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Income Tax Deduction for Certain Child and Dependent Care Expenses (General Fund Taxes -- Individual and Corporate Income Taxes)

Bill Agency

[LFB 2007-09 Budget Summary: Page 154, #3]

CURRENT LAW

Under current state law, there are no individual income tax deductions for child and dependent care expenses. Current federal law provides a nonrefundable individual income tax credit for child and dependent care expenses that are paid for the purpose of enabling a taxpayer to be gainfully employed. The maximum amount of expenses that can be claimed for the federal credit is $3,000 if the claimant has one qualifying child or dependent and $6,000 if the claimant has more than one qualifying child or dependent. The credit is calculated as a percentage of eligible expenses, with the percentage ranging from 35% to 20%, depending on the claimant's adjusted gross income (AGI).

Eligible claims for the federal credit must satisfy a number of tests, including a qualifying person test. Under the federal provisions, a qualifying person includes: (a) the claimant's qualifying child (which means that the child must have lived with the claimant for more than half the year, among other requirements) who is the claimant's dependent and who was under the age of 13 when the care was provided; (b) the claimant's spouse who was physically or mentally not able to care for himself or herself and lived with the claimant for more than half the year; and (c) a person who was physically or mentally not able to care for himself or herself, lived with the claimant for more than half the year, and, with certain exceptions, was the claimant's dependent.

The following tests must also be met to claim the federal credit: (a) with an exception related to being a student, the individual claiming the credit (and the individual's spouse, if married) must have earned income during the year; (b) the child and dependent care expenses must be being paid so that the individual claiming the credit (and the individual's spouse, if married) can work or look for work; (c) the payments for the child and dependent care must be made to someone who can not be claimed as a dependent of the individual claiming the credit or the individual's spouse; (d) the claimant's filing status must be single, head-of-household, qualifying widow(er) with dependent child, or, if married, married filing jointly (with certain exceptions); and (e) the care provider must be identified on the claimant's tax return. In addition, if a claimant excludes or deducts dependent care benefits provided by a dependent care benefit plan, the total amount excluded or deducted under such a plan must be less than the dollar limit for qualifying expenses under the credit.

GOVERNOR

Provide a deduction from the individual income tax for certain employment-related expenses for child and dependent care that may be claimed under the federal credit for child or dependent care expenses. Provide that the proposed deduction would be phased in over a four-year period, starting in tax year 2008. Specify that the following maximum deduction amounts would apply: (a) for tax year 2008, up to $750 for one qualified individual and up to $1,500 for more than one qualified individual; (b) for tax year 2009, up to $1,500 for one qualified individual and up to $3,000 for more than one qualified individual; (c) for tax year 2010, up to $2,250 for one qualified individual and up to $4,500 for more than one qualified individual; and (d) for tax years 2011 and thereafter, up to $3,000 for one qualified individual and up to $6,000 for more than one qualified individual. Provide that the deduction would have to be claimed for the same taxable year as the year to which the claim for the federal credit relates.

For nonresidents and part-year residents, provide that the deduction would have to be pro-rated based on the share of a claimant's total income that is taxable to Wisconsin. As under federal provisions for the child and dependent care credit, with certain exceptions for married taxpayers who have not shared the same household for the last six months of the taxable year, the bill would require married taxpayers to file a joint tax return to claim the deduction.

The administration has estimated that the proposed deduction would reduce individual income tax revenues by the following amounts: (a) $3.9 million in 2008-09; (b) $7.8 million in 2009-10; (c) $11.8 million in 2010-11; and (d) $15.9 million in 2011-12 and annually thereafter.

DISCUSSION POINTS

1. Federal law has provided a child and dependent care tax credit since 1976. Prior to that, since the mid 1950s, federal law had provided a tax deduction for certain employment-related child and dependent care expenses. The current federal credit is nonrefundable, provided on a sliding scale basis, for expenses for household and dependent care services necessary for gainful employment. The maximum credit, for taxpayers with AGI of $15,000 or less, is 35% of eligible expenses (which are capped at $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals). The percentage of eligible expenses that may be claimed for the credit is

reduced by 1% for each $2,000 increment of AGI over $15,000 until the percentage reaches 20% at AGI of $43,000. However, for AGI of $43,000 or more, the credit percentage remains at 20%.

2. The income thresholds for the credit are not indexed for inflation. However, the maximum credit was increased from 30% to 35% of eligible expenses under the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The EGTRRA provision resulted in an increase in the maximum credit from $1,800 to $2,100 (based on a maximum of $6,000 in eligible expenses for two or more qualifying individuals). Under current federal law, the increased maximum credit percentage under EGTRRA is scheduled to sunset as of January 1, 2011, at which time, in the absence of a law change, the maximum credit percentage will revert to 30% of eligible expenses.

3. As a result of the sliding scale in the federal credit, a lower-income taxpayer with the same eligible child or dependent care expenses as a higher-income taxpayer would receive a larger federal credit. For example, a taxpayer with one eligible child or dependent with AGI of $15,000 and eligible expenses of $3,000 could claim a credit of $1,050 (35% of $3,000). A taxpayer with the same eligible expenses and AGI of $45,000 could claim a federal credit of $600 (20% of $3,000).

4. Based on a report by the National Women's Law Center in April, 2006 (as updated through January 31, 2007) entitled *Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions*, 28 states (including the District of Columbia) currently provide some form of child and dependent care tax provisions. Most of these states provide a benefit that is tied to the federal credit, either as a credit equal to a specified portion of the federal credit or federally allowed expenses, or as a deduction of federally allowed expenses or a portion of such expenses. Of the 28 states with child and dependent care provisions, 23 states provide tax credits, four provide deductions, and one state provides both a credit and a deduction.

5. Wisconsin does not currently provide a tax benefit for employment-related expenses for taxpayers with children or dependents. The state does, however, provide a $700 personal exemption for each taxpayer, the taxpayer's spouse, and for each individual claimed as a dependent under federal law. Prior to 2000, a $50 credit was provided for each dependent of the taxpayer. Neither the personal exemptions nor the prior law dependent credit was related to child and dependent care expenses as a result of being employed.

6. As noted, the proposed deduction for child and dependent care expenses would be phased in over four years, starting in tax year 2008. The following table shows the maximum amount that could be deducted during each year of the phase-in period, along with the corresponding percentages of the maximum amount of expenses that may be claimed for the federal credit.

Tax Year	Maximum Deduction One Child	Two or More Children	Percent of Federal Maximum
2008	$750	$1,500	25%
2009	1,500	3,000	50
2010	2,250	4,500	75
2011 and after	3,000	6,000	100

7. The administration's estimate of the fiscal effect of the proposal in each year is based on applying the percentages shown above to the estimated fiscal effect of the proposal upon being fully phased-in. This methodology understates the expected cost of the proposal during the phase-in period (since the specified maximum dollar amounts would only be the equivalent of the relevant percentage of the total cost in the case of taxpayers who are eligible to claim the maximum credit amounts). Therefore, the fiscal effect of the proposal has been reestimated as a reduction of individual income tax revenues of $5.6 million in 2008-09, $10.1 million in 2009-10, $13.5 million in 2010-11, and $15.9 million in 2011-12 and annually thereafter. Compared to the bill, the estimated fiscal effect would be to reduce individual income tax revenues by an additional $1.7 million in 2008-09. Compared to the Governor's estimates for the other two years of the phase-in period, the reestimates would also reduce general fund tax revenues by $2.3 million in 2009-10 and $1.7 million in 2010-11.

8. Attachment 1 to this paper provides information on the distributional effect of the fully phased in proposal, based on simulations with the 2003 Wisconsin tax sample, which has data from over 21,000 tax returns, weighted to reflect all taxpayers in 2003. While the table does not reflect changes in the number of taxpayers since 2003, to the extent possible, changes in tax laws since then have been included. As shown in the table, it is estimated that, for the 3.9% of taxpayers eligible for a deduction under the fully phased in proposal, the average tax reduction would be $160. [It should be noted that, while there is a 2005 tax sample, it does not yet incorporate detailed information from applicable federal forms needed for purposes of the estimate. Therefore, the distributional table is derived from the 2003 tax sample.] The average tax benefit would be lower during the phase-in period.

9. While the federal credit is reduced on a sliding scale basis as income increases from $15,000 to $43,000, the sliding scale under the federal benefit would not apply with respect to the proposed state deduction (as the deduction would be based on expenses eligible to be claimed for purposes of calculating the federal credit, rather than the actual credit claimed). In addition, based on the state's marginal tax rate structure, a deduction is generally more valuable to higher-income taxpayers than to lower-income taxpayers. Therefore, the proposal would be less targeted to lower-income taxpayers than is currently the case for the federal provision.

10. Another option that would retain the sliding scale nature of the federal provision would be to provide a state tax credit based on a percentage of the federal credit, rather than the proposed deduction. Under this approach, a percentage of the federal credit could be specified that

would result in the total cost of the credit being comparable to the estimated fiscal effects included in the bill. For example, it is estimated that providing a state credit equal to one-third of the federal credit would reduce state tax revenues by approximately the same amount as the fully phased in deduction that would be provided under the bill. Such a credit could be phased in over a four-year period, starting in tax year 2008, as follows: (a) for tax year 2008, 8.4% of the amount claimed for the federal credit; (b) for tax year 2009, 16.7% of the amount claimed for the federal credit; (c) for tax year 2010, 25.1% of the amount claimed for the federal credit; and (d) for tax years 2011 and thereafter, 33.4% of the amount claimed for the federal credit. It is estimated that the fiscal effect of this option would be the same as the estimates included in the bill (in this case, estimating the costs during the phase-in period as a percentage of the fully phased in cost, would be appropriate, as the parameters for the phase-in period would be based on a percentage of the final credit amount).

11. Similar to the Governor's proposal, it is estimated that 3.9% of taxpayers would receive a tax benefit under this option. The average tax reduction in this case would be $158 (compared to the estimate under the Governor's proposal of $l60). However, with a benefit provided as a credit equal to one-third of the federal credit, the average benefit for taxpayers with Wisconsin adjusted gross income under $30,000 would be estimated to increase from $101 (under the Governor's proposal) to $142 per taxpayer. As a result, under this option, there would also be slight reductions in the average tax benefits for higher-income taxpayers, compared to the bill. Attachment 2 to this paper provides information on the distributional effect of this option. The average tax benefit would be lower during the phase-in period.

12. Some have suggested that a tax benefit for employment-related child and dependent care expenses is unfair to families in which a care-giver refrains from seeking employment in order to provide child or dependent care. From this perspective, it would be preferable to provide a tax benefit for all taxpayers with one or more children or other dependents. For example, a deduction could be provided for all children and other dependents that meet the federal requirements to be claimed as a dependent, with the additional requirement that, in the case of a dependent who is a child, the child would have to be under the age of thirteen (which is also required for the federal child and dependent care credit). Under such an approach, a deduction amount could be selected to have the same estimated fiscal effects as under the Governor's proposal, including the same phase-in period (at 25% of the final deduction amount for tax year 2008, 50% for 2009, 75% for 2010, and 100% for 2011 and thereafter). It is estimated that providing a deduction amount of $225 per eligible dependent (for the fully phased in deduction amount) would achieve these results, and would provide a tax benefit (when fully phased in) of approximately $30 per eligible taxpayer. This figure is considerably lower than the average benefits under either the Governor's proposal ($160) or the option described above that would provide a state credit based on the federal credit for child and dependent care ($158). The reason for the lower benefit per taxpayer under this option is that the same total tax benefit would be spread over a larger number of taxpayers. A distributional table for this option has not been provided because the tax sample does not include information on the ages of dependents.

ALTERNATIVES TO BILL

1. Approve the Governor's proposal. However, reestimate the fiscal effect in 2008-09 as a reduction in individual income tax revenues of $5.6 million. Compared to the bill, reduce estimated individual income tax revenues by $1.7 million. Compared to the Governor's proposal, the reestimated fiscal effects would also reduce general fund tax revenues by an additional $2.3 million in 2009-10 and $1.7 million in 2010-11.

ALT 1	**Change to Bill** Revenue	**Change to Base** Revenue
GPR	- $1,700,000	- $5,600,000

2. Delete the Governor's proposal and, instead, provide a non-refundable individual income tax credit equal to the following percentages of the federal credit for child-and dependent care: (a) for tax year 2008, 8.4% of the federal credit claimed; (b) for tax year 2009, 16.7% of the federal credit claimed; (c) for tax year 2010, 25.1% of the federal credit claimed; and (d) for tax years 2011 and thereafter, 33.4% of the federal credit claimed. Under this alternative, there would be no change to the estimated fiscal effects included in the bill.

ALT 2	**Change to Bill** Revenue	**Change to Base** Revenue
GPR	$0	- $3,900,000

3. Delete the Governor's proposal and, instead, effective in tax year 2008, provide a deduction for all children and other dependents that meet the federal requirements to be claimed as a dependent, with the additional requirement that, in the case of a dependent who is also a child, the child would have to be under the age of thirteen (which is also required for the federal child and dependent care credit). Specify that the deduction amount per eligible dependent would be $56 in tax year 2008, $112 in tax year 2009, $169 in tax year 2010, and $225 in tax year 2011 and thereafter. Under this alternative, there would be no change to the estimated fiscal effects included in the bill.

ALT 3	**Change to Bill** Revenue	**Change to Base** Revenue
GPR	$0	- $3,900,000

4. Delete provision.

ALT 4	**Change to Bill** Revenue	**Change to Base** Revenue
GPR	$3,900,000	$0

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Attachments

ATTACHMENT 1

Governor's Proposed Deduction for Child and Dependent Care Expenses (When Fully Phased In)

	Taxpayers With a Tax Decrease						% of All
Wisconsin Adjusted Gross Income	Count	Percent of Count	Amount of Tax Decrease	Percent of Amount	Average Change	Count of All Returns	Returns in AGI Class
Under $15,000	500	0.5%	-$48,000	0.3%	-$96	626,800	0.1%
15,000 to 20,000	200	0.2%	-9,000	0.1%	-45	158,600	0.1%
20,000 to 25,000	800	0.8%	-52,000	0.3%	-65	151,400	0.5%
25,000 to 30,000	2,800	2.8%	-326,000	2.1%	-116	141,200	2.0%
30,000 to 40,000	6,900	7.0%	-965,000	6.1%	-140	259,900	2.7%
40,000 to 50,000	7,800	7.9%	-1,173,000	7.4%	-150	209,700	3.7%
50,000 to 60,000	6,100	6.1%	-870,000	5.5%	-143	176,700	3.5%
60,000 to 70,000	6,900	7.0%	-1,205,000	7.6%	-175	150,600	4.6%
70,000 to 80,000	6,900	7.0%	-1,328,000	8.4%	-192	131,600	5.2%
80,000 to 90,000	8,100	8.2%	-1,454,000	9.1%	-180	114,800	7.1%
90,000 to 100,000	9,000	9.1%	-1,583,000	10.0%	-176	95,600	9.4%
100,000 to 150,000	27,800	28.0%	-4,385,000	27.6%	-158	216,700	12.8%
150,000 to 200,000	9,000	9.1%	-1,415,000	8.9%	-157	57,000	15.8%
200,000 to 250,000	3,000	3.0%	-419,000	2.6%	-140	20,300	14.8%
250,000 to 300,000	1,300	1.3%	-210,000	1.3%	-162	10,600	12.3%
300,000 and over	2,100	2.1%	-455,000	2.9%	-217	24,100	8.7%
TOTALS	99,200	100.0%	-$15,897,000	100.0%	-$160	$2,545,600	3.9%

SOURCE: 2003 Wisconsin Tax Sample

• Approximately 99,200 taxpayers, or 3.9% of all taxpayers, would receive a tax reduction under the Governor's proposal.

• For all taxpayers with a tax reduction, the average reduction would be $160.

• Taxpayers with income between $30,000 and $200,000 would receive 90.6% of the tax change and make up 89.4% of all taxpayers with a tax change.

• Individuals without a tax change would include those who do not claim the federal credit for employment-related expenses for child and dependent care and those who do not have a tax liability under current law.

ATTACHMENT 2

Proposal to Provide a State Child and Dependent Care Credit Based on One-Third of the Federal Credit (When Fully Phased In)

Wisconsin Adjusted Gross Income	Count	Percent of Count	Amount of Tax Decrease	Percent of Amount	Average Change	Count of All Returns	Returns in AGI Class
Under $15,000	500	0.5%	-$63,000	0.4%	-$126	626,800	0.1%
15,000 to 20,000	200	0.2%	-20,000	0.1%	-100	158,600	0.1%
20,000 to 25,000	800	0.8%	-88,000	0.6%	-110	151,400	0.5%
25,000 to 30,000	2,800	2.8%	-439,000	2.8%	-157	141,200	2.0%
30,000 to 40,000	6,900	6.9%	-1,038,000	6.6%	-150	259,900	2.7%
40,000 to 50,000	7,800	7.8%	-1,099,000	7.0%	-141	209,700	3.7%
50,000 to 60,000	6,200	6.2%	-805,000	5.1%	-130	176,700	3.5%
60,000 to 70,000	6,900	6.9%	-1,079,000	6.8%	-156	150,600	4.6%
70,000 to 80,000	6,900	6.9%	-1,235,000	7.8%	-179	131,600	5.2%
80,000 to 90,000	8,200	8.2%	-1,345,000	8.5%	-164	114,800	7.1%
90,000 to 100,000	9,100	9.1%	-1,581,000	10.0%	-174	95,600	9.5%
100,000 to 150,000	27,800	27.9%	-4,451,000	28.2%	-160	216,700	12.8%
150,000 to 200,000	9,100	9.1%	-1,452,000	9.2%	-160	57,000	16.0%
200,000 to 250,000	3,000	3.0%	-419,000	2.7%	-140	20,300	14.8%
250,000 to 300,000	1,300	1.3%	-207,000	1.3%	-159	10,600	12.3%
300,000 and over	2,100	2.1%	-450,000	2.9%	-214	24,100	8.7%
TOTALS	99,600	100.0%	-$15,771,000	100.0%	-$158	$2,545,600	3.9%

SOURCE: 2003 Wisconsin Tax Sample

• Approximately 99,600 taxpayers, or 3.9% of all taxpayers, would receive a tax reduction under a proposal to provide a state child and dependent cared credit based on one-third of the federal credit.

• For all taxpayers with a tax reduction, the average decrease would be $158.

• Taxpayers with income between $30,000 and $200,000 would receive 89.2% of the tax reduction and would make up 89.0% of all taxpayers with a tax change.

• Individuals without a tax change would include those who do not claim the federal credit for employment-related expenses for child and dependent care and those who do not have a tax liability under current law.