meets the eye. A single parent with two children does not see an actual increase in the value of the credit until her income exceeds $26,000, or almost twice the poverty threshold for such a family. In some cases, the CDCTC is actually worth less after EGTRRA because of increases in the Child Tax Credit, which can decrease the marginal value of the CDCTC for some lower-income families. Moreover, as under prior law, the maximum credit rates remain largely theoretical, since most people with low enough incomes to qualify for them do not owe income tax. People with modestly higher incomes will benefit from the higher rates, and most taxpayers can benefit from the higher limit on qualifying expenses. Although not shown below, lower-income people with expenses much less than the maximum can receive proportionately more benefit from the credit rate increases.

Under a refundable CDCTC, as was proposed by President Clinton in 2000, the actual value would match the statutory credit for low-income families.