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# TANF FUNDS MAY BE USED TO CREATE OR EXPAND REFUNDABLE STATE CHILD CARE TAX CREDITS

The high cost of child care represents a significant barrier to parents entering and remaining in the workforce. Because a primary goal of welfare reform is to increase parents' work effort, many states use federal and state welfare funds to subsidize low-income parents' purchase of child care. Such child care subsidies typically take the form of vouchers or direct payments to providers that offset some or all of the cost of care. In recent years, some states have expanded their child care funding to offer full or partial subsidies to many more working families. Nevertheless, many families leaving welfare, and many other low-income families, still face substantial child care bills, whether or not they receive subsidies.

In addition to providing direct subsidies, a state can reduce further the burden of child care costs by enacting a child care tax credit. Such a credit reimburses families for a portion of its work-related out-of-pocket child care expenditures in the previous tax year. Like direct child care subsidies, child care tax credits can support low-income families' efforts to enter and remain in the workforce. In recognition of this linkage, federal rules allow states to use Temporary Assistance for Needy Families block grant funds to help pay for a child care tax credit. States also have the option to count a portion of the cost of a child care tax credit toward their "maintenance-of-effort" (MOE) requirements under the TANF program.

There is an important limitation on using welfare funds for child care tax credits, however. Federal regulations require that any tax credit financed under the TANF program must be "refundable." A refundable credit is one that gives a family a payment when the credit amount exceeds a family's income taxes. The regulations specifically provide that welfare funds may be used only for the portion of a credit that exceeds a family's tax liability. Another requirement of the regulations is that recipients of the credit be "needy" under income guidelines established by the state, but in fact almost any family whose credit amount exceeds its tax liability is likely to be poor or near-poor, and states have great flexibility in setting program-specific income guidelines that define who is "needy."

## Why Create a Refundable Child Care Tax Credit?

In recent years states have demonstrated substantial interest in spending state and federal funds on child care programs. As part of a broader package of supports for child care, a refundable child care tax credit may be an attractive policy option for several reasons.

### Child care tax credits

The federal government and many state governments offer child care tax credits. The **federal Child and Dependent Care Tax Credit** equals 30 percent of allowable expenses for families with incomes $10,000 and below, with the percentage gradually declining to 20 percent for families with incomes above $28,000. "Allowable expenses" includes work-related expenses up to $2,400 for one child or $4,800 for two or more children. The federal credit is non-refundable.

**State child care tax credits** may be set at a flat or sliding-scale percentage of the federal child care credit amount, or they may be set at a flat or sliding-scale percentage of actual expenses. State credits may be refundable or non-refundable. A few states offer **child care deductions**, which allow families to deduct some or all of their child care expenses from their taxable income.

A full listing and discussion of child care tax credits and other tax provisions relating to child care may be found in *Making Care Less Taxing*, 1998, and *Recent Changes in State Child and Dependent Care Tax Provisions: Tax Year 2000*, 2000, both published by the National Women's Law Center, Washington, D.C.

- A tax credit can complement a state's direct subsidy programs by helping participating families meet their co-payment obligations. A study by the U.S. Department of Health and Human Services found that for families with incomes just above the poverty line, the average state required a co-payment for the care of a single child equal to 10 percent to 20 percent of family income, with the percentage rising as annual income rises from $15,000 to $20,000. Because a tax credit is based on out-of-pocket child care expenses, it can offset part of the co-payment cost.

- A tax credit also can assist low-income families that do not participate in direct subsidy programs. Many low-income families are not aware of subsidy programs, are on a waiting list, or do not participate for some other reason. These families may still incur substantial child care costs and therefore may still benefit from a tax credit. Moreover, in most states nearly all working families with children, even those with low incomes, file tax returns, so it is quite easy and convenient for them to claim child care credits. In at least some states with refundable tax credits, a substantial number of low-income families that do not participate in subsidy programs claim refundable credits.[1]

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[1] For example, in Minnesota, about 15,000 families received Child Care Development Fund subsidies in 1998, while about 35,000 families with incomes below $30,000 received the state's refundable child care credit. In Hawaii, about 4,000 families received CCDF subsidies and 6,000 families with incomes below $30,000 received the state's refundable child care credit. In both states, it is likely that parents receiving subsidies which did not cover their full child care costs also received the refundable child care credit.

- A child care tax credit may be more sustainable over a period of several years than a spending program. Spending programs are subject to annual appropriations and therefore may be subject to cutbacks, particularly in times of fiscal stress. Tax credits, by contrast, typically are not subject to the same level of budgetary scrutiny as spending line-items. In addition, most child care tax credits, even refundable credits, are broad-based tax expenditures available to taxpayers at a wide range of income levels (although only the refundable portion targeted to needy families would be reimbursable under TANF). Depending on its structure, a child care tax credit may provide tax offsets to many middle- and sometimes upper-income families as well as refunds to low- and moderate-income families. This broad base of beneficiaries may offer some protection against budget cutbacks.

### Creating or Expanding a Refundable Child Care Tax Credit with TANF funds

Twenty-seven of the 42 states with income taxes (including the District of Columbia) already have some sort of child care tax credit or deduction. Because only the refundable portion of the child care tax credit can be financed with TANF or MOE funds, a state's ability to make use of welfare funds for this purpose depends on the existing treatment of child care expenses under the state's tax system. (See Table 1.)

- **A state that already offers a nonrefundable child care tax credit** can use welfare dollars to make its existing credits refundable. Such a change could be financed entirely with TANF funds.

  States with existing nonrefundable credits include Delaware, the District of Columbia, Kansas, Kentucky, Louisiana, Maryland, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, and Vermont.[2]

- **A state that now allows families to deduct their child care expenses from their taxable incomes** could convert the deduction into a refundable credit of equivalent value, so that all families that presently benefit from the deduction would continue to benefit, and families that under current law have incomes too low to benefit from the deduction would gain a new benefit in the form of a tax refund. Such a change in most states would be fairly straightforward, and the new benefit could be financed entirely, or almost entirely, with TANF funds.[3]

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[2] In Rhode Island and Vermont, tax liability equals a percentage of federal tax liability after counting the federal child care tax credit; thus, each state implicitly offers a nonrefundable credit. In order to make the credit refundable, the state first would need to make its child care credit explicit.

[3] Specifically, the repeal of the existing deduction would pay for the portion of the new credit that offsets taxes; TANF dollars would pay for the portion of the new credit that is refundable. In a state with a progressive income

Alternatively, a state with a deduction could enact a new refundable credit in addition to the deduction.

States with existing child care deductions include Idaho, Massachusetts, Montana, and Virginia. Maryland has both a deduction and a nonrefundable credit.

- **A state that already offers a refundable child care credit** can use welfare funds to expand the refundable portion of the credit. This may be accomplished by increasing the dollar amount of credit available to families with incomes below a certain level, or by eliminating restrictions which some states place on receipt of the refundable credit. (Examples of states that restrict receipt of refundable credits include Arkansas, where the credit is refundable only for families enrolling in certain high-quality child care programs; Maine, where the credit is refundable only up to $500; and Colorado, where the credit is technically refundable but available only to families that have federal income tax liability, preventing virtually any poor or near-poor family from receiving a refund.)

To finance such an expansion entirely with welfare dollars, the state must set the income level low enough so that the credit expansion only targets families with no tax liability or whose tax liability is already entirely offset

**Table 1: State Child Care Tax Credits and Deductions**

| States with fully or partially refundable child care tax credits | | |
|---|---|---|
| Arkansas* | Iowa | Nebraska |
| California | Maine* | New Mexico |
| Colorado* | Minnesota | New York |
| Hawaii | | |
| **States with non-refundable child care tax credits** | | |
| Delaware | Louisiana | Oregon |
| District of Columbia | Maryland** | Rhode Island |
| | N. Carolina | S. Carolina |
| Kansas | Ohio | Vermont |
| Kentucky | Oklahoma | |
| **States with child care tax deductions** | | |
| Idaho | Massachusetts | Virginia |
| Maryland** | Montana | |
| **States with personal income taxes that do not offer child care tax credits or deductions** | | |
| Alabama | Indiana | North Dakota |
| Arizona | Michigan | Pennsylvania |
| Connecticut | Mississippi | Utah |
| Georgia | Missouri | West Virginia |
| Illinois | New Jersey | Wisconsin |
| **States with no personal income tax** | | |
| Alaska | New Hampshire | Texas |
| Florida | South Dakota | Washington |
| Nevada | Tennessee | Wyoming |

* In Arkansas, Colorado and Maine, the credits are refundable only to a limited extent; see text for discussion.
** Maryland offers both a credit and a deduction.
Sources: National Women's Law Center; Center on Budget & Policy Priorities.

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tax structure, some additional allocation of general fund dollars might be necessary to pay for the conversion of the deduction to a credit in order to make sure that all taxpayers are held harmless by the change.

by the child care credit and other tax credits. A broader expansion, encompassing families at a wider range of income levels, may be financed with a combination of welfare dollars (for the refundable portion of the cost for lower-income families) and general fund dollars (for the portion that offsets tax liability).

Ten states presently offer refundable child care tax credits: Arkansas, California, Colorado, Hawaii, Iowa, Maine (effective in 2001), Minnesota, Nebraska, New Mexico, and New York.

- **A state that does not offer parents any child care credits or deductions** may choose to enact a child care tax credit targeted to low-income families; the bulk of the cost of the credit could be financed under TANF. Alternatively, a state might choose to enact a refundable tax credit available to families at all income levels, with TANF funds paying for the refundable portion of the credit and general funds paying for portion of the credit that offsets taxes.

## Other Issues

Other than the requirement of refundability, there are few limitations on a state's ability to pay for child care tax credits through TANF. A TANF- or MOE-funded child care credit would not need to be limited to welfare recipients, nor would recipients need to have incomes below their states' welfare eligibility limits. The welfare law requires that TANF and MOE funds be spent on needy families, but states are allowed to set the definition of "needy." Moreover, states are allowed to set differing financial eligibility rules for different TANF- or MOE-funded programs. The state need only establish in its TANF state plan a program-specific income eligibility limit that would include all or nearly all recipients of tax credit refunds. Note that the federal "time limit" — the requirement that most adult welfare recipients may not receive federally funded welfare payments for more than 60 months in their lifetimes — and most other restrictions that attach to receipt of cash assistance under TANF do not apply to programs that are intended to support work, such as child care tax credits.[4] As a result, using TANF or MOE funds to support the refundable portion of a state child care credit would have no adverse consequences on the credit's recipients.

Largely due to declines in welfare caseloads, some states have large amounts of unspent federal block grant funds.[5] In addition, some states are finding that their own-source traditional

[4] Existing state child care credits meet the TANF definition of "work-related" because nearly all of them are calculated based on the federal credit's definition of allowable expenses, which includes only those expenses that allow a parent to be employed. The amount of expenses for purposes of calculating the credit is limited to the amount of earnings. In a two-parent family, the amount of allowable expenses is limited to the lesser of the parents' earnings, although there are special rules if one parent is a student or is disabled.

[5] Ed Lazere, *Unspent TANF Funds in the Middle of Federal Fiscal Year 2000*, Center on Budget and Policy Priorities, August 2, 2000, http://www.cbpp.org/8-2-00wel.htm.

welfare expenditures are declining. States whose welfare expenditures decline by more than a specified amount can face substantial federal penalties and loss of funds. A child care tax credit affords a constructive way for states to spend their federal funds or count additional state funds toward the MOE requirement.

The fact that refundable child care tax credits are a permissible use of welfare funds under the federal law, however, does not mean that method of financing is the right choice for every state. If a state finances a child care tax credit entirely from non-welfare funds, it can reserve welfare funds for other forms of child care assistance, such as direct subsidies, or other kinds of refundable tax credits, such as an Earned Income Tax Credits. Moreover, a state may determine that a child care tax credit should be considered tax relief and therefore should be financed from the same general revenue sources as other forms of tax relief, as all states enacting child care tax credits prior to the new welfare law have done. Nonetheless, for states seeking to expend welfare funds in ways that help families making the transition from welfare to work, financing a portion of a refundable child care tax credit with TANF or MOE funds can be an attractive option.[6]

## Examples of Refundable Tax Credits

### New York: A refundable child care credit funded partially through TANF

In each of the last five years, New York has expanded its refundable Child & Dependent Care Credit to provide substantial benefits for both low- and middle-income families. In 1995, the credit was set at 20 percent of the federal credit for all households regardless of income. By 2000, the credit equaled 110 percent of the federal credit for families with incomes below $25,000, with the percentage phasing down to 100 percent for families with incomes between and $50,000 and to 20 percent for families with incomes above $65,000. The annual cost of the credit, including both refunds and tax offsets, rose over that time from $40 million to an estimated $150 million per year. Most of that increase has been financed from general non-welfare funds, but in fiscal year 2001 New York is planning to count $9 million of the increase toward its TANF maintenance-of-effort requirement.

In 1996, the New York credit went to 271,000 state residents, of whom about 95,000 had incomes below $30,000 and about 45,000 of whom received tax refunds in excess of their liability. The current structure undoubtedly provides refunds to many more low- and moderate-income families.

### Minnesota and Iowa: Refundable child care credits available only to low- and moderate-

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[6] For further explanation of the TANF regulations, see the Center on Budget and Policy Priorities publication *Highlights of the Final TANF Regulations*, April 1999, http://www.cbpp.org/4-29-99wel.htm, and for information on the range of opportunities for using the funds to assist low-income families, see *Windows of Opportunity: Strategies to Support Low-Income Families in the Next Stage of Welfare Reform*, January 2000, http://www.cbpp.org/1-12-00wel.htm.

**income families.**

Minnesota offers a refundable credit to low- and moderate-income families based on the amount of federal child care credit for which a family qualifies. The federal credit equals 20 to 30 percent of allowable expenses, depending on income. Minnesota families with annual incomes below $17,720 in 1999 qualify for a refundable credit equal to 100 percent of the federal credit for which they are eligible. For families with incomes between $17,720 and $31,370, the maximum credit declines as income rises; families with annual incomes above $31,370 cannot qualify for the credit.

The Minnesota credit costs the state about $12 million per year, approximately $6 million of which offsets state income tax and the remaining $6 million of which is refunds in excess of tax liability. About 36,500 families receive a credit; families with incomes below $20,000 represent about half the recipients of the credit and receive about 62 percent of the benefits. The Minnesota credit is funded through the state general fund.

Iowa's refundable credit has a structure similar to Minnesota's. The credit is available only to families with incomes below $40,000. The credit equals a percentage of the allowable federal credit, with the percentage declining as income rises; the maximum credit equals 70 percent of the federal credit for families with incomes below $10,000. The Iowa credit in 1998 cost the state about $7 million, with $2.9 million of that paid in refunds to families with incomes too low to have any tax liability. Iowa's credit is funded through the state's general fund.

**Hawaii: A refundable child care credit available to all families.**

Hawaii offers a refundable tax credit equal to a percentage of a family's child care expenses. The amount of allowable expenses is limited to $2,400 for one child or $4,800 for two or more children, the same limits that apply to the federal child care credit. Families with annual incomes of $22,000 or less may claim a credit equal to 25 percent of expenses. For families with incomes between $22,000 and $40,000, the percentage rate declines as income rises; families with annual incomes above $40,000 may claim a credit equal to 15 percent of expenses.

In 1998, 26,000 Hawaii families claimed the credit, including about 3,000 with incomes below $20,000, and another 5,600 with incomes between $20,000 and $40,000. The total cost of the credit was $7.7 million, with families with incomes below $20,000 receiving $1.1 million in credits and families with incomes between $20,000 and $40,000 receiving $1.8 million in credits. The Hawaii credit is funded through the state general fund.