Dependent Care FSAs: The Uneven Playing Field for Employers and Workers

Social Policy Institute White Paper | 19-01

Washington University in St. Louis

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Dependent Care FSAs: The Uneven Playing Field for Employers and Workers

Part 1 of a two-part series of white papers on dependent care flexible spending accounts from the Social Policy Institute's Workforce Financial Stability Initiative.

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About the Social Policy Institute

The Social Policy Institute (SPI) is a new Washington University-wide initiative to address pressing social issues while fostering collaborations as catalysts for change among students, faculty, researchers, and community partners. The core aim of the Institute is to promote better understanding of social policy among all sectors and transform research evidence into innovative policy impacting social change at local, state, federal, and international levels.

About the Workforce Financial Stability Initiative

Established in 2017, the Workforce Financial Stability Initiative (WFSI) seeks to understand how frontline employees' work conditions affect their financial stability and to identify and test workplace innovations to improve these conditions.

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I. Preface

This research was funded by the Annie E. Casey Foundation. We thank them for their support but acknowledge that the findings and conclusions presented in this report are those of the authors alone, and do not necessarily reflect the opinions of the Foundation.

The authors are grateful to Don Baylor at the Annie E. Casey Foundation for his guidance and support throughout the project. We extend our thanks to Elaine Maag at the Urban Institute for offering her expertise related to interactions between the Earned Income Tax Credit and dependent care flexible spending accounts.

In this two-part series, we provide a field scan of the dependent care flexible spending accounts (DCFSAs) landscape, focusing on child care expenses. We describe the proliferation and utilization of these programs, identify barriers to usage by low- to moderate-income (LMI) parents, and explain features of DCFSA design and program administration that address some of these challenges. We also identify opportunities for improvements in public policies and employer practices that can level the DCFSA playing field for LMI employees.

Part 1 defines DCFSAs and outlines the process through which employees may obtain reimbursement, the benefits that employers may experience by offering DCFSAs, patterns of adoption of such plans by employers and employees, and employee decision-making regarding plan participation.

In Part 2, we describe features of DCFSA design and program administration that address some of the challenges and provide a set of policy proposals for consideration by both employers and policymakers.

II. Executive Summary

In 1983, the title of an article in the trade journal *Pension World* proclaimed, "A No-Cost Way to Provide Dependent Care Benefits," (Alden, 1983). Dependent care flexible spending accounts (DCFSAs) had burst onto the employee benefits scene.

Never specified in or intended by any legislation, DCFSAs were forged from the Economic Recovery Tax Act of 1981 by a handful of employee benefits consulting firms that saw an opportunity to create a new line of business. By naming their new product "dependent care flexible spending accounts," the consulting firms framed them as a way for employers to lay claim to providing dependent care benefits for their employees (Kelly, 2003).

Never mind that employers would not actually be spending money on dependent care – the accounts would enable employees to reimburse themselves with their own pre-tax dollars. Employers could offer a dependent care benefit for the low cost of having the accounts administered by the consulting firms that had invented them (Kelly, 2003).

"A No-Cost Way to Provide Dependent Care Benefits," *Pension World* declared. Indeed, the accounts proved to be quite a good deal for the consulting firms, who built successful lines of business administering the accounts. They are also a good deal for employers, who gain tax advantages (reduced payroll taxes) and recoup a portion of salary expenses through employee forfeitures of unused account balances.

However, they are not such a good deal for employees, who reap far fewer benefits.

Higher-paid parents may have the cash flow to manage the "double-hit" of setting aside pre-tax dollars for reimbursement of child care expenses already paid for out-of-pocket. They may also have enough tax liability to make reimbursing themselves for child care expenses with pre-tax dollars (up to $5,000, a fraction of total child care costs for many families) worth the effort, since high-income families disproportionately benefit from DCFSAs (National Women's Law Center [NWLC], 2016).

For example:

A Head of Household tax filer designates **$2,000** of their annual income to contribute to a DCFSA.

If this employee has **household income of *between $13,850 and $52,850*,** they would pay a **marginal tax rate of 12%** on taxable income above $13,850 and up to $52,850.

This employee would **save $240** on the $2,000 that they contributed to a DCFSA.

If this employee has **household income of *between $52,850 and $84,200 instead***, they would pay a **marginal rate of 22%** for taxable income above $52,850 and up to $84,200.

This employee would **save $440** on the $2,000 that they contributed to a DCFSA.

As currently designed, DCFSAs do not represent a level playing field for low- to moderate-income (LMI) parents struggling to pay for child and other dependent care.

In Part 1 of this two-part series, we review the DCFSA landscape from the perspective of LMI parents, illuminating the nearly unmanageable barriers to participation and highly complex decision-making process they must face to squeeze even the smallest benefit from these programs.

In Part 2, we examine some infrequently-provided options in DCFSA design and program administration, as well as opportunities for improvements in public policies that can help level the DCFSA playing field for LMI parents.

III. Contents

1. Introduction

Over the past 40 years, the US economy has experienced a massive shift in the conditions of work, particularly for those at the lower-end of the labor market. High-paying jobs available to workers without college degrees have dwindled while unstable employment in service sector jobs has surged (Bernhardt, 2011).

Employers previously absorbed much of the risk associated with employment, such as rising health care costs, but have now largely shifted this risk onto workers. Organizations have accomplished this "risk shift" by designing jobs that include features such as part-time hours, unstable and unpredictable work schedules, and lack of employee benefits such as paid time off and health care (Hacker, 2006). These unstable, inflexible jobs can make arranging high-quality child care difficult. Families in such situations may also find it difficult to utilize existing child care support resources, such as state and federal child care subsidies, which can have serious financial repercussions (Henly et al., 2015).

The economic strain on employees generated by such employment practices has produced the need for creative approaches to supporting these workers through avenues that can provide savings on expenses such as high-quality child care. Low-quality child care is associated with negative outcomes for children and, thus, the inability to pay for better-quality care puts children at risk (Loeb, Fuller, Kagan, & Carrol, 2004).

The Revenue Act of 1978 created Section 125 of the Internal Revenue Code that established cafeteria benefit plans. It was eventually interpreted in such a way as to give employers the option to offer their employees flexible spending accounts (FSAs) for both dependent care and health care expenses. FSAs allow employees to divert a portion of their earnings to be used for qualifying expenses on a pre-tax basis. Employees' diverted earnings are not subject to either federal income taxes or to payroll taxes for Social Security (FICA), Medicare, or Unemployment Insurance. In addition to reducing taxable income for some workers and enabling them to pay for qualifying expenses on a tax-free basis, employers benefit from reduced payroll taxes (i.e., the employer half of FICA and Medicare and Unemployment Insurance) that they would otherwise pay based upon their employees' taxable income (26 USC §125).

This two-part series will provide an overview of dependent care FSAs, focusing on child care expenses. We will describe the proliferation and utilization of these programs, identify barriers to usage by low- to moderate-income (LMI) workers (those with household incomes at or below Area Median Income as defined by the U.S. Department of Housing and Urban Development, ~$50,000 per year), and examine some infrequently-provided options in DCFSA design and program administration. We will also identify opportunities for improvements in public policies and employer practices that can help level the DCFSA playing field for LMI parents.

2. Dependent Care "Spending" Accounts? In Reality, Dependent Care *Reimbursement* Accounts

Contrary to their name, DCFSAs are not structured to allow employees to spend money on dependent care. Rather, these accounts enable employees to receive reimbursement for qualifying expenses for which they have already paid out-of-pocket. After employees have paid for care, they must submit documentation of these expenses to their plans' administrators to receive reimbursement.

Many employers outsource administration of these plans to third parties, such as employee benefits consulting firms, and with good reason. DCFSAs have complex rules and, as a tax-advantaged benefit, the potential consequences for failing to adhere to the rules can be serious for employers (U.S. Office of Personnel Management, 2006; Internal Revenue Service [IRS], 2018).

2.1 How the Money Goes In: DCFSA Contributions

The current maximum annual amount of pre-tax earnings that employees may divert to a DCFSA to be used for reimbursement for qualifying expenses is $5,000. Employees must elect contribution amounts prior to the beginning of the plan year, which typically begins January 1st and ends December 31st. Employees' elected amounts are then divided by the number of pay periods in the plan year and contributions are deducted from each paycheck equally throughout the year on a pre-tax basis.

These elected amounts can only be changed during the plan year if employees experience qualifying events, such as a change in marital status, the birth or adoption of a child, the death of a dependent, or a change in work status. Employees' diverted earnings are not subject to federal income taxes or to payroll taxes for Social Security (FICA), Medicare, or Unemployment Insurance. Thus, DCFSAs offer a financial benefit to employees via reduced taxes.

2.2 What Child Care Expenses Are Eligible for Reimbursement?

According to IRS regulations, qualifying child care expenses are eligible for reimbursement if the care is for a qualifying dependent and is necessary for the parent(s) to work, look for work, or attend school full-time.

A qualifying dependent is a child who:

- Is under the age of 13 years old or an older child who is not physically or mentally able to care for themselves, and
- Lives with the holder of the DCFSA for at least half the year.

In order to be considered to be attending school full-time, the parent must be:

- Enrolled as a full-time student;
- A full-time student for at least five months out of a calendar year; and
- Attending an eligible school, which includes high schools, universities, colleges, and technical and trade schools.

Institutions that do not qualify as "schools" are on-the-job training courses, online schools, and correspondence schools.

Qualifying expenses include child care that is provided:

- In the parents' home or the home of the child care provider, such as a nanny, au pair, babysitter, or relative who is not the dependent of the holder of the DCFSA;
- Outside of the home in a daycare center that meets all state and local regulations for such centers;
- At a before- or after-school program for care that is required so that the parents can work, look for work, or attend school full-time;
- During times in which school is not in session at a day camp, even for camps that are focused on a particular topic such as soccer or music as long as they allow parents to work, look for work, or attend school full-time;
- By someone other than the DCFSA holder's spouse or the child's other parent; and
- By someone who has a valid tax payer identification number.

For children under kindergarten-age, education expenses for preschools and early childhood education centers qualify for reimbursement. However, once a child reaches kindergarten and later grades, tuition expenses for any school no longer qualify for reimbursement.

Enrichment programs, lessons, and tutoring expenses do not typically qualify for reimbursement nor do expenses associated with overnight camps since they are not considered work-related expenses (U.S. Department of the Treasury, 2017).

2.3 How the Money Comes Out: Requirements and Processes for Reimbursement

Health care flexible spending accounts (HCFSAs) give employees access to the full amount of their annual elected contributions immediately at the start of the plan year. This so-called uniform coverage rule relates to IRS regulations of Section 125 cafeteria plans, to which DCFSAs are explicitly not subject (26 USC §125).

DCFSA funds are not available to employees for reimbursement until the contributions have been deducted from their paychecks. If employees' submitted child care expenses exceed the balance in their DCFSAs at the time of submission, they will not be reimbursed for the excess expenses until further deductions have been taken from their paychecks.

DCFSA plans include a use-it-or-lose-it provision, meaning, any account balance at the end of the plan year is forfeited and reverts to the employer. Most plans provide a grace period of 75 days after the plan year ends. However, employers are not required to include this provision in their DCFSAs. During the grace period, employees may submit expenses incurred towards the end of the plan year or expenses incurred during the grace period.

3. How Employers Benefit From DCFSAs

Employers stand to benefit from offering DCFSAs through reduced payroll tax liabilities, reduced salary expenses (recouped from DCFSA forfeitures), and, in theory, the potential for positive business outcomes arising from increasing the attractiveness of their employee benefits offerings.

3.1 Payroll Tax Savings

DCFSAs enable employers to reduce their payroll tax expenses since employees' pre-tax contributions are not subject to payroll taxes. In 2018, the Social Security tax rate for employers was 6.2%, the rate for Medicare was 1.45%, and the Unemployment Insurance tax rate was 6.0% for a total of 13.65% (U.S. Department of the Treasury, 2018). When employees reduce their taxable incomes through DCFSA contributions, employers are relieved of payroll taxes for Social Security, Medicare, and Unemployment Insurance, which can thus represent a savings of nearly 8% (Warner, Ribeiro, & Smith, 2003).

For example, an employer would generally owe payroll taxes of:

$8,190 on the salary of an employee who earned $60,000 per year

$3,720 for Social Security,

$870 towards Medicare, and

$3,600 towards Unemployment Insurance.

However, if the employee contributed the maximum of $5,000 to a DCFSA, the employer would owe payroll taxes of:

$7,508 on the employee's adjusted salary of $55,000 per year

$3,410 for Social Security,

$798 towards Medicare, and

$3,300 towards Unemployment Insurance.

The employer would gain **total tax savings of $682, approximately 8%.**

Depending upon levels of plan participation, these savings may cover, or even exceed, employers' costs for administration of DCFSAs (Beam & McFadden, 1996; Mercer Human Resource Consulting, 2005).

3.2 Reduced Salary Expenses: The Use-It-Or-Lose-It Provision

The use-it-or-lose-it provision can be a boon for employers. When employees do not use their full DCFSA balances in a given year, the money is not refunded to employees as taxable income. Rather, the balance reverts to the employer. Thus, DCFSA forfeitures, in effect, result in employers recouping part of the cost of their workers' annual salaries.

According to a 2013 survey, approximately 2% of contributions to DCFSAs are forfeited to employers (Mercer Human Resource Consulting, 2013). In the case of an employee contributing the maximum amount to their DCFSA ($5,000), a 2% forfeiture amounts to a $100 salary savings for the employer.

3.3 Theoretical Positive Business Outcomes for Employers

Since DCFSAs are framed as an employer benefit that supports working parents, an argument could be made that offering DCFSAs should result in positive business outcomes. Since DCFSAs should reduce child care expenses for parents, these savings may enable parents to afford higher-quality, more stable child care arrangements, the argument goes. Better child care arrangements should enable parents to be absent less frequently and be more productive while at work. However, no empirical evidence supports claims of business outcomes due to the use of DCFSAs.

Ample evidence demonstrates negative outcomes for working parents associated with unstable or poor-quality child care, such as increased absenteeism at work and lower productivity (Glass & Estes, 1997; Emlen & Koren, 1984). However, studies of workplace performance with respect to a range of child care benefits, such as on-site child care or employer-provided subsidy vouchers, present inconclusive evidence that a significant connection exists between employer-supported child care and reduced absenteeism and increased productivity.

Most positive outcomes related to child care benefits were self-reported or employer-reported improvements in employee attitudes, which may have positive effects on retention and recruitment (Goff, Mount, & Jamison, 1990; Kossek & Nichol, 1992; Morrissey & Warner, 2011). One survey of employees who received child care subsidy vouchers from their employer revealed that a majority of voucher recipients reported improved attitudes towards their workplace. Only a small minority reported that the vouchers helped them avoid breakdowns in child care (Morrissey & Warner, 2011), which may cause parents to be absent from work (Hofferth, Brayfield, Deich, & Holcomb, 1991).

If evidence is lacking that rich child care benefits, such as on-site care and child care vouchers, result in positive business outcomes, it seems unlikely that employers can reap business benefits from offering DCFSAs, which provide employees with far less financial assistance.

4. Patterns of Adoption of DCFSAs

DCFSAs came into being in the early- to mid-1980s through the entrepreneurial efforts of several employee benefits consulting firms. Adoption rates were low initially and generally limited to companies with existing relationships with these firms. DCFSA design evolved slowly over time via requests for guidance from the IRS as to acceptable plan structures (Kelly, 2003). The Bureau of Labor Statistics (BLS) did not even include DCFSAs in their employer surveys until 2008; no data on these programs were collected in the BLS Employee Benefits Survey (1985 to 2006), the predecessor to the BLS National Compensation Survey (NCS).

4.1 The Economic Recovery Tax Act of 1981: Legislative Intentions and the Transformed Meaning of "Subsidized"

As Kelly (2003) explains, the Economic Recovery Tax Act of 1981 included tax incentives that were meant to encourage employers to invest in on-site child care centers or pay subsidies to employees to offset child care expenses. In her analysis of the history of employer-sponsored child care, Kelly (2003) notes that, following the adoption of this legislation, employee benefits consulting firms saw an opportunity to parlay the language of this tax law into a business opportunity for themselves, one not intended by legislators.

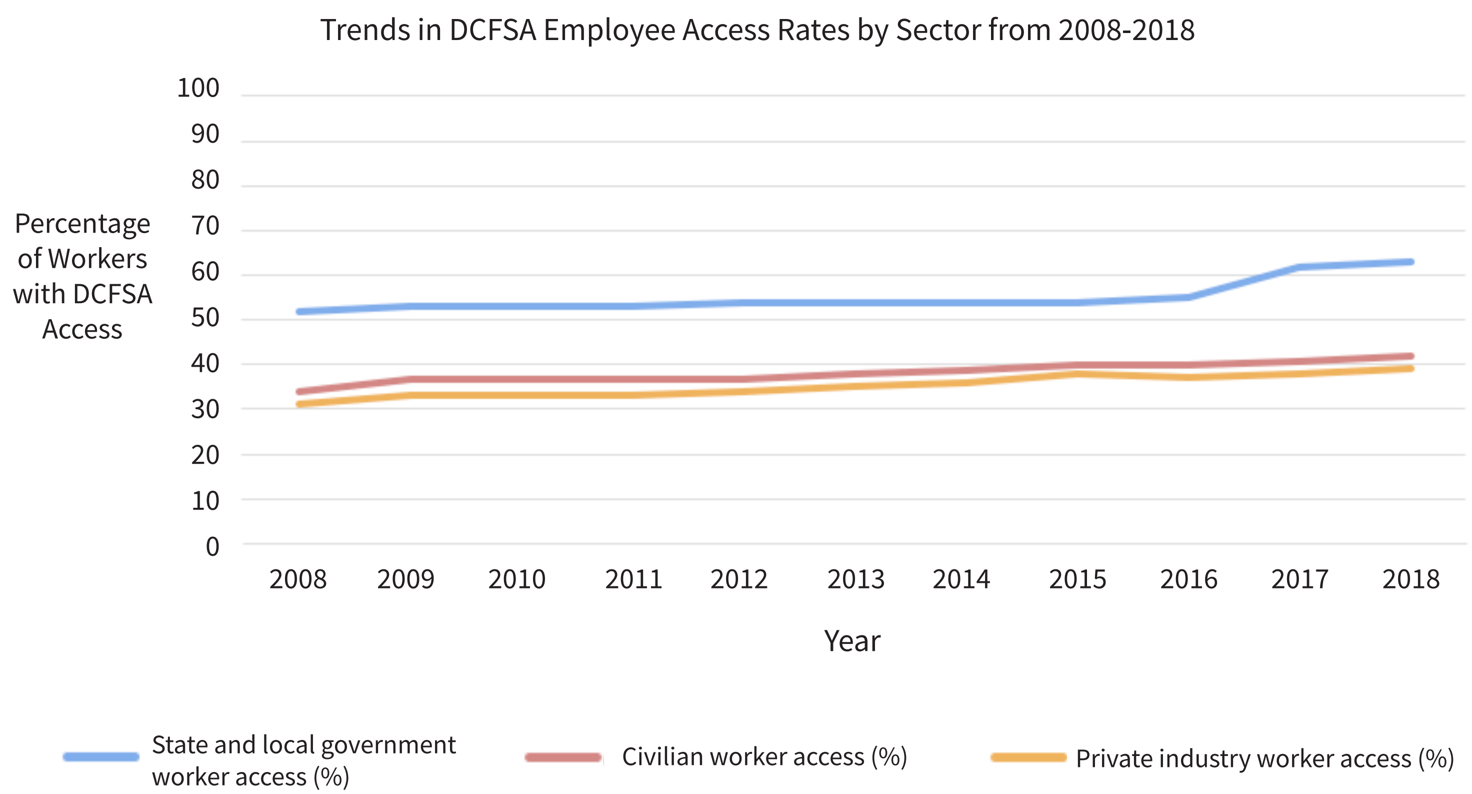
These consulting firms used the existing rules for cafeteria benefits plans (26 USC §125) as a basis for the rationale that tax-advantaged reimbursement accounts for dependent care expenses were a way for employers to help subsidize employees' child care expenses. Thus, rather than offering direct payments to employees or building on-site child care centers, employers could lay claim to subsidizing child care for employees for the relatively low cost of administering reimbursement accounts. As a result, consulting firms created a profitable new line of business for themselves that enabled employers to inexpensively offer some level of support for employees with families (Kelly, 2003).

4.2 DCFSA Adoption by Employers

Ever since DCFSAs were developed, U.S. workers have had uneven access to them. The BLS gathers data only for benefits that they deem timely and relevant in the national economy (N. Lavrenyuk, personal communication, December 19, 2018). In 2008, BLS began collecting data on DCFSA access (as opposed to general cafeteria plan access) via the National Compensation Survey. A decade later, only 42% of U.S. civilian workers (meaning private industry, state government, and local government workers) have access to DCFSAs through their employers (Acosta & Wiatrowski, 2008-2018).

According to data from the BLS National Compensation Surveys (Acosta & Wiatrowski, 2008-2018), this proportion has increased in the past decade, up from 34% in 2008, but the accounts still fail to reach over half of the U.S. workforce. Most access to DCFSAs is available through state and local government employment. Unlike the overall workforce, over half of state and local government workers have had access to DCFSAs for the past decade, rising from 52% in 2008 to 63% currently (Acosta & Wiatrowski, 2008-2018). (Figure 1)

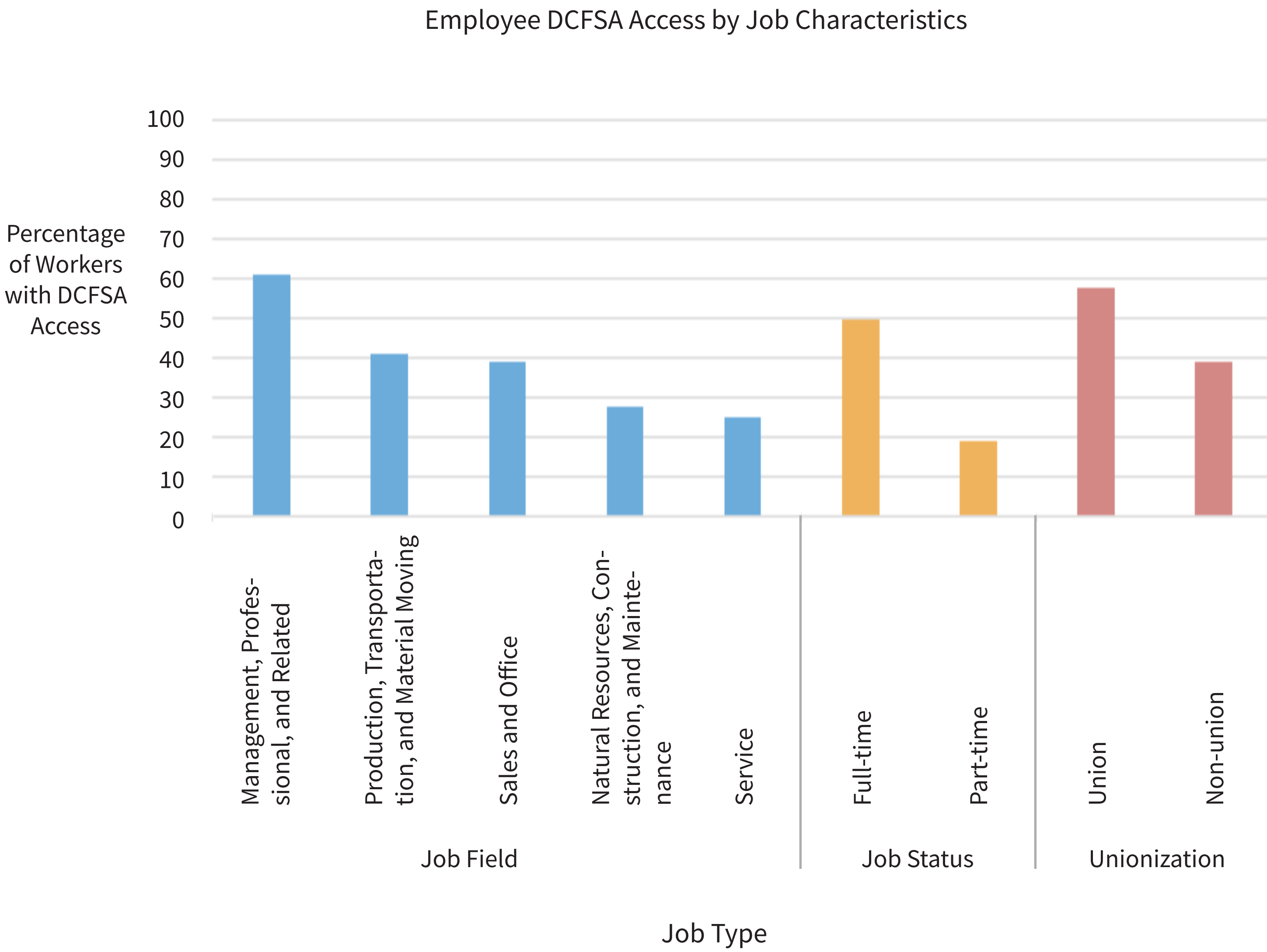
Figure 1



Note. Civilian workers includes private industry workers, state workers, and local government workers. Data from National Compensation Survey: Employee Benefits in the U.S., Bureau of Labor Statistics, 2008-2018.

Access to DCFSAs also varies by job type and compensation level. Employees in management and professional positions have much greater access to DCFSAs than workers in service and construction positions, for example (Figure 2). Similar divisions exist between full-time versus part-time workers and union versus non-union employees (Figure 2). Full-time employees have more access to DCFSAs than part-time workers and union workers have more access than non-union workers.

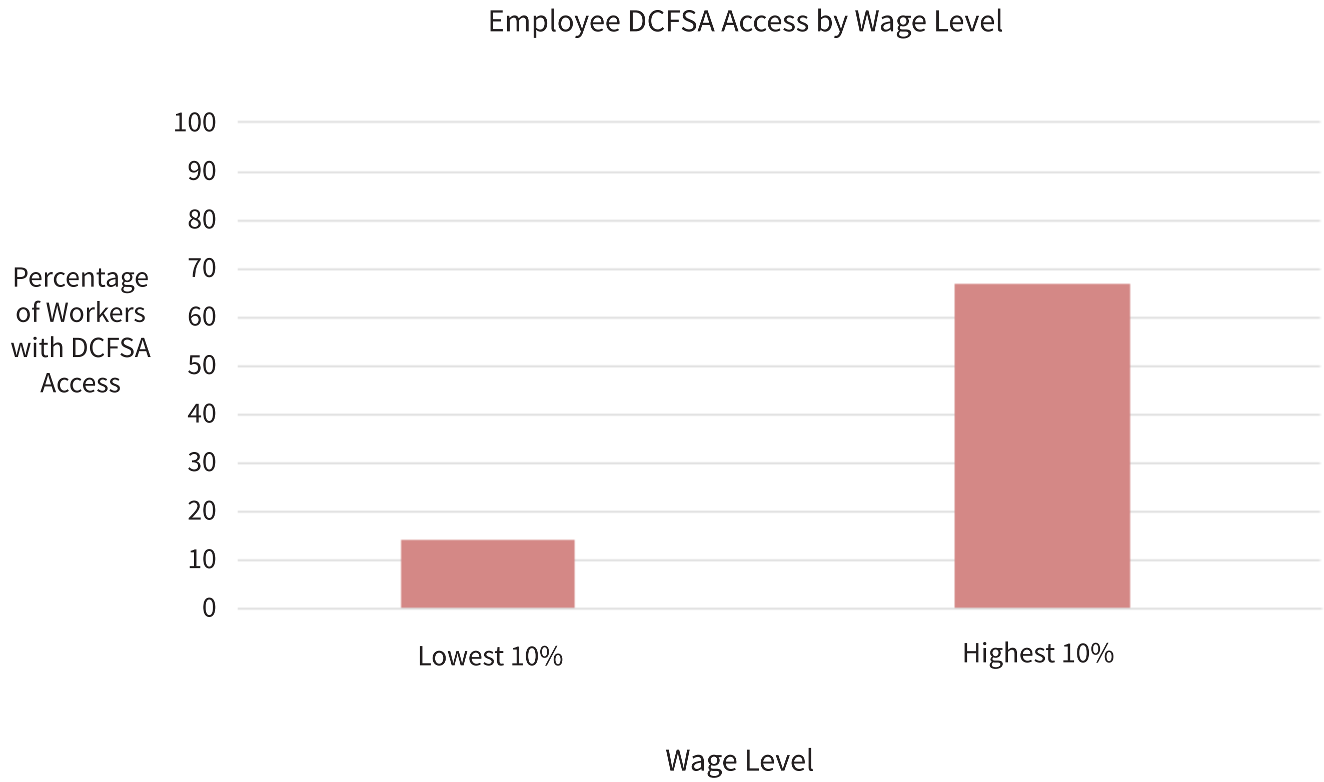
Figure 2



Note. Data from National Compensation Survey: Employee Benefits in the U.S., Bureau of Labor Statistics, 2008-2018.

Starker differences in DCFSA access appear by wage level. Only 14% of workers in the NCS sample who have jobs paying in the lowest 10% of wages have access to DCFSAs. In contrast, 67% of workers who have jobs paying in the highest 10% of wages have access to these accounts. (Figure 3)

Figure 3

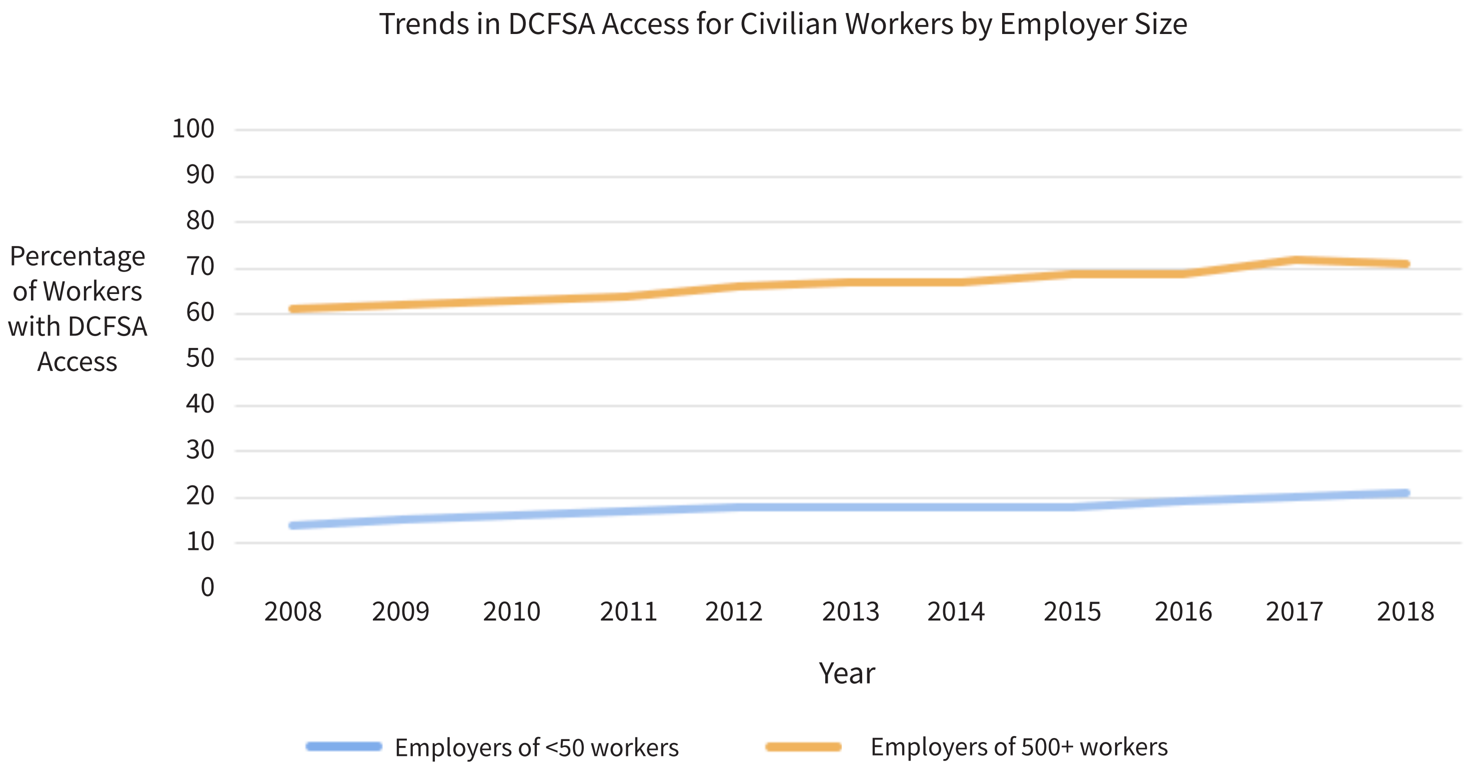


Note. Data from National Compensation Survey: Employee Benefits in the U.S., Bureau of Labor Statistics, 2008-2018.

However, the most significant difference in DCFSA access can be seen by employer size; larger employers offer considerably more access to DCFSAs than smaller employers.

In 2018, 71% of workers whose employers had 500 or more employees had DCFSA access while only 21% of workers whose employers had fewer than 50 employees had DCFSA access. This difference may be due to the greater capacity of large employers to hire benefits administration companies for DCFSA management (Kelly, 2003). In some studies, small employers have noted that the burden of setting up and managing these accounts is a deterrent to offering them (e.g., Warner, Ribeiro, & Smith, 2003). (Figure 4)

Figure 4



Note. Civilian workers includes private industry workers, state workers, and local government workers. Data from National Compensation Survey: Employee Benefits in the U.S., Bureau of Labor Statistics, 2008-2018.

The difference in DCFSA offerings by employer size may also be due to the faster pace at which new practices tend to spread across large employers that focus on staying competitive with their benefits offerings. Rogers' (2003) diffusion of innovations theory suggests that employers may adopt new practices simply because others within their network have adopted them, rather than for reasons specific to their own business strategies. According to this theory, innovations need not have an evidence-base of effectiveness for employers to adopt them. Rather, if employers learn that other employers have begun offering these benefits, they will tend to eventually offer them as well, regardless of any evaluation of the innovation.

4.3 DCFSA Adoption by Employees

The BLS considers DCFSAs an emerging benefit that does not represent a significant cost for employers and thus does not collect data on utilization rates in order to minimize the burden on NCS survey respondents (N. Lavrenyuk, personal communication, December 19, 2018). As a result, employee utilization data are limited and the data that do exist suggest that employee utilization rates are low.

A 2003 report found that only 14% of employees with access to DCFSAs used them (Employee Benefits Research Institute, 2003). A survey conducted in 2005 found the same utilization level; only 14% of employees with DCFSA access used them (Mercer Human Resource Consulting, 2005). However, evidence suggests that when employers make contributions to their workers' DCFSAs, utilization rates can be much higher. A study of Cornell University's DCFSA usage conducted in 2009 reported that 49.2% of eligible employees who were surveyed had an active DCFSA that was funded, in part, through contributions from Cornell (Hipp, Morrissey, & Warner, 2017).

It is possible that LMI employees' conditions of work may make DCFSA participation particularly challenging. Unlike higher-paid employees, LMI workers are more likely to be employed in part-time positions that are not benefits-eligible (Lambert, 1993). Additionally, LMI workers tend to be employed in jobs with higher turnover rates (Lane, 2000), making participation in DCFSAs more difficult. Even if employees in these types of jobs are eligible for DCFSAs, the less stable nature of their employment would likely discourage them from participating in a year-long benefit program requiring a commitment of their own funds at the start of the plan year.

Low levels of DCFSA utilization may also be attributed to a general lack of awareness concerning what DCFSAs are and whether or not an employer offers them. Data from a unique survey of LMI employees described in the following section reflects this absence of DCFSA awareness, even among those who may have access to the accounts.

4.4 Insights from LMI Employees: The Household Financial Survey

4.4.1 Employee Access and Awareness

Distributed biannually to a random sample of LMI tax-filers using TurboTax Freedom Edition[1], the first wave of the 2018 Household Financial Survey (HFS) included a module of questions about DCFSAs that was issued to all employed respondents who had dependents. These participants were asked whether or not their employers offered DCFSAs, whether or not they used DCFSAs, and why they did or did not use them.

Access to DCFSAs

Data gathered through the HFS show that the majority of respondents either did not have access to a DCFSA or did not know whether or not they had access; 45% reported that their employer did not offer a DCFSA, 24% were not sure, and 16% had never heard of DCFSAs (N=1,280). Only 15% of respondents reported that they did have access to a DCFSA, either through their own employer or their spouse or partner's employer.

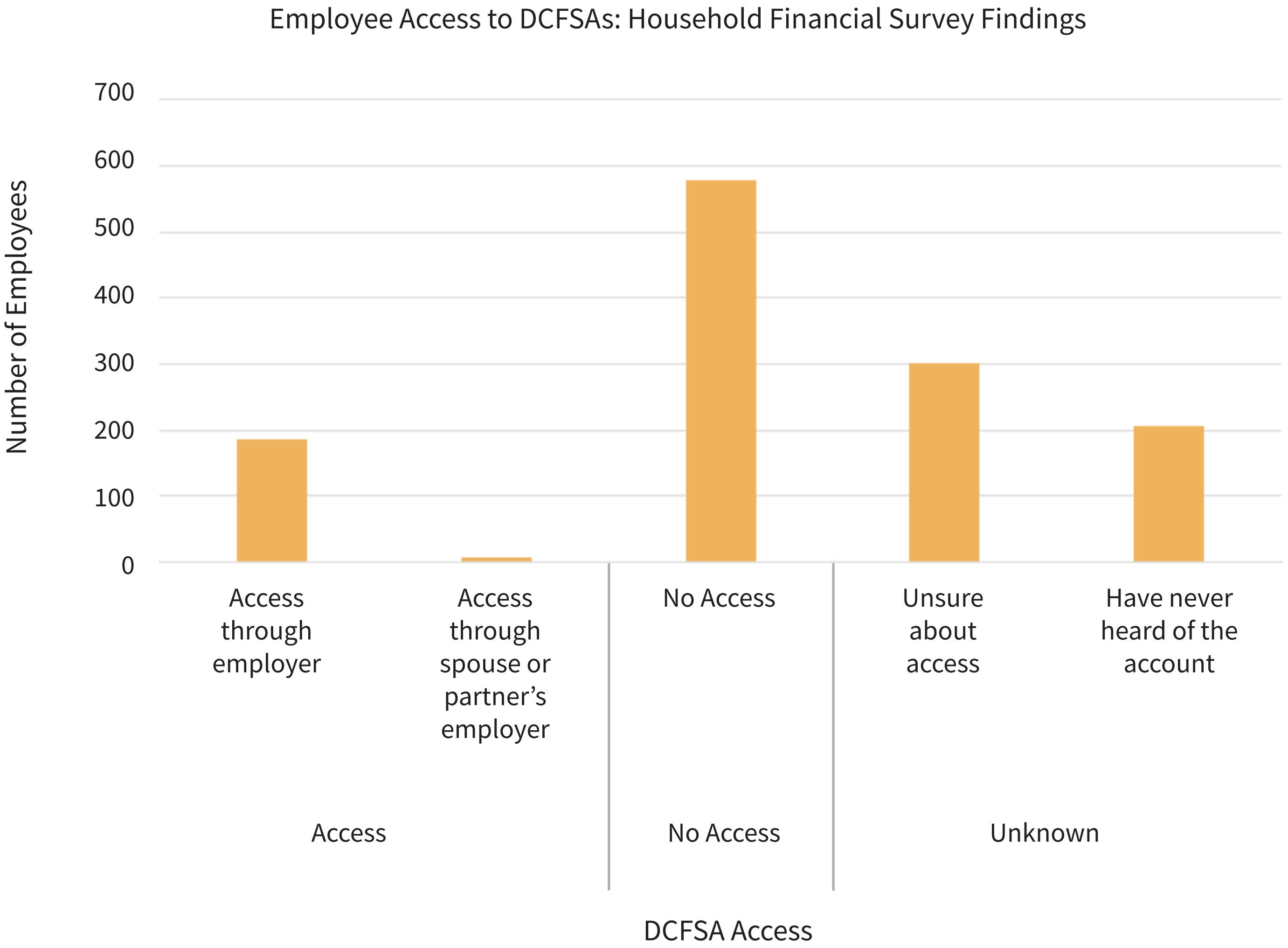
This substantial difference between employees who reported that their employers did not offer DCFSAs and workers who reported that their employers did offer the accounts aligns with 2018 NCS findings regarding DCFSA access for LMI employees. The NCS access rate of 14% for the lowest decile of earners closely mirrors the 15% of HFS respondents who reported that they had access to DCFSAs. (Figure 5)

Confusion between DCFSAs, HCFSAs, and health savings accounts (HSAs)

It is possible that these data may slightly overestimate the true number of respondents with DCFSA access. Among HFS respondents who reported that they had access to DCFSAs, some clearly misunderstood the question and gave responses that directly related to HCFSAs or health savings accounts (HSAs), which are a type of tax-advantaged employee benefit only available to those with high-deductible health care plans.

When asked why they did or did not choose to use DCFSAs, 97 respondents entered a written answer. Sixteen of these respondents (~17%), nine of whom reported that they used DCFSAs and seven of whom reported that they did not use DCFSAs, provided explanations specific to medical costs.

Figure 5



N=1280; yes=186, 14.53%; spouse or partner=8, 0.63%; no=579, 45.23%; not sure=301, 23.52%; never heard of it=206, 16.09%
Source: Household Financial Survey, 2018.

Among those who reported that they used DCFSAs, written responses included, "I learned I could save up for medical stuff," "prescription costs," and "my parents told me it would be valuable when coming into medical expenses." Among those who reported that they did not use DCFSAs, explanations included, "state health insurance," "use HSA instead," and "our children have Medicaid," as reasons why they did not use the accounts. One respondent confused the DCFSAs with HSAs, saying that they did not use the DCFSA because, "I opt to use the traditional low-deductible plan because I don't think I would save money with the FSA."

Since more employees have access to HCFSAs than to DCFSAs (Acosta & Wiatrowski, 2018), this confusion between the two account types is perhaps not surprising. Higher worker awareness of HCFSAs may also stem from variation in child care needs across the life cycle. HCFSAs may appeal to employees at any life stage since they are likely to incur health-related expenses, regardless of whether or not they have children young enough to require child care. In contrast, DCFSAs are only of use when employees have children young enough to attend child care. Thus, employer messages about HCFSA availability may resonate more frequently throughout employees' careers.

Between HFS respondents who reported not knowing what DCFSAs were and those who provided explanations clearly referring to medical costs, it is evident that DCFSAs are not a widely understood benefit within this sample.

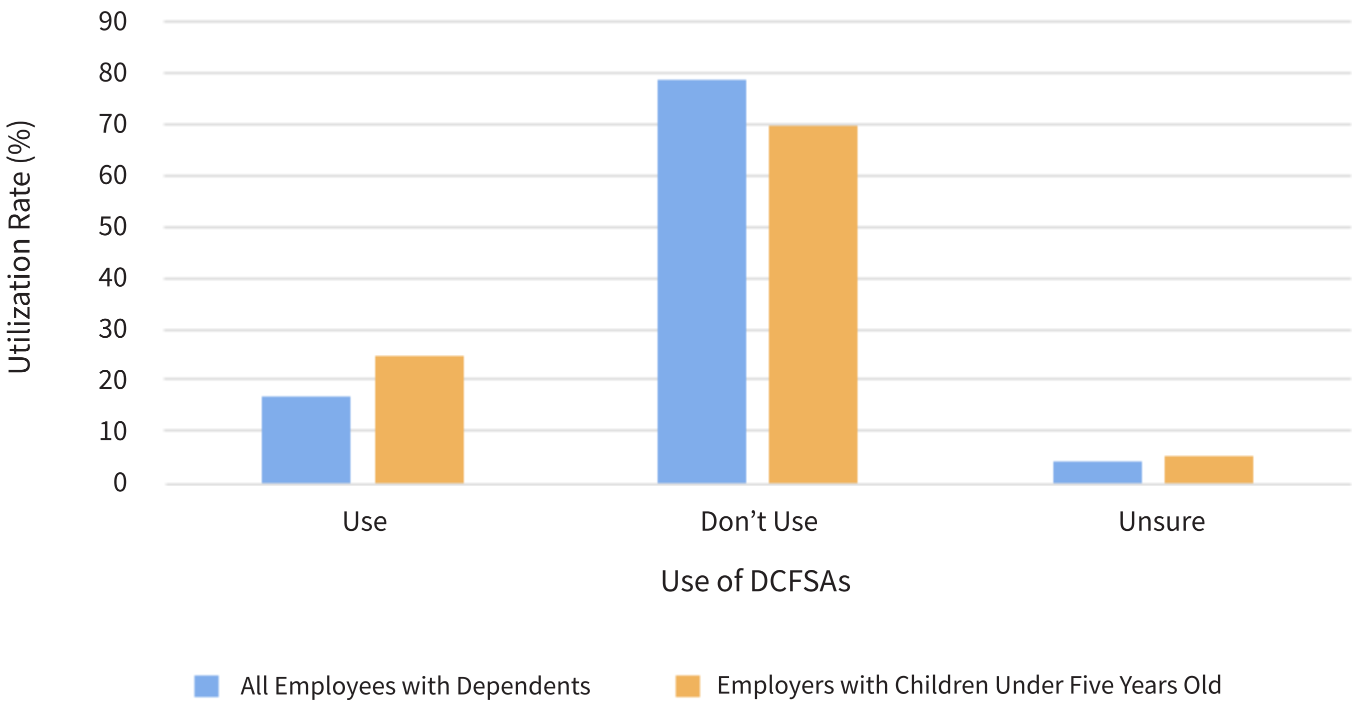
4.4.2 Employee Use of DCFSAs

Among employees who reported having access to DCFSAs, findings from the HFS suggest that few used these accounts. Only 17% of respondents who indicated that they had access to DCFSAs used them. Further, it is possible that even fewer had access in reality, given the confusion with HCFSAs and HSAs that some respondents demonstrated (Figure 6). Additionally, some employees were even confused about their own account usage, with 4% saying they did not actually know whether or not they had used a DCFSA.

Among employees with children under five years old, those most likely to have significant child care expenses, DCFSA utilization rates were higher (25% of employees). However, the largest group of respondents were non-users. Even among employees with the highest child care expenses, almost three-quarters chose not to use DCFSAs. Some potential reasons why employees with access to the accounts did not use DCFSAs are detailed in the following sections.

Figure 6

DCFSA Utilization Rates for Employees with Dependents: Household Financial Survey Findings



All employees with dependents: N=194; Employees with children under five years old: N=60
Source: Household Financial Survey, 2018.

5. Employee Participation Decisions: The Effects of Friction and Loss Aversion

The economic concept of friction refers to impediments to completing a transaction, such as the time and energy required to research a consumer purchase or the expense of conducting a stock sale (Conant, 1908). In the case of DCFSAs, there are many points of friction that reduce the attractiveness of participation, including the effort required to search out information about how DCFSAs work, the time and energy needed to calculate whether or not participation will be financially worthwhile, and the effort required to submit expenses for reimbursement.

The concept of loss aversion derives from prospect theory and is embodied in the famous behavioral economics phrase, “losses loom larger than gains” (Kahneman & Tversky, 1979). A large body of research demonstrates that people will act in ways that seem counter to their own best interests to avoid losing something of value. In the case of DCFSAs, it appears that loss aversion plays a role in employees’ decisions not to participate in these plans even when they could benefit financially by doing so. Said another way, use-it-or-lose-it looms larger than pre-tax savings.

Both friction and loss aversion appear to play roles in employees’ DCFSA participation decisions.

5.1 Barriers to LMI Employee Participation in DCFSAs

For LMI employees, there are three main barriers to DCFSA participation:

- Confusion about how programs work,
- Difficulty determining whether or not their families would benefit from DCFSA participation, and
- Difficulty managing the reimbursement arrangement that requires employees to both set money aside to pay for expenses and then pay for those expenses out-of-pocket.

The tax code is complex and communicating the value of DCFSA plans and the processes required to make use of them is a challenge for Human Resource (HR) departments. Additionally, LMI employees are more likely than their higher-paid counterparts to have lower reading levels, speak English as a second language, and/or work in non-office settings (e.g., warehouse operations, retail sales floors, home health care), making communication an even more challenging task (Wood, 2010; Capps, Fix, Passel, Ost, & Perez-Lopez, 2003; Bureau of Labor Statistics, 2018).

Determining the benefit of participating in DCFSA plans relies upon employees’ ability to calculate and understand both their expected annual child care expenses and projected tax liability at year-end. Thus, deciding whether or not they might expect to save money by participating in the program is a complicated task. Because of the use-it-or-lose-it provision, inaccurate estimates may come with the risk of losing a portion of their salaries.

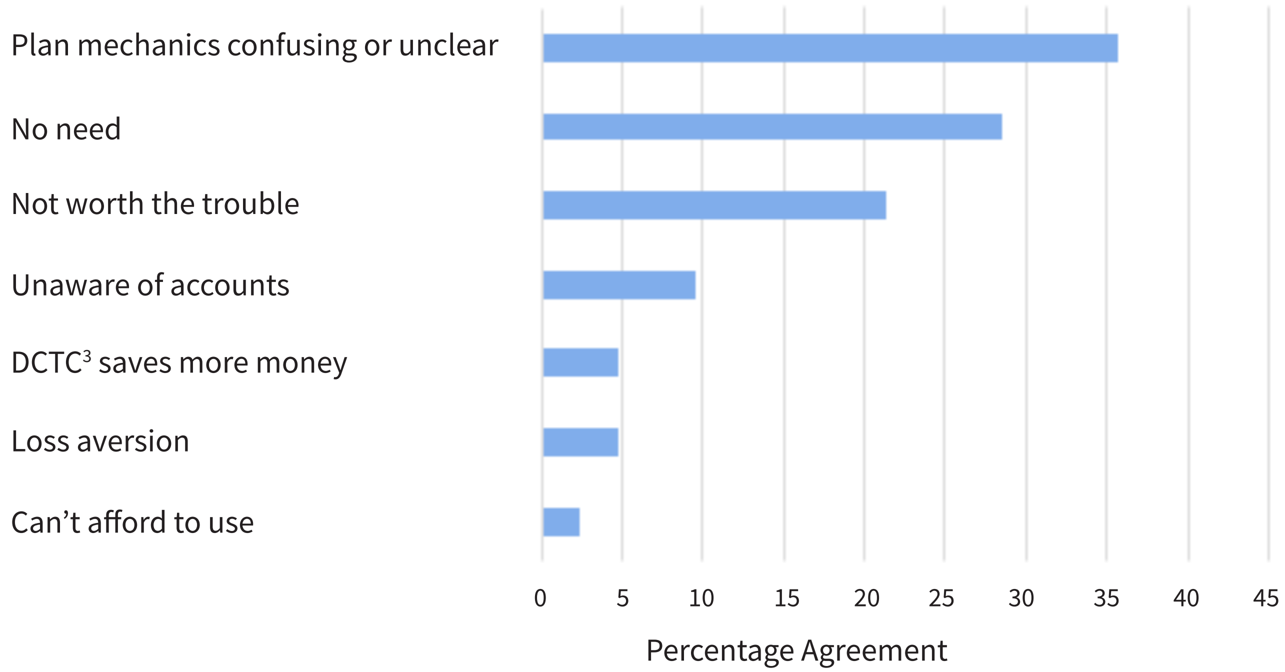
Finally, the so-called “double-hit,” meaning, employees must pay for care out-of-pocket while setting money aside with which to reimburse themselves, may make participation financially infeasible for LMI employees due to limits of cash flow throughout the month.

5.1.1 Confusion and Complexity: Eligibility, Expenses, and Access to Funds

Responses to questions about DCFSAs in the HFS highlight a significant barrier to using the accounts: employee confusion as to what they are and how they function. Of respondents with young children (under age

Figure 7

Primary Reason for DCFSA Non-Use[2] : Household Financial Survey Findings



Source: Household Financial Survey, 2018.
N=42

5) who had access to DCFSAs but chose not to use them, the most commonly cited reason was confusion about how the plans worked. (Figure 7)

Complexity in determining employee eligibility

For employees to determine whether or not they are eligible to participate in their employers' DCFSAs, employees must first determine whether their families' work arrangements and marital/custody configurations fit with eligibility requirements. Employees must locate the information, apply the rules to their particular circumstances, and decide whether or not they are eligible to participate.

As previously explained, only families who use child care in order for the parent(s) to work, look for work, or attend school full-time are eligible to participate in DCFSAs. Thus, a two-parent family that uses child care while one parent works part-time and/or attends school part-time would not be eligible to participate in a DCFSA.

Eligibility rules for divorced parents are complex and dependent upon the IRS definition of "custodial parent," the parent with whom the child lived for the greatest number of nights during the prior year. Special rules apply for divorced parents who work nights.

If the child lived with both parents for an equal number of nights, the parent with the highest adjusted gross income (AGI) would be deemed the custodial parent and would be eligible to participate in a DCFSA. Thus, if an employee is the lower-earning parent in a divorced family with equal custody, they would be ineligible to participate in their employer's DCFSA. No rationale is given in the regulations to explain why the parent who may have fewer financial resources to pay for child care is denied eligibility for a DCFSA, which has the potential to reduce the parent's child care expenses (U.S. Department of the Treasury, 2017).

Complexity in identifying eligible child care expenses

If employees determine that they are indeed eligible to participate in their employers' DCFSAs, they must next determine whether or not their child care expenses are eligible for reimbursement. This question rests upon employees understanding the eligibility requirements related to "qualifying dependents."

As previously noted, to be a qualifying dependent, a child must be under the age of 13 years old (or an older child who is not physically or mentally able to care for themselves) and live with the employee for at least half the year, as per the above rules for divorced parents. Once employees have determined whether or not they have qualifying dependents, they must next consider the type of child care for which they would seek reimbursement.

As noted earlier, expenses for child care provided in either the parents' home or the home of the child care provider, such as a nanny, au pair, babysitter, or relative who is not the employee's dependent and who has a taxpayer identification number, are eligible for reimbursement. However, the child care provider cannot be the employee's spouse or the child's other parent.

Expenses for daycare centers and preschools that meet all state and local regulations are also eligible for reimbursement, as are expenses related to before- and after-school care that is required so that parents can work or attend school full-time. When school is not in session, expenses for day camps qualify for reimbursement. However, overnight camps, enrichment programs, lessons, and tutoring expenses are not eligible expenses.

It is important to note that, in households in which an employee has both children who live with them full-time and children who live with them part-time (less than half of the year), child care expenses would not be reimbursable for the children who live there part-time, even if the same child care arrangement is used for all children. So, for example, if both a child living with the family full-time and a child living with the family for less than half of the year attend the same after-school child care program, only the expenses for the first child would be reimbursable.

Complexity due to variations between DCFSA and HCFSA provisions

Once employees have determined that they have child care expenses that are eligible for reimbursement through DCFSAs, they face another possible point of confusion. Many employers that offer DCFSAs also offer HCFSAs. As evidenced by written responses in the HFS, employees may confuse the two types of accounts. For example, as previously mentioned, one respondent indicated that they did not use a DCFSA because, "Our children have Medicaid."

One risk of such confusion relates to the variation in reimbursement processing between DCFSAs and HCFSAs due to the uniform coverage rule. The uniform coverage rule applies to HCFSAs and requires that employees have access to the full amount of their annual elected contributions immediately at the start of the plan year. In contrast, DCFSA funds are not available for reimbursement until the contributions have been deducted from employees' paychecks.

Table 1 shows the variation in provisions between DCFSAs and HCFSAs. Employees who are aware of the difference in reimbursement rules between the two types of accounts must take into consideration the implications of the more restrictive reimbursement rules associated with DCFSAs, as explained below.

Table 1

	Dependent Care Flexible Spending Accounts	Health Care Flexible Spending Accounts
Method of Funding	Salary reduction plan (pre-tax employee contributions)	Salary reduction plan (pre-tax employee contributions)
Eligible Expenses	Dependent care expenses for qualifying persons which are necessary for the caregivers to work, look for work, or go to school full-time	Dental, medical, and vision expenses not covered by health care plan for employee and dependents; no work or school requirement
IRS Regulations Governing the Plan	IRS section 125: cafeteria plans and IRS section 129: dependent care assistance plans	IRS section 125: cafeteria plans
Length of Optional* Grace Period After Plan Year	75 days	75 days
Maximum Contribution Per Year	$5,000	$2,500
Use-It-Or-Lose-It Rules	Employees forfeit unused funds after grace period; forfeited balances revert to employer	Employees can carry up to $500 to the next plan year; amounts in excess of $500 revert to employer
Uniform Coverage?	No, employees may only use what has been contributed at the time of reimbursement request	Yes, employees may use the full amount of annual elected contributions beginning on the first day of the plan year

*Employer is not required to offer a grace period

5.1.2 The Double-Hit: (Lack of) Availability of DCFSA Funds

Having determined their eligibility for their employers' DCFSAs and the eligibility of their child care expenses for reimbursement, employees must consider the implications of the lack of a uniform coverage rule for DCFSAs and reimbursement procedures.

For LMI employees, the double-hit of paying for care out-of-pocket while setting money aside with which to reimburse themselves appears to be the most substantial barrier of all to DCFSA participation.

The double-hit requires employees to have twice the cost of their child care available in their monthly cash flow. LMI employees who are likely living paycheck-to-paycheck are unlikely to have this kind of slack in their monthly budgets. One HFS participant with young children who did not use an available DCFSA explained the decision by responding, “[I] don’t make enough money.”

Timing is everything: Bank overdrafts

DCFSA reimbursement procedures require employees to submit documentation of child care expenses for approval before funds can be disbursed. As a result, in addition to managing twice the cost of child care in their monthly cash flow, employees must be prepared for a time lag between expense submission and reimbursement. They must also allow for the possibility that a claim may be denied initially and, thus, delayed.

Coordinating timing of paychecks, DCFSA deductions, child care expense payments, and reimbursements is both crucial and risky for LMI employees. A lack of alignment could result in high fees for bank account overdrafts. Findings from the HFS indicate that, indeed, LMI employees with young children (under age 5) who used DCFSAs were more likely to overdraft their bank accounts than those who did not use DCFSAs ($\chi^2(1)$= 4.76, p<0.05).

Not without a cushion: Financial illiquidity

Findings from the HFS also suggest that LMI employees recognized the risk of timing problems with DCFSA reimbursement and avoided enrolling in them unless they had a financial cushion available to make DCFSA use feasible.

Survey respondents were asked whether or not they could find $2,000 in case of an emergency. Among respondents with young children (under age 5) who had access to DCFSAs, those who were liquidity-constrained (“probably” or “certainly” could not find $2,000 in case of an emergency) were less likely to use DCFSAs than those who “probably” or “certainly” could find $2,000 in case of an emergency ($\chi^2(3)$= 10.09, p<0.05). These results suggest that LMI employees who did not have a financial cushion may have found DCFSA participation unmanageable.

5.2 Navigating the Process: From Decision to Reimbursement

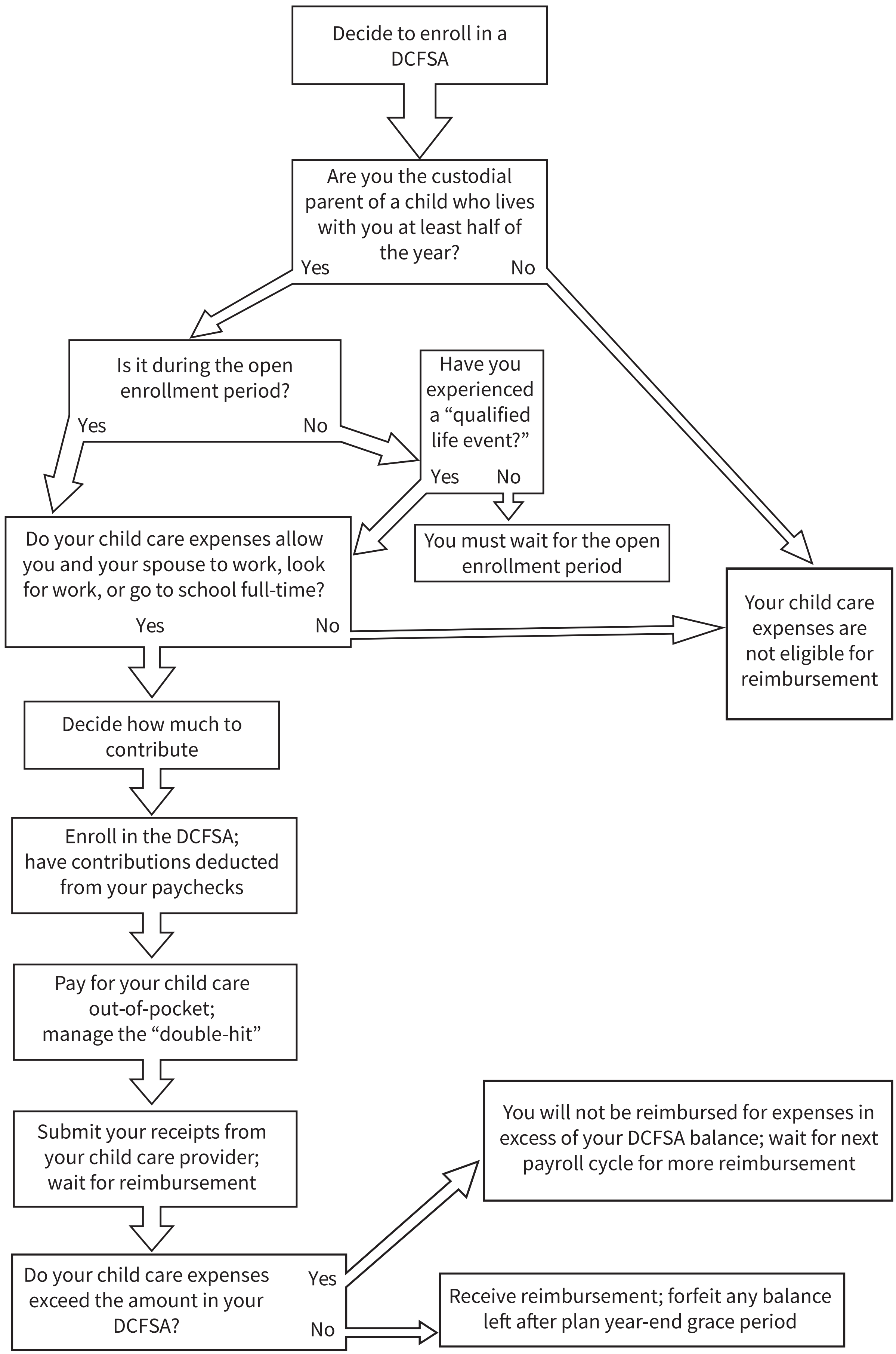
The flow chart on the following page maps the steps employees must navigate from the point of deciding to participate in a DCFSA, to determining their eligibility and the eligibility of their child care expenses, to maneuvering through the reimbursement process.

5.2.1 Is a DCFSA Worth the Trouble? A Complicated Task

When employees weigh the decision to participate in a DCFSA, in order to evaluate whether or not participating will benefit them financially, they must be able to forecast with a high level of certainty, 1) their expected child care costs for the plan year, and 2) their expected tax liability for the plan year, which will determine how much they may save by paying for child care with pre-tax dollars.

Estimating the cost of child care

LMI workers are often employed in fields with unstable and unpredictable scheduling practices, such as


Decide to enroll in a DCFSA
Are you the custodial parent of a child who lives with you at least half of the year?
Yes
No
Is it during the open enrollment period?
Yes
No
Have you experienced a "qualified life event?"
Yes
No
You must wait for the open enrollment period
Do your child care expenses allow you and your spouse to work, look for work, or go to school full-time?
Yes
No
Your child care expenses are not eligible for reimbursement
Decide how much to contribute
Enroll in the DCFSA; have contributions deducted from your paychecks
Pay for your child care out-of-pocket; manage the "double-hit"
Submit your receipts from your child care provider; wait for reimbursement
Do your child care expenses exceed the amount in your DCFSA?
Yes
No
You will not be reimbursed for expenses in excess of your DCFSA balance; wait for next payroll cycle for more reimbursement
Receive reimbursement; forfeit any balance left after plan year-end grace period

retail, home health care, and food service, that make it difficult for parents to arrange stable, high-quality child care (Carrillo, Harknett, Logan, Luhr, & Schneider, 2017; Henly & Lambert, 2014). Instability in child care arrangements, in addition to being associated with negative outcomes for children (Loeb, Fuller, Kagan, & Carrol, 2004), makes it difficult for parents to take advantage of financial supports for affording quality child care, such as state and federal child care subsidies (Henly et al., 2015). Uncertainty about their ability to use child care subsidies and the unpredictability of the cost of frequently-changing care arrangements makes calculating annual child care expenses extremely difficult.

Both the use-it-or-lose-it provision and associated strict limitations on changing DCFSA contribution amounts set up the possibility of a loss aversion response. Difficulty in confidently estimating the cost of child care in order to determine appropriate contribution amounts and avoid forfeiture may serve as a deterrent to participation among LMI employees, even if doing so could possibly garner some tax savings (Kahneman & Tversky, 1979).

Estimating tax liability: Tax credits and Medicaid

Paying for child care on a pre-tax basis is the key selling point of DCFSAs. However, employees' tax liabilities vary widely based upon their personal circumstances. Thus, determining the amount of tax savings that can be expected from DCFSA participation can only be determined on a case-by-case basis. In order to accurately estimate how much they may save in taxes, LMI employees must consider how certain tax credits and Medicaid eligibility may interact with DCFSAs.

The Child and Dependent Care Tax Credit (CDCTC)

DCFSAs are not the only tax-related benefit that can help employees with child care expenses; some workers may be eligible to use the Child and Dependent Care Tax Credit (CDCTC). The CDCTC and DCFSAs are not mutually exclusive; however, they can only be used together under specific circumstances.

The CDCTC allows tax filers to reduce the taxes they owe by receiving a tax credit for child care expenses from the previous year. Families may receive a credit based upon a maximum of $6,000 in child care expenses for households with two or more children. The CDCTC is a non-refundable tax credit, meaning, if filers do not owe any taxes, they will not receive tax refunds or increase their tax refund size by claiming this credit.

Child care expenses that have been reimbursed through a DCFSA may not be used to claim the CDCTC. However, if tax filers spend more on child care than the amount reimbursed through DCFSAs, they may apply the remaining amount to the calculation for the CDCTC, up to a total of $6,000 in child care expenses.

The example below shows the interaction between the CDCTC and DCFSA participation for a family with two or more children:

Annual child care expense	$7,500
Child care expenses reimbursed through a DCFSA	$5,000
Remaining child care expense to be applied to CDCTC (CDCTC limit [$6,000] – amount reimbursed through DCFSA [$5,000])	$1,000
Child care expense not subject to favorable tax treatment	$1,500

In this example, the family's annual child care expense of $7,500 is split into three parts as far as tax benefits are concerned. First, $5,000 of expenses were paid for with pre-tax dollars through use of a DCFSA for reimbursement. Next, $1,000 was claimed as a tax credit during year-end tax filing by using the CDCTC. Finally, $1,500 was not eligible for any favorable tax treatment.

The example above represents the most beneficial distribution of child care expenses between the CDCTC and DCFSAs for tax filers with incomes above $43,000 per year. Because the CDCTC offers a larger tax credit to lower-income tax filers, some LMI families who owe taxes at the end of the year will likely receive a larger benefit from using the CDCTC alone and not participating in a DCFSA.

The CDCTC provides a credit of 35% of child care expenses (up to a maximum of $6,000 in expenses) for tax filers earning less than $15,000 per year. The value of the credit declines incrementally, down to 20% of child care expenses (up to a maximum of $6,000 in expenses) for tax filers earning $43,000 or more.

As a result, LMI employees considering using DCFSAs must be cognizant of the possibly greater benefit of applying their child care expenses toward the CDCTC up to the $6,000 maximum. Employees would need to estimate their adjusted gross income (AGI) and child care expenses, calculate the tax credit they would receive from the CDCTC, and then compare the resulting tax savings against tax savings from making pre-tax contributions to a DCFSA, taking into account deductions for Social Security (FICA) and Medicare.

These calculations require daunting and complex estimates of income, tax deductions, and child care expenses. Some HFS respondents commented that they chose not to use a DCFSA because the CDCTC offered greater savings. Others explained that they chose to apply their child care expenses to the CDCTC rather than use a DCFSA because it was easier to use; the CDCTC does not require submission of documentation for reimbursement. Thus, families can claim the CDCTC without dealing with the double-hit of contributing to a DCFSA while paying out-of-pocket for child care.

For LMI families, another tax credit may also play a role in the DCFSA participation decision-making process: the Earned Income Tax Credit.

The Earned Income Tax Credit (EITC)

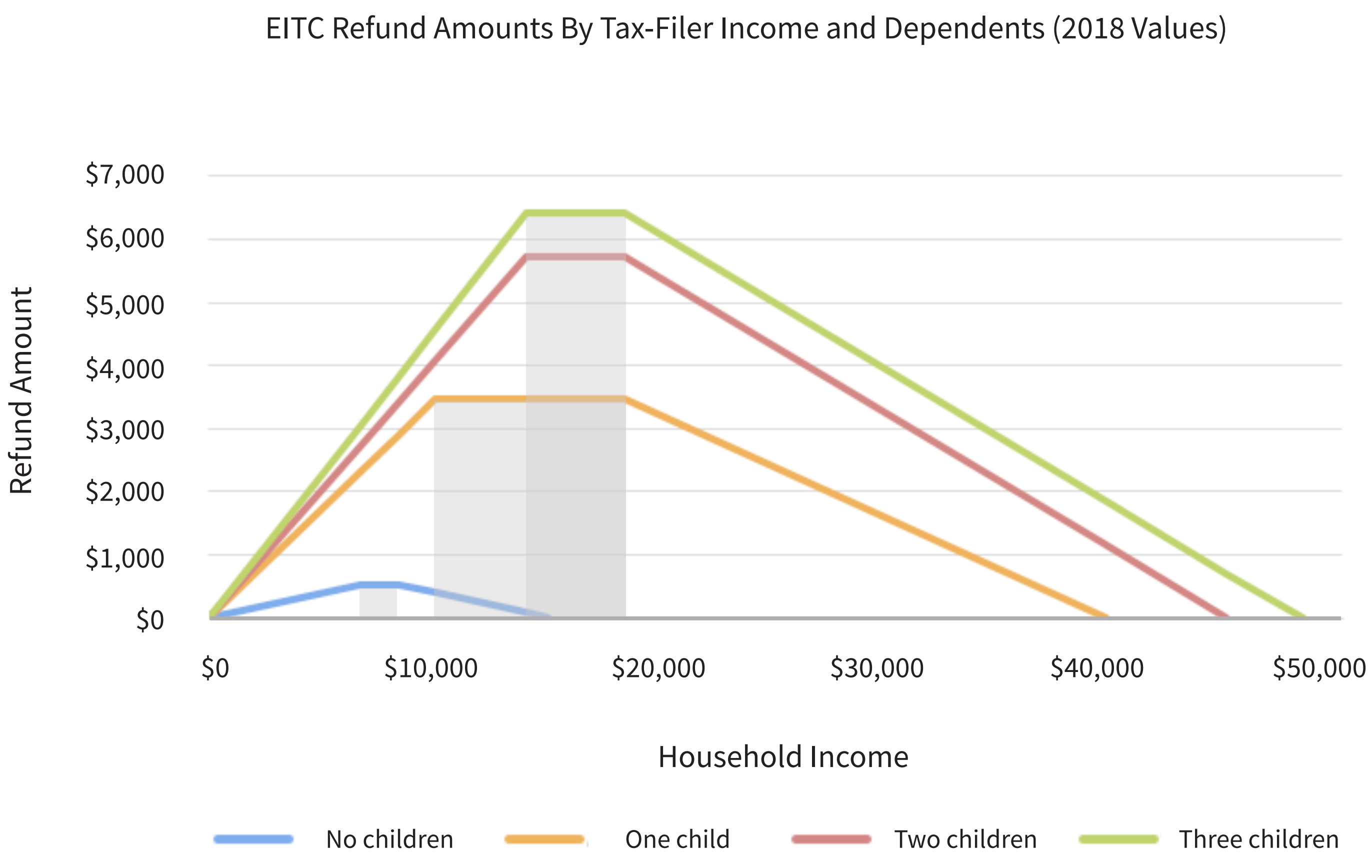
DCFSA contributions are deducted from employees' paychecks before taxes, the key selling point for these accounts. The underlying premise is that lowering taxable income is beneficial for employees.

However, LMI workers may be eligible for the EITC, a refundable tax credit meant to reduce poverty and reward work. Figure 8 displays the incentive structure of the EITC for households of varying sizes. Variation in the incentive for LMI workers to earn more money, thus raising their AGIs, is inherent in the design of the EITC. At some points along the curve, workers have a substantial incentive to increase their AGIs, making DCFSA participation, which lowers taxable income, resulting in a lower AGI, undesirable. At other points, workers' refundable credit amounts decline as AGI increases. In these circumstances, DCFSA participation benefits LMI workers by decreasing their taxable income and AGI, leading to an increase in the EITC amount they would receive.

Medicaid

Medicaid, the federal health insurance program for low-income Americans, is a valuable benefit for some

Figure 8



Note. Data from U.S. Department of the Treasury. Internal Revenue Service. (2018).

of the most vulnerable members of the U.S. workforce. The decrease in taxable income and, thus, AGI that DCFSA participation generates impacts not only EITC eligibility, but also Medicaid eligibility.

To qualify for Medicaid, applicants must have modified adjusted gross income (MAGI) that falls below a certain percentage of the federal poverty line (FPL). MAGI is calculated by taking AGI and removing certain tax deductions from the calculation, such as the student loan interest deduction.

The FPL percentage for Medicaid eligibility varies in states that have not expanded Medicaid under provisions of the Affordable Care Act (ACA). A majority of states have expanded Medicaid under the ACA; in those states, the income eligibility mark falls at 138% FPL. For a family of three in 2018, 138% FPL equals an annual income of $28,676.

Unlike the EITC, Medicaid eligibility is not subject to a phase-out period; families with incomes over the cap will not qualify for any portion of Medicaid. Thus, for families whose MAGI slightly exceeds the eligibility threshold, even a modest DCFSA contribution could lower their MAGI enough to qualify, generating a substantial financial benefit in the form of Medicaid coverage (Rosenbaum, Gonzales, & Trisi, 2013).

5.2.2 One LMI Employee's Dilemma:

The following is an example of some of the calculations an LMI employee would have to make to determine the potential benefit of using a DCFSA. The example given is for a single employee with one child making a gross income of $40,000 and paying $2,000 a year* for child care. This income is just below 250% of the federal poverty line for a family size of two, and falls just within the range of EITC eligibility.

> *This is a low estimate of 5% of household income. Affordable child care is considered to be no more than 10% of household income. In almost all states, the average cost of childcare well exceeds this standard.

1. Annual income: $40,000
2. Pay frequency: monthly
3. Number of paychecks/year: 12
4. Paycheck amount: $3,333.33 gross
5. Monthly child care costs: $166.67
6. Yearly child care costs: $2,000
7. Tax withholding from monthly paycheck:
   Personal allowances: 7; therefore,
   10% withholding rate applied to
   paycheck amount minus $2,767.00
   ($3,333.33 - 2,767.00) x 10% = $56.63
8. Yearly withholding ($56.63 x 12) = $679.56
9. Full CDCTC amount without use of DCFSA = 22% (determined by income) x $2,000 = $440
   However, because this credit is not refundable, this tax filer would not receive any of this sum in their refund.
10. EITC refund amount = $47

1. Annual income: $40,000 (- $2,000 from FSA contribution = $38,000)
2. Pay frequency: monthly
3. Number of paychecks/year: 12
4. Paycheck amount: $3,166.67 gross
5. Monthly child care costs: $166.67
6. Yearly child care costs: $2,000
7. Tax withholding from monthly paycheck:
   Personal allowances: 7; therefore,
   10% withholding rate applied to
   paycheck amount minus $2,767.00
   ($3,166.67 - $2,767.00) x 10% = $39.97
8. Yearly withholding ($39.97 x 12) = $479.64
9. Not eligible for CDCTC due to FSA use for full amount of child care costs
10. EITC refund amount = $367

Calculating the savings between not using a DCFSA and using a DCFSA for one adult and one dependent making $40,000 annually and paying $2,000 a year for child care with DCFSA contributions equal to this amount:

Yearly paycheck withholding difference = $679.56 - $479.64 =	$199.92
+ EITC refund difference = $367.00 - $47.00 =	$320.00
Total savings =	$519.92 yearly
	[$43.33 per month]

Additional questions:

- Is it possible to cover expenses given the double-hit? Paycheck will go from [$3,333.33 - $56.63 =] **$3,276.70** to [$3,166.67 - $39.97 =] **$3,126.70** per month and child care expenses might need to be paid for out-of-pocket before reimbursement, meaning the amount left over might go from [$3,276.70 - $166.67 =] **$3,110.03** to [$3,126.40 - $166.67 =] **$2,959.73**.
- If it is possible to cover monthly expenses with $2,959.73, is $519.92 worth the uncertainty about reimbursement and challenge of figuring out all of these calculations?

6. Conclusion

In this first part of a two-part series, we reviewed the DCFSA landscape from the perspective of LMI parents, illuminating the nearly unmanageable barriers to participation and highly complex decision-making they must face in order to squeeze even the smallest benefit from these programs.

While DCFSAs offer employers and higher-paid employees some benefits, as currently designed they offer much less value to LMI parents. In fact, analysis from the Household Financial Survey indicates that DCFSA participation is actually associated with a higher risk of overdrawing bank accounts among LMI parents with young children. With so few family-supportive programs and policies available to American workers, DCFSA design represents a sad missed opportunity to offer even minimal assistance to U.S. working families who need it most.

In Part 2 of this series, we examine some infrequently-provided options in DCFSA design and program administration, as well as opportunities for improvements in public policies and employer practices that can help level the DCFSA playing field for LMI parents.

End Notes

1. Via Refund-to-Savings, a collaborative initiative among Washington University in St. Louis, Intuit Corporation, and Duke University to test behavioral interventions to encourage LMI tax filers to save all or part of their refunds.

2. The categories reflected in this figure contain the following responses:

   Plan mechanics confusing and unclear included: "unsure how it works," "unsure how it works with joint custody," and "unsure about money saved."

   No need included written-in variants of having free care, family care, and no child care expenses.

   Not worth the trouble included: "money saved isn't worth the trouble," and "DCTC is easier."

   Unaware of accounts included: "don't know what it is," and written responses confusing the accounts with HCFSAs or HSAs.

   DCTC saves more money only included this response option.

   Loss aversion included: "use it or lose it," and "benefits may be lost."

   Can't afford to use represents the response of "don't make enough money."

3. "DCTC" refers to the Child and Dependent Care Tax Credit, often abbreviated as either DCTC or CDCTC.

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26 USC §125

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Disclaimer

Statistical compilations disclosed in this document relate directly to the bona fide research of, and public policy discussions concerning, financial security of individuals and households as it relates to the tax filing process and more generally. Compilations follow Intuit's protocols to help ensure the privacy and confidentiality of customer tax data.

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