

# FAMILY TAX POLICY

A Path Forward to Lifting Children out of Poverty

**A REPORT BY The U.S. Child Poverty Action Group**

Corporation for Enterprise Development (CFED), First Focus, MomsRising, National Association for the Education of Young Children (NAEYC); Save the Children Action Network (SCAN) and with research assistance on the child tax credit by the Century Foundation.



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March 14, 2017



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“...The fight against poverty and hunger must be fought constantly and on many fronts, especially in its causes. I know that many Americans today, as in the past, are working to deal with this problem. It goes without saying that part of this great effort is the creation and distribution of wealth.”

— Pope Francis —





# INTRODUCTION

“...The fight against poverty and hunger must be fought constantly and on many fronts, especially in its causes. I know that many Americans today, as in the past, are working to deal with this problem. It goes without saying that part of this great effort is the creation and distribution of wealth.”

— Pope Francis

These powerful words were spoken by Pope Francis before a joint session of Congress during his historic U.S. visit in 2015. Two years later, the harsh reality remains that nearly one-half of children in the United States live in poor or low-income households. For children of color, the poverty rate is even more alarming, with 63 percent of Hispanic children and 65 percent of black children living in poor or low-income households.

Poverty is a particularly serious problem for children, who suffer negative effects for the rest of their lives after living in poverty for even a short time. Beyond consequences for individual children, child poverty negatively affects the entire nation through increased expenditures on criminal justice and healthcare, as well as through lost revenue and economic output.

One way to combat child poverty is through increasing a family's cash income, which is critical for a family's economic security. Parents and caregivers need cash income to provide for their children by paying for rent and transportation to work, as well as by securing goods and services to improve their children's development and educational achievement.

A 1999 study out of Britain found that low-income families who received additional cash through the United Kingdom's child allowance policy prioritized this additional cash to purchase items for their children<sup>1</sup> such as books and toys that would improve their development. A 2012 study shows that an additional \$1,000 of income can raise children's test scores by 6 percent<sup>2</sup> in the short term.

The high costs of raising young children make it more likely for families to slide into poverty. The poorest 20 percent of families spend nearly one-seventh of their income on diapers—a major temporary expense of young childhood directly linked to the health of young children.<sup>3</sup> The cost of full-time center-based care for infants—which exceeds payments for rent and college tuition in the majority of states—means that families at or below the Federal Poverty Level (FPL) are paying between 24 percent of their incomes in Mississippi to 85 percent of their incomes in Massachusetts for child care alone. The high cost of raising kids continues through childhood—on average it costs over \$200,000 to raise one child from birth to age 18 (not including college).<sup>4</sup>

While successfully helping families with young children requires a mix of subsidies and tax solutions, the federal tax code is one of the most powerful tools we have to combat child poverty. In fact, just four federal tax policies account for nearly 40 percent of federal investments in children. Combined, the earned income tax credit (EITC), the child tax credit (CTC), the dependent exemption, and children's share of the tax exclusion for employer-sponsored health insurance total \$76 billion in refundable tax credits and \$109 billion in tax reductions.

Unfortunately, these important credits, exemptions, and exclusions are by no means forever protected within the tax code and in fact, as Congress debates a comprehensive overhaul of the tax code, these important policies have already come under scrutiny. Beyond protecting current tax-based policies, there are improvements needed to better support families in their pursuit of economic mobility.

The U.S. Child Poverty Action Group aims to ensure the federal tax policies helping families and children are not only protected in the tax code during the comprehensive tax reform debate in the 115th U.S. Congress, but are strengthened to better serve poor and low-income children and families, in particular. This paper offers a range of possible solutions and fixes to existing policy that would help to ensure the tax system benefits families with children at all income levels.

## The Threat

Members of Congress in both chambers and from both sides of the aisle have been calling for a revamp of the federal tax code for years. Many argue that in the thirty years since the last major overhaul, the code has gotten too complicated, become riddled with “special interest” credits and deductions, and that U.S. international tax policies are out of step with the rest of the modern world.

One of the most frequent tax reform plans call for eliminating nearly all credits, deductions, and exclusions from the code in favor of lower marginal tax rates. The argument follows that if the majority of families and businesses already lower their net tax burdens with credits and deductions—often called “loopholes”—why

not trade in the current code for a simpler one in which everyone pays lower rates and eliminate the loopholes. The challenge is that some of the “loopholes” marked for deletion include those helping low-income families, those living in poverty, and families with young children.

Unfortunately, there is precedent for proposing cuts to important family tax policies. For example former chairman of the U.S. House Committee on Ways and Means Dave Camp (R-MI) introduced a comprehensive tax reform plan in 2014 which would have amended all elements of the tax code affecting families, including personal exemptions, itemized deductions, and the child tax credits and earned income tax credits. While the plan increased and expanded the child tax credit, it did more harm than good by then repealing credits for child and dependent care and reducing the EITC for most families with more than one child.

From the other side of the aisle, the impact of tax policy on children is sometimes ignored. For example, although a number of provisions in the Affordable Care Act (ACA) are critical to children, two tax provisions are of the most concern. The first is known as the “Cadillac Tax,” which is set to impose a tax on health coverage that would likely fall disproportionately on family coverage plans. The other provision is often referred to as the “family glitch,” as it prohibits families from getting tax subsidies in the public health exchange in the case that an individual in a family receives an offer of employer coverage that is deemed “affordable” under the law. This disproportionately harms children because it fails to recognize that the cost of a family plan is significantly higher than individual coverage.

## The Opportunity

The November 2016 election results have accelerated the prospects of enacting comprehensive tax reform. President Donald Trump, Senate Majority Leader Mitch McConnell (R-KY), and House Speaker Paul Ryan (R-WI) have demonstrated commitment to signing into law a comprehensive tax reform bill in 115th Congress—even as early as in the first session.

The U.S. Child Poverty Action Group (CPAG) supports comprehensive tax reform and has completed an analysis of a number of critical tax policies that currently support children and families. Through the analysis it developed policy recommendations that are divided into four sections: (1) Credits, (2) Deductions, (3) Savings Accounts, and (4) Other Opportunities. These policy recommendations could do more to elevate children out of poverty. In addition, since deductions and savings accounts typically favor high-income families, while direct subsidies and refundable tax credits better meet the needs of low-income families, these strategies should be paired together to meet the needs of all families.



## SECTION ONE

# TAX CREDITS

## Child Tax Credits (CTC) And Young Child Tax credit

### BACKGROUND

**What is it?** The child tax credit (CTC) is a partially refundable tax credit available to households with dependent children, aimed at reducing the tax burden and financial stress associated with raising children. The child tax credit was proposed as part of Newt Gingrich's Contract with America, and was first enacted and signed into law by President Clinton through the Taxpayer Relief Act of 1997.

**Who is eligible?** The CTC is available to taxpaying households with qualifying children under the age of 17, including undocumented immigrants who file on behalf of their children using an individual taxpayer identification number. The child tax credit is available to all children whose families have work income, although tax filers with income above certain thresholds (these thresholds are based on marital status and number of qualifying children) are ineligible for the credit.

**How much is it?** The CTC reduces the amount of tax owed by \$1,000 per qualifying child. Those families with no tax liability are eligible for the additional tax credit, which is calculated as 15 cents for every dollar earned above \$3,000 up to the \$1,000 per child formula. Like the EITC, the CTC phases out as a family earns more, by increments of \$75 for every additional \$1,000 earned by the household over the earning threshold (\$110,000 married jointly, \$75,000 single, \$55,000 married filing individually).

**How do families get it?** The child tax credit is provided to families once a year, in a lump sum payment after individuals and families file their federal income tax return. The CTC is a partially refundable credit meaning individuals with zero tax liability can receive 15 percent of earnings above \$3,000, up to the credit's full value.

**How much help does it deliver?** In 2016, the CTC is estimated to deliver \$52.7 billion in aid to 35 million U.S. households (representing 70 percent of all American families). When combined with the EITC, the CTC is one of the strongest anti-poverty tools the United States has. In 2015, 9.8 million people, including 5.1 million children, were lifted out of poverty by the EITC and CTC.<sup>5</sup>

**Recent legislation:** The CTC was expanded to as much as \$1,000 per child in 2009 through the American Recovery and Reinvestment Act (ARRA) and related legislation to counteract falling incomes during the economic crisis. This expansion was made permanent via a bipartisan agreement struck in December 2015. The phase-in amount of the CTC was also dropped from \$8,500 in 2008 to \$3,000; any household with earnings above this threshold qualified for a partial credit.

## LIMITATIONS OF THE CTC

The child tax credit makes a major impact on child poverty and child well-being, but has limitations. The current CTC is estimated to lift 1.7 million children out of poverty.<sup>6</sup> But because the credit is only partially refundable and that partially refundable portion is only applied to earnings above \$3,000, the CTC is of limited benefit to those low-income households that have low or no earnings. For this reason, the CTC is modeled to lower the overall child poverty rate by 2.3 percentage points from 18.8 percent to 16.5 percent, but in actuality, is only estimated to reduce the deep poverty rate by 0.2 percentage points from 4.7 percent to 4.5 percent.<sup>7</sup> This is especially difficult for families of very young children who may experience a steep decline in income due to child caring responsibilities—and more than one-quarter of all poverty spells are triggered by the birth of a child.<sup>8</sup>

The CTC does little to address the skyrocketing high costs of raising young children, including paying for infant child care (the most expensive age due in part to the importance of having low staff ratios that support safety and quality), as well as additional costs associated with raising very young children (such as doctor's visits, diapers, and formula).

Single moms are especially hit hard: across fifty states, the annual cost of center-based infant care averaged over 40 percent of median incomes for single mothers.<sup>9</sup> The poorest 20 percent of families spend nearly one-seventh of their income on diapers, a major temporary expense of young childhood directly linked to the health of young children.<sup>10</sup> The high cost of raising kids continues through childhood—on average it costs over \$200,000 to raise one child from birth to age 18 (not including college).<sup>11</sup> Given these costs, providing for children individually rather than with the combined income of two employed parents can prove difficult.

Support of and concerns about the child tax credit come from different ideological perspectives. Observers have identified a marriage penalty in the credit, as the child tax credit begins to phase out at \$75,000 for unmarried filers and \$110,000 for married filers filing jointly, but the number of children may be the same in each family.<sup>12</sup> Other conservatives have argued that the most effective way to improve the well-being of children is to increase employment among parents, and the focus of tax reform should be on economic growth and not the size of the credit.<sup>13</sup>

## STRENGTHENING THE CTC

**Start refundability at first dollar:** The CTC does not become refundable until a family earns \$3,000. A good first step would be to start refundability with the first dollar of earnings like the EITC rather than an

arbitrary threshold of \$3,000, and allow more struggling families to be able to earn the full amount of the credit. This would amount to approximately an additional \$2.1 billion reaching low-income families per year.

**Smart increases in the credit:** Leaders from both parties have supported an increase in the child tax credit. Most recently, Senators Marco Rubio (R-FL) and Mike Lee (R-UT) proposed increasing the credit to \$2,500 per child, without changing its refundability. And, House Speaker Paul Ryan's "Better Way" plan proposes increasing the child tax credit to \$1,500, but the extra \$500 would not be refundable.<sup>14</sup>

While most families with children (including those with stay-at-home parents) face high costs of raising children, it is critical to target increases in the child tax credit. Any increase needs to maintain or improve refundability for vulnerable children, and ideally be a strategy for investing in our youngest children (see below). Increases in child tax credit that come at the expense of reductions to government programs that target poor children could easily be a net loss to these vulnerable families.

**Create a young child tax credit:** A young child tax credit involves a larger tax credit for families with young children—commonly defined as five-years-old and younger—and it is endorsed by multiple major organizations working with children. Recent proposals advanced in the Senate by moderate figures like Senator Michael Bennet and by the Democratic House leadership would target increases in the child tax credit to families with young children. Proposals for a refundable child tax credit range from \$1,500 per child, as proposed by Representative Rosa DeLauro (D-CT), to \$3,000, as proposed by Michael Senator Bennet (D-CO). In addition, legislation from Representative Rosa DeLauro and Senator Brown, has been introduced which would allow families to more readily use the extra income of the young child credit for regular expenses like diapers or housing.

Legislation introduced in the House and Senate would strengthen the young child tax credit by allowing parents the option of selecting a periodic payment of the credit through a method to be developed by the Treasury Department. This would allow families to more readily access the extra income of the young child credit as they need it, for regular expenses like diapers or housing.

In addition, congressional proposals have also extended eligibility for the young child tax credit to all families with young children, including those who have no labor market earning—recognizing that low-income families with young children are more likely to be unemployed than those at higher incomes.

**Index the credit to inflation:** The child tax credit of \$1,000 is not indexed to inflation and will continue to erode over time. Leaders from both parties have included indexation in various child tax credit proposals. However, it is important to note that indexing should be accompanied by first dollar refundability so that the effort to increase the amount of the child tax credit will benefit the poorest families as well as families at higher income levels. Indexation on its own would have an estimated cost of \$72 billion over ten years.<sup>15</sup>

**Protect eligibility of immigrant children:** Millions of children (the vast majority citizen themselves) of working undocumented immigrants receive crucial support through the child tax credit. A 2015 law tight-

ened rules for individuals filing for the credit on behalf of their children using an individual taxpayer identification numbers. These changes should address concerns of abuse of individual taxpayer identification number (ITIN) child credit provisions. No further legislative action to change eligibility of these filers should be taken until the effects of the 2015 law's changes are understood.

**Establish a universal child allowance:** An ambitious policy would be a universal child allowance for all children under the age of 18. This type of child benefit is practiced in countries across the industrial world, including Britain, Canada, and Australia, where the basic benefit is \$100 to \$350 per week. A child allowance could be created in the United States by reforming the child tax credit into a fully refundable tax credit with no earnings threshold. It would be paid monthly either through the Social Security Administration or as a periodic payment by the Internal Revenue Service (IRS).

Other features could be similar to the current child tax credit, including an earnings phase out at \$75,000 for single households and \$110,000 for married couples. Because it opens eligibility to the neediest, a child allowance policy would have a larger dollar for dollar impact on child poverty than other proposals. For example, a universal child allowance that provides \$2,500 per child for all families with children (ages 0–17) would lift 5.5 million children out of poverty. While costing \$109 billion more than the current child tax credit at first, it would also reduce the costs to society associated with child poverty, such as reduced crime and improved health.<sup>16</sup>

## Child and Dependent Care Tax Credit (CDCTC)

### BACKGROUND

**What is it?** The child and dependent care tax credit (CDCTC), sometimes referred to as the child care credit,<sup>17</sup> allows families to claim a credit if they paid expenses for the care of a qualifying individual that enabled parents to work, go to school or actively look for work.<sup>18</sup> The child and dependent care tax credit has been a part of the U.S. tax code since 1976,<sup>19</sup> with the modification of what would become Code Section 21 of the tax code.<sup>20</sup>

**Who is eligible?** According to the IRS, a taxpayer can claim this credit if the taxpayer's dependent individual was under the age of 13 when care was provided; the care was provided so that the taxpayer could work, attend school full-time, or look for work; the taxpayer's dependent individual is the taxpayer's child, stepchild, foster child, sibling, or stepsibling, or a descendant of one of these; and the dependent child has the same principal residence as the taxpayer for at least half the year.<sup>21</sup> Care expenses for a dependent or spouse who is "physically or mentally incapable of self-care" can also be claimed for the credit.<sup>22</sup>

**How much is it?** A taxpayer can claim a credit of up to \$1,050 for one qualifying child or dependent or \$2,100 for two or more qualifying children or dependents. The exact amount of the credit is determined by two things: (1) the amount of work-related expenses (up to \$3,000 for one child or dependent and up to \$6,000 for two or more children or dependents) paid to a care provider for the care of a qualifying child or dependent;<sup>23</sup> and (2) the family's adjusted gross income (AGI).<sup>24</sup> Based on AGI, a family can receive



between 20 and 35 percent of expenses as a credit, with lower-income families receiving a higher percentage of expenses: a family whose AGI is below \$15,000 would qualify for a credit of 35 percent of expenses, while a family with AGI above \$43,000 would qualify for a credit of 20 percent of expenses.<sup>25</sup>

**How do families get it?** The CDCTC is provided to the family/taxpayer once a year as a nonrefundable tax benefit when federal income taxes are filed.

**How much help does it deliver?** The CDCTC helps families to offset the costs of paying for childcare while the adults in the family are working or going to school. In 2016, estimates are that 12.7 percent of families with children benefited from the CDCTC; those families saw their taxes reduced by an average of \$551.<sup>26</sup> Like all nonrefundable credits, however, which reduce federal income tax liability (and can increase, but not provide, a tax refund), the CDCTC benefits middle-income families more than low-income families.

## LIMITATIONS OF THE CDCTC

Given the high costs of child care, the benefits of the CDCTC remain inadequate, and, in addition, are also provided after a federal tax return is filed—long after the care expenses for the prior tax year were incurred. Low- and moderate-income families often cannot wait until tax time to be reimbursed for costs they have already expended, so that subsidies, which are paid on a regular basis to families and/or child care providers as costs are incurred, are therefore more supportive of and helpful to low-income families. If we are truly going to reduce the exorbitant cost of child care many families in the United States face, as well as increase the supply of quality care, our government will have to enact a more comprehensive approach to child care—including increasing subsidies and investments in programs like the Child Care Development Block Grant (CCDBG), even as we expand and strengthen tax credit opportunities.

## STRENGTHENING THE CDCTC

**Make the credit fully refundable:** Nearly all legislation addressing needed improvements to the CDCTC. For example, recent legislation introduced by Senator Angus King (I-ME) and Senator Richard Burr (R-NC) has added the element of refundability as a core change, in addition to improvements identified below.

**Increase allowable expenses:** Child care costs more than college tuition in nearly half the states, and more than rent in the majority of cities. A credit that provides partial reimbursement of up to \$3,000 in expenses for one child and \$6,000 in expenses for two or more doesn't come close to addressing the enormous burden of expenses felt by families, and the amount of expenses needs to be raised to better reflect the true cost of care for young children.

**Increase the top credit rate:** The credit rate, currently capped at 35 percent, could be increased and indexed to inflation to better capture and address the true cost of care.

**Improve the structure of the payment:** Change the structure of the payment so that families receive the tax credit on a monthly basis or upfront basis, since that is how families pay for the costs of the care their children receive.

# Earned Income Tax Credit (EITC)

## BACKGROUND

**What is it?** The earned income tax credit (EITC) is a refundable tax credit available to eligible workers earning relatively low wages. Since the credit is refundable, an EITC recipient need not owe taxes to receive the benefit. Many low-income workers, especially those with children, may be eligible to receive the EITC. The EITC, enacted forty years ago, has evolved from a relatively modest tax benefit to a significant antipoverty program. The EITC has been expanded on a bipartisan basis by Presidents Reagan, Clinton, and Obama.

**Who is eligible?** Eligibility for and the amount of the EITC are based on a variety of factors, including residence and taxpayer ID requirements, the presence of qualifying children, age requirements for childless recipients, and the recipient's investment income and earned income. Similarly to eligibility for the CDC, tax filers with incomes above certain thresholds (these thresholds are based on marital status and number of qualifying children) are ineligible for the credit.

**How much is it?** The EITC varies based on a recipient's earnings. Specifically, the EITC equals a fixed percentage (the "credit rate") of earned income until the credit amount reaches its maximum level. The EITC then remains at its maximum level over a subsequent range of earned income, between the "earned income amount" and the "phase-out amount threshold." Finally, the credit gradually decreases to zero at a fixed rate (the "phase-out rate") for each additional dollar of adjusted gross income (AGI)—or earnings, whichever is greater—above the phase-out amount threshold. The specific values of these EITC parameters (e.g., credit rate, earned income amount) vary depending on several factors, including the number of qualifying children a tax filer has and his or her marital status. For the 2015 tax year, the maximum EITC for a tax filer without children is \$503 per year. Childless workers who claim the credit must be between the ages of 25 and 64. In contrast, the 2015 maximum EITC for a tax filer with one child is \$3,359 per year; for two children, \$5,548 per year; and for three or more children, \$6,242 per year.

**How do families get it?** The EITC is provided to individuals and families once a year, in a lump sum payment after individuals and families file their federal income tax return. The EITC is a fully refundable credit meaning that individuals with zero tax liability can receive the full amount of the credit as a refund.

**How much help does it deliver?** The EITC has had a significant impact on reducing poverty among recipients with children reducing the poverty rates of unmarried and married workers with children by 14.10 percent and 29.38 percent respectively, depending on the number of children the recipient has. In 2013, a total of \$68.1 billion was claimed by 28.8 million tax filers (19 percent of all tax filers), making the EITC the largest and one of the most successful need-tested anti-poverty program in the United States. In that year, 97 percent of all EITC dollars were claimed by families with children. The EITC also boosts military families. When combined with the refundable portion of the child tax credit, the EITC assists two million military and veteran households.<sup>27</sup>

Recent enacted legislation: Two temporary modifications to the EITC were enacted by the American Recovery and Reinvestment Act of 2009 (P.L. 111–5). First, ARRA enacted a temporary larger credit for families with three or more children by creating a new higher credit rate of 45 percent (previously, these tax filers were eligible for a credit rate of 40 percent). Second, ARRA expanded marriage penalty relief by increasing the earnings level at which the credit phased out for married tax filers in comparison to unmarried tax filers with the same number of children. The Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114–113) made these two modifications permanent.

## STRENGTHENING THE EITC

**Expand EITC to include youth formerly in foster care:** The EITC is not currently offered to adults under age 25 unless they are parenting. The current policy assumes that many adults ages 18 to 24 earn little income but rely on their parents for financial support. While this may be true for some young adults, this is almost never true for youth formerly in foster care. At 21, only 13.2 percent of youth formerly in foster care report living with a biological or foster parent.<sup>28</sup> Youth formerly in foster care are particularly vulnerable and deserve the benefits associated with poverty programs for adults.

Expanding the EITC would provide a much-needed benefit to approximately 135,000 former foster youth around the country and equip those youths to become successful adults and productive members of society. Individual youth could receive up to \$1,000 per year in assistance, resulting in a reduction in poverty and increased labor market participation with very little additional cost to the taxpayer.

**Expand the EITC to low-income workers not raising children in the home:** Bipartisan proposals exist, garnering support from both Republican and Democratic leadership in the House and Senate that would capitalize on the EITC's ability to lift low-income workers out of poverty by expanding this tax credit to workers who do not currently have children in their homes.

Democrats and Republicans, including President Obama and Speaker Paul Ryan, have offered near identical proposals that would lower the eligibility age for the EITC for workers not raising children in the home to 21 and raise the maximum credit for these workers to roughly \$1,000. In addition, there are proposals in the House (introduced by Representative Richard Neal (D-Massachusetts) and the Senate (introduced by Senator Sherrod Brown) that would ensure the federal tax code does not tax childless low-wage workers into poverty by providing an EITC that fully offsets these workers' payroll and incomes taxes.<sup>29</sup>

Expanding the EITC for these low-wage workers would prevent eight million people from being taxed into poverty; these are parents of adult children, non-custodial parents (who still have financial obligations to their children), grandparents who help care for our children, and even young workers who will someday have a family of their own.

**Design EITC so it meets emergency savings needs:** Based on research showing that a near majority of Americans have little or nothing saved for emergencies,<sup>30</sup> bipartisan legislation was introduced last Congress by Senators Cory Booker (D-NJ) and Jerry Moran (R-KS) that would allow filers to defer a portion of their EITC refund into an emergency savings account.<sup>31</sup>

**Reduce legitimate confusion that contributes to overpayments:** Overpayments in the EITC program can be reduced without making it harder to claim or reducing benefits. For example, the National Taxpayer Advocate recommends that the IRS allow filers to follow a state agency's determination that a taxpayer has qualified for certain public benefits to satisfy eligibility for the EITC, instead of using a different definition of "qualifying child."<sup>32</sup>

## American Opportunity Tax Credit (AOTC)

### BACKGROUND

**What is it?** Created in 2009 from the Hope Scholarship Tax Credit, the American opportunity tax credit (AOTC) was intended to improve upon tax-based aid for the high cost of college by providing a credit for a student's first four years of post-secondary education.

**Who is eligible?** Families or students with up to \$80,000 (\$160,000 for a married couple) can receive the credit.

**How much is it?** Filing individuals can receive a maximum of \$2,500 annual credit.

**How much help does it deliver?** Because this credit is not received until after the student has already begun college and incurred expenses, it is difficult for low-income students to prepare for these costs.<sup>33</sup>

### STRENGTHENING THE AMERICAN OPPORTUNITY TAX CREDIT

The AOTC was made permanent in the 2015 bipartisan tax deal, yet there are several ways to still improve access to the AOTC for low-income families and students, such as:

- + Allowing credit payments to be made periodically in order to help families and students prepare for college expenses;
- + Eliminating the four-year cap on the AOTC, for students who need more than four years to graduate;
- + Expanding outreach and education efforts to increase the take-up among low-income students and households of color;
- + Provide tax credits beginning in the early years of families saving for college so that low-income families are incentivized to save for college throughout their child's life;
- + Increasing refundability of the credit, for currently, families or students with no tax liability after receiving the credit can receive only 40 percent of remaining credit back, up to \$1,000.

## SECTION TWO

# TAX DEDUCTIONS

## Dependent Care Assistance Program (DCAP)

### BACKGROUND

**What is it?** The dependent care assistance program (DCAP) is an employer sponsored flexible spending account-type program that allows employees to set aside pre-tax dollars from their paycheck to pay for child and dependent care. It also allows employers to provide child care benefits to employees on a tax-free basis, up to a set cap. Employees who use DCAP are not eligible to claim the child and dependent care tax credit. The definitions for qualified dependent care expenses and qualified dependent used for the exclusion are the same as for the CDCTC; in other words, those families that the IRS classifies as “highly compensated employees”—or those that typically earn more than \$120,000.

**Who is eligible?** Any individual who has earned income and needs child care in order to work or be able to look for work is eligible for dependent care tax benefits. For DCAP specifically, only employees with employers that offer a DCAP plan—and are not “highly compensated employees”—can take advantage of the program.

**How much is it?** Employees can claim reimbursement for qualified dependent care expenses up to the amount they have withheld in their account. The average contribution to a DCAP was about \$3,300, which is lower than the \$5,000 maximum allowed under current law (for married couples; single individuals can claim up to \$2,500). This difference, between “average” and “allowable” contributions may reflect the “use or lose” nature of the funds and changes in employment (e.g., if an employee changes jobs from one employer that offers a DCAP to another that does not). Funds for dependent care expenses not used by March of the following year revert to the employer. The Mercer survey found that an average of only about 2 percent of funds are forfeited under the “use or lose” rules.<sup>34</sup>

**How do families get it?** For a DCAP, the employee agrees that a specified amount be set aside for the employer DCAP. The employer DCAP must be a written plan that is generally available to all employees, but it need not be funded by the employer. The tax benefit from the exclusion depends on the marginal tax

rate of the working caregiver and the amount that the working caregiver allocates to the DCAP each year. This type of arrangement is also known as a flexible spending arrangement or a flexible spending account, and is often offered as part of a cafeteria benefit plan, in which employees may choose from one or more taxable or nontaxable benefits.

**How much help does it deliver?** Higher-income individuals, who pay higher marginal tax rates, receive a larger reduction in their taxes, in dollar amounts, than middle- and low-income individuals. In 2010, the most recent year for which data are available, 1.2 million tax returns filed included claims for dependent care benefits; the exclusion reduced taxable income on those returns by an average of \$3,456.<sup>35</sup> The reduction in taxes was much smaller, because it equals the taxpayer's marginal tax rate multiplied by the reduction in taxable income. In 2010, the average income tax benefit for people using the exclusion was around \$1,000.<sup>36</sup> According to a Mercer survey, 58 percent of employers with fifty to 499 employees and 85 percent of employers with five hundred to 4,999 employees offered a DCAP in 2012.<sup>37</sup>

## LIMITATIONS OF DCAP

The DCAP, like all tax deductions, overwhelmingly benefits middle- and upper-income families because they have higher marginal tax rates, and can afford to set pretax money aside. Lower income families, often living paycheck-to-paycheck, can struggle to set aside income into a tax-deferred account, while families living in poverty typically do not earn enough to even incur net income tax liability, meaning they receive no or less benefit from a tax deduction.<sup>38</sup>

Data demonstrates that, currently, low- and moderate-income families receive a small share of the tax benefits of the DCAP. Families with AGI below \$75,000 receive just 10 percent of the tax benefits, while families with incomes above \$200,000 will receive 38 percent of the net benefits for tax year 2016.<sup>39</sup>

## STRENGTHENING DCAP

Direct assistance and refundable tax credits are more targeted towards meeting the needs of low- and moderate-income families; any DCAP expansion should be coupled with proposals that guarantee greater benefits to families with lower income brackets.

There are, however, significant improvements that can be made to the DCAP, as evidenced by previous DCAP legislation that has proposed a federal tax credit, dollar for dollar, to an employer who matches their employees' first \$1,000 of contribution to an account. This match could be scaled to make the match more generous for low-income earners, such as allowing a \$1 match for every \$0.50 contributed, an expansion of the match proposed by then-candidate Donald Trump for a direct federal match of \$500 for the first \$1,000 of family contributions to a dependent care savings account.

Another potential change would focus on "advanceability," which, with appropriate safeguards, would allow families to debit directly from an account at the time of paying for child care, rather than waiting for reimbursement at a later date. In addition, using what works well with some flexible spending accounts as a model for changes to the DCAP could produce additional benefits.

## SECTION THREE

# CHILDREN'S SAVINGS ACCOUNTS & ASSET BUILDING

## BACKGROUND

Over 1.3 million American children—and more than half of minority children—are born into families with limited to no savings to invest in their futures.<sup>40</sup> Studies have shown that even a small amount of savings can have a positive effect on a child's social-emotional development and improve a family's outlook for a child's future.<sup>41,42</sup> Indeed, 71 percent of children from high-savings, low-income families rise out of the lowest income quartile over their lives, compared with just 50 percent of children from low-income, low-saving families.<sup>43</sup>

Savings not only lift children and families out of poverty, but promote economic security, breaking the generational cycle of poverty. Children in low- and moderate-income families with even less than \$500 saved for college are three times more likely to enroll in college and four times more likely to graduate than children without any savings.<sup>44</sup>

The tax code is a critical tool to promote asset building and long-term savings. Yet current tax policy assists and incentivizes middle- and high-income families to save and build assets without similar provisions targeted to low-income families, who may be unable to take advantage of tax credits and savings accounts due to their lower tax liability or are unaware of these opportunities due to a lack of outreach.

Tax-based aid is an effective way to help families invest in their child's future, such as for higher education. Tax-subsidized college savings accounts and other programs can be very effective in helping families save for higher education. Yet in order to truly expand educational opportunity in the United States and to address racial inequities, we need to better target these accounts to low- and moderate-income households and households of color.

The tax code can also incentivize and assist families in building more savings and assets for purposes beyond higher education, yet would still help in contributing increased resources to support a child's healthy development and invest in their future. This can be done through increasing access to retirement savings account programs, as well as improvements to current tax credits such as the EITC.

## LIMITATIONS OF CURRENT POLICIES

529 accounts (529s), created in 1996, allow families to put aside savings for a child's higher education while receiving federal and state tax benefits. However, there are limitations of 529s. Only 3 percent of families use them, and these are disproportionately higher-income families.<sup>45</sup> Ten percent of 529 accounts are owned by those earning \$50,000 or less.<sup>46</sup>

Another limitation of 529s for low-income families is the effect of 529 contributions on public assistance eligibility. Currently, savings penalties, otherwise known as asset limits, for many anti-poverty programs provide a barrier for families receiving public assistance or are concerned they may need this assistance in the future.

Roth Individual Retirement Accounts (IRAs) are an effective tool in assisting low- and moderate-income workers to plan for future expenses, due to modest income caps and no penalties for withdrawal of funds before retirement for purposes such as higher education, homeownership, retirement and medical expenses. However, they are currently limited to those with earned income, thereby excluding these accounts to be established in a child's name and prohibiting the savings to grow throughout the child's life.

## STRENGTHENING CHILD SAVINGS ACCOUNTS

**Expand 529 accounts:** There are ways to expand use of 529s through the tax code. For example, the retirement savings contribution credit (known as the "saver's credit") could be expanded to include 529s, thereby allowing families making contributions to a 529 to receive a tax credit for such contributions. Another critical way to support low-income families utilizing 529s and saving for their children's futures is exempting any funds in these accounts from benefit program asset limitations.<sup>47</sup>

### Improve Savings Programs:

**+ Expansion of Roth IRAs:** Roth IRAs can be used for higher education, homeownership, medical expenses, and retirement. They can be withdrawn penalty-free before the time of retirement for any of these purposes. By expanding Roth IRAs to include children without earned income, it would allow parents, relatives, and organizations to make contributions in the child's name to the account. An initial investment of \$500 at birth and a \$250 investment each year could result in \$131,829 by the age of 65.<sup>48</sup>

**+ Expand 529 Accounts:** There are ways to expand use of 529s through the tax code. For example, the saver's credit could be expanded to include 529s, thereby allowing families making contributions to a 529 to receive a tax credit for such contributions. This policy, however, would need to be paired with a proposal to make the saver's credit refundable in order to help low-income Americans save. As it is now, the saver's credit is not refundable, so low-income families whose tax liability is eased by other credits like the EITC or CTC cannot access it. Another critical way to support low-income families utilizing 529s and save



for their children's futures is exempting any funds in these accounts from benefit program asset limitations.

**Incentivize savings through the EITC:** Tax season provides families an opportunity to build savings. Families eligible for the EITC receive a lump tax credit payment at this time of year, potentially providing them some financial flexibility to put some of this payment into savings and plan for the future. The federal government can help them take advantage of this opportunity to save. One way that has been proposed is to allow families to defer 20 percent of their EITC into a savings account for six months and receive an accumulated match for these funds.<sup>49</sup>

**Universal children's savings accounts:** Lifetime savings accounts should be created for all children at birth. Seeded with a small initial deposit from the government, savings put in by families are matched by the government. These funds can be used later for opportunities such as higher education or homeownership. This not only helps to provide a strong financial basis for future educational and personal growth opportunities, but also promotes positive savings behavior for families and children.

This is not a new idea. The bipartisan America Saving for Personal Investment, Retirement, and Education Act (ASPIRE) Act, which proposed to create a seeded savings account for every child in America, was reintroduced four times between 2004 and 2010.<sup>50</sup> In the 114th Congress, the USAccounts: Investing in America's Future Act (H.R. 4045) would have established an individual savings account for every child, with a \$500 seed investment.

Children's savings accounts have been piloted at the local level and are prime for expansion through federal policy. For example, San Francisco opened 1,200 accounts in the first year of its heralded Kindergarten to College program which serves all public school kindergarteners.<sup>51</sup> Similar programs have been launched in jurisdictions as diverse as Nevada, Maine, and Rhode Island.<sup>52</sup>



## SECTION FOUR

# OTHER TAX POLICIES TO CONSIDER THAT WOULD BENEFIT CHILDREN AND FAMILIES

## Housing & Homeownership

There are certainly other tax-based policies that have an impact in reducing child poverty. These include benefits to assist families with housing and homeownership. The lack of affordable housing in the United States is a big barrier to economic mobility for many families. However, in order to be effective in boosting economic mobility, investments in housing and homeownership through the tax code must target low- and moderate-income families. This includes reform of the Mortgage Interest Deduction to better assist low-income families who wish to become homeowners, as well as the creation of a renters credit or other measures to also support households who cannot afford or do not wish to become homeowners.

## School Readiness Tax Credits

Because 65 percent of children under six live in households in which all parents are working outside the home, implementing tax strategies that support the professionals caring for and educating these children is an economic development strategy that can have an outsize impact on the success of children, professionals, and the families who need to rely on child care in order to go to work themselves. The state of Louisiana, in making investments in small businesses, specifically child care centers (and their workers) to help grow local economies, has established a robust constellation of school readiness tax credits that support early childhood education; Nebraska has recently established similar legislation to focus on improving both quality and access as well.<sup>54</sup>

The critical strategy is informed by research indicating that early childhood educators are the linchpin of quality, and that, in order to deliver on the promise of early childhood education, we must strengthen the teaching profession and improve teaching practices, while also addressing the reality that compensation for early childhood educators is so low that it threatens the quality and stability of the early childhood field. The child care teacher and director credit is available to support staff who improve their teaching practices by increasing their qualifications and credentials.

Tax reform at the federal level presents an opportunity to incorporate this credit into the federal tax code, providing critical support for early childhood professionals—many of whom are themselves low-income working mothers—as well as families, their young children, and both the local and national economy.

## Periodical Payment of Credits

As referenced throughout this paper, one structural problem with using tax credits to address child poverty is that income is generally delivered only one time during the year. Several of our proposals above suggest advanced payment of credits. In the words of tax expert Steve Holt, “A move to advanced payment of credits is central to the future of the effectiveness of refundable tax credits.”<sup>55</sup>

Recent demonstration programs tested for the Earned Income Tax Credit have found high levels of satisfaction among families receiving the credit, and decreased levels of economic security during times of the year outside of tax time, like back to school and the end of the year. The success of the Affordable Care Act, which relies centrally on an advanced tax credit, shows the potential and pitfalls of advanced credit. Payment of a refundable credit directly to vendors, like health insurers in the case of the ACA, or within the scope of this paper to child care providers, faces fewer administrative challenges than paying advanced credits direct to families.

The prime concern is that families who opt for advanced credit will owe money to the IRS because they misestimate their tax credit. This concern can be mitigated by using real-time data sources at the time that an individual files for a credit; by taking the estimation out of the hands of employers and putting it into the hands of government, qualified tax preparers or trained vendors who would receive advanced credits; or by policies that mitigate the risk that a low-income family would owe taxes back to the IRS (for example, such a policy could ensure that families take only one advanced payment of tax credit rather than multiple).

More needs to be learned about advanced payment of tax credits, and CPAG recommends that the IRS participate in future demonstration programs that test advanced payment and the U.S. Department of Treasury dedicate its energy to suggest a blueprint for advanced payment going forward.

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