

## Untangling Children, Childcare, and the Code

The recently enacted Tax Cuts and Jobs Act doubled the child tax credit under Code Section 24 to \$2,000 starting in 2018 — but did not change either the Section 129 dependent care assistance program exclusion or the Section 21 dependent care tax credit. Nevertheless, depending on adjusted gross income, the newly lowered tax brackets could affect an employee’s calculus in considering whether excluding income through a DCAP or claiming the dependent care tax credit is more advantageous in a given year. Any available earned income tax credit and/or additional child tax credit may also factor into this analysis. Employers should be aware of possible employee confusion about these different — but similar sounding — Code provisions.

### Background

There are several provisions in the Internal Revenue Code (Code) that may be significant to taxpayers with children. Section 129 of the Code provides an income tax exclusion for benefits received through an employer-sponsored dependent care assistance program (DCAP) for the care of qualifying individuals. The maximum annual exclusion is \$5,000, or \$2,500 for an individual whose income tax filing status is “married, filing separately.” DCAP benefits include reimbursements of an employee’s eligible dependent care expenses from a dependent care flexible spending account, direct payment of those expenses by the employer, and the fair market value of on-site dependent care.

[Section 21](#) of the Code lets taxpayers claim a nonrefundable tax credit of up to 35% of the expenses they incurred during the year for the care of qualifying individuals. The maximum amount of expenses that can be taken into account in determining the credit amount is \$3,000 for one dependent and \$6,000 for two or more dependents. The applicable percentage of 35% is reduced by 1% (but not below 20%) for each \$2,000 (or fraction thereof) by which the taxpayer’s adjusted gross income exceeds \$15,000. Because of the progressive reduction in this Dependent Care Tax Credit (DCTC), the value of the credit diminishes incrementally by the amount an individual’s adjusted gross income surpasses this threshold.

#### Nonrefundable Versus Refundable

When a tax credit is nonrefundable, any excess amount expires the year it is used and is not refunded to the taxpayer. In contrast, a refundable tax credit can potentially increase the amount of a taxpayer’s refund.

**Comment.** Both the DCAP exclusion and the DCTC are only available for expenses incurred for the care of a “qualifying individual.” A “qualifying individual” under both provisions is a child who is the taxpayer’s dependent and is under age 13 when the care is provided; a spouse who is not physically or mentally able to care for him or herself; or any other person not physically or mentally able to care for him or herself who either is a dependent of the taxpayer or would have been a dependent but for specified reasons.

[Section 24](#) of the Code allows taxpayers to claim a nonrefundable credit for each qualifying child under age 17. Unlike the two Code sections discussed above, this Child Tax Credit (CTC) is designed to offset the costs of having children generally and is not specifically related to childcare expenses. The Tax Cuts and Jobs Act (TCJA) [doubled](#) the amount of the CTC to \$2,000, starting in 2018. (For more on the TCJA generally, see our [December 20, 2017](#) *Legislate*.) Section 24 also includes the [Additional Child Tax Credit \(ACTC\)](#), which is refundable for taxpayers where the amount of the CTC exceeds an individual’s tax liability.

[Section 32](#) provides for the refundable Earned Income Tax Credit (EITC), which, like the CTC, is not specifically related to childcare expenses. To qualify, the taxpayer’s earned income, adjusted gross income and investment income must be under a specified threshold that depends on the number of “qualifying children” in the household. For this purpose, a “qualifying child” must have a specified relationship with the taxpayer and either be under age 19 (or age 24, if a full-time student) and younger than the taxpayer, or be permanently disabled.

## DCAP Exclusion Versus DCTC

Any benefits received through a DCAP that the taxpayer excludes from income must be subtracted from the maximum applicable DCTC. This means that individuals must determine annually whether the DCAP exclusion or the DCTC will be more advantageous to them.

Generally, because the available DCTC amount diminishes progressively for taxpayers with adjusted gross income over \$15,000, the DCAP exclusion typically results in greater tax savings for higher earners. A DCAP may also prove a more valuable vehicle for taxpayers with only one dependent because of the \$3,000 limit on eligible DCTC expenses for such taxpayers.

The EITC and ACTC can also factor into this analysis. Because the definition of earned income for EITC purposes does not include salary reduction amounts, employees who participate in a dependent care flexible spending account will have lower earned income than if they did not participate — and therefore may qualify for the EITC where they would not have absent participation in a DCAP. Participation in a DCAP that lowers an individual’s earned income may also affect any available ACTC.

Some employers provide employees with general information and/or a calculator to help them understand the differences between a DCAP and the DCTC. Other employers do not communicate with employees on this topic at all, perhaps out of concern that such communications could be misconstrued as individual tax advice. Ultimately, the decision whether to use the DCAP exclusion or claim the DCTC is a personal tax matter that employees should discuss with their tax advisors.

## Does the New Tax Law Change Anything Here?

The TCJA did not directly address the rules governing either DCAPs or the dependent care expense credit, and the increase in the CTC does not affect an employee's DCAP pretax contributions or use of the DCTC.

But a key feature of the TCJA was its [lowering](#) of taxes for many individuals. In some circumstances, the reduction of an individual's tax liability under the new law could affect the point at which the DCTC is more valuable than a DCAP pretax contribution. Of course, it is not clear whether a reduction in taxes will have a material effect on employee decisions in this regard.

## In Closing

Employers should be aware of, and prepared to respond to, possible employee confusion between the different child- and childcare-related Code provisions.

### DCAP Nondiscrimination Testing

Several nondiscrimination requirements apply to DCAP benefits to ensure that they are not disproportionately provided to executives and other highly paid individuals. (See our [January 2, 2018 FYI In-Depth](#) to learn how each test operates.) Employers should be aware that the extent to which lower income employees opt for the DCTC over participating in a DCAP can adversely affect DCAP testing results, due to lower enrollment by non-highly compensated employees.

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