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Child Care, Welfare Reform, and Taxes

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CHILD CARE, WELFARE REFORM, AND TAXES

by Mary L. Heen

The welfare reform legislation passed by Congress last year makes significant changes in the social welfare system, followed this year by contrasting shifts in the federal tax system's treatment of families with children. This article discusses how the welfare and tax law changes affect overall child care policy and funding levels for work-related child care, and evaluates the newly enacted child tax credit and the existing child care tax credit in light of their combined effects on low income working families.

Welfare reform legislation signed into law last year repeals "entitlement" programs such as Aid to Families with Dependent Children (AFDC) and AFDC-related child care and substitutes two separate capped federal block grants to the states, giving the states greater freedom to impose their own requirements or restrictions without the necessity of applying for waivers of federal requirements. According to projections by the House Ways and Means Committee, the reform legislation halts the growth in overall federal welfare spending by approximately $55 billion over the next six years.[1] The devolution of authority to the states combined with the cap on federal funds and the abolishment of the statutory welfare entitlement make it increasingly important to monitor welfare reform initiatives at the state and local level.

Although the legislation provides some additional federal funds for work-related child care, whether the states will be able to meet the mandated work participation rates under the new law depends upon improving the availability, affordability, and quality of work-related child care at the state and local level. Advocates for low income families can play an important role in monitoring the implementation of welfare reform by the states, documenting the need for states to maintain or increase current levels of state support for work-related child care, and working with community leaders to find ways of addressing some of these pressing child care needs.

Child care assistance is provided through direct assistance programs (including cash and in-kind subsidies or voucher programs) and through tax adjustments. Some current federal tax provisions such as the child and dependent care tax credit under IRC § 21 and the exclusion for employer-provided child care under IRC § 129 focus specifically on work-related child care. However, those provisions benefit lower income families only if they are otherwise subject to federal income tax. Although a few states use refundable tax credits to deliver child care assistance targeted to low income families, the federal child care tax credit is not a refundable credit.

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The Community Tax Law Report's mission is two-fold: to serve as an educational tool and as a forum for policy discussion. *The Report* provides nonpartisan instruction and analysis of topics relating to the taxation of low income individuals.

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Child Care and Welfare Reform: *Continued from front cover*

Most recently, national legislative activity has focussed on per child tax credits. The Taxpayer Relief Act of 1997, signed into law on August 5th, adds IRC § 24 to the tax code, providing for a child tax credit of $500 per child ($400 per child beginning in 1998, and $500 thereafter) for qualifying children under the age of 17.[2] Unlike the child care tax adjustments provided by IRC §§ 21 and 129, the availability of the child tax credit does not depend upon work outside of the home. Like the work-related child care tax provisions, however, the child tax credit primarily benefits middle class families. The credit phases out at modified adjusted gross incomes of $110,000 in the case of joint returns ($55,000 for married taxpayers filing separately) and $75,000 for unmarried taxpayers, and is reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds the threshold amount.[3] Although the new law provides nearly $183.4 billion worth of child tax credits over a ten year period, many low income families will derive little additional benefit from the new credit.

To receive full benefit from the child tax credit, families must have i) federal income tax liability in an amount equal to or greater than the amount of the credit, net of applicable credits other than the earned income credit, or ii) have three or more qualifying children and be eligible for the refundable child credit under new IRC §24(d). Thus, low income taxpayers with smaller families are unlikely to receive much additional benefit from the child credit if they have work-related child care expenses eligible for the section 21 nonrefundable credit. By contrast, middle income taxpayers with work-related child care expenses may benefit from both the existing IRC § 21 child care tax credit (or the IRC § 129 exclusion for employer-provided child care) and the new IRC § 24 child tax credit.

Although the House version of the tax bill would have phased out the IRC § 21 child care tax credit in conjunction with the child tax credit for certain higher income taxpayers, the conference agreement appropriately rejected the phaseout of the section 21 credit. As I have argued elsewhere,[4] because both sections 21 and 129 serve important structural functions as offsets for certain tax discontinuities involving taxation of the family, their benefits should not be phased out at higher income levels. Instead, the important offset function served by these provisions should be extended to low income families through refundable credits.

The rest of the article explains the background and impact of the legislative changes in greater detail in the following five parts: 1) a brief explanation of the new welfare-related federal block grant programs; 2) issues facing low income families concerning the cost, availability, and quality of work-related child care; 3) a summary of the income tax work-related child care provisions; 4) how the current tax provisions affect low income workers; and 5) what should be done now. As

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set forth below, I conclude that the new welfare-related capped federal block grants fail to meet the need for additional child care funding. Federal income tax adjustments also fail to address the needs of low income families with work-related child care expenses, although the earned income tax credit operates, at least in part, as an important earnings subsidy for low income workers with children. The discussion ends with a call for an increased focus on and commitment to quality subsidized child care at the state and local level.

Welfare-related Federal Block Grant Programs

In place of AFDC and its related work and training program known as JOBS, the new law creates a welfare block grant called Temporary Assistance for Needy Families (TANF) capped at $16.4 billion per year, approximately the level of federal welfare expenditures in 1995. Implementation of TANF is effective July 1, 1997, although many states will be operating pre-approved waiver programs after that date. The new law (Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, § 103, 110 Stat. 2105) repeals the "entitlement" to welfare benefits, imposes strict time limits on the receipt of benefits (a maximum of 24 months of benefits without work, with a lifetime five-year limit), requires states to meet more stringent work participation levels (50% participation by 2002; and for two-parent families, 90% participation by 1999) and makes the work requirements applicable to mothers with younger children (1 year and older). To receive their full federal TANF grants, the states must spend only 75% of what they spent as state matching funds in 1994 (80% if they fail to meet mandated work participation rates, and 100% for access to a recession contingency fund). In addition, the law authorizes states to use up to 30 percent of their TANF grants for Child Care and Development Block grant activities (or for Title XX social services block grant activities, subject to certain restrictions). It has been estimated that the transfer provision, combined with the provision allowing states to reduce their historic levels of welfare spending will permit states to withdraw as much as $38 billion from welfare and work programs over the next six years.[5]

The new block grant for child care, made effective in 1996, is an expanded and revised version of the Child Care and Development Block Grant Program (CCDBG), and replaces AFDC-related child care, Transitional Child Care and the At-Risk Child Care programs. The child care block grant increases total federal child care funding over 1995 levels, provided through numerous separate programs, and consolidates it into one block grant program of about $3 billion in total funds in fiscal year 1997, increasing to $3.7 billion in fiscal year 2002. The total amounts represent discretionary funds (reauthorized through CCDBG in an annual amount of $1 billion) and "entitlement" funds for child care authorized at $2 billion beginning in 1997 ranging up to $2.7 billion in 2002). Of the capped "entitlement" funds, no state match is required for about $1.2 billion each year, which is the amount provided to the states in 1995 for AFDC-related child care, Transitional Child Care and At-Risk Child Care. The remainder of the child care "entitlement" funds are subject to historic maintenance-of-effort and matching requirements.[6]

As explained by the Children's Defense Fund (CDF), in THE STATE OF AMERICA'S CHILDREN 1997 YEARBOOK, the new law adds about $4 billion in new child care funds over six years and the states are required to put up matching funds to obtain the new child care funds. Even if states meet the matching requirements to receive all of the new dollars, the Congressional Budget Office has estimated that the new dollars are about $1.4 billion short of what would be needed to implement the new work requirements.[7] The child care funds thus fall far short of what would be needed to move low income families off the welfare rolls and to keep them off on a long-term basis.

Even if states meet the matching requirements to receive all of the new federal funds, the CBO estimates that the new funding is about $1.4 billion short of what would be needed to implement the new work requirements. The child care funds thus fall far short of what would be needed to move low income families off the welfare rolls and to keep them off on a long-term basis.

The Cost, Availability, and Quality of Child Care

Under the new law, welfare mothers must participate in work activities within twenty-four months of receiving benefits, unless states opt to require work sooner. Virginia, for example, has required work within ninety days.[8] The federal welfare reform law provides no guarantee of child care assistance or that child care will meet minimal standards. However, it exempts from failure-to-work penalties single custodial parents caring for a child under the age of six if the parent "proves that [she] has a demonstrated inability (as determined by the State) to obtain needed child care," including the unavailability or unsuitability of "informal child care" by a relative or under other arrangements. For purposes of determining whether states meet the monthly minimum work participation rates, a single parent of a child under the age of six is deemed to be meeting work participation requirements if the parent is engaged in work for twenty hours per week. States are permitted (but not required) to exempt a parent of a child under age one from the work requirement. Michigan, for example, has required parents of children three months of age or older to engage in work-related activities.

If low income families must pay the full cost of child care themselves, they face a major obstacle in their transition from welfare to work. In general, the type of child care purchased and the amount spent on care varies by the family's economic situation and the type of care used. Lower income families spend on average about twenty-five percent of their incomes on child care even though they spend significantly less, in absolute terms, on child care than families with higher incomes.[9] Those who pay for relatives to care for their children pay the lowest average weekly costs, with increasingly higher weekly average costs for family child care, center care, and in-home care by a non-relative.[10]

Experience with prior work programs indicates that those with low reimbursement rates and retroactive reimbursement tended to steer families toward informal child care. Such informal arrangements are more likely to be of relatively poor quality. A recent study of children in family child care and relative care concluded that "regardless of maternal education, the lower the child's family income, the lower the quality of the child care home in which he or she is enrolled" and that low income families "are more likely to be using care that is rated as being of inadequate quality [growth-harming] whereas middle-income families tend to use care that is adequate/custodial [neither growth-enhancing nor growth-harming]."[11] That finding, the study noted, differed from findings from research on center-based care, in which low income children in subsidized care were in better quality arrangements than middle income children.[12] In center-based care, the lowest quality care is received by toddlers and infants, with about forty percent of those studied receiving below a minimally adequate level, although little difference in fees was found for centers providing high- or low-quality care.[13]

A recent GAO study of the extent to which the current supply of child care would be sufficient to meet the anticipated demand for child care under the new welfare reform law found a growing gap in the sampled communities between known supply and expected demand, especially for certain age groups.[14] The study identified the price of care, the lack of transportation, the limited availability of nonstandard care (outside of normal working hours) and the quality of care as additional areas of concern for low income families. It concluded that the currently inadequate supply of known child care for children of certain age groups "is likely to grow, with disproportionately larger gaps for infants and school-aged children."[15] For example, the GAO found that in poor areas of Chicago, the currently known supply of child care by the end of fiscal year 1997 is sufficient to meet 61% of current demand for preschool care, compared with 11% and 30% of the demand for infant and school-aged care, respectively.[16] If known supply "does not increase, states may have to rely more on care for which they have little information" and the ability to assist families in locating appropriate care "may be more limited."[17]

Without substantially increased federal or state support of work-related child care, the new work requirements may be programmed for failure, or worse, may result in the endangerment of children. In some cases, mothers may face the choice of leaving their children in low-quality care or of staying with their children, and as a result, losing financial support. A GAO study of the states' early experience with benefit termination found that by the end of December 1996, failure to comply with work requirements (imposed under federally approved waiver programs) became the most significant reason for termination.[18] Explanations given by recipients for noncompliance with work requirements included wanting to stay home with children. In the sample studied by GAO, termination of welfare benefits also tended to result in loss of other assistance despite the families' continuing eligibility for such assistance under the law. After termination, the percentage of families receiving food stamps or Medicaid also declined significantly after termination, with 84-100 percent receiving such benefits before termination, and 26-61 percent receiving them after termination.[19]

Without substantially increased federal or state support of work-related child care, the new work requirements may be programmed for failure, or worse, may result in endangerment of children. Mothers may face the choice of leaving their children in low-quality care or of staying with their children, and as a result, losing financial support.

The Income Tax Work-Related Child Care Provisions

The Internal Revenue Code provisions specifically addressing child care expenses are IRC § 21, the child and dependent care tax credit, and IRC § 129, the exclusion from income for certain employer-provided child care benefits. The child care tax credit and the exclusion for employer-provided child care are estimated by the Joint Committee on Taxation to reduce federal revenues by about $2.8 billion and $.8 billion, respectively, in fiscal year 1997.

Although not specifically aimed at the child care expenses of working parents, the earned income tax credit, IRC § 32, provides a refundable tax credit for certain low income working families with children. In addition, the personal exemption deduction for dependents, IRC § 151, and the newly enacted child tax cred-

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it, IRC § 24, provide an adjustment in computing taxable income to account for the added household costs of taxpayers supporting children.

IRC §§ 21 and 129 provide tax benefits to all working parents, but upper- and middle-income taxpayers utilize them the most for reasons explained below. The following subparts describe in greater detail how the child care credit and employer-provided child care exclusion provisions work, and how the current design of these provisions makes it difficult for low income taxpayers to benefit from them.

How the Child Care Tax Credit Works

IRC § 21 provides a nonrefundable tax credit, the amount of which is equal to an "applicable percentage" of the eligible employment-related child care expenses paid by the taxpayer during the year. The applicable percentage, which ranges on a sliding scale of 20 to 30 percent, varies with adjusted gross income. The amount of child care expenses that may be taken into account depends upon the number of children included in the household maintained by the taxpayer. Eligible expenses are limited to $2,400 per year for one child, and $4,800 per year for two or more children. A taxpayer with adjusted gross income of $10,000 or less receives a credit of 30 percent of employment-related expenses. The credit percentage declines by one percentage point for each $2,000 (or fraction thereof) in adjusted gross income above $10,000, but in no case is the applicable percentage reduced below 20 percent. For taxpayers with adjusted gross incomes greater than $28,000, therefore, the applicable percentage is 20 percent. For taxpayers with adjusted gross income of $10,000 or less, and thus qualifying for the highest applicable percentage of 30 percent, the maximum credit is $720 for one child, and $1,440 for two or more children. For taxpayers with incomes in excess of $28,000, and thus qualifying for the lowest applicable percentage of 20 percent, the maximum credit is $480 for one child, and $960 for two or more children.

The amount of the dependent care credit and the applicable percentage income phase-down schedule have not changed since 1981. Income tax thresholds, however, have substantially increased since then. Thus, although § 21 appears to target low income taxpayers, the relationship between the credit percentage income phase-down and current income tax thresholds makes it unlikely that poor taxpayers receive any benefit from the credit. The Tax Reform Act of 1986 removed about six million poverty level families from the income tax rolls by increasing standard deduction and personal exemption amounts, and adjusting those amounts on a yearly basis for inflation. In 1997, for example, a family of four (two parents and two children) would owe no taxes on up to $17,500 of adjusted gross income (after taking account of a standard deduction of $6900 plus four personal exemptions of $2,650 each), which is above the federal poverty threshold of $16,050 for a family of four. A single head of household with one child would owe no taxes up to $11,350 of income (after taking account of a standard deduction of $6,050 plus two personal exemptions of $2,650 each) which is above the poverty level of $10,610 for a family of two. Although both families could be entitled to a child care tax credit, they would have no income tax liability to offset through use of the credit. The current thresholds for tax liability combined with the nonrefundability of the credit thus make it unlikely for poor families to benefit from the child and dependent care tax credit.

The current thresholds for tax liability combined with the nonrefundability of the credit make it unlikely for poor families to benefit from the child and dependent care tax credit. Thus, at low income levels, tax costs make working to cover child care costs an inherently losing proposition.

The Exclusion for Employer-Provided Dependent Care Assistance Programs

IRC § 129 provides an exclusion from the gross income of employees of amounts up to $5,000 paid by the employer under a dependent care assistance program. The dependent care assistance program must be a separate written plan of the employer for the exclusive benefit of employees and must meet certain other requirements. The amount of the exclusion may not exceed the lesser of the earned income of the employee or the earned income of the employee's spouse. Payments for child care made to the employee's spouse or certain other related individuals (another child of the employee, for example) are ineligible for exclusion.

Employers most frequently provide the dependent care assistance benefit through reimbursement accounts, sometimes referred to as flexible spending accounts, which may also cover other types of expenses, such as out-of-pocket health care expenses. Up to $5,000 may be paid into an dependent care assistance account (through a salary reduction plan) from which child care expenses of the employee are reimbursed. The effect of such a program is that the employee may pay child care expenses (or out-of-pocket health care expenses) with pre-tax dollars. Thus, the IRC § 129 exclusion operates as a complete adjustment, offsetting the tax costs of up to $5,000 of child care expenses, regardless of the taxpayer's marginal tax rate. About one-third of full-time employees at large and medium-sized private firms were eligible for such accounts in 1991, compared to nearly one-tenth of such workers who were eligible for child care benefits provided by the employer in the form of child care facilities provided at or near the workplace or through direct reimbursement of employee expenses.

Generally, taxpayers choose whether eligible child care expenses will be claimed under the § 21 credit or the § 129 exclusion. Double dipping is not permitted. For most middle or upper income taxpayers, the § 129 exclusion will provide the most benefit. For example, for taxpayers subject to the highest marginal tax rate of 39.6 percent, the § 129 exclusion is worth $1,980 compared to the maximum § 21 credit of $480 for one child or $960 for two or more children.

How the Tax Provisions Affect Low Income Workers

At low income levels, tax costs make working to cover child care costs an inherently losing proposition. Although tax costs of working in the wage labor market are somewhat offset by IRC §§ 21 and 129 for middle and upper income taxpayers, low income workers receive little or no benefit from those provisions. Thus, the low income mother generally is better off staying at home to care for the children (if she has other means of support) unless she earns substantially more than it costs to purchase adequate child care, or can rely on subsidized care or unpaid or low-cost relatives or friends for child care.

As has been pointed out by Professor Edward McCaffery, the tax costs result from a combination of the 15 percent marginal income tax rate on earned income above the tax threshold amounts, the 7.65 percent employee portion of social security taxes, and the phase-out percentage of the earned income credit.[20] As described in greater detail below, the earned income tax credit is structured to benefit low income working families: the amount of the credit initially increases with earnings, then remains constant as earnings increase, and then decreases with earnings until it is fully phased out.

In 1997, for example, the maximum refundable credit for a family with two or more qualifying children is $3,656 (as adjusted for inflation, equal to 40 percent of the earned income amount of $9,140). The maximum benefit applies at incomes between $9,140 and $11,930, and declines thereafter. A phase-out percentage (21.06 percent) is then applied to adjusted gross income (or, if greater, the earned income) in excess of $11,930. The benefit is fully phased out at $29,290 of adjusted gross income for a taxpayer with two or more qualifying children. Different percentages and amounts apply for families with one qualifying child (a maximum credit amount of $2,210, which represents a credit percentage of 34 percent applied to the earned income amount of $6,500, a phaseout percentage of 15.98 percent, and a threshold phaseout amount of $11,930; the credit is thus completely phased out at $25,760). The marginal income tax rate (15 percent), the employee portion of social security tax rates (7.65 percent), and the earned income credit phase out rate (21.06 percent) equal a combined federal tax rate of 43.71 percent for 1997 (or 38.6 percent for families with one child), without taking into account state taxes and the incidence of the employer portion of social security taxes.

The earned income tax credit phase-out percentages have the effect of increasing the marriage penalty (referring to the higher total income taxes paid by a married couple than what they would pay in taxes as two single workers) for families at low income levels. The marriage "penalty" results from a combination of progressive tax rates and the joint filing regime for married taxpayers. Because of the phase-out of the earned income tax credit as earnings increase, marriage penalties for certain low income families can exceed $3,000 per year.[21] In addition, as explained above, the phase-out percentages make the marginal tax rate very high for low income families earning at levels within the phase-out range. A possible offsetting adjustment to these high effective rates would be to make the child care tax credit refundable, and to increase the applicable percentage to at least 50 percent of an increased level of eligible child care expenses. Alternatively, § 129 programs could be made available to all employees.

The earned income tax credit phase-out percentages have the effect of increasing the marriage penalty for families at low income levels. Marriage penalties for certain low income families can exceed $3,000 per year.

The recently enacted child tax credit will do little to offset these effects, except for some limited benefits for large families. The basic per child credit (applicable beginning in 1998) applies to reduce income tax liabilities net of applicable credits other than the earned income tax credit. A family with one or two qualifying children must have sufficient adjusted gross income to be above the income tax threshold. As explained above, tax thresholds are currently somewhat above federal poverty income levels. Under the limitation on nonrefundable personal credits provided by IRC § 26, the aggregate amount of allowed credits cannot exceed the taxpayer's regular tax over any applicable tentative minimum tax. Accordingly, small families with poverty level incomes below the tax threshold amounts would get no benefit from either the child care tax credit or the per child tax credit. If the family had sufficient income to trigger tax, any regular tax liability would be reduced by any applicable nonrefundable personal

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credits, including the § 21 child care tax credit. If any amount of tax liability remained after application of the § 21 credit, the family would receive a portion of the basic child credit, but not in excess of the total remaining tax liability (prior to application of the earned income tax credit). The ordering rules of §§ 26 and 24 thus result in a reduction of regular tax liability (but not below zero) first by any applicable personal credits (child and dependent care credit, credit for adoption expenses, etc.), then by the child tax credit, and lastly, by the refundable earned income tax credit, which due to its potential refundability, may result in a negative or refund amount.

By contrast, large families (with three or more children) benefit from the additional refundable credit under IRC § 24(d), perhaps in part to reflect the lack of an adjustment under both the earned income credit and the child care tax credit for families with more than two children. The per child tax credit is refundable for families with three or more qualifying children, but is generally limited to the family's federal income tax liability plus their social security tax liability (FICA) minus the earned income credit amount. See IRC § 24(d).

Small families with poverty level incomes below the tax threshold amounts would get not benefit from either the child care tax credit or the per child tax credit.

Consider, for example, a dual earner family with a total adjusted gross income of $25,000 and three children. With five personal exemptions (5 x $2650) and a standard deduction amount ($6900 for married, filing jointly), the family would pay no federal income tax on the first $20,150 of income (based on 1997 inflation-adjusted amounts). Assuming a 15 percent tax rate applied to the remaining $4,850, they would have regular income tax liability of $727.50. If the family had eligible work-related child care expenses of at least $4800 for the year, their § 21 credit would total $1,056 (22% x $4800 = $1056). After being reduced by the § 21 credit amount, their tax income liability would be zero (with no refund of the remaining unused portion of the credit) after application of the credit ($728 - $1056 = ($328)). On wages of $25,000, the family would pay payroll tax of $1,912.50 (withheld from paychecks as the employees' portion of FICA taxes, or 7.65% of $25,000 = $1,912.50).

As explained by the statement of managers of the conference committee, under the Taxpayer Relief Act of 1997, the maximum amount of the child credit for each taxable year ($400 or $500 times 3 children; let's assume $1500) for a family with three or more qualifying children cannot exceed the greater of 1) the taxpayer's regular tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax liability, or 2) an amount equal to the excess of the sum of the taxpayer's regular tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA reduced by the earned income credit.[22] Reading the conference committee explanation alongside the statutory language of IRC § 24(d)(3) raises issues about how the managers applied the statute's reference to § 26 limitations (regular tax liability v. regular tax liability net of personal credits). Nevertheless, § 24(d) appears to apply to our hypothetical family of five as set forth below.

Because the family would not be subject to the alternative minimum tax (due to the $45,000 exemption amount of IRC § 55(d) in the case of a joint return), the greater of 1) the amount of the credit allowed under § 24 (without regard to § 24(d) and after application of the limitation under § 26)-- zero, or 2) the regular tax liability ($728) plus the FICA amount of $1,912.50 minus the sum of credits allowed other than refundable credits (§ 21 credit of $1056) and the earned income tax credit amount of $903 ($3656 minus the phaseout amount of $2,752.54), would equal $682. In this example, therefore, the total amount of the child tax credit for three children would be limited to $682. Because that amount exceeds the taxpayer's regular tax liability after application of the limitation under § 26 (zero), the excess of $682 is a refundable tax credit under § 24(d)(4).

Some families with fewer than three qualifying children may receive all or a portion of their child credit as a supplemental child credit under new IRC § 32(m) [sic] (technical corrections legislation may renumber that subsection as 32(n)). The supplemental credit is refundable as an amount in addition to the earned income credit. Such families may qualify for a supplemental child credit in an amount equal to the excess of the § 24 credit (after application of the limitation under § 26) over the alternative credit amount (computed as if § 24(d)(1) applied to families with fewer than three children). The alternative credit amount is the regular tax liability increased by social security taxes reduced by the sum of nonrefundable credits and the refundable earned income tax credit. The amount of the credit under § 24 then is reduced by the amount of the supplemental child credit.

Consider for example, a single parent family with adjusted gross income of $16,000 and one qualifying child. A head of household pays no tax on up to $11,350, and 15 percent above that amount, and thus would have regular tax liability of $698 ($4,650 x 15% = $698). Assuming this single mother had at least $2,400 in work-related child care expenses, her § 21 credit would be $648 (27% x 2,400 = $648), leaving her with $50 in regular tax liability. After application of the § 26 limitation, her allowable § 24 credit would be $50. The employee's portion of social security taxes on

$16,000 in wages would total $1224 ($16,000 x 7.065% = $1,224). Her earned income tax credit would amount to $1,560 ($2,210 maximum amount phased out for earnings over $11,930 at a phaseout percentage of 15.98, or $2210 minus $650 = $1,560). Her alternative credit amount thus would equal zero.[23] The excess of her allowable § 24 credit over her alternative credit equals a supplemental credit under § 32(m) of $50. That amount reduces her § 24 credit amount to zero. Thus, because her earned income tax credit plus the other nonrefundable credits equaled or exceeded her regular tax liability plus social security taxes, her allowable child credit is refundable up to the amount of her precredit income tax liability of $50.

As the above two examples show, low income working families with child care expenses receive little additional benefit from the child credit and thus cannot apply additional funds to child care expenses. The results for four hypothetical families (the first and third familes are the same as described in the examples above), three low income families and one middle income family, are summarized in Table 1 below.

Table 1. Benefit (in dollars) from Child Credit to Low Income Working Families with Child Care Expenses

Filing Status	A(hd of househld)	B (married)	C (married)	D (married)
No. of children	**1**	**2**	**3**	**3**
Adjusted Gross Income	16,000	21,000	$25,000	$50,000
Taxable income	4,650	3,500	4,850	29,850
Regular Income Tax	698	525	728	4,478
FICA Tax	1,224	1,607	1,913	3,825
§ 21 Credit (before § 26)	648	1,152	1,056	960
§ 21 Credit (after § 26)	648	525	728	960
Regular Income Tax Liability net of nonref. pers. credits	$ 50	0	0	3,518
§ 32(a) Credit (EITC)	1,560	1,746	903	0
Child Credit				
§ 24 credit--nonrefund.	0	0	0	1,500
Refundable § 24(d) credit	0	0	682	0
§ 32(m)[n] credit	$ 50	0	0	0

As explained earlier, the refundable child credit for taxpayers with three or more children is allowed against social security taxes only to the extent that the sum of the earned income tax credit plus personal nonrefundable credits does not fully offset regular tax liability plus social security taxes. That is most likely to occur in the upper ranges of earned income credit income phaseout levels (see above). If the taxpayer does not claim the earned income credit (or has income just above the completed phaseout levels of $29,290 for taxpayers with two or more qualifying children, or $25,760 for those with one child), then child credits not used to offset income taxes may be allowed to offset social security taxes.

On the whole, as estimated by Citizens for Tax Justice, only 2.4 percent of children in families in the lowest 20 percentile income group receive at least some child credit, and 38.3 percent of children in families in the second 20 percentile income group receive at least some benefit from the child credit. By contrast, 74.4 percent of children in families in the middle 20 percentile income group receive some portion of the child credit, and 82.3 percent of children in the fourth 20 percentile income group receive some benefit from the credit. (See Table 2 on page 18.)

What Should Be Done?

Additional federal and state child care funds will be necessary to meet the increased demand for subsidized child care under the new welfare reform law. These funds could be made available through direct assistance programs or through expanded refundable tax credits. The advantages and disadvantages of these different delivery mechanisms should be carefully evaluated in light of experience with welfare transfer programs such as JOBS-related child care programs and with tax delivery mechanisms such as the earned income tax credit and state refundable child care credits.

In the meantime, advocates for low income families should monitor the implementation of state welfare reform plans and document problems with implementation, including any gaps in the availability of affordable child care. Local strategies should be developed to meet these needs without compromising gains made in the past to improve the quality of care. At a minimum, states should be encouraged to provide matching funds necessary to receive their full share of new federal child care dollars.

States vary significantly in their commitment to child care and early childhood education, and the level of commitment does not necessarily reflect available state resources. For example, a 1994 analysis by the Children's

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Defense Fund of state commitment to early child care and education found that although Virginia was ranked fourteenth on personal income per capita, it ranked in the lowest third on financial commitment to child care and early education.

New approaches, including government and private sector partnerships should be explored to help meet the increased need for quality work-related child care. State and federal income tax changes also may be considered as a means of improving low income families' access to the labor market, including the adoption of refundable child care tax credits and other reforms aimed at reducing some of the obstacles facing low income working families. ■

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1. House Comm. on Ways and Means, 104th Cong., 2d Sess., OVERVIEW OF ENTITLEMENT PROGRAMS, 1996 GREENBOOK, Appendix L at 1331 (Comm. Print 1996) [hereinafter "1996 Greenbook"].

2. See Martin J. McMahon Jr., *The New Child Credits: Explainable Mechanics and Unfathomable Policy*, 12 TAX NOTES 1625 (Sept. 22, 1997).

3. IRC § 24(b).

4. Mary L. Heen, *Welfare Reform, Child Care Costs, and Taxes: Delivering Increased Work-Related Child Care Benefits to Low-Income Families*, 13 YALE LAW & POL'Y REV. 173, 210-16 (1995).

5. Children's Defense Fund, STATE OF AMERICA'S CHILDREN YEARBOOK 4 (1997).

6. 1996 GREENBOOK, *supra* note 1, Appendix L at 1362-63.

7. Congressional Budget Office, CBO MEMORANDUM: FEDERAL BUDGETARY IMPLICATIONS OF THE PERSONAL RESPONSIBILITY AND WORK OPPORTUNITY RECONCILIATION ACT OF 1996 at 13 (Dec. 1996) (showing a $1.4 billion total shortfall for 1997-2002 calculated by comparing the $18.94 billion estimated federal and state cost of child care if states meet the work requirements plus the $6.41 billion that would have been spent for At-Risk and Transitional Child Care under prior law, for a combined total of $25.35 billion, to the $23.95 billion in funding over that period for child care under the new welfare law). See also U.S. General Accounting Office, (CHILD CARE: WORKING POOR AND WELFARE RECIPIENTS FACE SERVICE GAPS 4-5, 15 (GAO/HEHS-994-87, May 1994) (observing that the inadequate supply of child care funds resulted in concentration of benefits for those currently or recently on AFDC, leaving service gaps for other low income working families with child care needs).

8. VA. CODE ANN. § 63.1-133.49(A) (Michie Supp. 1997).

9. See 1996 GREENBOOK, at 636-37.

10. House Comm. on Ways and Means, 103d Cong., 2d Sess., OVERVIEW OF ENTITLEMENT PROGRAMS, 1994 GREENBOOK, 540-41 (Comm. Print 1994); see generally National Research Council, Commission on Behavioral and Social Sciences and Education, Board on Children and Families, CHILD CARE FOR LOW-INCOME FAMILIES: SUMMARY OF TWO WORKSHOPS 41-47 (Deborah A. Phillips, ed.) (discussing the profile of child care arrangements used by low income families).

11. Ellen Galinsky *et al.*, THE STUDY OF CHILDREN IN FAMILY CHILD CARE AND RELATIVE CARE: HIGHLIGHTS OF FINDINGS 4, 90 (1994) (the study included care in the home of regulated family child care providers, nonregulated family child care providers who are not related to the child or children, and prviders who are nonregulated and are related to the child or children in care).

12. *Id.* at 91.

13. Cost, Quality & Child Outcomes Study Team, COST QUALITY, AND CHILD OUTCOMES IN CHILD CARE CENTERS: EXECUTIVE SUMMARY 2, 5 (Apr. 1995).

14. U.S. General Accounting Office, WELFARE REFORM: IMPLICATIONS OF INCREASED WORK PARTICIPATION FOR CHILD CARE 3 (GAO/HEHS-97-75, May 1997).

15. *Id.*

16. *Id.* at 11, tbl. 3.

17. *Id.* at 3.

18. U.S. General Accounting Office, WELFARE REFORM: STATES' EARLY EXPERIENCE WITH BENEFIT TERMINATION (GAO/HEHS-97-74, May 1997).

19. *Id.*

20. Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behaviorial Gender Biases in the Code*, 40 UCLA L. REV. 983, 1015-16 (1993).

21. Daniel R. Feenberg & Harvey S. Rosen, RECENT DEVELOPMENTS IN

Table 2. The 1997 Tax Act's $500 Child Credits Effects in 1998-2002, at 1997 Levels

Income Group	Family Income Range	Total No. of Children (millions)	Children receiving at least some child credit: Millions	Percent	Avg Credit per Child for Families w/children*
Lowest 20%	Less than $12,800	11.5	0.3	2.4%	$150
Second 20%	$12,800 - 22,600	11.2	4.3	38.3%	282
Middle 20%	$22,600 - 36,000	13.7	10.2	74.4%	402
Fourth 20%	$36,000 - 59,000	19.4	15.9	82.3%	436
Next 15%	$59,000 - 112,000	17.9	13.8	77.5%	430
Next 4%	$112,000 - 246,000	4.7	0.9	19.1%	227
Top 1%	$246,000 or more	1.2	0.0	0.7%	nm
All	**All**	**79.9**	**45.5**	**56.9%**	**$406**

*Note: In 1997 dollars, the maximum credit per eligible child averages $439 over the 1998-2002 period.
Source: Citizens for Tax Justice

THE MARRIAGE TAX (National Bureau of Economic Research Working Paper No. 4705, 1994).

22. See Conf. Comm. Rep. (to accompany H.R. 2014) Statement of Managers (released July 31, 1997) at 4-5.

23. Regular tax liability of $698 plus social security tax of $1224 ($698 + $1224 = $1922) minus the sum of the § 21 child care tax credit and the § 32(a) earned income tax credit ($648 + $1560 = $2208) equals zero ($1922 - 2208 = 0).

Where to Find References On-Line

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  http://speakernews.house.gov/mgr1.htm
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  http://www.urich.edu/~perspec/issue3/welfare.htm

Advocates for low income families should monitor the implementation of state welfare reform plans and document problems with implementation, including any gaps in the availability of affordable child care.

Dependency Exemptions: *continued from page 9*

the support, and the middle child providing 10 percent of the support. No one child provides over half of the parent's support. However, because the parent-child relationship appears on the § 152 relationship list, any one of these children could have claimed a dependency exemption for the parent if that child had provided more than half of the parent's support. The total provided by this group of three children is 100 percent, which is more than half. As a consequence, any member of this group who provided more than 10 percent of the parent's support, may be treated as having provided more than half of the parent's support. Because only the oldest child and youngest child provided more than 10 percent of the parent's support, either may be treated as providing more than half of the parent's support if the other signs the required declaration. For example, if the youngest child signs Form 2120, Multiple Support Declaration, and the oldest child attaches the form to her or his tax return, the oldest child may take a dependency exemption for the parent (so long as the parent has gross income less than $2,650). Under such an arrangement, the siblings can take turns claiming the dependency exemption.

If divorced or separated parents do not enter into a multiple support agreement, § 152(e) provides a special rule so that one of the parents may be deemed to have provided more than half of the support for their child for purposes of the support test. For this special rule to be available, one or both of the parents must have provided more than half of the child's support, and one or both of them must have had custody of the child for more than one-half of the year. As a result of changes to § 152(e) in 1985,[14] the custodial parent is the one who will be deemed to have provided more than half of the child's support unless the custodial parent signs a waiver, giving up any claim to the dependency exemption for the child for the year and the noncustodial parent attaches the signed waiver to her or his tax return.[15] The waiver can be executed on Form 8332.

For the special provision in § 152(e) to apply, the parents must be divorced, must be separated under a decree of separate maintenance or under a written separation agreement, or must have lived apart at all times during the last six months of the calendar year. The divorce decree can be a decree for total divorce or a divorce from bed and board. A separation agreement must be a writing to which both parents have agreed. Therefore, if one parent writes a letter to the other parent unilaterally dictating custody arrangements, that letter would not qualify as a separation agreement. If the parents have never been married, they may not use § 152(e).

There is authority for the proposition that if the custodial parent cannot benefit from the dependency exemption, it may be taken by a noncustodial parent who provides more than half of a child's support. For example, in one case, the father provided more than

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