

DEPARTMENT OF TAXATION ISSUE PAPER

Virginia Child Care Credit

ISSUE: At the last meeting of Joint Subcommittee Studying Early Childhood and Day Care Programs Task Force on Corporate Involvement and Funding of Day Care Programs it was suggested that a Virginia individual income tax credit for child care expenses be considered.

CURRENT LAW: Virginia currently provides an individual income tax deduction equal to the amount of employment related expenses upon which the federal child and dependent care credit is based. Generally, this credit base is limited to \$2,400 for one child and \$4,800 for two or more children. However, this credit base amount is reduced to exclude the value of any employer-provided day care services (up to \$5,000) and is limited to the earned income of the lower-earning spouse.

While Virginia allows a deduction for the full amount of employment related expenses upon which the federal credit is based, the federal credit itself ranges from a full 30% for persons with income below \$10,000 to 20% for taxpayers with income of \$28,000 or more. The credit is reduced by 1% for each \$2,000 in income between \$10,000 and \$28,000.

CHILD CARE CREDITS AND DEDUCTIONS IN OTHER STATES: Virginia is currently one of 23 states which provide some sort of credit or deduction for child care. 12 states have credits which are generally computed as a percentage of the federal credit, ranging from 10% to 50% of the federal credit. 5 states have a state-specific credit, based in part on the federal credit. The remaining 6 states, including Virginia, allow a deduction for the federally allowable expenses.

The federal credit is claimed on 8.8% of all returns, while state incentives are used by between 7-10% of taxpayers on the average.

OPTIONS FOR VIRGINIA CHILD CARE CREDIT: The subcommittee asked that the Department of Taxation review the revenue impact of a Virginia child care credit. Because no specific credit option was suggested, four different types of credits were impacted.

All of the credit options are based on a percentage of the federal credit or federal credit base. Retaining conformity to either the federal credit or credit base is essential both for compliance purposes and to make the computations easier for taxpayers. Additionally, each credit is "nonrefundable," that is the credit is limited to Virginia tax liability.

Summary of Options

OPTION 1 would provide a state individual income tax credit identical to the federal credit, that is based on between 20% and 30% of the allowable employment related expenses, declining by 1% for each \$2,000 in income between \$10,000 and \$28,000.

OPTION 2 would provide a credit, again declining between \$10,000 and \$28,000, with the federal credit amounts scaled down to equate to the Virginia tax structure. Thus the credits range from 6% to 4%.

OPTION 3 would provide a credit ranging from 6% at the lowest income levels to 10%. Because the top Virginia tax rate is 5 3/4%, any credit which begins at a level above 5 3/4% will provide a greater tax benefit to all taxpayers than the current deduction.

OPTION 4 would provide a flat 10% credit to all taxpayers, regardless of income level.

The current Virginia deduction costs approximately \$20 million annually. The revenue effects of any credit options are identified both in terms of their absolute costs and the extent to which the credit costs exceed the costs of the current deduction.

The following table summarizes the credit options and their costs.

| | <u>OPTION 1</u> | <u>OPTION 2</u> | <u>OPTION 3</u> | <u>OPTION 4</u> |
|----------------------------------|--|------------------|-----------------|-----------------|
| <u>Virginia Adjusted</u> | <u>Credit (as % of federal expenses)</u> | | | |
| \$ 0 - \$ 9,999 | 30.0% | 6.0% | 10.0% | 10.0% |
| 10,000 - 11,999 | 29.0 | 5.8 | 9.6 | 10.0 |
| 12,000 - 13,999 | 28.0 | 5.6 | 9.2 | 10.0 |
| 14,000 - 15,999 | 27.0 | 5.4 | 8.8 | 10.0 |
| 16,000 - 17,999 | 26.0 | 5.2 | 8.4 | 10.0 |
| 18,000 - 19,999 | 25.0 | 5.0 | 8.0 | 10.0 |
| 20,000 - 21,999 | 24.0 | 4.8 | 7.6 | 10.0 |
| 22,000 - 23,999 | 23.0 | 4.6 | 7.2 | 10.0 |
| 24,000 - 25,999 | 22.0 | 4.4 | 6.8 | 10.0 |
| 26,000 - 27,999 | 21.0 | 4.2 | 6.4 | 10.0 |
| 28,000 and over | 20.0 | 4.0 | 6.0 | 10.0 |
| | | (millions of \$) | | |
| <u>Absolute Cost of Credit</u> | \$78.6 | \$15.7 | \$24.3 | \$35.3 |
| <u>Cost of Current Deduction</u> | 19.1 | 19.1 | 19.1 | 19.1 |
| <u>Additional Cost of Credit</u> | 59.5 | (3.4) | 5.2 | 16.2 |

COMMENTS ON CREDIT OPTIONS:

- ◆ All of the credits examined are nonrefundable. Current Virginia law relieves married persons with income of less than \$8,000 of all Virginia tax liability--these taxpayers would receive no benefit from a credit. Likewise, taxpayers with substantial deductions and very little tax liability will in many cases receive no more benefit from a credit than from the current deduction.
- ◆ Viewing the costs of the various credit options, it is appropriate to consider whether a tax credit is a good alternative to a direct appropriation for child care programs. Tax credits generally carry substantially greater administrative costs and are a "hit and miss" approach to reaching target groups, that is, the credit will provide relief and/or incentives to taxpayers only if: 1) it is understood by taxpayers; 2) taxpayers have adequate income to absorb the credit; and 3) the credit is a sufficient motivator to encourage expenditures.
- ◆ Credits must also be considered in terms of their exportability. Some portion of every credit is exported to the federal government by taxpayers who itemize their deductions. This is also true for a deduction, but to a much lesser degree. The following example illustrates this concept.

A taxpayer with 2 children in child care has \$4,800 in qualifying expenses. Assuming the Virginia credit is 10%, the taxpayer would receive a \$480 credit. This increases the Virginia tax refund reportable for federal purposes, with the following results:

If the taxpayer is in a 17% federal tax bracket, the federal income tax will be increased by \$81.60, reducing the value of the credit to \$398.60. If the taxpayer is in the 28% federal tax bracket, the value of the credit is reduced by \$134.40 to \$345.60.

Therefore, the state "spends" \$480 to give a taxpayer a credit worth between \$80 and \$135 less because of the federal tax consequences.

ADMINISTRATIVE COSTS: Although the administrative costs of a child care credit would vary depending on how the credit is constructed, it is estimated that first-year costs might be approximately \$200,000.

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