DEPENDENT CARE ASSISTANCE PLAN
QUESTIONS AND ANSWERS

Question – How can an employee decide between using the employer's dependent care assistance plan and using the dependent care tax credit (Section 21)?

Answer – Current law prohibits "double-dipping" by taxpayers who pay child care expenses qualifying for the child care credit and who participate in a company sponsored dependent care assistance program.

An employee's tax benefit from the childcare credit is reduced to the extent he or she uses a company plan to cover expenses. Specifically, the maximum amount of qualifying expenses - $2,400 ($3,000 after 2002) for one child; $4,800 ($6,000 after 2002) for two or more children – a taxpayer may use for their child care credit is reduced dollar – for – dollar by amounts paid through a company plan. For example, if a company plan reimburses an employee with two children $4,000 for childcare expenses in 2003, only $2,000 ($6,000 - $4,000) of additional childcare expenses paid by the employee will qualify for the childcare credit.

As a result, all employees who have child care expenses exceeding $4,800 ($6,000 after 2002) and who may participate in a company sponsored dependent care assistance program must choose between the company plan and the childcare credit.

The choice depends on the employee's tax rate and whether or not amounts that would otherwise be allocated to childcare under the company plan can be allocated to other benefits. For example, if the company dependent care assistance plan is part of a cafeteria plan or FSA salary-reduction plan where the employees can choose to allocate the amount that would otherwise be allocated to childcare expenses to fund other benefits such as medical expenses, health insurance premiums, or life insurance, the employees will generally be better off if they elect benefits other than childcare reimbursements from their company plan. In this way they still get the full benefit of the company plan and may take the childcare credit for the childcare expenses they pay with after-tax dollars separately from the plan.

However, if the company plan does not allow the employees to use the amount that would otherwise be allocated to childcare expenses to fund other benefits, or for those employees who cannot fully use the other benefits that may be elected, the choice between the company plan and the childcare credit depends on their tax rate (taxable income), filing status, and adjusted gross income (AGI).

The childcare credit is equal to 30 percent (35 percent after 2002) of qualified expenses for persons with an AGI of $10,000 or less ($15,000 after 2002). The credit is reduced by one percentage point for each $2,000 of AGI above $10,000 ($15,000 after 2002) with a floor of 20 percent for persons with AGI over $28,000 ($43,000 after 2002). Therefore, for each dollar of qualifying childcare expenses, the tax savings range from 30 cents to 20 cents for AGIs ranging from $10,000 to $28,000 and above. After 2002, for each dollar of qualifying childcare expenses, the tax savings range from 35 cents to 20 cents for AGIs ranging from $15,000 to $43,000 and above.

In contrast, if childcare expenses are reimbursed through a company salary-reduction plan, the tax savings will depend on the person's tax rate, which is dependent on taxable income and filing status. Employees whose taxable income falls in the 15 percent tax bracket will save only 15 cents on each qualifying dollar of childcare expenses reimbursed through a company plan. Consequently, they should clearly opt out of the company plan and use the childcare credit since they will save between 5 and 15 cents (between 5 and 20 cents after 2002) more on the dollar. However, if taxable income falls in a tax bracket above 25 percent, the employee will save at least 25 cents on each qualifying dollar of childcare expenses reimbursed through the company plan. For these levels of taxable income the tax savings with the company plan will always equal or exceed the tax savings from the childcare credit.