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INSIGHT

COVID-19: Child Care Tax Provisions in H.R. 7327

July 24, 2020

The Coronavirus Disease (COVID-19) pandemic has broadly impacted child care in the United States. Surveys conducted in April of both working families with young children and child care providers found that the majority of child care providers had fully closed or reduced their enrollment. Data from the Bureau of Labor Statistics suggest that the number of child care workers decreased by about one-third between March and April (see Table B-1) and about one-quarter between March and June, with the latter number potentially reflecting the effects of states partially reopening. Parents and providers have questions about if and when child care facilities will be able to reopen safely. The COVID-19 pandemic has also amplified concerns about child care affordability.

As Congress continues to debate whether more needs to be done to address child care at the federal level, the House Rules Committee recently reported a resolution that would allow the House to consider two bills related to child care. One of those bills, the Child Care for Economic Recovery Act (H.R. 7327), includes several tax provisions, as summarized in this Insight. A discussion of nontax child care provisions in H.R. 7327 can be found here.

Child and Dependent Care Tax Credit (CDCTC)

Under current law, eligible taxpayers may claim the child and dependent care tax credit (CDCTC) to help offset their out-of-pocket work-related child and dependent care expenses.

The credit equals qualifying child and dependent care expenses—capped at $3,000 if the taxpayer has one qualifying individual and up to $6,000 if they have two or more qualifying individuals—multiplied by a credit rate. The credit rate varies based on adjusted gross income (AGI), with a maximum credit rate of 35% for taxpayers with AGI of $15,000 or less, gradually declining to 20% for taxpayers with AGI above $43,000. These dollar amounts are not adjusted for inflation. Because the credit is nonrefundable, the final credit amount is further limited by the taxpayer's income tax liability (e.g., taxpayers with no income tax liability receive no credit).

H.R. 7327 would:

1. Make the credit refundable (so the credit would no longer be limited by income tax liability).

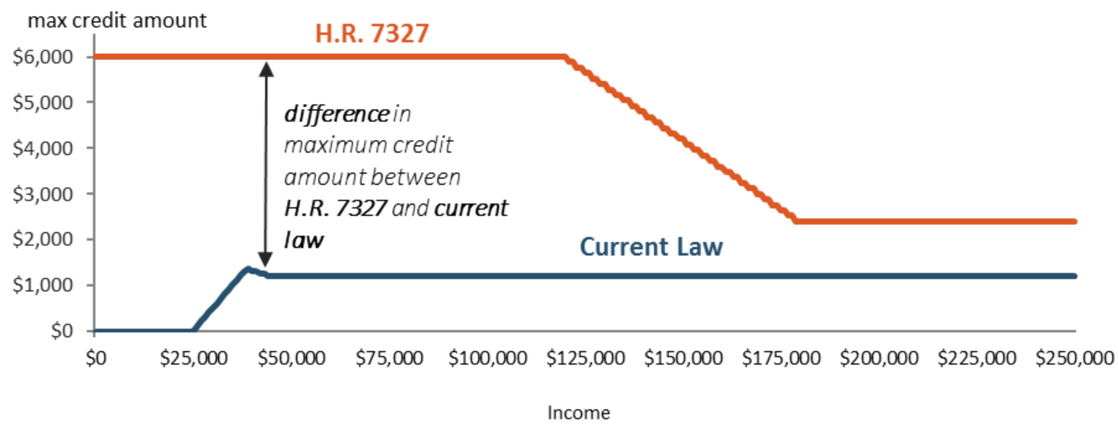
2. Increase the maximum amount of qualifying expenses to $6,000 for one qualifying individual (from $3,000), $12,000 for two or more qualifying individuals (from $6,000).
3. Increase the maximum credit rate to 50% (from 35%) and raise the threshold where the rate begins to decline to $120,000 (from $15,000).
4. Adjust the maximum dollar amounts and AGI thresholds for inflation going forward.

Similar changes were proposed in the HEROES Act (H.R. 6800).

The maximum potential credit amount of the CDCTC would increase under this proposal. However, lower-income taxpayers are less likely than higher-income households to receive the maximum credit, under current law or this proposal, because they tend to incur less in out-of-pocket child and dependent care expenses.

Maximum CDCTC under Current Law and H.R. 7327, by Income

Married Joint Filer with Two Qualifying Individuals



Sources: CRS analysis of Internal Revenue Code Section 21 and H.R. 7327.

Notes: This is a stylized example of the maximum amount of the CDCTC a hypothetical taxpayer could receive under current law and under H.R. 7327. Specificially, this example assumes a hypothetical taxpayer is a married couple filing jointly that has the maximum amount of eligible expenses for two qualifying individuals ($6,000 under current law, $12,000 under H.R. 7327), they claim the standard deduction and no other tax benefits, all their income is from earned income and earned income equals adjusted gross income (AGI). Low-income taxpayers do not receive the maximum amount of the credit under current law because the credit is nonrefundable and these taxpayers have little to no income tax liability.

The modifications to the CDCTC would increase the deficit by an estimated $88.7 billion from FY2020 to FY2030.

Dependent Care Flexible Spending Arrangements (FSAs)

Under current law, an employee can receive up to $5,000 in pretax employer-sponsored child and dependent care benefits, often as a flexible spending account or FSA (this limit is per taxpayer, not per dependent). This amount is not adjusted for inflation. Generally, contributions to a dependent care FSA are subject to a "use-or-lose" rule—after the end of the FSA's plan year, employees forfeit any remaining unused amounts. Employers are normally allowed to offer employees a "grace period" of up to 2½ months after the end of the plan year to use any remaining balance.

H.R. 7327 would:

1. Increase the maximum amount of pretax benefits from $5,000 to $10,500 and annually adjust this amount for inflation going forward;

2. Allow employers to extend the grace period for up to 12 months after the end of a plan year ending in 2020 (expanding upon flexibilities already provided by the IRS);
3. Allow employers to offer a one-time "carry over" of the full value of their dependent care benefits from the 2020 to the 2021 plan year, (i.e., temporarily eliminating the use-or-lose rule).

The modifications to the exclusion would reduce net federal revenues by an estimated $2.5 billion from FY2020-FY2030.

Employer Payroll Tax Credits

H.R. 7327 would create two new temporary refundable payroll tax credits for employers.

1. ***A 30% credit for qualified dependent care expenses employers pay on behalf of employees.*** Credit-eligible dependent care expenses would be limited to $2,500 per calendar quarter per employee. Taxpayers electing to claim the credit for dependent care expenses cannot claim any other deduction or credit for dependent care expenses on the amount of credit received. Federal government employers would not be eligible for the credit.
2. ***A 50% credit for fixed expenses (e.g., rent, mortgage, or utility costs) of qualified child care facilities.*** Credit-eligible child care facility fixed expenses would be limited to the lesser of (1) fixed expenses paid during the same quarter in 2019; (2) $25 million; or (3) the greater of 25% of qualified wages (as defined in the employee retention tax credit) or 6.25% of 2019 gross receipts. Credit-eligible child care facility fixed expenses would be further limited to $50,000 per calendar quarter. Qualifying facilities must be subject to a full or partial suspension of services due to COVID-19, or have a 50% decline in gross receipts from the previous year (with a partial credit allowed to taxpayers with a decline in gross receipts of at least 10% but less than 50%). Taxpayers electing to receive this credit cannot also deduct as a business expense the amount of credit received. Federal, state, or local government employers would not be eligible for the credit.

Like the payroll tax credits enacted for newly mandated paid family and medical leave in the Families First Coronavirus Response Act (P.L. 116-127), and the employee retention tax credit enacted in the CARES Act, employers could receive these credits in advance of when payroll taxes are due. The credits could be claimed on qualifying expenses paid from the date of enactment through December 31, 2020.

These payroll tax credits would be claimed against the employer's share of Social Security's old age, survivors, and disability (OASDI) payroll tax, currently 6.2% of the employee's taxable earnings base ($137,700 in 2020). A general fund transfer of revenue to the Old-Age and Survivors Insurance Trust Fund, Federal Disability Insurance Trust Fund, and Railroad Retirement Trust Fund would be made to maintain trust fund balances.

The temporary employer-paid dependent care payroll tax credit would reduce federal revenue by an estimated $21 million in FY2021. The temporary child care facility fixed expense payroll tax credit would reduce federal revenue by an estimated $84 million in FY2021.

Employee Retention Tax Credit for Domestic Workers

The CARES Act enacted an employee retention tax credit that allows eligible employers to claim a 50% payroll tax credit on up to $10,000 of qualified wages paid per employee while the business is closed or has reduced operations due to COVID-19. Currently, only employers operating a trade or business qualify for the credit. Household employers do not qualify.

H.R. 7327 would allow employers of domestic workers to claim the employee retention tax credit for wages paid when employee services are not provided due to COVID-19.

Expanding the temporary employee retention tax credit to include domestic workers would reduce federal revenue by an estimated $9 million from FY2020 to FY2021.

Author Information

Conor F. Boyle
Analyst in Social Policy

Molly F. Sherlock
Specialist in Public Finance

Margot L. Crandall-Hollick
Acting Section Research Manager

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