

EXECUTIVE SUMMARY:
**HOUSEHOLD & DEPENDENT CARE EXPENSES
DEDUCTION**

(INCOME TAX)

SEPTEMBER, 2015

JOINT SUBCOMMITTEE TO EVALUATE TAX PREFERENCES

- PREFERENCE:

§ 58.1-322 (D) (3)

- SUMMARY:

In calculating Virginia adjusted gross income, a taxpayer is allowed a deduction for expenses for household and dependent care services necessary for gainful employment. The amount of the deduction is based upon the federal credit for dependent care expenses.

- REVENUE IMPACT:

The deduction accounts for approximately \$30.0 million in reduced state tax revenues (Tax Year 2012).

- JOINT SUBCOMMITTEE RECOMMENDATION:

The Joint Subcommittee did not make any formal recommendation regarding the preference.

PREFERENCE REPORT:
HOUSEHOLD & DEPENDENT CARE EXPENSES
DEDUCTION
(INCOME TAX)

SEPTEMBER, 2015
JOINT SUBCOMMITTEE TO EVALUATE TAX PREFERENCES

Preference Description

In computing Virginia taxable income, subdivision D 3 of § 58.1-322 of the Code of Virginia allows a taxpayer to deduct from his Virginia adjusted gross income an amount "equal to the amount of employment-related expenses upon which the federal credit is based under § 21 of the Internal Revenue Code for expenses for household and dependent care services necessary for gainful employment." Essentially, a taxpayer is allowed to subtract a portion of the money paid for childcare or dependent care so as to allow the taxpayer to work full time.

The Virginia deduction only applies to expenses that qualify for the federal Child and Dependent Care Credit ("the federal credit"), and is equal to the amount of expenses claimed in calculating the federal credit.¹ For an expense to be eligible, it must relate to the care of a qualifying individual while the taxpayer is gainfully employed or is actively seek gainful employment. A qualifying individual is either a dependent under the age of 13, or a dependent who is physically or mentally incapable of self-care. Expenses are for care if the primary purpose is for the qualifying individual's well-being and protection, but does not include separate expenses such as food and clothing if such expenses are not incidental to the care. The care provided may be in-home care or care provided in a daycare-like setting. Costs for preschool, nursery school, or other education below a kindergarten level are eligible. Education costs for kindergarten and above are not eligible; however, before- and after-school care may be. In a dual-parent household, both parents must be working or in school to qualify for the federal credit.²

Under the federal credit, a taxpayer is allowed a credit of 20 to 35 percent of eligible expenses, based upon the taxpayer's adjusted gross income. A taxpayer with less than \$15,000 federal adjusted gross income would be allowed a 35 percent credit; a taxpayer with more than \$43,000 federal adjusted gross income is allowed a 20 percent credit, with a sliding scale for income in between. The total amount of the expenses claimed may not exceed \$3,000 if the taxpayer has one qualifying individual, or \$6,000 if

¹ See 23 VAC 10-110-143.

² See 26 CFR 1.21-1

the taxpayer has two or more qualifying individuals.³ After calculating the amount of the federal credit, the taxpayer would be allowed to deduct this amount from his Virginia adjusted gross income in computing his Virginia taxable income.

By way of example, consider a household with a federal adjusted gross income of \$90,000, where both spouses work full-time. The family has a one-year-old and a four-year-old child, who attend daycare at a rate of \$2,000 per month, or \$24,000 per year. The family is eligible to claim (on a joint return) \$6,000 of these daycare expenses for the federal tax credit. The amount of the credit will be \$1,200 (20 percent of \$6,000, based upon their income level). Additionally, the family will be eligible to deduct \$6,000 -- the amount of expenses upon which their federal credit was based -- from their Virginia adjusted gross income in calculating their Virginia taxable income.

Preference Purpose

The purpose of the deduction is to assist taxpayers in maintaining full-time, gainful employment. If the taxpayer has small children, or other dependents unable to care for themselves, the taxpayer must seek out care for such dependents in order to work full time. However, federal courts have declared that such expenses are not deductible as general business expenses.⁴ The dependent care deduction (and the federal credit) provides some relief to the taxpayer for these necessary expenses.

Legislative History & Background

1977: Just one year after the federal credit for household and dependent care services was enacted, the Virginia General Assembly enacted a deduction for an amount equal to five times the federal credit for household and dependent care services.⁵ The deduction was added to existing language in the Code of Virginia regarding Virginia deductions for itemized deductions claimed on federal income tax returns.

1979: A technical, and perhaps clarifying, amendment was adopted in 1979 to move the deduction to its own subdivision, and make it a standalone deduction.⁶

³ See 26 USC § 21.

⁴ See, e.g., Smith v. Commissioner, 113 F. 2d 114 (2d Cir.1940), affirming a ruling of the United States Board of Tax Appeals that expenses incurred by a couple, both of whom were employed, to hire a nursemaid for their infant child was not deductible as an ordinary and necessary business expense.

⁵ Chapter 612 of the Acts of Assembly of 1977.

⁶ Chapter 596 of the Acts of Assembly of 1979.

1982: The deduction was amended to limit the Virginia adjusted gross income deduction to the value of the federal credit claimed by the tax payer, which reflects that law still in place today.⁷

Revenue Impact

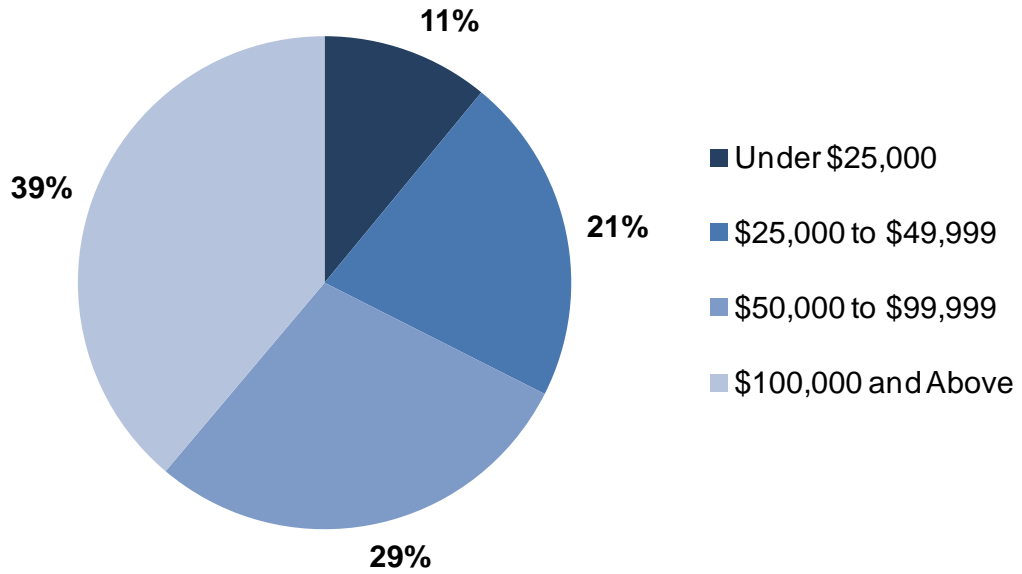
For Taxable Year 2012, the Child and Dependent Care Expenses Deduction was claimed on 198,005 returns, resulting in a total reduction in revenues of \$30.0 million. The average amount claimed was \$2,636 per return for an average reduced tax liability of \$152.

Taxpayers in higher income groups benefited significantly. Taxpayers with Federal Adjusted Gross Income of \$100,000 or more accounted for \$11.7 million or 39% of the total reduction in tax liability, and taxpayers in the \$50,000 to \$99,999 group accounted for \$8.6 million or 29%. Taxpayers in the lowest income group who earned less than \$25,000 accounted for only \$3.3 million but benefited the most in terms of their own tax bill, reducing their tax liability by an average of 28%.

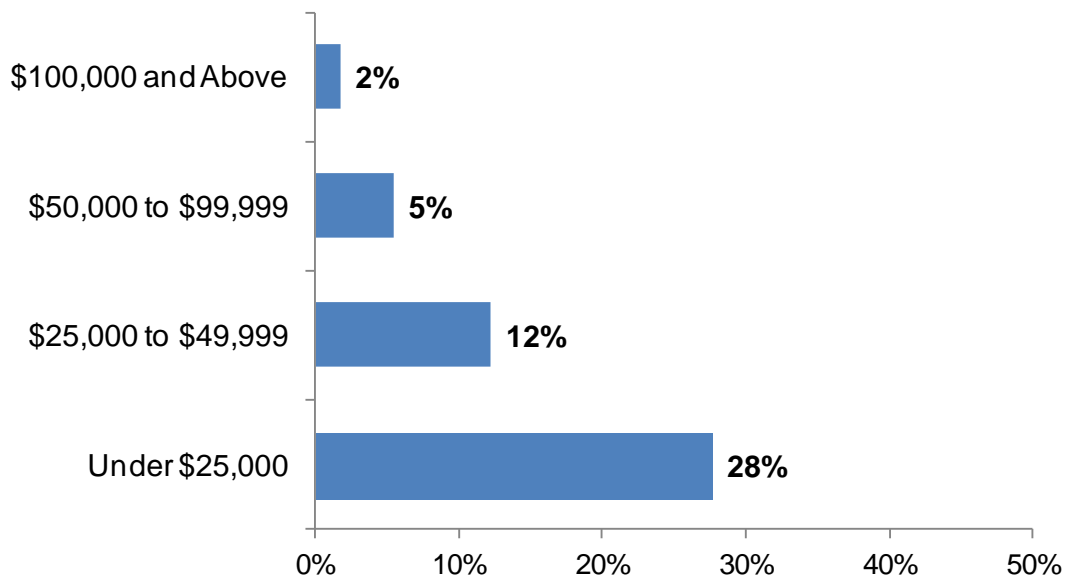
Child and Dependent Care Expenses Deduction by Income		
Federal Adjusted Gross Income	Reduced Tax Liability (millions)	Reduced Tax Liability per Return
Under \$25,000	\$3.3	\$114
\$25,000 to \$49,999	\$6.4	\$155
\$50,000 to \$99,999	\$8.6	\$160
\$100,000 and Above	\$11.7	\$159

⁷ Chapter 633 of the Acts of Assembly of 1982.

Child and Dependent Care Expenses Deduction Share of Tax Savings by Income



Child and Dependent Care Expenses Deduction Average Percentage Reduction in Tax Liability by Income



In addition to Virginia, 24 states and the District of Columbia offer some sort of tax preference related to dependent care expenses.⁸ The vast majority of these states offer a tax credit.

- Colorado, Hawaii, Iowa, Louisiana, Maine, Minnesota, Nebraska, New Mexico, and New York each offer a refundable tax credit. The amount of the credit varies from state to state, and most of these states place income limitations on the availability of the credit. For example, New York allows a credit equal to 110 percent of a taxpayer's federal credit, but only if the taxpayer makes less than \$25,000 per year. Hawaii does not link the state credit to the federal tax credit. Instead, it allows for a taxpayer to claim expenses of up to \$2,400 for one dependent, or \$4,800 for two or more dependents, and then based on income levels the taxpayer receives a credit of between 15 and 25 percent of these expenses.
- California, Delaware, District of Columbia, Georgia, Kentucky, Ohio, Oklahoma, Oregon, Rhode Island, and South Carolina each offer a nonrefundable tax credit. Most of these states determine the credit as a percentage of the federal credit. For example, Delaware allows a taxpayer to claim a credit equal to 50 percent of his federal credit. A few of these states impose income limitations, such as Oklahoma, which allows a taxpayer to claim a state credit equal to 20 percent of his federal credit, but only if his income is below \$100,000. Oregon allows a taxpayer to carry forward unused credits to future tax years.
- Arkansas and Vermont have a credit in place that is refundable in certain circumstances. Arkansas' credit, equal to 20 percent of the federal credit, is refundable if the expenses are related to daycare costs for a child under six years of age; the same credit is nonrefundable for expenses for older dependents. Vermont provides a refundable credit equal to 50 percent of the federal credit for taxpayers with income up to \$40,000 if filing jointly (\$30,000 limit if not filing jointly). A nonrefundable credit equal to 24 percent of the federal credit, with no income limitation, is available to other taxpayers.
- Maryland provides a tax deduction and a tax credit for dependent care expenses. All tax filers are eligible to deduct actual expenses up to \$3,000 for one dependent, or \$6,000 for two or more dependents. Individuals with income up to \$25,000, or joint filers with income up to \$50,000, are eligible for a nonrefundable credit. The amount of the credit is a percentage of the federal credit, ranging from 32.5 percent to 3.25 percent, based upon income.
- Like Virginia, Idaho and Massachusetts allow taxpayers to deduct from their state income expenses used in determining their federal credit. Montana also allows a deduction, but limits it to taxpayers with income up to \$27,600. The amount of expenses that may be claimed is also less than what may be claimed in computing the federal credit.

⁸ Arkansas, California, Colorado, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, and Vermont.

Other Information

Many employers offer employees a benefit of setting aside some money from their salary or wages, pre-tax, to be used for child care expenses. This exclusion allows those dollars to be exempt not only from income tax, but also payroll tax. Federal law limits the amount that may be set aside each year to \$5,000 per household. If this pretax option is offered and elected by an employee, such employee may not claim the same dependent care expenses paid for using set-aside funds for the federal tax credit. In calculating eligible expenses for the federal credit, a taxpayer must subtract out the amount of expenses paid for with these pretax dollars. The interaction of the pre-tax set aside and federal tax credit does limit the number of taxpayers who utilize the federal credit. Because the Virginia income tax deduction is based upon the amount of eligible expenses claimed under the federal credit, this program also impacts use of the state deduction.

In some circumstances, a taxpayer may derive some benefit from both programs. If a taxpayer has two or more qualifying dependents, he is eligible to claim up to \$6,000 of eligible expenses in calculating the federal credit. Assume this taxpayer's income exceeds \$43,000, the taxpayer's employer offers the pre-tax program, and the taxpayer sets aside the maximum \$5,000. This taxpayer would still have \$1,000 of expenses not covered by the pre-tax dollars that would be eligible for the federal credit. As a result, the taxpayer would be allowed a credit of \$200 (20 percent of \$1,000), and could take a \$1,000 deduction in calculating his Virginia taxable income.

Joint Subcommittee Recommendation

The Joint Subcommittee did not make any formal recommendation regarding the preference.

Preference Report Compiled by Staff from the
Virginia Division of Legislative Services and the
Virginia Department of Taxation